January 13, 2016

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Via Electronic Filing

RE: Open-End Fund Liquidity Risk Management Programs and Swing Pricing (File No. S7-16-15)

Dear Mr. Fields:

Charles Schwab Investment Management ("CSIM")[1] appreciates the opportunity to provide comments on the Securities and Exchange Commission's ("Commission" or "SEC") October 2015 proposal to require open-end funds to establish a liquidity risk management program, to permit a fund to use swing pricing under certain circumstances, and to require enhanced disclosure of information regarding the liquidity of a fund's holdings and its liquidity risk management program ("the proposal").[2]

CSIM Supports the Goals of the Proposal

CSIM and its parent company, The Charles Schwab Corporation (together, "Schwab"),[3] have had since their inception a strong focus on the individual investor, and it is from that perspective that we respond to the proposal. Schwab has long advocated for rules and regulations that protect individual investors while preserving the choices available to them and providing them with the best information with which to make informed investment decisions. Schwab also

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[1] Founded in 1989, Charles Schwab Investment Management, Inc. ("CSIM"), a subsidiary of The Charles Schwab Corporation ("Schwab Corporation"), is one of the nation's largest asset management companies, with more than $280 billion in assets under management as of December 31, 2015. It is among the country's largest money market fund managers and is the third-largest provider of retail index funds. CSIM currently manages 74 mutual funds, in addition to two separate account model portfolios, and 21 ETF offerings.

[2] "Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release," SEC Release Nos. 33-9922; IC-31835. 80 Fed. Reg. 62274, October 15, 2015.

[3] The Charles Schwab Corporation is a leading provider of financial services, with more than 325 offices and 9.7 million active brokerage accounts, 1.5 million corporate retirement plan participants, 1 million banking accounts, and $2.55 trillion in client assets as of November 30, 2015. Through its operating subsidiaries, the company provides a full range of wealth management, securities brokerage, banking, money management and financial advisory services to individual investors and independent investment advisors.

recognizes that in today's global, fast-changing markets, appropriate measures need to be taken to ensure that funds can operate in volatile markets and meet redemption needs in all circumstances. Schwab appreciates the Commission's effort to find a balanced approach in this proposal that will increase investor confidence in open-end funds while preserving the important role these funds play in our markets and in our economy. We strongly endorse the twin goals as outlined in the proposal:

> Taken together, these reforms are designed to provide investors with increased protections regarding how liquidity in their open-end funds is managed, thereby reducing the risk that funds will be unable to meet redemption obligations and mitigating dilution of the interests of fund shareholders. These reforms are also intended to give investors better information with which to make investment decisions, and to give the Commission better information with which to conduct comprehensive monitoring and oversight of an ever-evolving fund industry.[4]

It is the strong view of CSIM that all funds should have a robust liquidity risk management program in place and that funds should have the flexibility to tailor that program to the particular needs of the fund. We also support the proposal's requirement that each fund must set a fund-specific minimum portion of net assets that can be convertible to cash within three days. In addition, we support many of the proposal's requirements for enhanced disclosure for investors, though we do recommend that the Commission draw a clear distinction between information and data that is reportable to the SEC and information that is made available to the investing public.

Concerns with the Proposal

While supportive of the general goals of the proposal, CSIM has a number of concerns that we believe can be addressed to strengthen the proposal, and we make several suggestions of how to do so. Our concerns are in these areas:

1. Liquidity "Buckets": The requirement that a fund report the liquidity of its portfolio positions in six liquidity categories or "buckets" will create an illusion of precision that does not exist and will not benefit investors. We recommend an alternative approach that reduces the number of categories to three, which will better meet the goals of improving transparency while minimizing discrepancies and reducing the opportunity for misleading or confusing investors.

2. Disclosures to the Public: Some of the required disclosures to the public will do more harm than good by confusing investors, causing them to place undue emphasis and reliance on information that is not standardized and which is so subjective as to make it impossible for the kind of fund-to-fund comparison the requirement will encourage investors to make. We recommend that some disclosures to the Commission be kept confidential and not shared with the public.

[4] 80 Fed. Reg. at 62276.

3. Swing Pricing: Swing pricing could, in concept, be an important additional tool for ensuring that funds can meet redemption demand and for equitably portioning the burden of panic selling during a volatile market, but the operational challenges stemming from the current structure of the US market for open-end funds make swing pricing difficult, and for some funds, impossible, to implement at this time. We explored some additional options that would achieve the same goal as swing pricing, but those, too, have significant operational challenges. We recommend that before adopting the swing pricing proposal a group be convened to study what could be done to make swing pricing a viable option for all funds in the US markets.

4. Costs of Implementation: We note that the operational costs associated with the proposal are significant – and those costs will inevitably be passed on to investors. Moreover, the operational costs may be prohibitive for some smaller fund complexes, leading to consolidation and reduction in choice for investors. We suggest this could be partly alleviated if the Commission considers making basic distinctions in levels and obligations of reporting based upon the general liquidity of the fund, with enhanced reporting required for funds that have a larger percentage of less liquid or illiquid securities.

5. General Concern About Overemphasizing One Risk Factor: Finally, we have a general concern that the rule proposal overemphasizes the importance of liquidity as a factor in determining the quality of a fund. There are a wide variety of factors that an investor should consider when making an investment decision and liquidity risk, while important, is only one of those factors. The rule proposal could unintentionally create an environment that leads to investors believing that liquidity is the most important factor.

