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Delegation and Oversight of Liquidity Risk Management for Sub-Advised Mutual Funds

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In planning for the implementation of liquidity risk management (LRM) programs, as required by new Rule 22e-4 (rule) under the Investment Company Act of 1940 (1940 Act),[1] mutual fund complexes that include sub-advised funds will need to determine the appropriate role of sub-advisers in administering their LRM programs. The Staff of the Securities and Exchange Commission (SEC) recently issued guidance endorsing a range of possible roles for sub-advisers, from handling discrete responsibilities to being the primary administrator of a fund's LRM program as a whole. Given this flexibility, fund management and boards should consider whether—and if so, how—they will allocate responsibilities for administering a sub-advised fund's LRM program among the fund's primary adviser, sub-adviser(s), other service providers, or a combination thereof. As discussed in detail below, these considerations should account for the special competences of each entity, the level of complexity in coordinating the LRM program across one or more of these entities, the use of other third-party service providers to provide analytical support for the LRM program, and the ability to exercise appropriate oversight of any delegated LRM program responsibilities.

Overview of the Rule

The rule generally requires registered open-end investment companies (other than money market funds) to establish written LRM programs that provide for:

- The assessment, management, and periodic review of a fund's liquidity risk;
- The classification of a fund's portfolio investments into one of four liquidity categories—highly liquid investments, moderately liquid investments, less liquid investments, and illiquid investments—as well as the monthly review of these classifications; and
- The determination and periodic review of a fund's highly liquid investment minimum (HLIM), as well as the adoption of shortfall procedures for when a fund drops below its HLIM.[2]

To implement an LRM program, a fund's board must designate the primary adviser, a sub-adviser, or one or more fund officers as responsible for administering the fund's program (program administrator). The program administrator should maintain sufficient independence from and hence may not be comprised solely of members of a fund's portfolio

management team, although such individuals may otherwise inform and contribute to the program administrator's implementation of a fund's LRM program.

Delegation of LRM Program Responsibilities to Sub-Advisers

In January 2018, the SEC Division of Investment Management responded to certain frequently asked questions (FAQs) concerning the manner in which responsibilities under a fund's LRM program may be delegated to third parties, including to a fund's sub-adviser.[3] The FAQs were intended to address some of the unique challenges posed by the rule for funds that employ one or more sub-advisers.[4]

The FAQs confirm that, where appropriate, a sub-adviser may be designated by a fund's board as the program administrator.[5] A board overseeing a fund managed by a single sub-adviser may wish to consider designating that sub-adviser as the program administrator in view of the sub-adviser's existing responsibilities, including the responsibility for making the portfolio management decisions that underlie the fund's liquidity risk profile. A sub-adviser may be less appropriate for this designation, however, if a fund has more than one sub-adviser (that is, a multi-manager fund) or if the sub-adviser provides more limited services, as may be the case with certain smaller, boutique sub-advisers that possess neither the staff nor the systems necessary to fully assume the non-investment-related responsibilities under an LRM program (for example, annual board reporting[6]). In this regard, a board that wishes to designate a sub-adviser as the program administrator should consider whether the sub-adviser has already assumed other substantial compliance responsibilities for the fund and whether the sub-adviser would agree to such an arrangement, with or without additional compensation.

For these same reasons, a board overseeing a sub-advised fund may wish to designate the fund's primary adviser—particularly, members of the adviser's risk management and/or compliance teams—as the program administrator, in light of the primary adviser's existing fund administration, operations, risk management, and compliance framework with the fund. Importantly, the FAQs explicitly acknowledge that such a program administrator would nonetheless retain the flexibility to delegate specific LRM program responsibilities to the fund's sub-adviser (as well as other third parties), subject to the program administrator's "appropriate oversight" and any fund policies and procedures governing the delegation.[7]

For example, a fund whose primary adviser serves as its program administrator may consider its sub-adviser(s) as more knowledgeable with respect to the liquidity of the fund's investments. Under these circumstances, a board may wish to allocate the responsibility (or permit the program administrator to allocate the responsibility) to classify the liquidity of such investments to the sub-adviser(s). The FAQs also state that the program administrator may use a hybrid approach, whereby both the primary adviser and sub-adviser contribute to the fund's liquidity classifications.[8] If a sub-adviser in such arrangements wishes to further sub-delegate or otherwise rely upon a third-party service provider to fulfill its LRM program responsibilities, the fund's LRM program must permit sub-delegation and provide for corresponding diligence of the third party (as discussed in the next section).

