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SEC Proposes ETF Rule, Amends Liquidity Risk Reporting Rule and Requires Inline XBRL Reporting by Funds

SUMMARY

At an open meeting held on June 28, 2018, the Securities and Exchange Commission (SEC) voted, among other actions, to: (i) propose a rule and related form amendments under the Investment Company Act of 1940 that would permit exchange-traded funds that satisfy certain conditions to operate without first obtaining an exemptive order from the SEC; (ii) adopt amendments to Form N-PORT and Form N-1A related to liquidity risk management by open-end management investment companies (other than money market funds and small business investment companies); and (iii) adopt amendments to rules and forms to require the use of the Inline eXtensible Business Reporting Language (XBRL) format for submission of fund risk and return summary information.

New Exemptive Rule for Most Exchange-Traded Funds: The SEC voted unanimously to propose for comment a new rule and form amendments intended to modernize the regulatory framework for most exchange-traded funds (ETFs). Under the proposed rule, ETFs that satisfy certain conditions would be permitted to operate within the scope of the Investment Company Act of 1940 (the Investment Company Act) and participate in the market without applying for individual exemptive orders from the SEC. ETFs relying on the rule would need to comply with conditions that are generally consistent with the conditions in existing exemptive orders. The SEC is also proposing to "replace hundreds of individualized exemptive orders with a single rule," and rescind exemptive relief previously granted to an ETF if the ETF would be able to rely on proposed rule 6c-11 in order to "level the playing field among most ETFs and protect ETF

investors."[1] The SEC is seeking comment from the public on various aspects of the proposal; comments are due 60 days after publication of the proposal in the Federal Register.

Changes to Liquidity Risk Management Reporting Requirements for Certain Open-End Funds: The SEC voted 3-2 (Commissioners Stein and Jackson dissenting) to adopt rule and form amendments that would require certain funds to discuss in their annual or semiannual shareholder reports the operation and effectiveness of their liquidity risk management programs, which replaces a currently pending requirement that funds publicly disclose historical aggregate liquidity classification data for their portfolios through Form N-PORT. The SEC also adopted amendments that will permit a fund to attribute a percentage amount of a single portfolio holding into multiple liquidity categories in specified circumstances. The amendments will become effective on September 10, 2018.

Inline XBRL Requirements: The SEC voted 4-1 (Commissioner Pierce dissenting) to adopt amendments that would require the use of Inline XBRL for risk/return summaries submitted to the SEC by funds. The SEC also eliminated the requirement to post XBRL data on websites. The amendments will take effect in phases.

This memorandum summarizes key aspects of the SEC's package of approved and proposed rules. The discussion of Inline XBRL is limited to the principal aspects relevant to registered investment companies. For a discussion of the new Inline XBRL requirements for operating companies, please see our memorandum dated July 5, 2018, "SEC Adopts New Rules Affecting Public Company Reporting."

[1] Securities and Exchange Commission, Press Release 2018-118, *SEC Proposes New Approval Process for Certain Exchange-Traded Funds* (June 28, 2018).

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I. NEW APPROVAL PROCESS FOR MOST EXCHANGE-TRADED FUNDS

In its release titled "Exchange Traded Funds" (Release No. IC-33140; File No. S7-15-18), the SEC voted to propose a new rule under the Investment Company Act with the stated goal of "creat[ing] a consistent, transparent, and efficient regulatory framework for ETFs" and "facilitat[ing] greater competition and innovation among ETFs."[1] Under the proposed set of rules and form amendments, ETFs that satisfy certain conditions would be permitted to operate without obtaining an exemptive order from the SEC under the Investment Company Act. The specific proposals are as follows:

- **Proposed Rule 6c-11**: the new rule would create a consistent regulatory framework for ETFs by eliminating certain conditions that the SEC has previously included within its numerous individualized exemptive orders and by removing historical distinctions between actively managed and index-based ETFs.
- **Rescission of Certain ETF Exemptive Relief**: the SEC is proposing to (i) rescind exemptive relief previously granted to an ETF if the ETF would be able to rely on proposed rule 6c-11; (ii) rescind exemptive relief permitting ETFs to operate in a master-feeder structure; and (iii) grandfather existing master-feeder arrangements involving ETF feeder funds while preventing the formation of new ones.
- **Proposed Amendments to Forms N-1A and N-8B-2**: the proposed amendments would require ETFs to provide additional information on Form N-1A (the form for open-end management investment companies) and Form N-8B-2 (the form for unit investment trusts) to investors who purchase and sell ETF shares in the secondary markets, such as the bid-ask spread, and premiums and discounts from the ETF's net asset value (NAV); the requirement would apply equally to ETFs structured as registered open-end management investment companies or unit investment trusts.

A. BACKGROUND

The SEC first granted relief to permit an ETF to operate in 1992; today, there are more than 1,900 SEC-registered ETFs with aggregate net assets of $3.4 trillion, approximately 15% of total net assets of all registered investment companies.[2] ETFs have characteristics of both mutual funds, which issue redeemable securities, and closed-end funds, which generally issue shares that are not redeemable and that are listed on a national securities exchange and trade at market-determined prices. The creation and redemption processes of an ETF together with secondary market trading in ETF shares provide arbitrage opportunities designed to maintain the market price of ETF shares at or close to the NAV per share of the ETF.

ETFs currently operate as investment companies under the Investment Company Act in reliance on exemptions from certain provisions thereof,[3] with the SEC having granted over 300 exemptive orders to date.[4] The SEC first proposed rule 6c-11 under the Investment Company Act in 2008 to permit ETFs to

form and operate without the need to obtain individual exemptive relief; however, the SEC never acted on the 2008 proposal.

