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Client Alert

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The SEC's New Liquidity Management Rule and Exchange-Traded Funds

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The Securities and Exchange Commission recently adopted new Rule 22e-4 ("Liquidity Rule") requiring all open-end investment companies, including exchange-traded funds ("ETFs") but excluding money market funds, to adopt and implement written liquidity risk management programs reasonably designed to assess and manage their liquidity risks ("Liquidity Management Programs"). This alert discusses the Liquidity Rule requirements for ETFs. For a general discussion of the Liquidity Rule, see our alert entitled "SEC Adopts Liquidity Management Rules."

The SEC acknowledged in the adopting release for the Liquidity Rule that ETFs have different liquidity issues than mutual funds given that ETFs generally redeem in kind rather than in cash and the authorized participants ("APs") (or their customers) bear the costs of the ETFs' liquidity needs. Accordingly, the Liquidity Rule has been tailored for ETFs as follows:

- All ETFs must assess, manage and periodically review their liquidity risk, taking into account two additional liquidity risk factors that are specific to the structure and operation of ETFs, as well as the specified liquidity risk factors, as applicable, for all funds.
- An ETF that qualifies as an "In-Kind ETF" will not be required to classify the liquidity of its portfolio investments by level of liquidity or set a minimum percentage of its portfolio that must be invested in highly liquid assets.

These ETF-specific requirements are discussed further below.

ETF Liquidity Factors in a Nutshell

- Evaluate portfolio liquidity and prices/spreads of ETF shares, efficiency of arbitrage and AP participation levels
- Evaluate effect of creation and redemption basket composition

Liquidity Risk Management Programs for ETFs

An ETF will be required to adopt and implement a written Liquidity Management Program that is reasonably designed to assess and manage its liquidity risk. 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. As part of their Liquidity Management Programs, ETFs will be required to assess, manage and periodically review (at least annually) certain liquidity risk factors, as applicable. The SEC acknowledged in the adopting release that certain factors may not apply to an ETF but additional risk factors may be relevant. The two additional risk factors that ETFs must consider, as applicable, in developing their Liquidity Management Programs, are:

- The relationship between the ETF's portfolio liquidity and the way in which, and the prices and spreads at which ETF shares trade, including the efficiency of the arbitrage function and the level of active participation by market participants (including APs); and
- The composition of the ETF's creation and redemption baskets.

Evaluating Portfolio Liquidity and the Arbitrage Function

An ETF must consider the relationship between the liquidity of its portfolio securities and other instruments and the arbitrage function in assessing its liquidity risk. If an ETF has significant amounts of illiquid securities in its portfolio, APs may find it difficult to evaluate available arbitrage opportunities and manage their risk exposure. Declining liquidity of portfolio securities also may make it difficult for market participants, such as APs, to assemble the baskets for purchase of ETF shares and sell securities that are received in an in-kind redemption. This could lead to less creation unit transactions and widening bid-ask spreads, thus impairing the arbitrage process. The SEC discussed in the adopting release that the level of active market participation is important to the way in which, and the prices and spreads at which, ETF shares trade.

Evaluating the Creation and Redemption Baskets

The second liquidity risk factor that ETFs must consider is the effect of the composition of the creation and redemption baskets on the overall liquidity of the ETF's portfolio. A creation or redemption basket may or may not reflect a pro rata share of the ETF's portfolio.

The adopting release explained that an ETF whose basket does not reflect a pro rata share of the fund's portfolio may alter the liquidity profile of the ETF's portfolio and may adversely affect the ETF's future ability to meet cash redemptions or mitigate shareholder dilution. The release further noted that an ETF should consider the effect of basket composition even if a basket reflects a pro rata share of the ETF's portfolio. For example, a basket that reflects a pro rata share of the ETF's portfolio may hold a larger number of smaller positions that may be more difficult for APs to trade efficiently. Some commenters suggested that increasing ETF basket flexibility and eliminating the 2% limitation on redemption transaction fees would help ETF liquidity and the arbitrage process. The SEC declined to address these comments and noted in the adopting release that this subject was beyond the scope of the rule-making.

Exemptions for ETFs from Liquidity Bucket Classification and Highly Liquid Investment Minimum Requirements

The SEC's adopting release recognizes that ETFs have a unique creation and redemption process and the Liquidity Rule provides for certain exemptions for "In-kind ETFs" from the liquidity bucket classification and highly liquid investment requirements of the Rule (the "Exemptions").

