

January 13, 2016

Mr. Brent J. Fields  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, D.C. 20549

Re: Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release (File Nos. S7-16-15 and S7-08-15)

Dear Mr. Fields:

The Independent Directors Council<sup>1</sup> appreciates the opportunity to comment on the Securities and Exchange Commission's liquidity risk management and swing pricing proposals.<sup>2</sup> Fund directors, who represent the interests of fund shareholders and would have significant responsibilities under the proposed rules, have a unique and important perspective to offer on this initiative.

As the SEC notes, daily redeemability is a defining feature of open-end funds.<sup>3</sup> Liquidity risk management, thus, is critical to the functioning of an open-end fund.<sup>4</sup> Fund advisers have primary responsibility to manage liquidity risk as part of the portfolio management and investment risk

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<sup>1</sup> IDC serves the U.S.-registered fund independent director community by advancing the education, communication, and policy positions of fund independent directors, and promoting public understanding of their role. IDC's activities are led by a Governing Council of independent directors of Investment Company Institute member funds. ICI is a leading, global association of regulated funds, including mutual funds, exchange-traded funds, closed-end funds, and unit investment trusts in the U.S., and similar funds offered to investors in jurisdictions worldwide. ICI's U.S. fund members manage total assets of \$17.9 trillion and serve more than 90 million U.S. shareholders, and there are approximately 1,900 independent directors of ICI-member funds. The views expressed by IDC in this letter do not purport to reflect the views of all fund independent directors.

<sup>2</sup> Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, SEC Release No. IC-31835 (September 22, 2015) (the "Release"), available at <http://www.sec.gov/rules/proposed/2015/33-9922.pdf>.

<sup>3</sup> See Release, *supra* n. 2, at 6.

<sup>4</sup> The liquidity risk management program proposal applies to all open-end funds, except money market funds, and the swing pricing proposal applies to all open-end funds, except money market funds and exchange-traded funds (ETFs). This letter's references to "funds" is intended to cover the open-end funds to which the particular proposal applies.

management functions, and fund boards oversee the adviser's management of liquidity risk as part of their general oversight responsibilities. Fund directors take seriously their oversight responsibilities on behalf of *all* shareholders – including those who wish to redeem out of a fund and those who wish to remain in a fund.

IDC supports the essential goal of the SEC's proposal, which is to promote "effective liquidity risk management throughout the open-end fund industry, thereby reducing the risk that funds will be unable to meet redemption obligations and mitigating dilution of the interests of fund shareholders."<sup>5</sup> IDC also supports providing the SEC—as the primary regulator of funds—with data and information to facilitate its monitoring of liquidity trends in the industry and funds' liquidity risk profiles and providing investors with information that might assist them in making informed investment decisions.

We have serious concerns, however, with certain of the underlying requirements of the proposal, which would be challenging for boards to oversee. The proposal's prescriptive requirements—namely, the six-category asset classification scheme and the three-day liquid asset minimum requirement—would not further the SEC's goals and, in fact, could detract from them, to the detriment of funds and their shareholders, as well as the capital markets.

As discussed below in Section I, we believe that the SEC should instead take a less prescriptive approach to liquidity risk management regulation, which we outline in Section II. We believe that this approach would achieve the SEC's objectives without presenting the complexities and other disadvantages of the SEC's proposed approach. In Section III we discuss why, in our view, the proposal's prescriptive requirements are problematic, and in Section IV we explain our objections to the proposed SEC reporting and public disclosure of detailed liquidity information. Finally, we discuss our views on the swing pricing proposal in Section V. Swing pricing would offer funds another potential tool for mitigating dilution of shareholder interests. As the SEC acknowledges, however, it also presents a host of significant operational obstacles and other challenges. We, therefore, urge the SEC to study and address these issues more thoroughly and present a more comprehensive discussion of them in a re-proposal before considering whether to adopt a swing pricing rule.

Before turning to our comments on the proposal, we wish to address the critically important issue of the role of fund boards in these proposals. We were pleased to see that the SEC's proposals generally rely on fund directors as overseers and not as micro-managers.<sup>6</sup> In this regard, the SEC acknowledges the importance of diligent oversight to an effective liquidity risk management program.

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<sup>5</sup> Release, *supra* n. 2, at 1.

<sup>6</sup> For example, under the proposed liquidity risk management program, the board would initially approve a fund's program and any material changes to the program and receive a written report, at least annually, on the adequacy of the program and its effectiveness. The swing pricing proposal takes a similar approach. The Release also makes clear that oversight does not mean that a board must dive into the minutiae of a program, but rather can rely on summaries that "familiarize directors with the salient features of the program." See Release, *supra* n. 2, at 175.

We agree that it is appropriate to require board oversight in this area. We do not agree, however, that liquidity risk management presents the type of potential conflict of interest between the adviser and the fund that would typically require independent scrutiny by a fund board (e.g., certain affiliated transactions between the adviser and the fund), as suggested in the Release.<sup>7</sup> Fulfilling an oversight responsibility as part of a general fiduciary duty is markedly different than meeting a detailed specific regulatory obligation designed to protect against potential conflicts of interest (such as approving cross-trades under Rule 17a-7 under the Investment Company Act of 1940 (“1940 Act”)) and, as such, could implicate different levels of responsibility for fund directors.