B. PROPOSED RULE 6c-11

1. Scope

Proposed rule 6c-11 would define an ETF as a registered open-end management investment company that (i) issues and redeems creation units to and from authorized participants in exchange for a basket of "securities, assets or other positions" and cash balancing amount, if any; and (ii) issues shares that are listed on a national securities exchange and traded at market-determined prices.[5]

The proposed rule would apply only to certain types of ETFs:

Type of ETF	Within Scope of Proposed Rule 6c-11?
ETFs organized as Open-End Management Investment Companies	Yes
ETFs organized as Unit Investment Trusts	No, but existing UIT ETFs will be grandfathered
Index-Based ETFs	Yes
Actively Managed ETFs	Yes
Leveraged ETFs	No. New leveraged ETFs may apply for an exemptive order
Share Class ETFs	No. New share class ETFs may apply for an exemptive order
Master-Feeder ETFs	No, but existing master-feeder ETFs will be grandfathered

a. Open-End Management Investment Companies

The proposed rule would apply only to ETFs organized as open-end management investment companies, and would not apply to those organized as UITs "given the limited sponsor interest in developing ETFs organized as UITs" and the different regulatory framework required by the unmanaged nature of UITs.[6] The SEC notes that most ETFs today are open-end management investment companies rather than UITs. ETFs organized as UITs would continue to operate under the terms and conditions in their exemptive orders.

b. Index-Based ETFs and Actively Managed ETFs

Proposed rule 6c-11 would provide exemptions for both index-based ETFs and actively managed ETFs, which the SEC considers to be similar in respect of operational matters despite their different investment

objectives or strategies.[7] The SEC believes that permitting index-based and actively managed ETFs to operate under the same rule would "provide a level playing field among those market participants," and would provide a more consistent and transparent regulatory framework.[8]

c. Leveraged ETFs

The proposed rule would not be available for leveraged ETFs, identified in the proposed rule as those that "seek, directly or indirectly, to provide returns that exceed the performance of a market index by a specified multiple or to provide returns that have an inverse relationship to the performance of a market index, over a fixed period of time" and that typically require a rebalancing of their portfolios on a daily basis.[9] The SEC states that this daily reset feature and the effects of compounding leveraged returns may result in performance significantly different from some investors' expectations.

d. Share Class ETFs

Proposed rule 6c-11 would not cover an ETF "structured as a share class of a fund that issues multiple classes of shares representing interests in the same portfolio."[10] Hence, the proposed rule would not provide any relief from sections 18(f)(1) or 18(i) of the Investment Company Act, nor would it expand the scope of rule 18f-3 under the Investment Company Act, which provides a limited exemption from sections 18(f)(1) and 18(i) by permitting registered open-end management investment companies or series or classes thereof to issue more than one class of voting stock.

ETFs seeking relief from sections 18(f)(1) or 18(i) are expected to do so through the SEC's exemptive application process, where the SEC can continue to weigh policy considerations in the context of the facts and circumstances of a particular applicant.

e. Master-Feeder ETFs

Although the SEC's exemptive orders have previously provided relief allowing ETFs to operate as feeder funds in a master-feeder structure, due to the lack of interest in this structure the SEC is proposing to rescind the master-feeder relief granted to ETFs that do not in fact rely on the relief as of the date of the proposal (June 28, 2018).[11] The SEC proposes to grandfather existing master-feeder arrangements involving ETF feeder funds, but prevent the formation of new ones by amending relevant exemptive orders.

2. Exemptive Relief Under Proposed Rule 6c-11

Consistent with prior exemptive orders, proposed rule 6c-11 would provide exemptions to ETFs within its scope from certain provisions of the Investment Company Act. Specifically, the rule would permit an ETF meeting the conditions of the proposed rule to:

- redeem shares only in creation unit aggregations;

- issue shares to be purchased and sold at market prices rather than at NAV per share;
- engage in in-kind transactions with certain affiliates; and
- in certain limited circumstances, pay authorized participants the proceeds from the redemption of shares in more than seven days.

a. Treatment of ETF Shares as "Redeemable Securities"

Under the proposed rule, an ETF would be considered to issue "redeemable securities" within the meaning of section 2(a)(32) of the Investment Company Act and regulated as an open-end fund within the meaning of section 5(a)(1) of the Investment Company Act.[12] Therefore, the rules under the Securities Exchange Act of 1934 (the Exchange Act) that apply to redeemable securities would apply to ETFs relying on proposed rule 6c-11. Consequently, ETFs relying on the proposed rule would be eligible for (i) the "redeemable securities" exceptions under rules 101(c)(4) and 102(d)(4) of Regulation M and rule 10b-17(c) under the Exchange Act in connection with secondary market transactions in ETF shares and the creation or redemption of creation units, and (ii) the exemption for a "registered open-end investment company" in rule 11d1-2 under the Exchange Act.[13]

b. Trading of ETF Shares at Market-Determined Prices

Section 22(d) of the Investment Company Act prohibits investment companies from selling a redeemable security to the public at a price different from the current public offering price in the prospectus. Rule 22c-1 requires dealers to sell, redeem, or repurchase a redeemable security only at a price based on its NAV.

