SEC ADOPTS LIQUIDITY RISK MANAGEMENT RULES

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March 7, 2017
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Who is Subject to Rule 22e-4

• Rule 22e-4 will require mutual funds and other open-end management investment companies, including ETFs, to establish and implement a written liquidity risk management program.

• The rule excludes:
  – Closed-end funds
  – Money market funds

• Other exceptions:
  – “In-kind ETFs” are excluded from certain requirements, specifically, the asset classification and highly liquid investment minimum requirements
  – Funds primarily holding highly liquid assets are exempt from the highly liquid investment minimum requirement
Liquidity Risk – Definition

**Background**: Open-end mutual funds are required to make payment to shareholders within seven days of a redemption request.

**Final Rule**: Liquidity risk is the risk that a fund could not meet requests to redeem shares issued by the fund without significant dilution of remaining investors’ interests in the fund.

- Removed the proposed rule’s requirement that a fund assess the risk that it could not meet redemptions “without materially affecting the fund’s NAV”

- Removed the reference to reasonably foreseeable redemption requests under stressed conditions, but this requirement is retained in the liquidity risk assessment factors

Final rule definition focuses on the relationship between liquidity and sale price and the risk of not being able to meet investor redemptions without significant dilution to non-redeeming shareholders.

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Recent Liquidity Developments

Recent industry developments have increased the SEC’s focus on the importance of liquidity and liquidity risk management. In particular:

- The growth of fixed income funds and alternative funds (i.e., funds with non-traditional asset classes, non-traditional investment strategies, and/or less liquid assets (such as private debt)).
- The evolution of trade settlement periods vs. the timing of a fund’s payment of redemption proceeds to its shareholders
  - settlement periods for trading fund shares have shortened (generally T+3 or less) but certain fund investments (such as bank loans) still have longer settlement periods, including settlement periods that exceed 7 days.
Elements of the Liquidity Risk Management Program

The written liquidity risk management program will be required to include the following elements:

- Assessment, management, and periodic (at least annual) review of a fund’s liquidity risk based on specified factors;
- Classification of the liquidity of fund portfolio investments;
- Determination of a highly liquid investment minimum;
- Limitation on illiquid investments;
- For funds that engage in, or reserve the right to engage in, redemptions in-kind, establishment of redemption in-kind policies and procedures; and
- Board oversight

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Funds will be required to assess, manage, and periodically (not less than annually) review their liquidity risk, based on the following factors (as applicable):

- The fund’s investment strategy and the liquidity of its investments during both normal and reasonably foreseeable stressed conditions, including:
  - whether the investment strategy is appropriate for an open-end fund
  - the extent to which the strategy involves a relatively concentrated portfolio or large positions in particular issuers, and
  - the use of borrowings for investment purposes and derivatives

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– Short-term and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions

Although not required by the new Rule, the SEC provided as guidance the following cash flow projection considerations: (1) size, frequency, and volatility of historical purchases and redemptions; (2) fund’s redemption policies; (3) fund’s shareholder ownership consideration; (4) fund’s distribution channels; and (5) degree of certainty associated with cash flow projections.

– Holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources

– Additional risk factors must be considered by ETFs

– A fund will not be required to consider any factor above that is not applicable to the fund, and a fund may take into account considerations in addition to the factors set forth above.

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Classification of the Liquidity of Fund Portfolio Investments

• Each fund, except for in-kind ETFs, will be required to classify each portfolio investment into one of four liquidity categories, based on the number of days in which the fund reasonably expects the investment would be convertible to cash (or sold or disposed of, as applicable) in current market conditions without significantly changing the market value of the investment.

• In classifying investments, a fund must use information obtained after reasonable inquiry and take into account relevant market, trading, and investment-specific considerations.

• A fund must review classifications at least monthly (in connection with Form N-PORT filings) and more frequently if changes in relevant market, trading, and investment-specific considerations are reasonably expected to materially affect one or more of its investments’ classifications.
Classification of the Liquidity of Fund Portfolio Investments – Categories

• The four liquidity categories (proposal had six) are as follows:
  – **Highly liquid investments**: cash and any investment convertible into cash (i.e., sold and sale is settled) in 3 business days or less without significantly changing the market value of the investment;
  – **Moderately liquid investments**: convertible into cash in more than 3 calendar days but in 7 calendar days or less without significantly changing the market value of the investment;
  – **Less liquid investments**: able to be sold or disposed of in 7 calendar days or less without significantly changing the market value of the investment; but settlement is expected to be more than 7 calendar days;
  – **Illiquid investments**: cannot be sold or disposed of in 7 calendar days without significantly changing the market value of the investment.
• Value Impact Standard