Accordingly, we urge the SEC to ensure that any final rules, as well as the SEC’s enforcement of them, continue to recognize and characterize appropriately the oversight function of fund boards. In particular, we recommend that the SEC include a statement in the adopting release of the final rule that the board is not responsible for determining the liquidity of any security, and that its role is to provide oversight of a fund’s liquidity risk management program.<sup>8</sup> To reinforce these points, we also recommend that the SEC include a statement that the board’s oversight responsibilities are the same as they are in other areas of portfolio management and fund operations, and, thus, any action a board takes, based on information provided by the adviser and/or other persons, would be evaluated by the SEC based upon a reasonable business judgment standard.<sup>9</sup>

## **I. The SEC’s Objectives Can Be Achieved Through a Less Prescriptive Approach**

To support its proposal, the SEC notes that since it last provided liquidity-related guidance 20 years ago, the fund industry has grown significantly, markets have become more complex, and funds pursue more complex investment strategies, including fixed income and alternative investment strategies that are focused on less liquid asset classes.<sup>10</sup> The SEC also states that through its outreach, it has found that, while some funds and their managers have developed comprehensive liquidity risk management programs, others have dedicated significantly fewer resources to managing liquidity risk through a formalized approach. We agree that these developments and observations warrant the SEC’s

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<sup>7</sup> See Release, *supra* n. 2, at 174-176.

<sup>8</sup> This statement would clarify that the SEC’s previous characterization of the board’s role in connection with Rule 144A securities—a characterization with which we disagree—is not broadly applicable. In that context, the SEC stated that “determination of the liquidity of Rule 144A securities in the portfolio of an investment company issuing redeemable securities is a question of fact for the board of directors to determine, based upon the trading markets for the specific security.” See Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities under Rules 144 and 145, Release No. IC-17452 (April 23, 1990) [55 FR 17933 (April 30, 1990)].

<sup>9</sup> Of course, as with any decision a fund director makes on behalf of fund shareholders, a director’s decision made in connection with a liquidity risk management program would be protected by the business judgment rule under state law.

<sup>10</sup> See Release, *supra* n. 2, at 7.

consideration of whether to impose new requirements concerning liquidity risk management. These developments support a flexible, rather than a prescriptive approach, however.

The SEC does not identify any significant industry-wide liquidity failures—in terms of failures to meet redemption requests or significant dilution of shareholders' interests as the result of shareholder transactions—to justify its more prescriptive requirements. Moreover, other market factors—not mentioned in the Release—support a more flexible approach. For example, an important consideration is that half of the assets in long-term mutual funds are in retirement-related accounts, which generally have stable shareholder bases.<sup>11</sup> Another consideration is the important role funds can play during times of market stress. In those situations, funds can be buyers of less liquid assets and, thus can help to alleviate liquidity pressures when the markets are in most need of that relief. Thus, regulating liquidity risk in a way that could limit an adviser's ability to manage a fund to the benefit of *all* fund shareholders, could not only hurt the fund shareholders, but the capital markets as well.

**A. Funds have successfully managed liquidity risk for the past 75 years, and, thus, wide-ranging reforms are not warranted.**

Funds have a statutory obligation to pay redemption proceeds within seven days of a redemption request (absent unusual circumstances),<sup>12</sup> and most do so in less than half that time (*i.e.*, three days or less). Putting aside the regulatory obligations, any failure to meet the redemption requests of fund shareholders carries substantial reputational risk for funds and their advisers. Moreover, fund advisers have a strong incentive to minimize dilution of shareholders' interests because dilution can adversely affect fund performance.

For the past 75 years, funds have generally succeeded in managing liquidity risk. Funds have met their redemption obligations through a range of market cycles and events, including more recently the financial market crisis of 2007-2009 and the reaction of bond mutual fund investors in 2013 to a sharp rise in long-term interest rates as a result of monetary policy. Funds have done so by employing a variety of tools available to them, including using cash on hand (including from inflows), selling portfolio securities, interfund lending, and lines of credit. Even in the rare case of a fund encountering challenges in meeting redemptions, the regulatory structure is in place for the fund to seek an SEC order permitting it to suspend redemptions.<sup>13</sup>

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<sup>11</sup> See Letter from Brian Reid, Chief Economist, ICI, to Brent J. Fields, Secretary, SEC, regarding Open-End Fund Liquidity Risk Management Programs: Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release (File Nos. S7-16-15 and S7-08-15) (January 13, 2016) ("ICI Research Letter").

<sup>12</sup> See Section 22(e) of the 1940 Act.

