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Investment Services Regulatory Update

New Rules, Proposed Rules, Guidance and Alerts

SEC STAFF GUIDANCE AND ALERTS

Division of Investment Management Staff Issues Liquidity Risk Management Program FAQs

On January 10, 2018, the staff of the SEC's Division of Investment Management issued guidance in the form of frequently asked questions (FAQs) relating to the liquidity risk management (LRM) program requirements of Rule 22e-4, which was adopted in October 2016. The FAQs generally address two categories of questions: (i) the delegation of LRM program administrative duties to sub-advisers and (ii) the definition and applicability of Rule 22e-4 to "In-Kind ETFs." The following is a summary of the issues addressed in the FAQs.

Sub-Advised Funds

- The staff clarified that a board may designate a sub-adviser as LRM program administrator under Rule 22e-4. The staff additionally stated that a program administrator may delegate specific responsibilities (e.g., providing liquidity classifications for the fund's investments) to a sub-adviser or other appropriate third party and, further, that entities with delegated responsibilities may sub-delegate to others, provided there is appropriate supervision. The staff noted that the fund retains ultimate responsibility for complying with Rule 22e-4. Accordingly, the staff recommended that a fund implement policies and procedures governing the scope and conditions of delegating LRM program responsibilities.
- Because Rule 22e-4 requires funds—and not advisers—to adopt LRM programs, an investment adviser (including a sub-adviser) has no independent obligation to adopt and implement its own LRM program.

- The staff recognized that certain investment advisers (or sub-advisers) may provide advisory services to multiple funds in multiple fund complexes that have differing practices, including different LRM programs with unique policies and procedures (including different LRM programs for funds in the same complex). The FAQs clarified that an entity administering multiple LRM programs that differ from one another is under no obligation to reconcile those programs, the programs' methodologies or the programs' outputs (e.g., different liquidity classifications of certain investments). The staff further clarified that each fund's board-approved LRM program will control how an adviser or sub-adviser carries out any of its responsibilities under Rule 22e-4 to that particular fund.
- Further to the previous bullet point, an investment adviser, sub-adviser or other LRM program administrator, or its delegate, may classify the same investment differently across multiple funds based on the funds' differing LRM programs. The staff noted that, under Rule 22e-4, "a fund must take into account 'relevant market, trading, and investment-specific characteristics' in classifying its portfolio investments' liquidity," and that different funds (even funds within the same complex) are permitted to arrive at different conclusions.
- Pursuant to an LRM program administrator's ability to delegate, an LRM program administrator may adopt an approach whereby multiple entities (e.g., the investment adviser and a sub-adviser) may have input as to the liquidity classification of particular investments. In such instances, the staff believes a fund may consider addressing in its LRM policies and procedures how to treat a circumstance in which the adviser and sub-adviser reach a different conclusion regarding the liquidity classification of a particular investment. The staff noted certain possible solutions, including allowing a specified party's determination to control, employing a factor analysis or hierarchy or using the most conservative determination. However, the staff clarified that other methodologies could be used.
- The staff clarified that in a multi-manager fund in which the various sub-advisers of distinct sleeves are responsible for designating the liquidity classification of portfolio investments, each sub-adviser is permitted to classify the same investment differently even within the same fund, and that none of the fund, the LRM program administrator or the adviser or sub-adviser has any obligation to reconcile these differences for compliance purposes (e.g., monitoring compliance with the fund's highly liquid investment minimum, if applicable, or the 15% limit on illiquid investments).
- The staff noted that, notwithstanding the foregoing bullet point, Form N-PORT does not permit a fund to report more than one liquidity classification for a single investment. Accordingly, an LRM program's policies and procedures should include a methodology for selecting a single liquidity classification for Form N-PORT reporting purposes in circumstances in which

different sub-advisers classify the same investment differently for compliance purposes. For illustrative purposes only, the staff noted that a fund may choose to report the classification of the sub-adviser with the largest position in the asset, calculate a weighted average and round to the nearest liquidity classification or report the most conservative (i.e., the lowest) liquidity classification. The staff encouraged a fund with diverging liquidity classifications to report these policies and procedures in the explanatory notes section of Form N-PORT.