Consistent with prior exemptive orders, proposed rule 6c-11 would provide exemptions from section 22(d) and rule 22c-1 to allow investors to purchase and sell individual ETF shares on the secondary market at market-determined prices that may be different from the price in the prospectus or based on NAV.[14] The SEC believes exemptions from these provisions are appropriate because the arbitrage mechanism already addresses the concerns of shareholder dilution and unjust discrimination behind these provisions.

c. Affiliated Transactions

Section 17(a) of the Investment Company Act prohibits purchases and redemptions of ETF creation units by affiliated persons of ETFs.[15]

Consistent with prior exemptive orders, the proposed rule would provide an exemption from sections 17(a)(1) and 17(a)(2) of the Investment Company Act with regard to the deposit and receipt of baskets to affiliated persons of an ETF "solely by reason of: (i) holding with the power to vote 5% or more of an ETF's shares; or (ii) holding with the power to vote 5% or more of any investment company that is an affiliated person of the ETF."[16]

This relief is intended promote the arbitrage mechanism and reduce concentration risk by allowing a greater pool of market participants to engage in arbitrage using in-kind baskets. However, in light of the fact that proposed rule 6c-11 would provide additional flexibility by allowing an ETF to use custom baskets (*see infra* Section I.B.3.e), thereby increasing the possibility of different treatments for affiliates and non-affiliates in terms of an ETF's receipt and delivery of baskets, the SEC is not proposing to cover additional types of affiliated relationships, such as broker-dealers affiliated with an ETF.[17]

d. Additional Time for Delivering Redemption Proceeds

Section 22(e) of the Investment Company Act prohibits open-end funds from paying redemption proceeds more than seven days after the tender of their shares for redemption.

Proposed rule 6c-11 would grant relief from section 22(e) to permit an ETF to delay satisfaction of a redemption request if "a local market holiday, or series of consecutive holidays, the extended delivery cycles for transferring foreign investments to redeeming authorized participants, or the combination thereof prevents timely delivery of the foreign investment included in the ETF's basket."[18] An ETF relying on the exemption would need to deliver foreign investments as soon as practicable, but not later than 15 days after the tender to the ETF of one or more creation units of its shares for redemption.

The SEC is proposing to include a sunset provision in the rule, so that it would expire ten years from the rule's effective date, owing to technological innovation and changes in market infrastructures and operations that are expected to lead to shorter settlement cycles.

3. Conditions for Reliance on Proposed Rule 6c-11

ETFs would be required to comply with various specified conditions in order to rely on the exemptive relief provided by proposed rule 6c-11. These conditions are generally consistent with those in prior exemptive orders, which the SEC believes have "effectively accommodated the unique structural and operational features of ETFs while maintaining appropriate protections for ETF investors."[19]

a. Issuance and Redemption of Shares

Consistent with prior exemptive orders, proposed rule 6c-11 would require ETFs to "issue (and redeem) creation units to (and from) authorized participants in exchange for baskets and a cash balancing amount (if any)."[20] The SEC intends for this condition to promote the ETF share issuance and redemption process that is important for the arbitrage mechanism.

- **Authorized Participant**. Proposed rule 6c-11 would define an "authorized participant" as "a member or participant of a clearing agency registered with the [SEC], which has a written agreement with the ETF or one of its service providers that allows the authorized participant to place orders for the purchase and redemption of creation units."[21]

- **Creation Units**. Proposed rule 6c-11 would define "creation unit" as "a specified number of ETF shares that the ETF will issue to (or redeem from) an authorized participant in exchange for the deposit (or delivery) of a basket and a cash balancing amount (if any)."[22] Under the proposed rule, an ETF would generally issue and redeem shares only in creation unit aggregations, but would be permitted to sell or redeem individual shares in limited circumstances, such as on the day of consummation of a reorganization, merger, conversion or liquidation.

- **Suspension of Issuance and Redemption**. Proposed rule 6c-11 would allow an ETF to suspend "the redemption of creation units only in accordance with section 22(e) of the Investment Company Act, and an ETF may charge transaction fees on creation unit redemptions only in accordance with rule 22c-2."[23] The SEC believes that an ETF may suspend the issuance of creation units "only for a limited time and only due to extraordinary circumstances," such as market closures, and that it should not be able to set transaction fees so high as to effectively suspend the issuance of creation units.[24]

b. Listing on a National Securities Exchange

Consistent with prior exemptive orders, proposed rule 6c-11 would only cover ETFs that issue shares "listed on a national securities exchange and traded at market-determined prices."[25] Listing shares for trading on a national securities exchange is a fundamental characteristic of ETFs. This definition excludes an ETF that is suspended or delisted from a national securities exchange.

c. Intraday Indicative Value

Departing from exchange listing standards and prior exemptive orders, proposed rule 6c-11 would not require the dissemination of an ETF's intraday estimate of its NAV per share, or intraday indicative value (IIV).[26] The SEC believes that the IIV is no longer used by market participants when conducting arbitrage trading, and may not represent the actual value of an ETF if its securities are traded less frequently. Proposed rule 6c-11 would instead condition its relief on the daily disclosure of portfolio holdings.

d. Daily Portfolio Transparency

The SEC believes that daily portfolio transparency is important for the arbitrage mechanism of ETFs. The SEC's prior exemptive orders have generally required ETFs to provide either full or partial portfolio transparency, yet the SEC observes in the release that as a practical matter all ETFs provide full portfolio transparency.[27]

- **Website Disclosure**. Proposed rule 6c-11 would require an ETF to "disclose prominently on its website … the portfolio holdings that will form the basis for each calculation of NAV per share" to be made "each business day before the opening of regular trading on the primary listing exchange of the ETF's shares and before the ETF starts accepting orders for the purchase or redemption of creation units."[28] Departing from the 2008 proposal, the SEC is proposing a full transparency requirement for all ETFs without distinguishing between index-based ETFs or actively managed ETFs.