Exemptions for In-Kind ETFs

An In-Kind ETF, as defined in new Rule 22e-4, is an ETF that publishes its holdings daily and meets redemptions through in-kind transfers of securities, positions and assets and no more than a de minimis amount of cash. An ETF must disclose on new Form N-CEN whether it is an In-Kind ETF. The SEC believes that ETFs that satisfy redemptions with more than de minimis cash would generally have the same liquidity risks as a mutual fund. An ETF that wishes to qualify as an In-Kind ETF is required to have certain written policies and procedures as part of its Liquidity Management Program that describe to the extent applicable:

- The process the In-Kind ETF uses to analyze the ability to redeem in-kind under all market conditions such that it is unlikely to fail to qualify for the Exemptions;
- The circumstances in which the In-Kind ETF may include a de minimis amount of cash in an in-kind redemption;
- The amount of cash the In-Kind ETF will treat as de minimis;
- The process to manage and (or approve) any portion of a redemption that is paid in cash; and
- The process for documenting the In-Kind ETF's determination that a cash amount is de minimis.

In making a determination that a cash amount is de minimis, the adopting release specified that an In-Kind ETF may consider, if applicable: (i) the amount (both in dollars and as a percentage of the entire redemption basket) and frequency with which cash is used to meet redemptions; and (ii) the circumstances and rationale for using cash to meet redemptions. However, "de minimis" is not defined in the Liquidity Rule, and as discussed below, there is a considerable lack of clarity as to what amount of cash the SEC would view as de minimis.

Determining De Minimis Cash

The exemptive orders under which ETFs operate permit them to fully or partially satisfy redemption orders in cash. However, if an ETF were to use more than de minimis amount of cash (as determined in accordance with its written policies and procedures) to meet redemptions, it would not qualify as an In-Kind ETF and would not be eligible for the Exemptions. The SEC does not define "de minimis" for this purpose but the release establishes some parameters. For example, the SEC considers the amount of cash included in a redemption basket to make up for the difference in market value of the basket of securities and other assets delivered in the redemption and the market value of the ETF shares redeemed ("balancing amount") to be de minimis, because these cash amounts are typically small.

In addition, the contribution of cash to a redemption basket representing the amount of uninvested cash in an ETF's portfolio would also be considered de minimis. On the other hand, the SEC believes that even one redemption that is all in cash to a single AP would not qualify as de minimis. The adopting release states that the ETF could qualify in later years to be an In-Kind ETF if the circumstances are not repeated but provides no guidance on what this means. It is unclear how many years would be adequate or what circumstances cannot be repeated.

Also left unclear is how cash delivered in lieu of derivatives or other instruments would be viewed under the Liquidity Rule. An ETF, in accordance with its exemptive order, may provide cash in substitution for certain positions or assets in its portfolio, such as derivatives that cannot be transferred to the AP. The adopting release noted (without further clarification) that "depending on the size of the position being substituted for, such a transaction may not always be de minimis."

De Minimis Cash in a Nutshell			
Purpose of cash in redemption	**De Minimis**	**Not De Minimis**	**May be De Minimis**
Balancing Amount (difference between value of basket of securities delivered in redemption and value of shares redeemed)	X		
Representation of uninvested cash in portfolio	X		
Substitution for a portfolio position or asset ("cash in lieu")			X (depending on the size)
All cash redemptions		X	

As discussed above, an In-Kind ETF, which suddenly failed to qualify as such, would be required to classify its assets in liquidity buckets and comply with the highly liquid asset minimum requirements of the Liquidity Rule. However, under the Liquidity Rule, the ETF would not be prevented from purchasing additional non-conforming assets if it breached its highly liquid investment minimum. This provision provides flexibility to address potentially adverse situations, including tracking error that may arise as a result of complying with the highly liquid investment minimum. We expect that there will be further guidance from the SEC with respect to de minimis cash because of the consequences of failure to qualify as an In-Kind ETF.

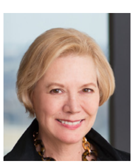
Daily Portfolio Holdings Disclosure

An In-Kind ETF is required to publish its holdings daily. The adopting release noted that currently an ETF meets this requirement by posting on its website each day before commencement of trading of fund shares on the exchange, the identities and quantities of the securities and other assets or positions held by the fund that will form the basis of the fund's calculation of net asset value at the end of the business day. The SEC explained in the adopting release that this portfolio transparency allows APs to evaluate the liquidity of the ETF's portfolio securities. Currently, not all ETFs are required to disclose their portfolio holdings on a daily basis. If an ETF is not already making such disclosures, it will need to do so to qualify for the Exemptions.

Practice Points and Tips

Please see our alert "SEC Adopts Liquidity Management Rules" for generally relevant Practice Points and Tips.

Investment Management Group



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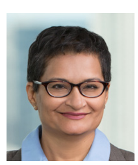

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