In-Kind ETFs

Under Rule 22e-4, ETFs that satisfy redemptions through in-kind transfers of securities positions and assets, other than a *de minimis* amount of cash, and that publish portfolio holdings on a daily basis are "In-Kind ETFs" that are exempt from certain LRM program requirements. The FAQs address the following considerations with respect to In-Kind ETFs under the Rule:

- For purposes of determining an ETF's status as an In-Kind ETF, Rule 22e-4 permits each ETF to determine what constitutes a *de minimis* amount of cash in its policies and procedures; the Rule does not establish a precise methodology. Rather, an ETF may take "a variety of reasonable approaches," provided the approach is applied consistently. The staff stated that it would not object to an approach that includes testing each individual redemption transaction or testing redemption transactions in the aggregate over a reasonable period of time to ensure that the cash amounts used are *de minimis*. For determining what is a "reasonable period of time," the staff suggested a day or a week for an ETF with frequent redemption basket activity or a month for an ETF with less frequent redemption basket activity. However, the staff stated that in no event would a period in excess of one month be deemed reasonable.
- Although *de minimis* amounts may differ depending on the facts and circumstances of each ETF, the staff believes that it would be reasonable to determine that overall redemption proceeds paid in cash not exceeding 5% would be *de minimis*, but that it would be unreasonable to determine that redemption proceeds paid in cash exceeding 10% (subject to permissible exclusions, e.g., the amount of uninvested cash in the ETF's investment portfolio) are *de minimis*. An ETF should evaluate its particular facts and circumstances to determine whether an amount of cash in excess of 5% (subject to permissible exclusions) is *de minimis*, including whether such cash redemptions would give rise to liquidity risks substantially similar to those applicable to mutual funds.
- The staff clarified that an ETF may exclude the cash portion of redemption proceeds that is proportionate to the uninvested cash in the ETF's investment portfolio for purposes of defining and testing compliance with the *de minimis* standard.

- Noting the practical considerations that would prevent an ETF that loses its status as an In-Kind ETF from coming into immediate compliance with the provisions of Rule 22e-4 from which In-Kind ETFs are exempt, the staff stated that it would not recommend enforcement against an ETF that loses its In-Kind ETF designation so long as the ETF comes into compliance with the Rule "as soon as reasonably practicable" after the In-Kind ETF designation is lost.
- A new ETF with little or no operating history may use a forward-looking analysis of its policies and procedures and expected redemption practices to determine that it is an In-Kind ETF. The staff stated, more generally, that backwards-looking redemption history is not by itself dispositive, and that an ETF with an operating history may consider making material changes to its policies and procedures and redemption practices to qualify as an In-Kind ETF.

The SEC expects to update the FAQs from time to time to include responses to additional questions.

The FAQs are available at: https://www.sec.gov/investment/investment-company-liquidity-risk-management-programs-faq

SEC Staff Issues Guidance Regarding Tax Cuts and Jobs Act

On December 22, 2017, the Tax Cuts and Jobs Act (the Tax Act) was signed into law. On the same date, the SEC staff issued Staff Accounting Bulletin No. 118 (SAB 118), in which the staff provided guidance for publicly traded companies, auditors and others to help ensure timely public disclosures of the accounting impacts of the Tax Act. SAB 118 is intended to assist companies in applying the Financial Accounting Standards Board's Accounting Standards Codification Topic 740, Income Taxes (ASC Topic 740) in the reporting period in which the Tax Act was enacted, particularly in circumstances in which the accounting for certain income tax effects of the Tax Act is incomplete at the time of issuance of a company's financial statements for the reporting period.

Also in late December 2017, the staff of the SEC's Division of Investment Management issued an information update (the Information Update) responding to concerns that funds taxed as C corporations under the Internal Revenue Code had raised regarding the impact of the Tax Act on their daily net asset value calculations. Any fund that includes deferred tax asset or liability calculations in its net asset value calculation is affected by the Tax Act's new lower corporate tax rate. In the Information Update, the staff indicated that funds may apply SAB 118 to their daily net asset value calculations by making a reasonable estimate of the Tax Act's effect. Any future change in that estimate, based upon new or more precise information, would be a change in the estimate and not a net asset value error. The staff also stated that funds must inform investors regarding the material impacts of the Tax Act on net asset value calculations and material provisions for which the accounting is incomplete, if applicable. The disclosures about these impacts may be made in a press release, website disclosure or "some other reasonable manner."

SAB 118 is available at: https://www.sec.gov/interps/account/staff-accounting-bulletin-118.htm

The Information Update is available at: https://www.sec.gov/divisions/investment/imannouncements/im-info-2017-07.pdf

NEW RULES

SEC Delays Form N-PORT EDGAR Filing Requirement by Nine Months

On December 8, 2017, the SEC adopted a temporary rule (the Temporary Rule) delaying by nine months the requirement that registered investment companies file reports on new Form N-PORT[1] on the EDGAR system. Under the Temporary Rule, larger fund groups that previously would have been required to submit their first reports on Form N-PORT on EDGAR for the period ending June 30, 2018 (due no later than July 30, 2018) will submit their first reports on Form N-PORT on EDGAR by April 30, 2019. Smaller fund groups will begin submitting reports on Form N-PORT on EDGAR by April 30, 2020. Notably, larger fund groups must begin collecting and maintaining information required to be included on Form N-PORT by the original June 1, 2018 compliance date, notwithstanding that the information will not be submitted to EDGAR. The Form N-PORT information collected and maintained during this nine-month delay period (the Delay Period) will be subject to all applicable recordkeeping rules and requirements, including being subject to examination by the SEC staff. Smaller fund groups will not be required to collect and maintain Form N-PORT information during the Delay Period.