<sup>13</sup> See Release, *supra* n. 2, at n. 82 (citing Section 22(e) of the 1940 Act and noting that the SEC "has rarely issued orders permitting the suspension of redemptions for periods of restricted trading or emergency circumstances but has done so on a few occasions."). We note that the SEC issued an order just last month to suspend redemptions of a concentrated high-yield bond fund, whose portfolio assets were composed primarily of debt instruments rated CCC or lower, or not rated at all. See

**B. Funds are successful investment products, and the SEC should be careful not to alter their character or diminish their value to investors.**

For many years, the fund industry has helped millions of investors meet their most important long-term financial goals, such as saving for retirement, education, or home ownership, while also allowing them to access their investments as needed. To date, funds have operated under a regulatory framework developed by the SEC under the 1940 Act that, while imposing strict standards on such matters as valuation, liquidity, redemptions, leverage, transactions with affiliates, and custody of fund assets, also has afforded fund managers the flexibility to pursue a wide range of investment strategies in response to investor demand.

The SEC's proposal breaks new ground by regulating the management of portfolio risks and, thus, should do so with extreme caution. Portfolio management is complex and incorporates the management and balancing of a range of risks, including liquidity risk. In order to achieve investment returns, a fund must incur investment risks. Fund managers seek the best risk/reward return for a fund relative to the fund's objectives and risk profile. This is what fund shareholders expect when they invest in a fund, and this expectation is different from that associated with placing assets in a bank account. Thus, the SEC should be careful not to impose bank-like regulations on funds.

The SEC should also take care not to impose a compliance burden on funds that detracts from, rather than enhances, liquidity risk management. Prescriptive requirements could cause funds and their managers to focus unnecessarily on complying with those requirements and less on their own professional methods and analytics for managing liquidity risk. Meeting prescriptive regulatory requirements also could foster a false sense of security by a fund regarding its ability to satisfy redemptions, notwithstanding that the requirements do not genuinely enhance the fund's liquidity risk management.

Furthermore, the proposed SEC reporting and public disclosure of liquidity determinations increases the potential for adverse, unintended consequences. For example, if funds were required to disclose detailed liquidity information, such as the six-category classifications, this disclosure could incentivize funds to avoid investments in assets classified as "less liquid," even though the liquidity risks of such investments could be adequately managed. A migration toward more liquid assets could lead to diminished returns for fund investors and reduce the diversity of investment choices. Moreover, migration toward a more homogenized industry could lead to more correlated activity, including during times of market stress.<sup>14</sup>

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Third Avenue Trust and Third Avenue Management LLC; Notice of Application and Temporary Order, Release No. IC-31943 (December 6, 2015). As the Commission is quite aware, it is very rare for a fund to seek to suspend redemptions, and this fact points up the historic success with which funds have managed liquidity throughout the industry's history.

<sup>14</sup> See generally ICI Research Letter, *supra* n. 11.

## II. The SEC's Goals Would be Better Met Through a More Flexible Program

We believe that the SEC's goals would be better met by requiring funds to adopt a less restrictive liquidity risk management program, subject to the requirements we outline below. Although funds currently manage liquidity risk through a range of practices, we agree that requiring all funds to establish formal programs would impose a discipline on the process that would benefit funds and their shareholders.

We recommend that a fund's liquidity risk management program include the following components.

- **Policies and Procedures.** We support requiring funds to adopt and implement written policies and procedures that address the following.
  - *Assess and periodically review the fund's liquidity risk.* We suggest that a fund's policies and procedures provide for the assessment and review of the fund's liquidity risk.<sup>15</sup> Instead of requiring funds to classify portfolio assets according to the proposed six-category scheme, we suggest that funds classify the liquidity of their portfolios as follows:
    - *Most Liquid Assets:* any cash held by a fund, and any position in an asset that the fund believes is convertible into cash within three business days, within the context of normal trading.
    - *Illiquid Assets:* assets that are considered "15% standard assets," as defined in the proposal.<sup>16</sup>
    - *Intermediate Liquidity Assets:* assets that are not Most Liquid Assets or Illiquid Assets.
  - *Manage the fund's liquidity risk.* A fund's policies and procedures would be required to include processes for reasonably ensuring that the fund has sufficient liquidity to meet redemptions under normal and reasonably foreseeable stressed conditions, consistent with its investment objective. Those procedures might include establishing targets or ranges for "highly liquid assets" (as defined by the fund and which could coincide with Most Liquid Assets) that the fund will

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<sup>15</sup> We would support requiring the policies and procedures to include factors to consider for the assessments. We do not have the expertise to comment on the specific factors proposed by the SEC in Proposed Rule 22e-4(b)(2). We are generally supportive of the SEC suggesting factors in the adopting release—not in the rule—so long as the SEC makes clear that they are optional.

<sup>16</sup> We recommend that funds be required to comply with the 15% standard asset requirement, as proposed.

maintain to meet expected redemptions. We do not support requiring a fund to maintain the three-day liquid asset minimum, however. Nor, in contrast to the proposal, do we support a requirement that a fund maintain a specified level of highly liquid assets under which it would be prohibited from investing in “less liquid” assets whenever it fell below that threshold.