  – **Proposed Rule** – convertible to cash at a price that does not materially affect the value of the asset
  – Commenters opposed this standard because of the difficulty of separating market impact of a fund’s trades from other reasons that an asset’s price may move, such as market events

  – **Final Rule** – convertible to cash without significantly changing the market value of the asset
  – this standard does not require a fund to re-value or re-price the investment for classification purposes, nor does it require a fund to incorporate general market movements in liquidity determinations or estimate market impact to a precise degree.
Although not required by the new Rule, the SEC provided the following factors that funds may consider in evaluating portfolio investments’ liquidity characteristics and managing liquidity risk:

- Existence of an active market for an asset class or investment;
- Exchange-traded nature of an asset class or investment;
- Frequency of trades or quotes;
- Average daily trading volume and units outstanding relative to the size of the fund’s position;
- Volatility of trading prices;
- Bid-ask spreads;
- Standardization and simplicity of asset class’ or investment’s structure;
- Maturity and date of issue of fixed income securities;
- Restrictions on trading and limitations on transfer; and
- Relationship of the asset to another portfolio asset.
Classification of the Liquidity of Fund Portfolio Investments – Guidance (con’t.)

- Funds can classify investments by asset class, unless market, trading, or investment-specific considerations with respect to a particular investment are reasonably expected to significantly affect the liquidity characteristics of that investment as compared to the fund’s other portfolio holdings within that asset class.

- General categories (such as equities and fixed income) are not sufficient and procedures for classifying by asset class should allow for meaningful distinctions between classes and sub-classes (e.g., market capitalization for equities and issuer type and credit quality for fixed income).

- A fund must determine whether trading varying portions of a position in a particular investment or asset class, in sizes that the fund would reasonably anticipate trading, is reasonably expected to significantly affect the liquidity of that investment (i.e., market depth), and, if so, the fund must take this determination into account when classifying the liquidity of that investment or asset class.

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Classification of the Liquidity of Fund Portfolio Investments – Guidance (con’t.)

• If a security’s liquidity classification is adjusted downward as a result of a fund’s market depth analysis, the fund’s entire position in the investment is subject to the new classification (not, as proposed, to portions of such position).

• For derivatives transactions that a fund has classified as moderately liquid investments, less liquid investments, or illiquid investments, the fund must identify the percentage of its highly liquid investments that are segregated to cover, or pledged to satisfy margin requirements in connection with, derivatives transactions in each of these classification categories.
  – For purposes of calculating this percentage, a fund that has segregated or pledged non-highly liquid investments as well as highly liquid investments to cover derivatives transactions, should first use segregated or pledged assets that are highly liquid investments to cover derivatives transactions classified in the three lower liquidity classification categories.
  – This percentage is disclosed on Form N-PORT.
Determination of a Highly Liquid Investment Minimum

- A fund will be required to determine an appropriate minimum percentage of its net assets that must be invested in highly liquid investments.
  - *Highly Liquid Investments*: cash and any investment that is reasonably expected to be convertible into cash within 3 *business* days without significantly changing the market value of the investment.

- A fund will **not** be prohibited from acquiring assets other than highly liquid investments in the event the fund falls below its minimum and the requirement is **not** intended to suggest that a fund should only, or primarily, use its most liquid investments to meet redemption requests.
In determining the highly liquid investment minimum, a fund will be required to consider the same factors it considers (as applicable) in assessing its liquidity risk, as previously discussed (including the specific factors for ETFs).

- A fund should consider these factors as they apply both during normal conditions and during stressed conditions that are reasonably foreseeable during the period until the next review of the minimum.
Determination of a Highly Liquid Investment Minimum (con’t.)

- With respect to investment strategy and portfolio liquidity, examples of when a fund may choose to establish an increased highly liquid investment minimum include:
  - Strategy that typically has had greater volatility of flows than other investment strategies (such as alternative funds and emerging market debt funds).
  - Leveraged strategy (e.g., a fund with leverage through bank borrowings or that has significant fixed obligations to derivatives counterparties).
  - Strategy that requires a significant amount of highly liquid investments to be segregated to cover derivatives transactions or pledged to satisfy margin requirements in connection with derivatives transactions.

- With respect to cash flow, should consider the degree of certainty associated with the short-term and long-term cash flow projections.

- With respect to holdings of cash and cash equivalents, should consider such holdings as well as the availability of other funding sources (e.g., line of credit).

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Determination of a Highly Liquid Investment Minimum (con’t.)