I. Liquidity Risk Management Program

Support for Requiring Funds to Have a Program in Place

CSIM strongly supports the Commission's requirement that each fund establish a written liquidity risk management program and the requirement that each fund periodically revisit each element of the program to ensure that it can evolve with changing circumstances and market conditions. All funds should have such a program in place and information about it should be easily available to investors, both in the fund prospectus and on the fund's website. We also support the basic program elements that the Commission has specified in the proposal as the fundamental building blocks of a strong liquidity risk management program:

> (i) classification, and ongoing review of the classification, of the liquidity of each of the fund's positions in a portfolio asset (or portions of a position in a portfolio asset); (ii) assessment and periodic review of the fund's liquidity risk; and (iii) management of the fund's liquidity risk, including the investment of a set minimum portion of net assets in assets that the fund believes are convertible to cash within three business days at a price that does not materially affect the value of that asset immediately prior to the sale.[5]

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[5] 80 Fed. Reg. at 62287

For individual investors, the importance of a robust liquidity risk management program cannot be overstated. More than 90 million Americans own mutual funds, and have invested nearly $12.5 trillion of their assets in long-term mutual funds alone.[6] Those numbers reflect the enormous confidence investors have in the fund industry. Key to that overall confidence is the understanding investors have that they can redeem their shares for cash. The Commission defines liquidity risk as "the risk that a fund could not meet requests to redeem shares issued by the fund that are expected under normal conditions, or are reasonably foreseeable under stressed conditions, without materially affecting the fund's net asset value."[7] For the individual investor, this risk is paramount: anything that threatens the investor's ability to redeem his or her shares at a time of the investor's choosing undermines one of the very reasons mutual funds are so appealing in the first place.

More Flexibility Needed for Existing Liquidity Risk Management Programs

CSIM supports the attempts the Commission has made to build flexibility into the rule for funds to develop a liquidity risk management program that is best suited to the specific needs of each fund. The proposal notes that "the proposed program requirements are more principles-based and would permit each fund to tailor its liquidity risk management program to the fund's particular risks and circumstances."[8] This reflects the reality that there are currently thousands of different funds in the US market, composed of different assets, with different strategies, different goals, different management styles, and different levels of risk, including liquidity risk. As the Commission notes,

> a fund whose ownership is relatively concentrated, and that has an investment strategy requiring it to hold a significant portion of unlisted securities that do not trade frequently, would likely establish a different liquidity risk management program than a fund whose portfolio assets consist mostly of exchange-traded securities with a very high average daily trading volume.[9]

While we agree with this goal, the Commission's proposal may not succeed in achieving it. As we discuss in more detail below, there are elements of the proposed liquidity risk management program that are highly prescriptive – in particular, the classification of liquidity in six categories – and that should be changed to be more effective.

Moreover, many firms already have in place, or are in the process of developing, their own liquidity risk management programs, and the rule should ensure that effective programs already in place need not be scrapped. Since 2014, CSIM has been developing a liquidity risk management program in order to best gauge and define appetite for liquidity risk at the firm and fund level, as well as to specify our own fund-level liquidity guidelines with a view to enhancing investor confidence. A measurement component of the program develops tools to estimate

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[6] *2015 Investment Company Fact Book.* Investment Company Institute, inside front cover and p. 30. Available at: http://www.ici.org/pdf/2015_factbook.pdf.

[7] 80 Fed. Reg. at 62287.

[8] *Id*.

[9] *Id.*, at 62288.

security liquidity, aggregate these to the fund level and incorporate liquidity measurement in the portfolio management process. A contingency component estimates contingency financing needs at the fund and firm level, secures external lines of funding, and creates an advance plan of alternatives to handle exigencies. A valuation component creates a process for security valuation under stress. All components have been developed for incorporation into existing fund and regulatory compliance mechanisms.

CSIM has devoted considerable resources and energy to developing this program, which is designed to meet the specific needs of our funds. To the extent the rule is principles-based, firms can have the needed flexibility to develop an effective program within the parameters outlined by the Commission. But where the rule is too prescriptive, it undermines that effort and could force firms to unwind effective liquidity risk management programs that they have already developed in order to meet new criteria. To guard against that outcome, we recommend that discretion be provided in the rule to allow the fund to determine the liquidity risk management program that best suits the particular needs of the fund.

We note that the Commission has requested comment on whether the liquidity risk management program requirement should be placed on exchange-traded funds. While we believe that key characteristics of exchange-traded funds, such as the fact that they are priced and traded throughout the day, reduce the liquidity risk, we do not oppose the Commission's including exchange-traded funds in the proposal in order to enhance investor understanding of an ETF's liquidity. In addition, as we have noted in prior submissions to the Commission and its staff, we believe that ETFs should be given greater flexibility and equal footing to determine the composition of its portfolio creation and redemption baskets, which will provide the investment adviser with an additional tool to better manage fund liquidity.[10]

Individual Investors Will Be Better Served By Simplifying the Liquidity Categories

We support the concept in the proposal of classifying assets within a fund in different liquidity categories or "buckets." The rule specifies that all funds must classify the level of liquidity of each of the fund's positions in a portfolio asset using six liquidity categories: 1) convertible to cash within 1 business day; 2) convertible to cash within 2-3 business days; 3) convertible to cash within 4-7 calendar days; 4) convertible to cash within 8-15 calendar days; 5) convertible to cash within 16-30 days; and 6) convertible to cash in more than 30 calendar days.[11] While we support this concept, we have significant concerns with the details of the Commission's proposal and recommend a simplified approach that we believe would better serve investors.

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[10] As we have noted in the past, the evolving exemptive application process for exchange-traded funds has led to some ETFs having a competitive advantage as a result of having less restrictive requirements. For example, exemptive relief for newer entrants to the exchange-traded fund space requires that creation and redemption baskets reflect a pro rata slice of the ETF's portfolio securities, while the exemptive relief of other ETF sponsors does not include such a requirement. These and other inequities can dramatically impact the ETF's ability to manage liquidity. *See*, e.g., comment letter from Andy Gill, Charles Schwab & Co. Inc., and Marie Chandoha, Charles Schwab Investment Management on "Request for Comment on Exchange-Traded Products" (File No. S7-11-15). Available at: http://www.sec.gov/comments/s7-11-15/s71115-28.pdf.

[11] 80 Fed. Reg., at 62293.

Under the Commission's proposal, each fund is required to "assess the relative liquidity of each portfolio position based on the number of days within which it is determined, using information obtained after reasonable inquiry, that the fund's position in an asset (or a portion of that asset) would be convertible to cash."[12] The proposal goes on to outline nine factors that the fund would be required to consider in making the determination of which liquidity bucket each position in a portfolio asset should fall.