- *Stress testing.* We suggest that a fund’s policies and procedures require periodic stress testing, at such intervals as the board determines appropriate, of the fund’s ability to meet redemptions during reasonably foreseeable stressed conditions. The policies and procedures should also provide for a report on the results of such testing to be provided to the board, at such time as the board determines is appropriate.
- **Liquidity Program Administrator.** We support the SEC’s proposal to assign the responsibility of administering the liquidity risk management program to the fund’s investment adviser or an officer or officers of the fund (“Liquidity Program Administrator”), which could be a committee of the adviser, including its valuation committee.<sup>17</sup> We oppose, however, imposing on the board the responsibility of approving the designation of the Liquidity Program Administrator. Liquidity risk management is a critical component of the investment management function and is within the adviser’s purview of responsibilities. We do not believe that the board should be tasked with designating the person(s) responsible for this function, just as the board is not responsible for designating other personnel who perform other critical functions, such as portfolio trading or fund accounting. Requiring the board to designate specific personnel draws them too far into the management function.<sup>18</sup> Instead, the policies and procedures, which the board would approve, should include a description of the responsibilities of the Liquidity Program Administrator.
- **Board approval and oversight.** An important component of any such program would be board oversight. Similar to the requirement included in the SEC’s proposal, the board’s responsibilities should include initially approving the program, including the policies and procedures, and material changes to the program. The board also should receive a written

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<sup>17</sup> We also agree that the Liquidity Program Administrator should not be solely portfolio managers of the fund.

<sup>18</sup> Although IDC’s suggested liquidity risk management program is analogous to the fund compliance program rule (Rule 38a-1 under the 1940 Act), it differs from that rule in some important respects. For instance, given the possibility that an adviser might not be forthcoming about certain compliance issues, the fund compliance program rule contains several provisions designed to promote the independence of the chief compliance officer (“CCO”), including requiring the board to approve the designation of the CCO. We do not believe that this is necessary in connection with a liquidity risk management program.

report, at least annually, from the Liquidity Program Administrator that describes the adequacy of the fund's liquidity risk management program and the effectiveness of its implementation. Of course, funds and boards would have the discretion to require other board reports, such as periodic (*e.g.*, quarterly) liquidity reports or event-based reports, such as when there has been unusual redemption activity or when a specified level of illiquid assets is reached.

- **Disclosure.** We would support requiring funds to report to the SEC on Form N-PORT, on an aggregated basis, the percentages of the fund's portfolio that fall into each of the three liquidity categories described above, but we strongly object to making this information publicly available.<sup>19</sup> We would instead support amendments to Form N-1A requiring a fund to disclose in its registration statement a narrative description of the fund's liquidity risk management program.

We believe that the formal program we describe above would enhance liquidity risk management across the fund industry, just as the compliance program rule enhanced the compliance function over a decade ago. From the fund board's perspective, the compliance program rule was, at the time, revolutionary, and is, today, a driver of compliance focus within a fund complex and in the boardroom. Although compliance has always been a cornerstone of the fund industry, the rule raised the bar for compliance across the industry. It did this, not by telling funds how to construct the compliance function, but by establishing a procedural framework that funds could tailor to their specific circumstances. Similarly, under IDC's proposed approach, although liquidity risk management practices would vary, there would be a heightened focus within a fund complex and in the boardroom on the adequacy of those practices and on a fund's preparedness to meet redemption needs in normal and reasonably foreseeable stressed conditions.

### **III. The Proposed Six-Category Classification Scheme and Three-Day Liquid Asset Minimum Requirement are Highly Problematic**

The SEC's proposed liquidity risk management program includes two components that introduce a host of complexities and potential unintended consequences: a six-category classification scheme and a three-day liquid asset minimum requirement. These requirements would impose unwarranted burdens on funds, would be difficult for boards to meaningfully oversee, and would not further the SEC's goals.

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<sup>19</sup>The SEC also will be able to monitor liquidity trends through portfolio information it will receive on proposed Form N-PORT, as well as through inspections and examinations by SEC staff.



**A. The six-category classification scheme is too granular and not useful.**

Under the proposed classification scheme, a fund would have to classify each of its positions in a portfolio asset (or portion of a position in a particular asset) based on six categories representing the number of days in which it is determined, using information obtained after reasonable inquiry, that the fund's position in the asset (or portion thereof) would be convertible to cash at a price that does not materially affect the value of that asset immediately prior to sale.<sup>20</sup>

**1. The proposed classification is not a proven or widely-used methodology.**

Although the SEC suggests that the proposed classification scheme might be used by a fund “to better plan how it would meet redemptions occurring in a day, a week, or some other period”<sup>21</sup> and that the scheme “may have practical benefits,”<sup>22</sup> it does not demonstrate that this approach is superior to the variety of risk management practices followed by experienced money managers. To the best of our knowledge, very few such managers—if any—classify portions of portfolio assets in the manner proposed by the SEC. While fund managers certainly may view the liquidity of a fund's portfolio assets across a liquidity spectrum, and some may classify portfolio assets into a range of categories, we are not aware that their processes require the level of certainty suggested by the SEC's bottom-up proposal, in terms of the number of days it would take to liquidate a position and the market impact of such a sale – and, in some instances, for *portions* of a position. For example, many managers focus on assessing the liquidity of an *entire* portfolio and do not find it useful to over-refine the analysis by evaluating whether the number of days to liquidate a portion of a particular position is six days or seven.