- **Disclosure of Securities, Assets or Other Investment Positions**. Proposed rule 6c-11 would require an ETF to disclose on its website all portfolio holdings forming the basis of the ETF's next calculation of NAV per share, intended to cover an ETF's securities, assets or other positions including its cash holdings, short positions and written options.[29] To standardize disclosure, the proposed rule would require that "portfolio holdings information be presented and contain information regarding description, amount, value and/or unrealized gain/loss (as applicable) in the manner prescribed within Article 12 of Regulation S-X, which sets forth the form and content of fund financial statements."[30]

e. Baskets

Proposed rule 6c-11 would require ETFs within its scope to "adopt and implement written policies and procedures" that cover the methodology used to construct and accept baskets.[31] The rule would also give ETFs flexibility to use custom baskets if they adopt further policies and procedures that provide detailed parameters for such baskets.[32]

- **Basket Flexibility**. Exemptive orders since approximately 2006 have required that an ETF's basket generally correspond *pro rata* to its portfolio holdings with limited exceptions. However, proposed rule 6c-11 would provide additional basket flexibility and apply the same standards to all ETFs relying on the rule.[33] Moreover, in light of the increased risks presented by custom baskets, proposed rule 6c-11 would require an ETF using custom baskets to (i) adopt policies and procedures that are in the best interest of the ETF and its shareholders, including any processes for revisions to, or deviation from, those parameters, and (ii) specify the titles or roles of the employees of the ETF's investment adviser that reviews such baskets for compliance purposes.[34] The SEC believes that the ETF's board of directors' oversight of the ETF's compliance policies and procedures, as well as its general oversight of the ETF, would provide an additional layer of protection.

- **Posting of a Published Basket**. Proposed rule 6c-11 would require an ETF to prominently disclose on its website at the beginning of each business day information relating to a published basket and estimated cash balancing amount.[35] Specifically, an ETF would need to publish one basket that it would exchange for orders to purchase or redeem creation units to be priced based on the ETF's next calculation of NAV per share each business day.

f. Website Disclosure

Proposed rule 6c-11 would require an ETF to disclose on its website the following information:

- the ETF's daily NAV, market price, and premium or discount, each as of the end of the prior business day;[36]

- the median bid-ask spread for the ETF's most recent fiscal year (this information would also be required to be disclosed in its prospectus);[37] and

- historical information regarding the ETF's premiums and discounts if over 2% for more than seven consecutive trading days, and a discussion of the factors reasonably believed to have contributed to the premium or discount. [38]

g. Marketing

Proposed rule 6c-11 would not contain the marketing requirements that have been a condition of ETF exemptive orders; for example, there will be no requirement that an ETF identify itself in sales literature as an ETF that does not sell or redeem individual shares, or that the ETF explain that investors may purchase or sell individual ETF shares through a broker via a national securities exchange.[39]

4. Recordkeeping

Proposed rule 6c-11 would expressly require an ETF relying on the rule to preserve and maintain copies of all written agreements between the ETF (or its relevant service provider(s)) and authorized participants permitted to purchase or redeem creation units directly from the ETF, as well as any information regarding the baskets exchanged with authorized participants for at least five years (the first two years in an easily accessible place).[40]

C. EFFECT ON PRIOR EXEMPTIVE ORDERS

The SEC is proposing to amend and rescind exemptive orders previously issued to ETFs that would be permitted to rely on proposed rule 6c-11. The SEC is proposing to rescind only the "portions of an ETF's exemptive order that grant relief related to the formation and operation of an ETF" and would not rescind relief from section 12(d)(1) or sections 17(a)(1) and (a)(2) under the Investment Company Act related to fund of funds arrangements involving ETFs.[41] The SEC further would not rescind any exemptive relief of ETFs that would not be permitted to rely on proposed rule 6c-11. In order to provide time for ETFs to transition to the new rule, the SEC is proposing to amend existing orders to provide that the relief contained therein would terminate one year following the effective date of any final rule.

D. AMENDMENTS TO FORM N-1A, FORM N-8B-2, AND FORM N-CEN

The SEC is proposing various revisions to Form N-1A, Form N-8B-2, and Form N-CEN to reflect proposed rule 6c-11.

II. AMENDMENTS TO LIQUIDITY DISCLOSURE REQUIREMENTS

In its release titled "Investment Company Liquidity Disclosure" (Release No. IC-33142; File No. S7-04-18), the SEC adopted amendments under the Investment Company Act relating to liquidity risk reporting requirements for registered open-end management investment companies and ETFs (regardless of whether they are organized as management investment companies or UITs), but excluding money market funds and small business investment companies (hereinafter, a "fund"), through Form N-PORT and Form N1-A.

A. BACKGROUND

In October 2016, the SEC adopted rule 22e-4 and new Form N-PORT under the Investment Company Act. Rule 22e-4 requires a fund to adopt a written liquidity risk management program "reasonably designed to assess and manage the fund's liquidity risk," and the program must classify each of the fund's portfolio investments into one of four investment categories: (i) highly liquid, (ii) moderately liquid, (iii) less liquid, or (iv) illiquid.[42] The rule further requires: a highly liquid investment minimum; restrictions on the amount of illiquid investments a fund may purchase; review and oversight of the liquidity risk management program by the fund's board of directors; and recordkeeping. Funds are required to file a monthly portfolio report with the SEC on a confidential basis through Form N-PORT to disclose the liquidity categorization of each of the fund's portfolio investments, indicating the aggregate percentage of a fund's portfolio in each category. Information reported for the third month of each fiscal quarter on Form N-PORT would be made publicly available 60 days after the end of the fiscal quarter.[43]

B. OVERVIEW OF CHANGES TO FORM N-PORT

The following chart summarizes the changes that have been made to the liquidity risk management disclosure framework:

2016 Rules	New Rules
Through Form N-PORT, a fund must publicly disclose on a ***quarterly basis*** the ***aggregate percentages*** of a fund's investment portfolios assigned to each of the four liquidity categories pursuant to rule 22e-4.	On the fund's annual shareholder report, a fund must provide on an ***annual or semiannual basis*** a ***narrative discussion*** of the operation of the fund's liquidity risk management program for the most recent fiscal year.
On Form N-PORT, a fund must disclose ***a single*** liquidity classification for each investment portfolio holding.	On Form N-PORT, a fund may report a single portfolio holding in ***multiple*** liquidity classifications in three specified circumstances where splitting would provide more accurate disclosure.
Cash holdings are not reported.	On Form N-PORT, a fund must disclose the amount of ***cash and cash equivalents*** not reported in Parts C and D thereof.