Unfortunately, assessing the relative liquidity of each portfolio position is a subjective exercise that does not lend itself well to a formulaic approach. Every fund manager will bring to the decision-making process a host of factors above and beyond those laid out in the proposal, and will be influenced by their own experience, biases and outside pressures. Managers will inevitably assess the liquidity of a particular security differently, with one placing it in one liquidity bucket and another placing it in a different liquidity bucket.

Indeed, the skill with which a portfolio manager assesses liquidity and reacts to changes in the marketplace that affect that liquidity is one of the distinguishing skills for which a portfolio manager is hired in the first place. Attempting to standardize the process of assessing liquidity and liquidity risk could impede innovation and differentiation within the asset management space. As a result, we recommend that the Commission make the nine factors it outlines in the proposal guidance, rather than requirements, providing more flexibility to fund managers to use their skill and expertise in the assessment of a security and the fund's liquidity.

Our most significant concern with the proposal is that it creates an "illusion of precision" that does not exist. The hyper-specificity of the six liquidity categories in the Commission's proposal misunderstands current liquidity assessment practices, by carving up liquidity into segments that have no practical meaning in the industry. The fund industry has never tried to determine whether a security is convertible to cash within such specific windows nor with the level of precision required by the proposal. For example, a portfolio manager is likely to be challenged in determining whether an asset can be converted to cash in 13 days versus 17 days[13] – yet the proposal requires that such a distinction be made in order to determine whether the asset is classified in the 8-15 day bucket or the 16-30 day bucket. Even within more liquid buckets, the distinction between a security that can be converted to cash with 2 days and one that can be converted to cash within 4 days is subjective and can be affected by changing market conditions.

In the proposal's discussion of the public reporting of this information, the Commission states that "a fund could determine that it could convert half of a portfolio position to cash in 2-3 business days and the other half of the position in 4-7 calendar days…"[14] The fund would be required to report the dollar amount attributable to each classification. But estimating the percentage of a particular portfolio asset that is convertible to cash in a particular time frame is highly dependent on broader market circumstances. We do not believe this level of specificity is

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[12] *Id.*, at 62292.

[13] Liquidity determinations become much more difficult for less liquid and illiquid securities. In our experience, it becomes particularly difficult to pin an exact date for when a less liquid security or illiquid security can be converted to cash past the seven-day mark.

[14] 80 Fed. Reg., at 62346.

relevant to investors, since the circumstances in which an entire fund asset needed to be liquidated at once would be exceedingly rare. The fund need only be able to liquidate the percentage of the portfolio asset (along with other assets in the portfolio) necessary to meet redemptions, which is likely to be far less than the entire position.

A potential unintended consequence of the Commission's proposal is that we fear it will increase competitive pressure on portfolio managers to assess the assets in the fund as more liquid than they really are. The Commission's emphasis on narrow differences in liquidity will inevitably lead to firms closely monitoring the liquidity assessments of comparable funds of other firms and then adjusting their own liquidity assessments in order to ensure they are not "out of step" with their competitors, particularly funds that have similar strategies and objectives. This will be especially true on the less-liquid end of the spectrum, where there exists less certainty with respect to how many days it might take a fund to convert a position to cash.

We also note that fund firms that adopt a "conservative" approach to assessing liquidity will be making their own portfolios look *less* liquid, by making conservative estimates of how long it will take them to turn their positions into cash. Firms that take a more aggressive approach, potentially underestimating the amount of time to convert certain positions to cash, would, perversely, appear to investors to be *more* liquid. Thus, the regulatory apparatus proposed by the Commission may incent aggressive, riskier estimations of an inherently difficult-to-predict factor. We do not believe individual investors will be well-served by a construct that effectively rewards funds that are less conservative when estimating their liquidity.

In addition, making a fund appear more liquid may conflict with a fund's investment mandates and strategies. If a fund begins to hold more cash or increase its investment in more liquid assets, this could result in tracking error. Over decades, the industry has developed funds with a wide range of characteristics and wide variety of risk levels. No one questions that this has been a positive development for investors, some of whom have a larger appetite for risk than others. The pressure to make a fund more liquid could stifle innovation and lead to a narrower range of options for investors. Investors who understand the risks associated with funds that invest in less liquid assets should have the option to invest in such funds. As long as those risks are clearly communicated and disclosed, regulation should not discourage their development.

Finally, the Commission observes in the proposal that "some third-party service providers currently provide data and analyses assessing the relative liquidity of a fund's portfolio assets"[15] and notes that these services could be used in the liquidity classification process. In fact, we believe that, should the proposed rule be finalized, third parties will inevitably scramble to both provide analytic services to funds and to produce easy-to-read "liquidity comparison" charts for investors to use to compare funds based on their liquidity. We think both outcomes are not in the best interests of funds and investors. Because there is no accepted methodology for determining liquidity and there is an inherent degree of subjectivity in the analysis, we think third parties will be unable to provide an accurate assessment of the liquidity of a fund and, worse, could be providing misleading comparative information to investors, contrary to the underlying goals of the Commission's proposal.

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[15] *Id.*, at 62297.

A strong third-party market for assessing and comparing funds by liquidity will be doing a disservice to investors by creating an "illusion of comparability." Liquidity within funds that have similar objectives will be hard to compare. Liquidity across different types of funds will mislead investors into thinking that a more liquid fund is a "better" investment than a less liquid fund, even though the two funds may have vastly different strategies and objectives. We believe third-party liquidity "scorecards" and comparative charts should be discouraged, rather than encouraged, by the Commission. Over-reliance on third-party assessments has proven dangerous in the securities arena before – for example, in the analyst scandals of the early 2000s and in the more recent issues plaguing the credit-rating industry. In the latter case, the Commission eliminated references to third-party credit ratings precisely because of the lack of reliability and independence in that space.