And, of course, any such current practices are for *internal* purposes only. Requiring funds to disclose such classifications would introduce a level of scrutiny and potential for second-guessing that would infringe upon and detract from the usefulness of that process—concerns that we discuss in Section IV.

**2. The market impact determination makes the proposed classification scheme extremely challenging.**

Under the proposal, fund managers would be required to make judgments about how quickly an asset position could be converted to cash without materially affecting the value of the asset immediately prior to its sale. This type of determination would be extremely difficult to make with any precision or confidence, given the proposed time intervals for the classification scheme and the unpredictable nature of market impact, among other things. In some instances, for example, it might be

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<sup>20</sup> The day ranges represented by the six categories are: 1 business day; 2-3 business days; 4-7 calendar days; 8-15 calendar days; 16-30 calendar days; and more than 30 calendar days. See Proposed Rule 22e-4(b)(2)(i).

<sup>21</sup> Release, *supra* n. 2, at 70.

<sup>22</sup> Release, *supra* n. 2, at 80.

difficult to determine with a high degree of confidence whether a particular asset could be converted to cash without materially affecting the value of the asset in three days (and be in the 2-3 business day category) or four days (and be in the 4-7 calendar day category). In addition, predicting the market impact of a sale with any precision is very difficult to do, especially when there are a number of external events that also can affect the price of an asset.<sup>23</sup> Moreover, the liquidity of any particular asset is fluid and constantly changing. Determining the liquidity classification for a portfolio asset on a particular day would necessarily fail to take into account unknowable future market conditions and, thus, may not be very meaningful. The proposed requirement that funds review the classifications on an ongoing basis and revise them, as appropriate, increases these challenges.

### **3. The proposed reporting and/or disclosure of the classifications would exacerbate the problems with this requirement.**

The SEC proposes that a fund report on proposed Form N-PORT the classification of its portfolio assets in the six categories on a monthly basis. The quarter-end information would be available to the public, sixty days after the end of the quarter.

The highly prescriptive nature of the six-category scheme, and the subjective nature of the judgments underlying that detailed data, would not produce particularly useful data for the SEC or investors and could expose funds, their advisers—and fund boards—to being second-guessed. These very significant adverse consequences, which we discuss in Section IV, are additional reasons to discard the proposed six-category approach.

#### **B. The proposed three-day liquid asset minimum requirement is unnecessarily rigid.**

Under the proposal, each fund would be required to determine a minimum percentage of its net assets that must be invested in three-day liquid assets (“three-day liquid asset minimum”)<sup>24</sup> and periodically review, no less frequently than semi-annually, the adequacy of the fund’s three-day liquid asset minimum. If a fund were to fall below its minimum, it would be precluded from purchasing “less liquid assets”<sup>25</sup> until it once again met or exceeded its minimum.

The proposed three-day liquid asset minimum requirement follows the same definitional approach as the six-category classification scheme. In particular, it requires determining the number of

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<sup>23</sup> In the event the SEC adopts an approach similar to the proposed six-category approach, we strongly urge that, at a minimum, it eliminate the “market impact” element of that approach. The focus should turn on whether the asset can be converted to cash, even in times of market stress, regardless of the impact that conversion to cash has on the market.

<sup>24</sup> A three-day liquid asset is defined as “any cash held by a fund and any position of a fund in an asset (or portion of the fund’s position in an asset) that the fund believes is convertible into cash within three business days at a price that does not materially affect the value of that asset immediately prior to sale.” Proposed Rule 22e-4(a)(8).

<sup>25</sup> A “less liquid asset” would be any position of a fund (or portion of the fund’s position in an asset) that is not a three-day liquid asset. Proposed Rule 22e-4(a)(6).

days a portfolio position could be converted to cash without materially affecting the value of the asset immediately prior to its sale. This approach is subject to the same problems outlined above, including the challenges of making these determinations with a high degree of confidence.

In addition, the rigidity of the requirement prohibiting a fund that falls below the three-day liquid asset minimum from purchasing “less liquid assets” until after it has restored the minimum would infringe on portfolio managers’ ability to pursue investment strategies and make investment decisions for the benefit of the fund and its shareholders. For example, a fund that seeks to maintain weightings in certain sectors, countries, securities or other asset types would be restricted in its ability to pursue that strategy any time it fell below the three-day liquid asset minimum. Moreover, in some cases, certain less liquid assets, such as those the portfolio manager views as undervalued, may present a buying opportunity that could be beneficial to the fund.