C. ELIMINATION OF PUBLIC REPORTING OF AGGREGATE LIQUIDITY INFORMATION

The SEC amended Item B.8 of Form N-PORT to eliminate the requirement that funds publicly disclose the aggregate percentage of its investments assigned to each liquidity category.

The SEC indicated that using aggregate liquidity information without a full explanation of the "underlying subjectivity, model risk, methodological decisions, and assumptions that shape this information" could be misleading to investors.[44] The SEC further expressed concern that this could create incentives for funds to "classify investments as more liquid and … inappropriately highlight liquidity risk compared to other, potentially more salient risks of the fund."[45] At the same time, the SEC rejected amending Form N-PORT

to require the significant level of detail and narrative context that the SEC believes would be necessary for investors to more fully appreciate a fund's liquidity risk profile and the subjective nature of its categorization, as this would undermine the form's very purpose. Instead, the SEC judged that effective disclosure would be better achieved through prospectus and shareholder report disclosure than through Form N-PORT.

D. ANNUAL OR SEMIANNUAL SHAREHOLDER REPORT DISCLOSURE

In conjunction with eliminating the requirement for public disclosure of aggregate liquidity information through Form N-PORT, the SEC amended Form N-1A to require funds to briefly discuss the operation and effectiveness of a fund's liquidity risk management program in a new section of the fund's annual or semi-annual shareholder report.[46]

Rule 22e-4(b)(2) requires a fund's board of directors to review at least once a year a written report prepared by the person designated to administer the liquidity risk management program of the fund that "addresses the operation of the program and its adequacy and effectiveness," including, if applicable, the operation of the highly liquid investment minimum and any material changes to the program."[47] Form N-1A sets out the information that funds are required to include in their shareholder reports.

Under amended Form N-1A, only liquidity events that materially affect a fund's performance must be disclosed in the Management Discussion of Fund Performance section (MDFP) of the shareholder report. The SEC decided to move liquidity risk disclosure outside of the MDFP "because this information does not directly relate to performance results," and doing so "would avoid concerns about unduly focusing investors on liquidity risk and diluting the MDFP."[48] By moving this disclosure to a new section on Form N-1A that may be included in either a fund's annual or semi-annual shareholder report (compared to the MDFP which is included only in annual reports), the SEC believes that funds can better "synchronize the required annual board review of liquidity risk management programs with the production of this discussion in the shareholder report, reducing costs and allowing funds to provide more effective disclosure."[49]

The SEC is not providing an exemption from the new narrative disclosure requirement for funds that primarily hold assets that are highly liquid investments or for ETFs that create and redeem their shares on an in-kind basis.[50] The SEC noted that investors stand to benefit from such disclosure, even though these funds "may face fewer, or different liquidity risks than other funds, and thus the discussion … may be proportionate or different than for other funds."[51]

Under the new requirement, a fund may elect to provide the same information provided to its board of directors about the operation and effectiveness of the liquidity risk management program during the previous fiscal year. Such discussions may, but are not required to, cover:

- the role of the classification process;
- the 15% illiquid investment limit;
- the highly liquid investment minimum;
- particular liquidity risks or challenges faced during the past fiscal year, for example, significant redemptions, or changes in the overall market liquidity of the investments held by the fund; and
- other contextual and supplemental information about the fund's liquidity risk management process, for example, empirical data metrics such as the fund's bid-ask spreads, portfolio turnover, or shareholder concentration issues.[52]

E. MULTIPLE CLASSIFICATION CATEGORIES

The SEC amended Item C.7 of Form N-PORT to allow a fund to attribute a percentage amount of a single holding to multiple liquidity categories in the following specific instances:

1. if portions of a fund's portfolio have different liquidity-affecting features that may justify treating the holding as two or more separate investments for liquidity classification purposes, taking into account a reasonable anticipation of the trade size for each portion;[53]
2. if a fund has a numerous sub-advisers managing different portions of its portfolio who hold different views on the liquidity classification of the single holding with such multiple portions, taking into account a reasonable anticipation of the trade size for each portion; or
3. if a fund classifies its holdings based on the assumed full liquidation of the entire position.

The SEC noted that the requirement to classify each holding into a single classification category "poses difficulties for certain holdings and may not accurately reflect the liquidity of that holding, or be reflective of the liquidity management practices of the fund."[54] The SEC believes that permitting split-reporting under the specified circumstances will allow for a more precise view of the liquidity of these securities, especially as funds will be required to indicate which circumstance led them to split-report the classification categories.[55] Under new Item C.7.b of Form N-PORT, a fund opting to attribute multiple categories to a holding must note which of the three specified circumstances led the fund to do so.

F. DISCLOSURE OF CASH AND CASH EQUIVALENTS NOT ELSEWHERE REPORTED ON FORM N-PORT

The SEC amended Form N-PORT to add new Item B.2.f, which requires funds to publicly disclose on a quarterly basis the amount of cash and cash equivalents held but not reported in Part C (Schedule of Portfolio Investments) and Part D (Miscellaneous Securities) of Form N-PORT.[56] While cash would be classified as a highly liquid investment under rule 22e-4 and would have been included under the former requirement for aggregate liquidity disclosure, this new disclosure on cash and cash equivalents is intended to provide more complete information in analyzing a fund's compliance with the highly liquid investment minimum as well as to allow monitoring of trends such as net inflows and outflows. However,

to avoid double-counting items more appropriately reported in Part C or Part D, the new requirement will only apply to cash and cash equivalents not reported in those sections.

G. COMPLIANCE DATES

The SEC provided a tiered set of compliance dates based on asset size, with compliance dates set such that funds have at least one year's experience with operating their liquidity risk management program before providing narrative disclosure in their shareholder reports.