We note that our overriding concern in this area is with disclosure of the information on liquidity "buckets" to investors. As discussed above, CSIM strongly believes that investors will not be well-served by the level of detail required by the proposal and that the result will be an overemphasis on liquidity as a determining factor for investors. But we acknowledge that the Commission's market oversight efforts could be aided by more detailed reporting on the liquidity of a fund's portfolio assets. As we discuss further in the Reporting and Disclosure section below, we are open to a construct in which what is reported publicly to investors is different than what is reported to the Commission or, alternatively, a regime in which less liquid funds are required to report more detailed information than funds that meet a "highly liquid" standard. We note that the same challenges outlined above exist, but we believe that the Commission staff is more qualified than investors to understand the subjectivity involved in liquidity classification determinations and is better equipped to determine when a fund is understating or overstating the liquidity of its portfolio assets.

Alternative Approach

As an alternative approach, CSIM recommends simplifying the liquidity categories made available to the public to three: convertible to cash within 1-3 days; convertible to cash within 1-7 days; and convertible to cash in greater than 7 days. We recommend these categories in part because they are timeframes that are already familiar to asset managers and investors. Rule 15c6-1 of the Exchange Act requires settlement of securities trades within three business days, while Rule 22(e) of the Investment Company Act contains a seven calendar day requirement for meeting redemptions. For investors, these are long-standing, familiar deadlines on which they have relied for decades. We believe that less sophisticated investors will be able to understand that a position that is convertible to cash within three days would be considered highly liquid, an asset convertible to cash in 4-7 days is moderately liquid, and an asset convertible to cash in more than seven days is less liquid or illiquid.

We recommend that the second category be inclusive of the first category to help investors understand the total portion of the portfolio's assets that is convertible to cash within seven days. In other words, if a fund reports that 40 percent of its assets are convertible to cash within 1-3 days and 82 percent of its assets are convertible to cash within 1-7 days, an investor could make the easy calculation that 42 percent of the assets are convertible to cash within 4-7 days. We

think the more relevant information for investors, however, is that 82 percent of the assets are convertible to cash within 7 days, so we recommend making that number stand out clearly in the reporting.

Three categories rather than six also helps alleviate our concerns with the "illusion of precision" that we think results from the hyper-specificity of the categories proposed by the Commission. The degree of precision decreases as the number of categories increases, particularly for less liquid securities. In other words, the time it will take to convert a less liquid or illiquid security to cash is much more difficult to predict than the time it will take to convert a highly liquid security to cash. Investors will reap little benefit from forcing fund managers to be highly specific about something that is difficult to predict. What is most relevant to investors is the degree to which they can redeem their fund shares for cash and the likelihood that the redemption request will be satisfied in a timely fashion. While the liquidity determinations we recommend will continue to be subjective (though less subjective and less imprecise than the six categories proposed by the Commission),[16] our proposed categories conform to time frames that are understandable and familiar to both fund managers and investors.[17] The three-category approach reduces the chances of mischaracterizing the overall liquidity of a fund.

Our alternative approach strikes a balance by meeting the Commission's goal of providing investors (and regulators) with a better picture of the overall liquidity of a fund without forcing fund managers to use untested, yet highly-specific dividing lines between liquidity classification categories. That said, we believe even our alternative solution contains a degree of subjectivity and will be of limited use for investors in making comparisons among different funds. What will benefit investors is the requirement that each fund have a robust liquidity risk management program in place; that funds have the flexibility to construct, maintain and alter that program in response to the particular needs of the fund; that funds set and report a minimum level of three-day liquid securities suitable for meeting anticipated redemptions; and that investors have transparency into how the fund's investment adviser views the liquidity of the fund and the fund's ability to meet redemptions within both three and seven days.

Three-Day Liquid Asset Minimum

We generally support the Commission's proposal to have the fund's board establish, maintain, publicize, and, if necessary, alter, a minimum amount of assets that are convertible to cash within three days (the "three-day liquid asset minimum"). This will be a useful tool to help funds meet redemptions, but, perhaps more importantly, to give confidence to investors that the fund will be able to meet redemptions. In addition, the three-day liquid asset minimum, when combined with

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[16] While the 1-3 day, 1-7 day and 7 days or more categories will still involve subjective judgments by asset managers, thereby limiting the usefulness of comparing the percentages across funds and fund companies, we believe the information is valuable to investors because it gives them some insight into how their investment adviser views the liquidity profile of the fund. Investors would then also be able to compare the 1-3 day percentage to the fund's three-day liquid asset minimum to monitor how successfully the adviser is managing actual fund liquidity as compared to the fund's three-day target liquidity.

[17] We note that our proposed alternative aligns with the current Rule 2a-7 requirements adopted as part of the Commission's 2014 Money Market Fund reform efforts. Rule 2a-7 requires money market funds to maintain a certain percentage of daily liquid assets (securities that can be disposed of within one day) and weekly liquid assets (securities that can be disposed of within seven days).

our recommended three liquidity categories, will allow investors to assess the portfolio manager's performance by comparing the actual 1-3 day liquidity of the fund to the fund's three-day liquid asset minimum.

It is critically important that flexibility be afforded to the fund board in the setting of this minimum. The rule requires fund boards to keep written records of how the fund's three-day liquid asset minimum was determined.[18] But the rule proposal goes on to specify several factors that fund boards are *required to consider* in determining that three-day liquid asset minimum. We would suggest that, rather than codifying a set of factors, the Commission craft guidance on factors that it believes a fund board should consider in making its determination of the three-day liquid asset minimum. Such guidance could include all of the factors outlined in the proposed rule, in addition to other factors that the board may determine are relevant for the particular fund. Requiring fund boards to take into account all of those factors does not take into consideration the particular qualities of the fund.

We agree with the Commission's decision not to set a floor or an across-the-board standard figure for the three-day liquid asset minimum. Rather than create an arbitrary "red line" for funds, the Commission defers to the expertise of the fund manager and the fund's board to make this determination. This flexibility is appropriate given the vastly different objectives and strategies of different funds. We do not believe there is any realistic way for the Commission to set a specific three-day liquid asset minimum that would be appropriate across all funds.