Instead of the three-day liquid asset minimum requirement, as discussed above, we propose that funds establish processes for reasonably ensuring that it has sufficient liquidity to meet redemptions under normal and reasonably foreseeable stressed conditions, which could include establishing targets or ranges of highly liquid assets. We also propose requiring funds to conduct periodic stress tests.<sup>26</sup> In light of the wide range of liquidity risk profiles across the industry, we believe that this approach would offer a fund the flexibility to determine for itself whether it has sufficient liquidity to meet expected redemptions, but without the problems associated with the proposed three-day liquid asset minimum requirement.

#### **IV. The Proposed Form N-PORT Liquidity Disclosures Are Misguided**

IDC supports the SEC’s role as primary regulator of funds and its interest in being able to monitor liquidity trends in the industry and funds’ liquidity risk profiles. For this reason, we support providing the SEC with the percentages of the fund’s portfolio that fall into each of the three liquidity categories described in Section II. We also support providing investors with the information they need to make informed investment decisions, and, thus, recommend requiring funds to disclose additional, narrative information about their liquidity risk management programs in fund registration statements.

For the reasons discussed below, we strongly object to requiring funds to report to the SEC detailed liquidity information based on the proposed six-category classification scheme. We also object

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<sup>26</sup>The SEC states that it considered requiring funds to conduct stress tests of their own design relating to the extent the fund has liquid assets to cover possible levels of redemptions instead of the three-day liquid asset minimum requirement. The SEC favored the three-day liquid asset minimum approach, because, among other things, it would require consideration of a set of factors. *See* Release, *supra* n. 2, at 328-29. Stress testing, however, also could be based on a similar set of factors.

to making any liquidity classification information publicly available, even if it were required to be reported to the SEC on proposed Form N-PORT.<sup>27</sup>

*The six-category classifications data would not be particularly useful for the SEC or investors.* Given the subjective nature of the judgments regarding the highly prescriptive liquidity classifications, as well as the different ways funds might weigh the factors for assessing liquidity, funds are likely to report varying views regarding the number of days with which they could sell a position in the same asset without materially affecting its market price. The reports, therefore, will not lend themselves to comparisons across funds by the SEC or investors, nor will they produce reliable industry-wide data. As we previously stated in connection with proposed Form N-PORT, given the subjective judgments involved in making liquidity determinations and the variations in the way funds could report those determinations, disclosures regarding liquidity determinations could be confusing to investors.<sup>28</sup> In addition, the disclosures could make certain larger funds look more “risky” from a liquidity standpoint than smaller ones, leading investors to make investment decisions based on potentially confusing information.<sup>29</sup> Finally, given the fluid nature of liquidity, quarterly reports subject to a 60-day lag would not provide meaningful information to investors and could be highly confusing and potentially misleading.

*The prescriptive nature of the six-category scheme increases the potential for second-guessing of liquidity determinations and adversely influencing portfolio management decisions.* Funds could disclose a variety of views regarding the liquidity of a particular asset position, and any view—especially if it differs from most other views—could be vulnerable to being second-guessed. Public disclosure, therefore, could encourage funds to classify positions similar to others—to avoid looking like an outlier—causing the industry to lose the benefits of diverse views on liquidity. Moreover, to the extent the disclosure leads funds to take more conservative approaches to liquidity—*i.e.*, by investing in more liquid instruments—this could lead to diminished returns for fund investors and to a more homogenized, and less diverse, fund industry.

In light of the complexity and burdens associated with the classification scheme, as well as the second-guessing concerns, many funds might determine to use third-party vendors to supply liquidity determinations. While the use of such vendor-provided liquidity assessments might be entirely appropriate in many instances, it could raise additional concerns, including the possibility that a liquidity provider’s downgrade of a liquidity classification for a particular asset could cause funds,

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<sup>27</sup> As noted in Section II, although we support reporting to the SEC on proposed Form N-PORT the liquidity information based on our proposed three categories, we oppose making this information publicly available.

<sup>28</sup> See Letter from Amy B.R. Lancellotta, Managing Director, IDC, to Brent J. Fields, regarding Investment Company Reporting Modernization; File No. S7-08-15 (August 11, 2015).

<sup>29</sup> See ICI Research Letter, *supra* n. 11, for a discussion of the potential anomalous results of the SEC’s proposed approach.

seeking to maintain a particular liquidity risk profile, to dispose of that asset at the same time. In addition, the use of third-party vendors increases fund expenses, which may be borne to a greater extent by smaller funds.

*Investors do not need detailed liquidity information.* Although the SEC suggests that the proposed Form N-PORT liquidity disclosures would “assist investors in making investment choices that better match their risk tolerances,”<sup>30</sup> we assert that the fund’s registration statement—not Form N-PORT—should be the source for information investors need to make informed investment decisions. Investors already receive a great deal of information about funds’ liquidity risks and redemption policies, and we are not aware that investors have asked for any additional information.<sup>31</sup> The SEC suggests that academic researchers, financial analysts, and economic research firms could use liquidity-related data reported on proposed Form N-PORT to evaluate fund portfolios and related risks.<sup>32</sup> Such sophisticated analysts, however, can use the portfolio information that funds will disclose on proposed Form N-PORT to conduct their own analyses.