In order to ensure investors receive the same information that they currently receive during the Delay Period, the Temporary Rule also extends the requirement to file reports on Form N-Q through the March 31, 2019 reporting period for larger fund groups and through the March 31, 2020 reporting period for smaller fund groups. The Temporary Rule does not affect any requirements relating to the new annual Form N-CEN, which will continue to be required for fiscal years ending on or after June 1, 2018.

The adopting release for the Temporary Rule states that the SEC recognizes “the importance of sound data security practices and protocols for sensitive, nonpublic information, including information that may be competitively sensitive” and, in this connection, notes recent efforts directed by SEC Chairman Jay Clayton to assess and strengthen the SEC’s cybersecurity risk profile. Certain of these measures, the adopting release explains, “which will be designed to improve EDGAR’s functionality and security, could negatively affect EDGAR’s ability to validate and accept Form N-PORT filings in a timely manner, in particular during peak filing periods.” Thus, the SEC determined it was appropriate to delay the Form N-PORT filing requirement to allow for completion of the SEC’s internal data security review and implement and test any resulting modifications.

The adopting release for the Temporary Rule is available at: https://www.sec.gov/rules/final/2017/33-10442.pdf

The SEC staff previously prepared responses to certain questions related to the investment company reporting modernization reforms. These FAQs are available at: https://www.sec.gov/investment/investment-company-reporting-modernization-faq

1 The SEC approved new Form N-PORT as part of a broader set of reporting reforms adopted on October 13, 2016. *See* Investment Company Reporting Modernization, Investment Company Act Release No. 32314 (available at: https://www.sec.gov/rules/final/2016/33-10231.pdf). Form N-PORT requires all registered management investment companies (other than money market funds and small business investment companies) and unit investment trusts that operate as exchange-traded funds to report information about their monthly portfolio holdings to the SEC in a structured data format no later than 30 days after the close of each month using the SEC’s EDGAR system. In general, reports on Form N-PORT for every third month of each fiscal quarter will be available to the public 60 days after the end of the fiscal quarter.

Public Statements, Press Releases and Testimony

PUBLIC STATEMENTS

SEC Division of Investment Management Director Dalia Blass Discusses Board Outreach Initiative

IIn her keynote address at the Investment Company Institute's Securities Law Development Conference on December 7, 2017, Dalia Blass, Director of the SEC's Division of Investment Management, discussed, among other things, the Division's Board Outreach Initiative. This initiative, intended to "holistically revisit the responsibilities of the board," will involve a review of the current responsibilities charged to fund boards under the 1940 Act and engagement with fund directors and others to determine whether any changes to these responsibilities should be made.

Director Blass stated that, although fund boards have played an important role in fund governance since 1940, the responsibilities of boards have grown significantly over the years. A goal of the initiative is to determine whether the accumulation of board duties has distracted from areas where board oversight is most valuable, such as managing the conflicts that may arise between funds and their service providers. Director Blass stated that "[o]riginally, directors were asked to focus on just those key areas where important conflicts could emerge—advisory and underwriting contracts, valuation and certain accounting and audit roles." Director Blass further explained that over the years the SEC and its staff have given additional responsibilities to fund boards under various new rules and pursuant to the terms of exemptive and no-action relief to involve the board in monitoring compliance and addressing potential conflicts. She stated that although these responsibilities individually make sense, at some point the staff needs to ask whether the numerous responsibilities imposed on fund directors are appropriate in the aggregate.

To that end, Director Blass stated that the Division has "made good progress on cataloging all of the rules, no-action letters and exemptions that impose fund board responsibilities." In addition, Director Blass has instructed the Division's staff to begin its outreach and engagement with fund directors and other stakeholders to help the Division understand (1) where the board's focus is most valuable, (2) what the information flow to directors looks like, and (3) the situations in which directors feel that they have a meaningful role to play versus situations in which they are overseeing matters more appropriately handled by others. Director Blass stated that as the Division gathers information it will consider whether to recommend any changes to board responsibilities.

The transcript of Director Blass's remarks is available at: https://www.sec.gov/news/speech/blass-keynote-ici-securities-law-developments-conference-2017

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Investment Services Group

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