- A fund will also be required to adopt and implement policies and procedures for responding to a shortfall in a fund’s highly liquid investments below its highly liquid investment minimum.
  - Could specify actions to consider to respond to a shortfall under different conditions and how a fund will determine the timeframe by which it will bring assets back above the minimum.
  - Must include reporting shortfalls to the board no later than the board’s next regularly scheduled meeting.
  - Must include reporting to board within 1 business day if a shortfall lasts more than 7 consecutive calendar days.
Determination of a Highly Liquid Investment Minimum (con’t.)

- A fund must maintain a written record of how minimum was determined.
- A fund will be required to review its highly liquid investment minimum no less frequently than annually.
- A discussion of a fund’s highly liquid investment minimum must be included in the written annual report to the board on the adequacy and effectiveness of the fund’s liquidity risk management program.
- A fund’s board is not normally required to specifically approve the highly liquid investment minimum.
  - During the time of a shortfall, however, the highly liquid investment minimum can only be changed with board approval.
- Money market funds, In-kind ETFs, and any fund that primarily holds assets that are highly liquid investments will **not** be subject to the highly liquid investment minimum.
Determination of a Highly Liquid Investment Minimum (con’t.)

- **Form N-PORT**
  - Requires a fund to report, on a non-public basis, the fund’s highly liquid investment minimum, whether the minimum has changed during the reporting period, and the number of days the fund was below its minimum during the reporting period.

- **Form N-LIQUID**
  - Requires a fund to confidentially notify the SEC within 1 business day if its holdings in highly liquid investments fall below the minimum for more than 7 consecutive calendar days.
Limitation on Illiquid Investments

• A fund (including an In-kind ETF) will be prohibited from acquiring any illiquid investment if, immediately after the acquisition, more than 15% of the Fund’s net assets would be invested in illiquid investments.
  – *Illiquid Investments*: any investment that the fund reasonably expects cannot be sold in current market conditions in 7 *calendar* days without significantly changing the market value of the investment.
  – Requirement is not meant to result in funds selling illiquid assets at fire sale prices or at inopportune times.

• A fund will be required to review its illiquid investments at least monthly in connection with its reporting the liquidity classification for each portfolio investment on Form N-PORT.
Limitation on Illiquid Investments (con’t.)

• A fund will be required to report to its board within 1 **business** day when its illiquid assets exceed 15% of its net assets.
  – Also would expect such instances to be addressed in the written report provided to the board regarding the adequacy and effectiveness of the liquidity risk management program.

• If a fund remains in breach 30 days from the occurrence (and at each consecutive 30 day period thereafter), the fund’s board, including a majority of the independent trustees, must assess whether the plan presented to it for bringing this percentage back into compliance continues to be in the best interest of the fund.
Limitation on Illiquid Investments (con’t.)

- Form N-LIQUID
  - Requires a fund to confidentially notify the SEC within 1 business day after:
    - The fund’s level of illiquid assets exceeds 15% of its net assets, or
    - If the fund’s level of illiquid assets previously exceeded 15% of its net assets, the fund’s level of illiquid assets have changed to be less than or equal to 15% of the fund’s net assets.

- Form N-PORT
  - Requires a fund to confidentially disclose the liquidity classification of each investment, including the determination of whether an investment qualifies as an illiquid investment, monthly.
  - Requires a fund to publicly disclose the aggregate percentage of a fund’s holdings invested in illiquid assets on a quarterly basis, with a 60 day delay.
Redemption In-Kind Policies and Procedures

- A fund (including an In-kind ETF) that engages in or reserves the right to engage in in-kind redemptions will be required to adopt and implement written policies and procedures regarding in-kind redemptions as part of the management of its liquidity risk.
  - Generally should address the process for redeeming in-kind, as well as the circumstances under which the fund would consider redeeming in-kind.
  - Effective policies and procedures would likely address how a fund would determine which securities it would use in an in-kind redemption, or whether the Fund plans to redeem securities in-kind as a pro rata ratio of the fund’s securities holding or in a non-pro rata manner.
  - A fund also may consider having policies and procedures that address the ability of investors to receive in-kind redemptions.
Cross-Trades

• Funds may consider engaging in cross-trades to be a useful liquidity risk management tool.

• Rule 17a-7 compliance policy suggestions:
  – May be prudent to subject less liquid assets to careful (potentially heightened) review before engaging in a cross-trade to confirm satisfying all requirements of Rule 17a-7. In particular:
    – Review to ensure market quotations are readily available.
    – Assess the quality of quotations provided by dealers.
    – Review to ensure a current market price is available.
    – Review to ensure cross-trade is consistent with investment objective, investment strategies, and risk profile.
**Board Oversight**

- **Role of Fund Board:** Per the adopting release, it is one of general oversight and the SEC expects that directors will exercise their reasonable business judgment in overseeing the liquidity risk management program on behalf of investors.