## V. The Availability of Swing Pricing Requires Further Study

Swing pricing would introduce a significant shift in the way funds are priced and sold. Whereas for 75 years the daily NAV has been almost “sacrosanct,” the SEC now proposes to permit funds to allow investors to buy or sell fund shares at an adjusted NAV under specified circumstances. Because fund directors have important responsibilities in overseeing the pricing of fund shares, they are strongly interested in ensuring that this proposed departure from the standard method of pricing will benefit fund shareholders.

The proposed swing pricing rule would permit a fund to use swing pricing to adjust its current NAV per share to mitigate dilution of the value of its outstanding redeemable securities as a result of shareholder purchase and redemption activities, provided that it has established and implemented swing pricing policies and procedures in compliance with the rule’s requirements. The swing pricing policies and procedures must:

- Specify the fund’s *swing threshold* (*i.e.*, the amount of net purchases and redemptions of fund shares, expressed as a percentage of the fund’s NAV, that triggers swing pricing);
- Specify how the *swing factor* (*i.e.*, the amount, expressed as a percentage of the fund’s NAV, by which the fund adjusts its NAV per share when net purchases or redemptions

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<sup>30</sup> See Release, *supra* n. 2, at 43.

<sup>31</sup> As noted in Section II, we suggest that funds provide a narrative description of their liquidity risk management processes in the registration statement.

<sup>32</sup> See Release, *supra* n. 2, at 71.

exceed the swing threshold) will be determined and whether it would be subject to any upper limit; and

- Provide for *periodic review*, no less frequently than annually, of the fund's swing threshold.

Under the proposal, a fund's board, including a majority of the independent directors, must approve the fund's swing pricing policies and procedures (including the fund's swing threshold and any swing factor upper limit), as well as any material change to the policies and procedures. The board also would be responsible for designating the fund's investment adviser or officer(s) responsible for administering the swing pricing policies and procedures, and for determining the swing factor that would be used each time the swing threshold is breached.<sup>33</sup>

The Release identifies several potential benefits as well as costs and complexities of the proposed swing pricing rule, and we urge the SEC to carefully consider comments from ICI and others that provide more detail regarding these matters and bring additional issues to its attention.<sup>34</sup> We note, in particular, concerns about the operational challenges associated with funds' ability to obtain reliable flow information in order to determine whether the swing threshold will be exceeded. Intermediaries, including those that support omnibus trading, generally transmit aggregated trades after the fund's NAV is determined and provide limited, if any, intraday order flow information. The operating model in Europe, where swing pricing is used successfully, differs in significant ways from the U.S. model. For example, in many instances, European funds employ multiple trading cut-off times and make greater use of currency-based orders (compared to the greater prevalence of share- or percentage-based transactions in the U.S.). These European practices can promote greater confidence in the accuracy of fund flow details.<sup>35</sup> Indeed, it appears that significant—and costly—changes in the way purchases and redemptions are processed in the U.S. would be required before swing pricing would even be feasible here.

In light of the operational obstacles essentially precluding implementation of swing pricing in the U.S. at this time, we suggest that the SEC address it separately from the liquidity risk management proposal. We urge the SEC to study the comments it receives in response to this proposal and to present a more comprehensive discussion of swing pricing's advantages and challenges, including the

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<sup>33</sup> Under the proposal, the determination of the swing factor must be reasonably segregated from the portfolio management function of the fund. Proposed Rule 22c-1(a)(3)(ii)(B).

<sup>34</sup> See Letter from David W. Blass, General Counsel, ICI, to Brent J. Fields, Secretary, SEC, regarding Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release (File Nos. S7-16-15 and S7-08-15) (January 13, 2016) ("ICI Letter").

<sup>35</sup> See ICI Letter, *supra* n. 34, for a discussion of European and U.S. practices.

operational changes that would need to be made for swing pricing to be feasible, in a re-proposal before it takes further action.

As the SEC continues to study swing pricing, we urge it to consider the following recommendations.

*There should be no presumption that funds should adopt swing pricing.* Under the proposal, swing pricing would be optional, and we support this permissive approach. We urge the SEC to reinforce the optionality of swing pricing by making it clear that there should be no implied presumption that funds ought to adopt swing pricing and that no liability can result from a decision not to use it.

If the SEC were to adopt optional swing pricing, we would expect many fund advisers to undertake an analysis to determine whether or not swing pricing would be appropriate for their funds. We also would expect the adviser to present its recommendations to the board (even though a determination not to adopt swing pricing is not required under the proposal). Many fund advisers and boards may reasonably determine, based on the particular facts and circumstances of a fund, not to adopt swing pricing for that fund. The analysis might reveal that any dilution resulting from purchase and redemption activity is minimal (such as for a fund with a stable shareholder base and relatively low portfolio transaction costs), while (i) the administrative complexity of swing pricing may increase the risk of processing and other errors, and (ii) the costs associated with implementing and operating a swing pricing program—which likely would be borne ultimately by the fund’s shareholders—may be substantial.