Notably, to the extent that the investment-related responsibilities delegated under these arrangements involve the incorporation of broader fund-specific inputs (for example, taking into account the fund's anticipated redemptions or deferring to the program administrator with respect to determining an investment position's reasonably anticipated trading size), a fund could instruct its program administrator to provide those fund-specific assumptions to the fund's sub-adviser(s) on an ongoing or periodic basis. For a multi-manager fund, the FAQs provide that the arrangement between a fund's program administrator and its sub-advisers would be subject to the same considerations as above, with the exception that the sub-adviser's delegated responsibilities would apply

with respect to only its distinct sleeve, not the fund as a whole.

The FAQs recognize that investment advisers and sub-advisers may provide advisory services to funds in multiple fund complexes, and that advisers and sub-advisers may have responsibilities under each fund's LRM program. The FAQs explain that a fund's LRM program should be "tailored to the fund's risks and circumstances" and acknowledge that differences in LRM programs may occur. Importantly, however, the FAQs state that an adviser or sub-adviser is "under no obligation to reconcile" (1) the elements of different LRM programs; (2) the underlying methodologies, assumptions, or practices of different LRM programs; or (3) the outputs of different LRM programs (including the liquidity classifications of fund investments).[9]

The FAQs also provide that multiple funds in the same complex may use different liquidity classifications for the same investment if appropriate in light of the facts and circumstances. Similarly, the FAQs state that different sub-advisers managing separate sleeves of a multi-manager fund may assign different liquidity classifications to the same investment. Under these circumstances, the FAQs state that "neither the fund, program administrator, nor the adviser, nor the sub-advisers with delegated [LRM program] responsibilities would be under any obligation to resolve these differences for compliance purposes (for example, in connection with monitoring for compliance with the fund's [HLIM] (if applicable) and the 15 percent limit on illiquid investments)."[10]

The FAQs note, however, that Form N-PORT does not allow funds to report more than one liquidity classification for each investment held by the fund. For reporting purposes, the FAQs suggest that a fund could reconcile any differences by using the liquidity classification of the sub-adviser with the largest position, calculating the weighted average and rounding to the nearest liquidity classification or using the most conservative classification.[11]

While the FAQs provide funds with significant flexibility to delegate LRM responsibilities, the FAQs also emphasize that compliance with the rule is ultimately the responsibility of the fund. As such, the program administrator should "oversee any liquidity risk monitoring or risk management activities undertaken by the fund's service providers."[12]

Appropriate Oversight of Delegated LRM Program Responsibilities

The adopting release and the FAQs do not discuss what constitutes "appropriate oversight" of delegated LRM responsibilities. In the absence of specific guidance, one possible approach is for the program administrator to supervise delegated responsibilities through a process along the lines of that used to comply with Rule 38a-1 under the 1940 Act.[13] In the SEC's adopting release for Rule 38a-1,[14] the SEC stated that "[a] chief compliance officer should diligently administer . . . oversight responsibility by taking steps to assure herself that each service provider has implemented effective compliance policies and procedures administered by competent personnel. The chief compliance officer should be familiar with each service provider's operations and understand those aspects of their operations that expose the fund to compliance risks."[15] Using a similar approach, the program administrator's oversight processes under an LRM program would, therefore, mirror an adviser's processes for overseeing other delegated functions, such as valuation, proxy voting, and best execution. Based on this framework, we have identified below a number of practices that one may wish to consider when delegating responsibilities under an LRM program to a sub-adviser.