In addition, we would recommend that the Commission alter the rule proposal to eliminate the requirement that the fund board approve any changes to the three-day liquid asset minimum. We do not believe this would be practical, as it can be difficult to convene a fund board on short notice, and the fund may need greater flexibility to alter the minimum based on market circumstances. We recommend that the rule allow the fund board to designate the fund or fund's advisor to adjust its liquidity minimum quickly when circumstances warrant. In such circumstances, the fund or fund advisor must provide a written report to the fund's board within a specific amount of time, explaining the circumstances that warranted a change in the fund's three-day liquid asset minimum. The fund board would be in an oversight role. We note that the Commission contemplated the complexity of assembling the board on short notice in the proposal, observing in a discussion of an alternative proposal that the Commission considered but did not propose:

> This would provide flexibility, for example, for a fund to adjust its liquidity profile very quickly in light of changing market conditions, whereas a fund subject to the three-day liquid asset minimum requirement might not be able to do so as quickly to the extent a fund's board would be required to approve a change in the fund's three-day asset liquid minimum.[19]

We read this as an acknowledgement that the Commission recognizes that board approval of every change in a fund's three-day liquid asset management may be impractical from a logistical standpoint. We agree and thus recommend altering the proposed rule to allow the fund board to

[18] 80 Fed Reg., at 62311-62312.

[19] *Id.*, at 62365.

designate the ability to change the minimum to the fund advisor, subject to notice of any such change to the Board.

For this reason, we also suggest that the rule clarify that a fund cannot be charged with a compliance violation based solely on the fund's liquidity falling below the three-day liquid asset minimum, if documentation exists to show that the fund made a good-faith effort to consider the factors outlined in the Commission's guidance and made a reasonable determination based on those factors as to what an appropriate three-day liquid asset minimum should be. As the Commission notes in its discussion of the required periodic review of a fund's three-day liquid asset minimum:

> A fund's three-day liquid asset minimum could become outdated for multiple reasons. For example, a fund's shareholder ownership concentration could change or market events could reveal that shareholder redemption patterns are different than anticipated under certain circumstances. Additionally, market events or national regulatory, monetary, and fiscal policies could affect the liquidity of a fund's portfolio assets. Any of these events, or similar events influencing a fund's cash flows, portfolio liquidity, or the other liquidity risk factors included in proposed rule 22e-4(b)(2)(iii), could alter the level of three-day liquid assets that a fund would determine appropriate to manage its liquidity risk.[20]

We think it highly likely that, at some point, most funds will "miss" their three-day liquid asset minimum due to market or world events that cannot be reasonably anticipated. A demonstration by the fund that a good-faith effort was made to consider all the relevant factors outlined in Commission guidance should protect a fund from penalties or other enforcement action in extreme market circumstances.

II. Reporting and Disclosure

CSIM supports enhanced disclosure of information about the liquidity of open-end funds[21] as a means to help the Commission in its role as the industry's primary regulator and to help investors make more informed investing decisions by providing more transparency into fund investment practices. Information about the fund's liquidity risk management program will be particularly helpful to investors, as will disclosure of a fund's overall liquidity picture and a fund's three-day liquid asset minimum. CSIM also supports enhanced reporting to the Commission, so that regulators have as much information as possible to fulfill their core obligations to protect investors and to maintain fair, orderly and efficient markets. Importantly, though, these two goals are not always aligned: information and data that will be helpful to the Commission in fulfilling its mission is not always information that is useful to the investing public. As noted in CSIM's comment letter on the Commission's Investment Company Reporting Modernization

[20] *Id*., at 62315.

[21] As noted above, CSIM proposes an alternative to the Commission's proposal for the liquidity categories that would be provided to investors, which we believe will be more understandable for investors.

proposal in 2015, we recommend that not all information reported to the Commission should be made available to the public.[22]

Specifically, we recommend that the Commission continue to make Form N-Q, which details portfolio holdings, available to the public on its current filing and release schedule, while keeping the monthly filing of Form N-PORT – or at least key elements of Form N-PORT – confidential. We further recommend that the Commission make available to the public a general assessment of the liquidity of a portfolio at the fund level, rather than the individual security level. The Commission could, for example, require a fund to report the percentage of its assets in each of the three liquidity "buckets" that we recommend above. More detailed information, including the fund's assessment of the liquidity of each asset at the individual security level, could be provided to the Commission but kept confidential.

Another approach the Commission could consider is requiring more detailed reporting from funds that hold a larger percentage of securities that are less liquid or illiquid. The Commission could set a threshold of the percentage of the most liquid securities a fund must hold in order to be exempt from the more detailed reporting. Funds in the most liquid category would continue to report the fund-level liquidity in the three classifications we recommend above, while funds holding a greater percentage of less liquid and/or illiquid securities would be required to report a more detailed liquidity analysis at the individual security level. We note that the Commission has taken such a bifurcated approach before, including in its recent rule proposal on derivatives, which has enhanced requirements for funds whose aggregate exposure to derivatives exceeds 50% of its net assets.[23]

We recommend these alternative approaches because we are concerned, for several reasons, that the disclosures outlined in the Commission's proposal will not be beneficial for investors. First, we believe that the investing public would be overwhelmed by the sheer volume of information reported on Form N-PORT. With more than 17,000 open-end funds and exchange-traded funds reporting this information on a monthly basis, and each reporting the liquidity of anywhere from dozens to more than a thousand individual portfolio assets, the amount of information will be overwhelming to investors. It is not at all clear how investors would sift through this information to make sense of it.

Moreover, because there are no uniform standards for measuring liquidity beyond the most liquid securities, funds will use their own methodologies to assess the liquidity of each fund position, inevitably leading to different assessments of the liquidity of a particular portfolio asset. Investors are likely to be confused by this information, particularly in situations when the same portfolio asset is classified in a different liquidity bucket by two different funds. Investors are more likely than not to believe that a fund is a) more or less liquid than it actually is and/or b) more or less liquid than another comparable fund offered by a different asset manager. Since the

[22] See comment letter from David J. Lekich, Charles Schwab Investment Management, Inc., on "Investment Company Reporting Modernization" (File No. S7-08-15) and "Amendments to Form ADV and Investment Adviser Act Rules" (File No. S7-09-15), August 11, 2015 ("CSIM Reporting Modernization letter"). Available at: http://www.sec.gov/comments/s7-08-15/s70815-314.pdf.