	Compliance Date	First Filing Date
FORM N-PORT		
Larger Entities (group NAV ≥ $1B)[57]	Jun 1, 2019	July 30, 2019
Smaller Entities (group NAV < $1B)	March 1, 2020	April 30, 2020
FORM N-1A		
Larger Entities	December 1, 2019	Firms distributing shareholders reports after the compliance dates would be subject to the new requirement.
Smaller Entities	June 1, 2020	

H. TREASURY ASSET MANAGEMENT REPORT AND EVALUATION OF OTHER APPROACHES

In 2017, the U.S. Department of Treasury published the "Asset Management and Insurance Report" that recommended the SEC to embrace a "principles-based" approach to liquidity risk management rulemaking.[58] After receiving comments both in support and against such an approach, the SEC continues to solicit feedback on the new liquidity framework and to "analyze the extent to which the liquidity classification process and data" are achieving the SEC's goals.[59] The SEC has requested public feedback on the following topics, among others:

- the costs and benefits of the classification requirements of rule 22e-4;
- the extent that investors and others benefit from public liquidity classification information, and potential alternative types of information that could be provided; and
- whether or not the SEC should move towards a more principles-based approach, and the principles underpinning such approach.

I. COMMISSIONER REACTIONS

At the open meeting held on June 28, 2018, the two Democratic Commissioners issued dissenting statements. Commissioner Kara M. Stein referred to the new rules as a "rollback of public disclosure" and commented that, in her view, the SEC should have first observed how the originally proposed framework, which had been unanimously approved, would have worked before eliminating the

requirement for public disclosure of basic liquidity information to investors.[60] Commissioner Stein also expressed displeasure at the notion of possibly moving to "a more principles-based approach" that may invite greater discretion in complying with the rules.[61] Commissioner Robert J. Jackson, Jr. also commented that the adopted rules seemed to him to be based on "the bizarre claim that investors might find information about liquidity so confusing that we serve them best by keeping the information secret," and that the SEC's rulemaking creates uncertainty for market participants who have already made significant investments in the liquidity classification framework.[62]

III. INLINE EXTENSIBLE BUSINESS REPORTING LANGUAGE REQUIREMENTS FOR FUNDS

In its release titled "Inline XBRL Filing of Tagged Data" (Release No. 33-10514; File No. S7-03-17), the SEC adopted amendments to require the use of the Inline eXtensible Business Reporting Language (XBRL)[63] format for the submission of financial statement information and fund risk/return summaries; to eliminate the 15 business day XBRL filing period for fund risk/return summaries; and to eliminate the requirement for funds to post XBRL data on their websites.[64] The amendments also eliminated the SEC's voluntary program for the submission of interactive financial data. The amendments do not affect the categories of filers or scope of disclosures subject to XBRL requirements.

A. BACKGROUND

XBRL requirements currently apply to funds pursuant to Form N-1A and related rules under Regulation S-T.[65] In 2009, the SEC adopted rules requiring funds to submit risk/return summary information in XBRL format as exhibits to registration statements and prospectuses,[66] and to publish the same Interactive Data File (IDF) on their website.

On March 1, 2017, the SEC issued for comment proposals to improve the quality and usefulness of XBRL data and to decrease XBRL preparation costs in its release titled "Inline XBRL Proposing Release".[67]

B. FINAL AMENDMENTS

1. Inline XBRL Requirements

Under the final amendments to rule 405, funds will be required to submit risk/return summary information in XBRL format.[68] The XBRL format allows funds to embed data directly into an HTML document, which eliminates the need to tag a copy of the information in a separate exhibit; funds must include contextual information about the XBRL tags embedded in the filing as an exhibit to the HTML document. Further, funds will remain subject to rule 405(c) which provides data quality requirements on IDF submissions.[69]

The SEC adopted rule changes to permit funds to submit IDFs concurrently with certain post-effective amendments to registration statements and to eliminate the 15 business day filing period for the submission of risk/return summaries.[70]

Related Official Filing	Timing of IDF Submission
Post-effective amendments filed pursuant to paragraphs (b)(1)(i), (ii), (v), or (vii) of rule 485	IDF must be filed either: (1) concurrently with the filing; or (2) in a subsequent amendment that is filed on or before the date that the post-effective amendment that contains the related information becomes effective.[71]
Initial registration statements and **post-effective amendments** filed other than pursuant to paragraphs (b)(1)(i), (ii), (v), or (vii) of rule 485	IDF must be filed in a subsequent amendment on or before the date the registration statement or post-effective amendment that contains the related information becomes effective.[72]
Any **form of prospectus** filed pursuant to rule 497(c) or (e)	IDF must be submitted concurrently with the filing.[73]

The SEC expects that these amendments will allow risk/return summary information to reach investors more quickly than it currently does, as the XBRL format allows investors to view the embedded data within the context of the related official filing as an integrated, single-document without having to download the information into separate applications.[74]

The SEC extended the phase-in period in order to provide funds with additional time to transition to XBRL format and to adjust to the elimination of the filing period, as summarized in the table below.

Funds	Compliance Date
Funds in groups with net assets of $1 billion or greater as of the end of the most recent fiscal year[75]	Any initial registration statement (or post-effective amendment that is an annual update to an effective registration statement) that becomes effective on or after ***two*** years after the effective date of the amendments.
All other funds	Any initial registration statement (or post-effective amendment that is an annual update to an effective registration statement) that becomes effective on or after ***three*** years after the effective date of the amendments.

The amendments permit funds to file using XBRL format prior to the applicable compliance date; funds can do so after the EDGAR system has been modified accordingly to accept such submissions, anticipated to be completed by March 2019.