Initial Due Diligence

If the primary adviser serves as program administrator and contemplates delegating certain responsibilities under an LRM program to a sub-adviser, the program administrator should satisfy itself that the sub-adviser's LRM-related controls, written policies and procedures, and testing functions are

reasonably designed to prevent violations of the rule. The program administrator should also consider whether delegated responsibilities will be carried out by individuals whose roles are sufficiently separate from the portfolio management team, such as risk management and/or compliance personnel.

When the program administrator has delegated to the sub-adviser responsibility for making liquidity classifications, the program administrator should generally understand the sub-adviser's proposed methodologies, inputs, and assumptions. In addition, the program administrator could ask the sub-adviser how it intends to satisfy the requirement to make a reasonable inquiry in obtaining relevant information. If the sub-adviser plans to classify investments by asset class, rather than on an investment-by-investment basis, the program administrator should consider whether the sub-adviser has adopted procedures that define such asset classes meaningfully and with particularity. The program administrator can also, on a periodic basis, assess the sub-adviser's procedures for identifying exceptions due to market, trading, or issuer-specific considerations.[16]

The program administrator may also wish to consider the frequency of monitoring the fund's compliance with the HLIM and 15 percent limit on illiquid investments and classifying a fund's portfolio investments and whether such activities will be primarily conducted internally or by an independent party.[17] The program administrator should determine the extent to which the sub-adviser's processes for complying with specific liquidity thresholds, including the HLIM (if applicable), the 15 percent limit on illiquid investments, and any client-specific guidelines, have been incorporated into its compliance program.[18] Given the volume of data called for by the rule, a program administrator should also review the sub-adviser's documentation processes and its means for safeguarding potentially sensitive fund holdings information. The FAQs provide that a sub-adviser could sub-delegate some or all of its delegated responsibilities to another party, subject to appropriate oversight. If a sub-adviser intends to sub-delegate to a third-party vendor, the program administrator should determine how the sub-adviser will supervise that vendor. In addition, the program administrator should apprise the board of these oversight activities and create a strong record of doing so in the board agenda and minutes.

Ongoing Oversight

Once an LRM program has commenced, the program administrator should monitor the sub-adviser's implementation of the fund's program. To the extent that the program administrator periodically conducts onsite assessments of the sub-adviser, the program administrator might spend time reviewing the sub-adviser's LRM-related compliance systems, meeting with personnel responsible for administering the LRM program, and discussing LRM practices with the sub-adviser's portfolio managers. For program administrators that oversee multi-manager funds and engage numerous sub-advisers, the program administrator could focus its attention on sub-advisers that invest primarily in less liquid or illiquid investments (or investments with longer settlement periods or that trade infrequently). In calibrating its level of oversight, the program administrator may also wish to consider other factors, including the degree to which the sub-adviser relies on manual processes; the level of subjectivity in its liquidity determination procedures; the sub-adviser's size, strategy, and organizational complexity, and experience managing assets subject to the requirements of the 1940 Act; and the frequency of past compliance errors.

To supervise a sub-adviser's liquidity classification responsibilities, a program administrator could test a sample of the investments held by the fund, ideally those representing a range of asset classes. The program administrator could also engage a third-party vendor for these purposes. However, given the subjectivity of liquidity classifications, the program administrator should generally establish "tolerance ranges" to accommodate differing views as to the liquidity of a particular portfolio investment. The

program administrator should also consider whether it will retain the ability to challenge and/or override specific liquidity category determinations.

To mitigate compliance risk, the program administrator could require the sub-adviser to provide periodic reports or certifications regarding the operation of the LRM program, particularly if the sub-adviser already provides such reports or certifications for other compliance purposes. Such reports might contain, for example, information regarding LRM program compliance errors, fluctuations in the portfolio's liquidity profile, and a summary of material changes to the sub-adviser's LRM procedures and processes. The program administrator should request more detailed information as part of its annual 15(c) information request letter and consider the appropriate level of detail to provide to the board in its annual report.