*The SEC should address concerns about error processing.* If, following a reasonable inquiry, fund flow estimates used to determine whether a swing threshold has been exceeded turn out to be incorrect, the fund may misstate its NAV. Current error correction policies require a fund to correct pricing errors and for fund sponsors to reimburse shareholders experiencing a material economic loss due to the error. We urge the SEC to state in any re-proposal that, in the circumstance of swing pricing, any NAV misstatements due solely to limitations in the fund flow information that the fund reasonably has available to it should not trigger order reprocessing or expose the fund, its manager, or its board to any type of liability.<sup>36</sup>

*The SEC should be mindful of the impact this proposal could have on smaller funds.* Although swing pricing would be optional, employing this option may be more feasible for larger fund complexes, which have greater resources to develop the operations infrastructure needed for this feature and the ability to negotiate with intermediaries to receive flow information on a timelier basis. These

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<sup>36</sup> See ICI Letter, *supra* n. 34, for a more complete discussion of error processing.

advantages may lead to a disparity in the use of swing pricing between larger funds and smaller funds, which could affect comparative performance among funds.

*The adviser, rather than the board, should designate the person(s) responsible for administering swing pricing policies and procedures.* Similar to our comment above in connection with the liquidity risk management program proposal, we believe that the adviser, rather than the board, should be responsible for designating the person(s) responsible for administering the swing pricing policies and procedures and for determining the swing factor that will be used each time the swing threshold is exceeded. The board can oversee swing pricing processes—including approving policies and procedures that describe the role and responsibilities of the person(s) who administer swing pricing and determine the swing factor—without being drawn into management-level decisions regarding which person(s) should perform the functions.

## **VI. Other Liquidity Risk Management Tools**

We offer the following views about other potential liquidity risk management tools.

*Interfund Lending.* Interfund lending is an important liquidity tool available to those funds who have received exemptive relief. We encourage the SEC to codify the exemptive orders so that all funds might benefit from this tool.

*Suspension of Redemptions.* As discussed above, the fund industry has a 75-year history of success in meeting redemption requests. The current regulatory requirements as well as market incentives to meet shareholders' needs have contributed to this success. We believe that the current regulatory framework, which requires funds to obtain an SEC order before suspending redemptions provides the appropriate safeguard for shareholders.<sup>37</sup> As the SEC acknowledges, such occurrences are rare, and we believe the current framework allows for timely action to protect shareholders' interests. Accordingly, we agree with the SEC's determination to maintain the regulatory framework regarding suspension of redemptions.<sup>38</sup>

*Cross Trades.* The Release includes guidance concerning cross trades that links a fund's ability to cross-trade assets with the assets' liquidity. Rule 17a-7 under the 1940 Act allows cross trading between affiliated funds and accounts if certain conditions are met, including that market quotations be readily available to price exchange-traded securities, and that over-the-counter securities be priced at the

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<sup>37</sup> See Section 22(e)(3) of the 1940 Act; *see also supra* n. 13 and accompanying discussion.

<sup>38</sup> In light of the unique character of money market funds, we supported the SEC's proposed rules allowing those funds to suspend redemptions in certain circumstances. *See* Letter from Amy B.R. Lancellotta, Managing Director, IDC, to Elizabeth M. Murphy, Secretary, SEC, regarding Money Market Fund Reform; Amendments to Form PF (File No. S7-03-13) (September 17, 2013) and Letter from Michael S. Scofield, Chair, IDC Governing Council, to Elizabeth M. Murphy, Secretary, SEC, regarding Money Market Fund Reform (File No. S7-11-09) (September 8, 2009).



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average of the then-highest bid and lowest offer. In the Release, the SEC states that “the less liquid an asset is, the more likely it may not satisfy rule 17a-7.”<sup>39</sup> This statement conflates liquidity and valuation in an inappropriate manner. We recommend that the adopting release not include this suggestion.

## VII. Conclusion

Fund directors take seriously their responsibilities to oversee the management of liquidity risk on behalf of all of a fund’s shareholders. We support the goals of the SEC’s proposal, which would further protect shareholders’ interests, and believe that those goals can be met through a modified form of the liquidity risk management proposal, as we have outlined above.

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If you have any questions about our comments, please contact Annette Capretta, Deputy Managing Director, at (202) 371-5436 or me at (202) 326-5824.

Sincerely,



Amy B.R. Lancellotta  
Managing Director  
Independent Directors Council

cc: The Honorable Mary Jo White, Chair  
The Honorable Kara M. Stein, Commissioner  
The Honorable Michael S. Piwowar, Commissioner

Mr. David Grim  
Director, Division of Investment Management

Securities and Exchange Commission

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<sup>39</sup> See Release, *supra* n. 2, at 173.