- With respect to the program, a fund’s board will be required to initially approve:
  - The fund’s liquidity risk management program, and
  - The designation of a program administrator
    - May not be solely portfolio managers, but can be assigned to the investment adviser or group of officers.
  - A fund can delegate the administration of part of its program to third party service providers.

- Directors will be allowed to initially approve the liquidity risk management program by reviewing summaries of the program provided by persons familiar with the program:
  - Familiarize the Board with the salient features of the program and inform the Board how the program assesses the fund’s liquidity risk.

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Board Oversight (con’t.)

- The board will be required to review, at least annually, a written report that addresses the operation of the program and assesses its adequacy and the effectiveness of its implementation, including:
  - The operation of the highly liquid investment minimum (if applicable) and
  - Any material changes to the program.
- Boards will **not** have to approve material changes to the program, but still must review material changes as part of its annual Rule 38a-1 review.
- Board oversight with respect to compliance with illiquid investment and highly liquid investment minimums.
Exchange Traded Funds (ETFs)

- Overview:
  - Unique liquidity concerns of ETFs
  - Required Liquidity Risk Management Program elements
  - In-Kind ETFs
  - De Minimis amount of cash
    - What is “De Minimis”
    - What is “cash”
    - Related Liquidity Risk Management Program requirements
  - Reporting on Form N-CEN
Unique Liquidity Concerns of ETFs

- **Equitable treatment of all shareholders**
  - APs redeem from the ETF at NAV, while shareholders redeem in secondary market at market price.
  - Illiquidity in ETF portfolio → transaction costs on market participants → widen ETF bid-ask spread → widen the spread between the ETF's trading price and its NAV → APs (which transact at NAV) are getting a different price than shareholder (which transact at trading price).

- **Secondary market impacts**
  - Illiquidity could discourage market makers from making a market, which in turn impacts the arbitrage opportunities and could make the ETF more difficult to price, trade, and hedge.

- Liquidity concerns are applicable to all ETFs, including In-Kind ETFs.
ETF Liquidity Risk Management Program Elements

- All ETFs must assess, manage, and periodically review their liquidity risk and needs, taking into account, as applicable, the liquidity risk factors applicable to mutual funds.

- All ETFs also must consider the following additional factors that are specific to the structure and operation of ETFs:
  - **The relationship between the ETF’s portfolio liquidity and:**
    - the way in which ETF shares trade;
    - the prices and spreads at which ETF shares trade;
    - the efficiency of the arbitrage function; and
    - the level of active participation by market participants (including APs).
  - **The effect of the composition of baskets on the overall liquidity of the ETF’s portfolio**
In-Kind ETFs

• **Definition**
  – ETF that meets redemptions through in-kind transfers of securities, positions, and other assets, other than a de minimis amount of cash, and that publishes its portfolio holdings daily.

• **Benefits**
  – Do not need to classify portfolio holdings into four liquidity categories.
  – Not subject to highly liquid investment minimum.
What is De Minimis?

Balancing Amount

Cash corresponding to uninvested cash in portfolio

Cash in lieu (depending on amount)

Cash redemption

De Minimis

Possibly De Minimis

Not De Minimis
What is Cash?

- Cash means cash in US Dollars.
- It does not mean cash equivalents or foreign currency.
Related Liquidity Risk Management Program Requirements

- Liquidity Risk Management Program should include:
  - How the ETF analyzes whether it can redeem in-kind in all market conditions
  - Under what circumstances the ETF would use a de minimis amount of cash to meet redemptions
  - What level of cash qualifies as de minimis
  - Description of how ETF will manage and/or approve any portion of redemptions paid in cash
  - Documentation as to the determination that cash amount was de minimis

- Factors to consider in making these determinations:
  - Absolute dollar amount of cash
  - Dollar amount relative to redemption basket
  - How often cash is used
  - Circumstances and rationale for using cash
• Qualification as an In-Kind ETF is an ongoing, not a static, determination:
  – If market conditions change and an ETF can no longer meet de minimis requirement, it would no longer be an In-Kind ETF and would be subject to liquidity classifications and highly liquid investment minimums
  – Adopting release notes that an ETF may conclude in "later years" that it does qualify as an In-Kind ETF again if circumstances are not repeated
Reporting on Form N-CEN