[23] "Use of Derivatives by Registered Investment Companies and Business Development Companies." SEC Release No. IC-31933; File No. S7-24-15. 80 Fed. Reg. 80884, December 28, 2015.

investor will have no way to compare the criteria used by each fund manager to determine the liquidity, the information fails to benefit the investor and may actually harm the investor.

Second, CSIM fears that making this information public will lead to a rise in third-party aggregators of liquidity data, producing a similar situation as the one that plagued the credit-rating agencies in the run-up to the financial crisis of 2008. In that situation, investors came to rely upon credit-rating agencies and their assessments of securities, even though the rating agencies were later found to have inflated their ratings. For that reason, we are not comforted by the Commission's assertion that "third-party data analyzers could use the reported information to produce useful metrics for investors about the relative liquidity of different funds with similar strategies."[24] Because those metrics would be based on the subjective assessments of each fund about its own liquidity, CSIM believes that over-reliance on third parties will be a negative outcome for individual investors.

Third, we are concerned that the reporting process could create a misleading view of the liquidity of a fund because of the lag time in the reporting itself. Liquidity determinations are by their nature specific to a point in time and can change soon after that point in time, rendering them less valuable to investors, particularly for comparative purposes. The liquidity of a particular security can be dramatically affected by market conditions and by specific developments related to that security. There are countless instances of a breaking news development that has affected the liquidity of a security, for example. As a result, a security that has been assessed as being highly liquid on one day, in one set of market circumstances, may turn out to be less liquid another day, in a different set of market circumstances. The liquidity assessment and categorization envisioned by the Commission will inevitably be only a snapshot in time, reported with a significant lag. An investor reviewing a publicly-reported assessment of fund liquidity is virtually certain to be reviewing outdated information and thus believe that a fund is more or less liquid than it actually is.

Finally, the volume of information on liquidity may mislead investors into thinking that the liquidity of a fund is the only, or at least the most important, factor to consider when making an investment decision. While fund liquidity is important, there are many factors that an investor should consider when making an investment decision. As a result, we believe any disclosure to the public about the liquidity of a fund or its assets be accompanied by disclosure educating investors about both the utility and the limitations of the information.[25]

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[24] 80 Fed. Reg., at 62346.

[25] Fund registration statements and websites should explain to shareholders in plain English that the purpose of the liquidity disclosures is to inform investors about how a portfolio manager is managing liquidity in a fund, and specifically how that liquidity is being managed against a fund's published three-day liquid asset minimum. It is intended to help investors assess the likelihood a fund can meet redemption requests in a timely fashion. The disclosure should also inform investors that the liquidity assessments are point in time and that a portfolio manager's assessment of the liquidity of a given security or fund can change and fluctuate as market conditions change, sometimes rapidly. In addition, given the subjective nature of liquidity determinations, the disclosure should also caution investors that the liquidity information has limited use for comparative purposes and should be considered only in conjunction with other investment factors, such as the fund's investment objective, strategy, expenses, performance and other risks.

For these reasons, we believe our recommended alternatives will be more useful to investors, by providing them with an overview of each fund's liquidity in three, easy-to-understand categories and by allowing for investors to compare the actual liquidity of the fund to the three-day liquid asset minimum set by the fund. While either of our alternatives would not completely solve our concerns about the subjectivity of the liquidity determination leading funds to self-report their assets as more liquid than they really are, we believe that rigorous Commission oversight will reduce this problem, as the Commission would have access to the underlying security-by-security liquidity assessments made by the fund. The Commission has the expertise to understand the methodologies used to determine the liquidity of each portfolio asset. Strong oversight by the Commission will reduce attempts to mischaracterize the liquidity of a portfolio asset, and there will be less incentive to do so if this information is not made available to the public.

III. Swing Pricing

The second major element of the Commission's proposal is to permit a fund, in certain circumstances, to implement "swing pricing." The proposal defines swing pricing as

> the process of adjusting the fund's NAV to effectively pass on the market impact costs, spread costs, and transaction fees and charges stemming from net capital activity (*i.e.,* flows into or out of the fund) to the shareholders associated with that activity, in order to protect other shareholders from dilution arising from these costs.[26]

CSIM supports the goal of ensuring that faster-moving shareholders are not advantaged over remaining shareholders in times of market volatility. We also agree, at least in theory, that "in addition to mitigating potential dilution arising from purchase and redemption activity, swing pricing could also help deter redemptions motivated by any first-mover advantage."[27] This is potentially an important additional tool for funds to ensure that first movers bear some of the cost of their activity rather than have those costs be borne by remaining shareholders.

Unfortunately, we believe it will be difficult for most funds to implement this potentially useful tool in the US market. To implement swing pricing, a fund must understand its entire picture of redemptions and purchases in order to assess accurately the day's net flows. While individual investors can and do enter mutual fund trades during the course of a trading day, those trades are not executed until well after the 4 p.m. Eastern Time close of the market. But the redemption and purchase requests that have come in during the trading day represent only a portion of a fund's daily flows. A significant portion of the flow comes from retirement plans and other "omnibus" trades that are not known until well after market close and, importantly, well after the typical time for striking the net asset value of a mutual fund. At Schwab's affiliated broker-dealer, on average, about 30% of the gross purchases and redemptions come through the retirement channel, which is not known until well after the end of the trading day. The result is a "chicken and egg" problem inherent in the current process: retirement plans need the NAV in order to process and aggregate plan participant requests, but funds would need the retirement

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[26] 80 Fed. Reg., at 62327.

[27] *Id.*, at 62329.

plan information before the NAV is known in order to determine whether to implement swing pricing.