The program administrator may want to consider whether its own procedures will foster continuity in the fund's LRM program in the event that a sub-adviser experiences a temporary business disruption or is terminated. If the program administrator expects that it would administer a fund's LRM program directly in those circumstances, the administrator should consider whether it would assume responsibility for making liquidity determinations, or engage a third-party vendor to do so, subject to the administrator's oversight. The program administrator should be aware of the potential impact to the fund's liquidity classifications and compliance with the HLIM or 15 percent limit on illiquid investments that might result following the replacement of a sub-adviser with a manager that uses different classification methodologies and inputs. To address this risk, the program administrator could impose guidelines that require the sub-adviser to maintain a buffer with respect to the HLIM or 15 percent limit.

Conclusion

The FAQs should help allay certain industry concerns regarding the potential complexity of implementing an LRM program on behalf of a sub-advised fund. The FAQs give ample flexibility to the program administrator to delegate LRM responsibilities, allowing for variation in LRM practices across funds in the same complex and different funds managed by the same adviser. Nonetheless, the program administrator must be mindful that it cannot delegate away the fund's ultimate responsibility to comply with the rule. A program administrator that has delegated certain responsibilities to a sub-adviser should establish an effective oversight process before availing itself of the flexibility afforded by the FAQs.

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NOTES

1 *See Investment Company Liquidity Risk Management Programs*, 81 Fed. Reg. 82,142 (Nov. 18, 2016 (adopting release). The original compliance date for the rule was December 1, 2018 for fund complexes with $1 billion or more in net assets (larger fund complexes) and June 1, 2019 for fund complexes with less than $1 billion in net assets (smaller fund complexes). However, following requests by multiple industry participants, including Dechert LLP, on February 21, 2018 the SEC extended by six months the compliance dates for certain of the rule's requirements, including the requirements relating to the classification of investments, highly liquid investment minimum, board approval (except approval of the program administrator), and related reporting requirements. For these elements of the rule, the compliance date is now June 1, 2019 for larger fund complexes and December 1, 2019 for smaller fund complexes. The compliance dates for the other requirements of the rule, including the requirement to assess, manage, and periodically review liquidity

risk, and the 15 percent limit on illiquid investments, remain unchanged. *See Investment Company Liquidity Risk Management Programs; Commission Guidance for In-Kind ETFs*, 83 Fed. Reg. 8,342 (Feb. 27, 2018).

2 *See* Jeffrey S. Puretz, Brenden P. Carroll, Aaron D. Withrow and Nicholas DiLorenzo, "Interpretive and Other Challenges to Liquidity Classification under the SEC's New Liquidity Risk Management Rule," 24 *The Investment Lawyer* 7 (2017); Julien Bourgeois, John O'Hanlon, Aaron Withrow, and Christine Schleppegrell, "Liquidity Risk Management and Swing Pricing: The SEC's New Rules and Rule Amendments," 24 *The Investment Lawyer* 2 (2017).

3 *See* SEC, "Investment Company Liquidity Risk Management Programs Frequently Asked Questions, Division of Investment Management" (Feb. 21, 2018) (FAQs), *available at https://www.sec.gov/investment/investment-company-liquidity-risk-management-programs-faq*. The FAQs also provide guidance on the definition of an "in-kind" exchange-traded fund (In-Kind ETF). For more information on the guidance on In-Kind ETFs, *see* "SEC Staff Issues Liquidity Rule Frequently Asked Questions," Dechert OnPoint, *https://info.dechert.com/10/10070/february-2018/sec-staff-issues-liquidity-rule-frequently-asked-questions.asp*. In addition, on February 21, 2018, the SEC Division of Investment Management issued a second set of FAQs providing guidance on liquidity classifications, reasonably anticipated trading sizes, compliance monitoring, reporting requirements and exchange-traded funds that do not qualify as In-Kind ETFs under the rule. *See* FAQs.

4 For example, the requirement to classify a fund's portfolio investments into one of four liquidity categories may require coordination (and in some cases, the resolution of differences) among a fund's program administrator, primary adviser, and sub-adviser, as well as any other third party responsible for liquidity classifications (*e.g.,* third-party model or data provider). This coordination may require substantial effort, particularly if there are differing views as to the liquidity of a particular portfolio investment.