- ETF must identify itself as an In-Kind ETF.
- All ETFs required to report the average of units redeemed in-kind and in cash during the reporting period.
Recordkeeping

• Fund must maintain:
  – a written copy of the program and certain associated fund policies and procedures;
  – copies of certain materials provided to the fund board in connection with initial approval of liquidity risk management program; and
  – a written record of the policies and procedures related to how the highly liquid investment minimum, and any adjustments thereto, were determined (including materials provided to the board related to a fund falling below its highly liquid investment minimum).
• Form N-1A (*June 1, 2017 compliance date*)
  – Item 11 to require disclosure regarding (i) typical redemption payment timeline, and (ii) methods the fund typically expects to use to meet redemption requests (*e.g.*, sales of portfolio assets, holdings of cash, etc.)

• Form N-PORT
  – Public: Aggregated percentage of a fund’s portfolio representing each of the four classification categories, available on a quarterly basis.
  – Public: Percentage of a fund’s highly liquid investments that are segregated to cover, or pledged to satisfy margin requirements in connection with, the fund’s derivatives transactions classified in the moderately liquid, less liquid, and illiquid investments classification categories, available on a quarterly basis.
  – Confidential: Position-level liquidity classification information and information regarding a fund’s highly liquid investment minimum (including the minimum itself, whether the minimum has changed during the reporting period, and the number of days the fund was below its minimum during the reporting period).

• Form N-CEN
  – Lines of credit and interfund borrowing and lending (including use of each during the period).
  – An ETF must report whether it is an In-Kind ETF as defined in the liquidity rule.
Disclosure (con’t.)

• Form N-LIQUID
  – Requires a fund to confidentially notify the SEC within 1 business day after:
    – The fund’s level of illiquid assets exceeds 15% of its net assets,
    – If the fund’s level of illiquid assets previously exceeded 15% of its net assets, the fund’s level of illiquid assets have changed to be less than or equal to 15% of the fund’s net assets, or
    – Once its highly liquid investments have been below its minimum for more than 7 consecutive calendar days.
Compliance Dates

Liquidity Risk Management Program, Form N-LIQUID, Form N-PORT, and Form N-CEN

• Fund groups with net assets of $1 billion or more – December 1, 2018

• Fund groups with net assets of less than $1 billion – June 1, 2019

  – “Fund group” includes all investment companies in the same “group of related investment companies.”
  – Rule 0-10 under the 1940 Act defines “group of related investment companies” to mean two or more management companies (including series thereof) that (i) hold themselves out to investors as related companies for purposes of investment and investor services; and (ii) either (a) have a common investment adviser or have investment advisers that are affiliated persons of each other; or (b) have a common administrator.

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Christopher Menconi advises investment companies, including mutual funds and exchange-traded funds (ETFs), and their investment advisers and boards of directors on regulatory, compliance, organizational, and operational matters. He also advises insurance companies on the regulation of variable insurance products under the federal securities laws.
Sean Graber advises companies in the securities industry on investment management matters. Investment advisers, mutual funds, closed-end funds, private investment companies, registered funds of hedge funds, and exchange-traded funds seek his advice on organizational issues, registration, and ongoing regulatory compliance matters. He also serves as counsel to the boards of directors of mutual funds, and he advises insurance companies on regulatory matters relating to variable insurance products.
David W. Freese works closely with mutual funds, exchange-traded funds (ETFs), closed-end funds, private funds, and their investment advisers to navigate the shifting terrain. He brings particular experience in launching new fund complexes, from identifying legal issues that arise from proposed fund strategies, through initial US Securities and Exchange Commission (SEC) registration, organizational board of directors meetings, and fund seedings.
Beau Yanoshik focuses his practice on the regulation of investment companies and investment advisers. He advises clients on forming and registering investment companies, including exchange-traded investment companies, and he provides ongoing advice regarding various regulatory compliance and securities law issues. Additionally, Beau counsels on transactional matters, including reorganizations, mergers, and acquisitions involving investment companies. He additionally assists with regulatory filings and in obtaining exemptive and no-action relief from various provisions of the Investment Company Act of 1940.
Our Global Reach

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Our Locations

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*Our Beijing office operates as a representative office of Morgan, Lewis & Bockius LLP. In Shanghai, we operate as a branch of Morgan Lewis Consulting (Beijing) Company Limited, and an application to establish a representative office of the firm is pending before the Ministry of Justice. In Hong Kong, Morgan Lewis has filed an application to become a registered foreign law firm and is seeking approval with The Law Society of Hong Kong to associate with Luk & Partners.
THANK YOU