We observe that the Commission, in a rule proposal that runs to 114 pages of text in the *Federal Register*, devotes just two paragraphs to discussion of "Operational Processes Associated with Swing Pricing."[28] We believe the operational issues warrant considerably more attention. Those paragraphs note that

> Because the deadline by which a fund must strike its NAV may precede the time that a fund receives information concerning daily net flows from the fund's transfer agent, a fund may wish to arrange for interim feeds of flows from its transfer agent or distributor in order to reasonably estimate its daily net flows for swing pricing purposes.[29]

This suggestion, however, does not account for how a fund would get intraday information from, for example, a large retirement plan that typically rolls up all the transactions made over the course of the day by plan participants into a single "omnibus" report. That information typically comes to the fund two to four hours after the close of the market and the volume contained in that report can materially affect a fund or a portfolio asset of a fund.

As a result, in order to make a determination of whether to implement swing pricing, a US-based fund would need to estimate the flow information that will come in later in the day, what the Commission in its proposal calls making a "reasonable inquiry."[30] Swing pricing, however, should be a tool of last resort – an action taken only in the most narrow circumstances. Such a decision should not be made on an estimate or inquiry; it should be made on facts. Since the proposal requires that a fund must pre-establish a set "swing threshold," at which point the fund would be required to adjust its price by a pre-established "swing factor," there is no way to know whether the threshold has been reached until all information about net flows is available. Without access to all facts about net flows, a fund cannot make a reasonable determination whether to implement swing pricing. Swing pricing should not occur without certainty that it is in the best interest of the fund and its investors. It should not occur based on an estimate.[31]

The Commission makes much in the proposal of the fact that swing pricing has been implemented and proven an effective tool in Europe. We concur with this assessment. But most

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[28] *Id.*, at 62341.

[29] *Id.*, at 62341.

[30] *Id.*, at 62328.

[31] We understand that some funds may receive significant flow information prior to the time the funds strike their NAV (e.g., 80% or more), such that it may be possible for them to confidently measure those flows against the fund's swing threshold. But this is not the case for all funds, and we understand that some funds may receive a small portion of that information on any given day (e.g., 20-30%). This is particularly true for funds made available principally through retirement plan channels. While swing pricing could be adopted and used as an option for funds that receive sufficient flow information, we believe this could create an uneven playing field, in which some funds are able to utilize the swing pricing option and others are not. As a result, we do not believe swing pricing should be adopted until the operational challenges associated with swing pricing are resolved and it becomes an equallyreliable option for all funds.

funds in Europe have a very different operational structure. Most significantly, most funds have a 12 p.m. cut-off time for transactions to get that day's price. That allows several hours for the fund to gather the necessary information on the day's flows, from all sources, in order to determine whether to implement swing pricing. The determination of whether to swing the price is based on *actual* or near complete flow information rather than *estimated* flow information. In addition, European-based funds generally receive the next day's price, known as T+1 pricing. In such a situation, funds have all the information needed to apply swing pricing uniformly, without disadvantaging certain shareholders.

One option available to a US-based fund to implement swing pricing, then, is to impose an earlier cut-off time for investors to request a purchase or a redemption in order to get that day's price. Such a cut-off would need to be set several hours before market close, at perhaps 12 p.m. Retirement plans and other omnibus trades would need to impose a similar cut-off in order to provide funds with the flow data necessary to determine whether swing pricing needs to be imposed.[32] But the vast majority of funds are likely to be unwilling to change their cut-off times unless all funds did, to eliminate the competitive disadvantage. Imposing such a requirement on the industry by regulatory requirement would mitigate that issue, but would create a competitive disadvantage for mutual funds with other types of investment products, such as hedge funds and collective trusts, that could continue to accept trades throughout the day.

A related option is to require the entire industry to adopt T+1 pricing: investors who place an order to purchase or redeem shares would receive not the price struck at the end of the day on which they place their trade, but rather the price struck at the end of the day following their trade request. This would require Congress to change the Investment Company Act of 1940, which we do not believe politically or practically feasible. It would also represent a fundamental reshaping of an industry that has served investors for decades.

In preparing our response to the Commission's swing pricing proposal, CSIM considered various alternatives that would achieve the same goals, including imposing exit or redemption fees; implementing "dual pricing," or moving to the aforementioned T+1 environment. Each of these options, however, has its own significant operational, structural or legal challenges and will have a significant impact on investors. As previously noted, such steps would place open-end funds at a competitive disadvantage to other investment vehicles, such as hedge funds and collective trusts.

As a result of the above-outlined complexities, we do not believe the Commission should move forward at this time with a rule that finalizes swing pricing as an option for open-end funds. We recommend that the Commission convene a working group of fund representatives to work with Commission staff to examine further how the concept of swing pricing can be adapted for use in the US market or whether an alternative can be developed that achieves the same worthy goals.

[32] We note as an aside that even this process does not solve the above-described "chicken and egg" problem, as retirement plans would still need the NAV in order to run their processes.

Additional Concerns with the Swing Pricing Proposal

While CSIM believes that the operational challenges to implementing swing pricing on an equitable basis across all funds are, at the moment, insurmountable, we support efforts by the industry and the Commission to continue to work toward finding a suitable solution. With that in mind, we offer additional comments regarding the swing pricing proposal that the Commission should consider if and when those operational challenges are solved or an alternative is deemed viable.

First, each fund should be required to develop policies and procedures regarding how it determines whether swing pricing should be implemented and what factors are considered by the fund before making that decision. This should include determining the fund's swing threshold (the point at which a fund must consider whether to impose swing pricing) and the fund's swing factor (the amount by which a fund will adjust its NAV if swing pricing is determined to be appropriate). These policies should be approved by the fund's board, clearly disclosed in the fund's prospectus and easily accessible to the public online.

Those policies and procedures, including the setting of the swing threshold and the swing factor, should not be determined by regulation, but by the fund itself. While the proposal grants some discretion to the fund's board in developing the policies and procedures for swing pricing, the proposal also goes into detail on what elements a fund is required to consider in specifying its swing threshold. The proposal envisions a one-size-fits-all threshold that does not adequately take into account the variety of factors and market conditions that could exist. The rule should allow a fund board discretion to develop its own factors, clearly outlined in its policies and procedures, for determining whether to implement swing pricing.