5 *See also* adopting release, 81 Fed. Reg. at 82,213 n.810.

6 At least once a year, a fund's board, including a majority of independent board members, must review a written report detailing the operation of the fund's LRM program that is provided by the program administrator.

7 *See* FAQs*, supra,* n.3, at FAQ No. 1. FAQ No. 1 explicitly acknowledges that a fund's program administrator may delegate responsibilities under the fund's LRM program to third parties, including the fund's sub-adviser, "subject to appropriate oversight." The FAQs also make clear that a fund's LRM program should provide clear authority to the program administrator to delegate certain responsibilities, as well as any limitations or conditions on the ability to delegate these responsibilities.

8 The Staff explained in FAQ No. 6 that, if a fund's program administrator delegated responsibility to classify the liquidity of the fund's portfolio investments to *either* the fund's primary adviser or sub-adviser, "that entity's decisions would control how the fund classifies its investments." However, if a fund's program administrator delegated responsibility to classify the liquidity of the fund's portfolio investments to *both* the fund's primary adviser *and* sub-adviser, the Staff noted that a fund's LRM program "could address how the fund would resolve" any differing views on the liquidity of a particular portfolio investment. The Staff then provided the following "illustrative" examples of how a fund's LRM program could address these differing views: (1) identify the specific entity whose liquidity classifications control; (2) establish another method to determine which liquidity classification would control (*e.g.,* a factor analysis or hierarchy); or (3) adopt the most conservative (*i.e.,* least liquid) classification. *See id.*, *supra* n.3, at FAQ No. 6.

9 *See id.*, *supra* n.3, at FAQ Nos. 3 and 4.

10 The Staff noted, however, that a fund's LRM program could have a process for resolving these differences. Accordingly, for purposes of complying with a fund's HLIM or 15 percent limit on illiquid

investments, a multi-manager fund could potentially have holdings in a particular portfolio investment where a portion of that investment is classified in one liquidity category while another portion of that same investment is classified in a different liquidity category. For non-multi-manager funds, the rule does not permit liquidity classifications of *portions* of portfolio investments.

[11] *See id.*, *supra* n.3, at FAQ No. 9.

[12] *See* adopting release, 81 Fed. Reg. at 82,214.

[13] Rule 38a-1 generally requires funds to adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws, review those policies and procedures annually for their adequacy and the effectiveness of their implementation and designate a chief compliance officer to be responsible for administering the policies and procedures.

[14] *See Compliance Programs of Investment Companies and Investment Advisers*, 68 Fed. Reg. 74,714, 74,722 (Dec. 24, 2003).

[15] For purposes of this article, references to an investment adviser include a fund's chief compliance officer, which is usually an employee of the adviser.

[16] In FAQ No. 17, the Staff stated that policies and procedures must provide for a "reasonable framework" for identifying exceptions, and could include automated processes.

[17] The Staff emphasized in FAQ No. 24 that the program administrator should conduct "regular monitoring" of the fund's compliance with the HLIM and 15 percent requirements, which it deems "critical to the functioning of [the rule]." Specifically, the Staff noted its belief that a fund should account for different factors that impact the fund's compliance, including changes in the value or size of existing investments, the acquisition of new investments, and the reclassification of existing investments. The Staff noted in FAQ No. 28 that it would not object to procedures that limit the obligation to re-evaluate an investment's liquidity classification due to market, trading, or issuer-specific considerations to events that are "objectively determinable." The FAQ notes as examples of such events a trading halt or delisting of a security, issuer or counterparty default or bankruptcy, significant macro-economic developments, or natural disasters or political upheavals for funds with concentrated geographic exposures.

[18] The Staff stated in FAQ Nos. 30–31 that while a fund is not required to classify investments on a pre-trade basis, the fund should nevertheless implement policies and procedures reasonably designed to prevent violation of the 15 percent limit on illiquid investments. The Staff noted that one way this could be achieved is by limiting investments in certain predetermined asset classes that it reasonably believes to be illiquid. FAQ No. 31 includes a detailed discussion of the factors that the fund might consider in identifying such asset classes.