2. Elimination of the Website Posting Requirements and 2005 XBRL Voluntary Program

The requirement for funds to post XBRL data on their websites will be eliminated upon the effective date of the amendments in light of the fact that users can obtain reliable access through EDGAR.[76] The 2005 XBRL Voluntary Program for financial statement information interactive data will similarly be terminated as of the effective date given its very infrequent use.[77]

3. Technical Amendments

The SEC adopted certain conforming changes consistent with the amendment in format to the IDF, elimination of the website posting requirements, and termination of the 2005 XBRL Voluntary Program.

* * *

ENDNOTES

[1] Securities and Exchange Commission, Release No. IC-33140; File No. S7-15-18, *Exchange Traded Funds* (June 28, 2018) ("ETF Release"), at 6.

[2] *Id*.

[3] *Id*., at 6, 9 (explaining that ETFs have been historically organized as open-end funds or UITs under the Investment Company Act). *See* 15 U.S.C. §80a-5(a)(1) (defining the term "open-end company") and 15 U.S.C. §80a-4(2) (defining the term "unit investment trust").

[4] *Id., at 6.*

[5] *Id.,* at 16, citing proposed rule 6c-11(a) (defining "exchange-traded fund"). Under the proposed rule, the term "basket" would be defined to mean the securities, assets, or other positions in exchange for which an ETF issues (or in return for which it redeems) creation units. The term "exchange-traded fund" thus would include ETFs that transact on an in-kind basis, on a cash basis, or both.

[6] *Id.,* at 19. A UIT is defined as an investment company organized under a trust indenture or similar instrument that issues redeemable securities, each of which represents an undivided interest in a unit of specified securities. A UIT has a fixed life – a termination date for the trust is established upon its creation. *Id*., at 17.

[7] *Id.,* at 24.

[8] *Id.,* at 26.

[9] *Id.,* at 28-29.

[10] *Id*., at 138.

[11] *Id*., at 141.

[12] *Id.*, at 37.

[13] *Id*., at 39.

[14] *Id.,* at 41.

[15] *Id.*, at 50 (citing 15 U.S.C. §80a-2(a)(3)(A), (B) and (C)). An affiliated person of an ETF includes, among others: (i) any person directly or indirectly owning, controlling, or holding with power to vote, 5% or more of the outstanding voting securities of the ETF; (ii) any person 5% or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote by the ETF; and (iii) any person directly or indirectly controlling, controlled by, or under common control with the ETF.

[16] *Id*., at 51.

[17] Id., at 53.

[18] *Id*., at 55. A "foreign investment" under proposed rule 6c-11 would be defined as "any security, asset or other position of the ETF issued by a foreign issuer (as defined by rule 3b-4 under the Exchange Act) for which there is no established U.S. public trading market (as that term is used in Regulation S-K under the Securities Act)." *Id*., 58-59. The relief from the requirements of section 22(e) would not affect any obligations arising under rule 15c6-1 under the Exchange Act, which requires that most securities transactions be settled within two business days of the trade date. *Id*., at 55 n.152 (citing 17 CFR §240.15c6-1).

[19] *Id*., at 62.

[20] *Id*., citing proposed rule 6c-11(a).

[21] *Id*., at 63, citing proposed rule 6c-11(a). This definition differs from the definition of "authorized participant" recently adopted by the SEC in connection with Form N-CEN, which defines the term as a broker-dealer that is also a member of a clearing agency registered with the SEC or a Depository Trust Company participant and has a written agreement with the ETF or one of its service providers that allows the authorized participant to place orders to purchase and redeem

creation units of the ETF. The proposed definition also differs from the definition in the SEC's prior exemptive orders and Form N-CEN as it does not include "a specific reference to an authorized participant's participation in DTC since DTC is itself a clearing agency." The SEC is proposing a corresponding amendment to Form N-CEN. *Id*. at 63-64.

22 *Id*., at 64, citing proposed rule 6c-11(a). While the SEC recognizes that creation unit sizes are important, it does not find it necessary to propose an express requirement that "an ETF establish creation unit sizes reasonably designed to facilitate arbitrage." *Id*., at 64-65.

23 *Id*., at 67.

24 *Id*.

25 *Id*., at 70, citing proposed rule 6c-11(a).

26 *Id*., at 72.

27 *Id*., at 77-80.

28 *Id*., at 77, citing proposed rule 6c-11(c)(1)(i)(A). In addition, the proposed rule would require the portfolio holdings that form the basis of the calculation to be the ETF's portfolio holdings as of the close of business on the prior business day.

29 *Id*., at 82-83.

30 *Id*., at 83, citing 17 CFR §§ 210.12-12, 12-12A, 12-13, 12-13A, 12-13B, 12-13C, and 12-13D.

31 *Id*., at 88.

32 *Id*. Proposed rule 6c-11 defines two types of "custom baskets" – first, baskets that are "composed of a non-representative selection of the ETF's portfolio holdings," and second, "different baskets used in transactions on the same business day." *Id*., at 95-96, citing proposed rule 6c-11(a).

33 *Id*., at 94.

34 *Id*., at 96-98.

35 *Id*., at 103.

36 *Id*., at 109, citing proposed rule 6c-11(c)(1)(ii). Proposed rule 6c-11 would define the term "market price" to mean: (i) the official closing price of an ETF share; or (ii) if it more accurately reflects the market price of an ETF share at the time as of which the ETF calculates current NAV per share, the price that is the midpoint of the national best bid and national best offer, calculated as of the time NAV per share is calculated. *Id*. at 109-110. Further, the SEC is proposing to amend Form N-1A to remove a definition of market price that differs from the above definition. *Id*., at 111.

37 *Id*., at 115.

38 *Id*., at 116-20. In order to eliminate potentially duplicative disclosure requirements, the SEC is proposing to eliminate similar requirements in Item 11(g)(2) and Item 27(b)(7)(iv) of Form N-1A. Such information would need to be maintained on the website for at least one year following its posting. *Id*., at 118-19.

39 *Id*., at 130-31.

40 *Id*., at 134. Specifically, the proposed rule would require an ETF to maintain records setting forth the following information for each basket exchanged with an authorized participant: (i) name and quantity of the positions constituting the basket; (ii) identification of the basket as a "custom basket" and a record of its compliance with the ETF's policies; (iii) cash balancing amounts; and (iv) the identity of the authorized participant. *Id*.

41 *Id*., at 143.

42 17 CFR § 270.22e-4.

43 Securities and Exchange Commission, Release No. 33-10231; File No. S7-08-15, *Investment Company Reporting Modernization* (October 13, 2016), at 145.

ENDNOTES (CONTINUED)

44 Securities and Exchange Commission, Release No. IC-33142; File No. S7-04-18), *Investment Company Liquidity Disclosure* (June 28, 2018) ("Liquidity Disclosure Release"), at 11.

45 Liquidity Disclosure Release, at 12.

46 New Item 27(d)(7)(b) of Form N-1A.

47 Liquidity Disclosure Release, at 14.

48 *Id*., at 16.

49 *Id*.

50 Rule 22e-4 defines "In-Kind ETF" as an exchange-traded fund that meets redemptions through in-kind transfers of securities, positions and assets other than a *de minimis* amount of cash and that publishes its portfolio holdings daily. Rule 22e-4(a)(9).

51 Liquidity Disclosure Release, at 18.

52 *Id*., at 18-19.

53 The SEC lists as examples: (i) "a fund might hold an asset that includes a put option on a percentage (but not all) of the fund's holding of the asset"; and (ii) "a fund might have purchased a portion of an equity position through a private placement that makes those shares restricted (and therefore illiquid) while also purchasing additional shares of the same security on the open market." *See* Liquidity Disclosure Release at 21, fn. 77, 78.

54 Liquidity Disclosure Release, at 20.

55 *Id*., at 25-26.

56 The SEC cites the U.S. generally accepted accounting principles definition of cash equivalents: "short-term, highly liquid investment that … are … [r]eadily convertible to known amounts of cash … [and that are] [s]o near their maturity that they present insignificant risk of changes in value because of changes in interest rates." Liquidity Disclosure Release, at 28.

57 The SEC defines "larger entities" as funds that, together with other investment companies in the same "group of related investment companies," have net assets of $1 billion or more as of the end of its most recent fiscal year, and "smaller entities" as funds that, together with other investment companies in the same group of related investment companies, have net assets of less than $1 billion as of the end of its most recent fiscal year. *See* Investment Company Liquidity Risk Management Programs, Investment Company Act Release No. 32315 (Oct. 13, 2016) [81 FR 82142 (Nov. 18, 2016)], at n. 997.

58 U.S. Department of the Treasury, *A Financial System That Creates Economic Opportunities: Asset Management and Insurance* (Oct. 26, 2017), *available at* https://home.treasury.gov/news/featured-stories/a-financial-system-that-creates-economic-opportunities-asset-management-and; *see also* U.S. Department of the Treasury, *A Financial System That Creates Economic Opportunities: Asset Management and Insurance Fact Sheet* (Oct. 26, 2017), *available at* https://www.treasury.gov/press-center/press-releases/Documents/Asset_Management_and_Insurance_Fact_Sheet.pdf; Sullivan & Cromwell LLP, *U.S. Treasury Report on Asset Management and Insurance Industry Regulation* (November 2, 2017), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_US_Treasury_Report_on_Asset_Management_and_Insurance_Industry_Regulation.pdf.

59 Liquidity Disclosure Release, at 31.

60 Securities and Exchange Commission Open Meeting on June 28, 2018, archived webcast *available at* https://www.sec.gov/video/webcast-archive-player.shtml?document_id=062818openmeeting .

61 *Id.*

62 *Id.*

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ENDNOTES (CONTINUED)

International. *See* https://specifications.xbrl.org/spec-group-index-inline-xbrl.html (retrieved June 20, 2018) and https://specifications.xbrl.org/presentation.html (retrieved June 20, 2018).

64 Securities and Exchange Commission, Release No. 33-10514, File No. S7-03-17, *Inline XBRL Filing of Tagged Data* (June 28, 2018) ("Inline XBRL Filing Release").

65 *See* General Instruction C.3.(g) to Form N-1A; rule 405 of Regulation S-T.

66 *See* Securities and Exchange Commission, Release No. 33-9006, File No. S7-12-08, *Interactive Data for Mutual Fund Risk/Return Summary* (Feb. 11, 2009), as corrected by Release No. 33-9006A (May 1, 2009); General Instruction C.3.(g)(i), (ii), and (iv) to Form N-1A.

67 Securities and Exchange Commission, Release No. 33-10323, File No. S7-03-17, *Inline XBRL Filing of Tagged Data* (Mar. 1, 2017).

68 *See* new rule 405(a)(3)(ii) of Regulation S-T.

69 17 CFR 232.405(c)(1).

70 *See* new General Instruction C.3.(g) to Form N-1A; *see also* new rule 405(a)(3)(ii) of Regulation S-T.

71 *See* new General Instruction C.3.(g)(i)(B) to Form N-1A.

72 *See* new General Instruction C.3.(g)(i)(A) to Form N-1A.

73 *See* new General Instruction C.3.(g)(ii) to Form N-1A.

74 Inline XBRL Filing Release, at 32.

75 The SEC defines "fund groups" as "groups of related investment companies" consisting of funds and other investment companies. The term "group of related investment companies" has the same meaning as the term in rule 0-10 under the Investment Company Act. Rule 0-10 defines the term as applied to management investment companies as 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. 17 CFR 270.0-10(a)(1). *See* Inline XBRL Filing Release, at 3 n.1.

76 Inline XBRL Filing Release, at 54. Website posting is currently required by rule 405(g) and General Instruction C.3.(g) to Form N-1A.

77 *Id.*, at 55.

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