Second, funds should have discretion to determine whether hitting the fund's swing threshold requires the implementation of swing pricing. The swing threshold is by its very nature an arbitrary line, set in a particular moment in time. While funds will of course take great care in setting that threshold, it remains arbitrary because it cannot anticipate all circumstances; indeed, as soon as the threshold is set, it becomes outdated by virtue of changing market circumstances. By the time that threshold is crossed, months or years may have passed, and the market circumstances will undoubtedly be very different than they were when the swing threshold was first determined. The Commission envisions a rigid application of swing pricing, which is not in the best interest of investors.

We recommend that the swing threshold be set as a guideline, a reflection of where the fund believes the risk occurs. But the fund must have the discretion to decline to impose the swing factor when the swing threshold has been crossed, if the fund determines that the particular circumstances do not warrant swing pricing. Conversely, the fund should have the discretion to impose swing pricing prior to the swing threshold being breached if it determines that doing so is in the best interest of the fund and its investors. Flexibility would protect a fund from being forced to impose swing pricing when circumstances do not warrant taking such action or from being unable to impose swing pricing when circumstances do warrant it simply because the swing pricing policy of a fund did not anticipate a particular set of circumstances. The key factor is an assessment by the fund that it has sufficient cash available to meet redemptions without

impacting the fund's net asset value. That determination should be made by analyzing the particular circumstances, rather than by crossing an arbitrary threshold set days, months or years earlier.[33]

Third, the rule's approval and oversight requirements create a cumbersome approval structure that could be detrimental to the fund's ability to react quickly to changing market conditions. The rule requires the board, including a majority of the board's independent directors, to approve the fund's swing pricing policies and procedures and any subsequent changes thereto. The proposal does – appropriately, in our view – recognize that board approval for the actual implementation of swing pricing is unrealistic. As the Commission notes, the decision whether or not to impose swing pricing will undoubtedly take place during a volatile market and a decision will need to be made with haste. The complex logistics of convening the board to review the circumstances and adjust the swing threshold as necessary undermine the utility of swing pricing.

To that end, the proposal allows the board to designate the fund's investment adviser or other officers to administer the fund's swing pricing policies and procedures, including making the determination that implementing swing pricing is appropriate. We recommend clarifying the rule to ensure that fund boards must approve the fund's swing pricing policies and procedures and must review on a regular basis whether adjustments should be made to the policies and procedures. But the fund board should delegate to an appropriate individual or committee the decision-making process regarding whether to implement swing pricing.

Fourth, the rule should incorporate a safe harbor for boards and funds that protects the board, the fund and any individual from liability regarding decisions made to implement (or not implement) swing pricing, if the fund's swing pricing policies and procedures were in place, those policies and procedures were clearly followed correctly, and the level of board oversight was appropriate. Fund boards, advisors and individuals should not have to act (or not act) in fear of being second-guessed by shareholders, courts and regulators.

To reiterate, we offer these four recommendations only if and when the fundamental operational hurdles that prevent swing pricing from being implemented in the current US markets are overcome.

IV. Operational Costs and Implementation Time

We recognize that development and implementation of the liquidity risk management program will be a costly and time-consuming endeavor. While CSIM already has a program in place, modifications will undoubtedly be required to meet the regulation's requirements. Development of swing pricing capability, in the case that the Commission and the industry are able to overcome the structural challenges outlined above, will be an enormous undertaking. An

[33] We note that in the Money Market Fund reform rules of 2014, the rule provides a trigger point at which the fund's board must determine whether to impose liquidity fees and/or redemption gates, but the rule is flexible, allowing both for a decision by the fund's board not to impose fees or gates when the trigger is reached and also to impose gates or fees proactively, prior to the trigger being reached, if circumstances warrant. Similar discretion should be provided in the liquidity risk management rule for open-end funds.

entirely new system will have to be built, with significant data processing capabilities. In addition, extensive policies and procedures will need to be developed, including new compliance oversight and supervisory procedures. Additional personnel will need to be hired.

CSIM believes that the Commission has significantly underestimated the cost of developing and implementing the systems and procedures to comply with the proposed rule. In particular, we note that the Commission has estimated a one-time cost of $1.3 million to $2.25 million to establish and implement swing pricing policies and procedures, and that the Commission has based this estimate in part on the staff's estimates of the costs of implementing the fees and gates provisions of the 2014 money market fund reform rule.[34] CSIM can state categorically that its own experience is that the implementation cost estimates for the money market fund reform rule were understated severely. It is our belief that implementing swing pricing would likely be more costly, on the order of four to five times the estimates.

The implementation costs and ongoing operational costs of the entire proposal are likely to be overwhelming for smaller fund companies. CSIM believes that many small fund companies will simply be unable to afford compliance with the rule and will be forced to cease operations or consolidate with a larger fund company, reducing investor choice. The situation is exacerbated by the somewhat paradoxical framework of placing the same burden of liquidity risk management program oversight and reporting on, for example, a straightforward, low-cost, robust, highly liquid fund as on a fund that operates with a less liquid strategy. The latter fund can charge higher fees based on the suggestion that it delivers higher performance – performance derived from what is, fundamentally, a risk premium resulting from the acceptance of higher liquidity risk. The most obvious solution to rectify such an imbalance would be to make some distinctions in levels of liquidity risk management program oversight and reporting, and we suggest how the Commission could make such distinctions above.

As with any rule proposal, there is a need to ensure that the right balance is struck between its goals and its costs. Generally, CSIM believes that the proposal has positive benefits for the Commission in its role as the industry's primary regulator and in support of its mission of protecting investors. We also believe that there are potential benefits to investors. We urge the Commission to consider our recommendations for reduced reporting for funds that hold a very high percentage of the most liquid securities as a way to reduce overall costs.

Finally, the proposal recommends two different compliance dates depending on the size of the fund: 18 months after the effective date of the rule for larger fund companies and 30 months after the effective date for smaller fund companies. CSIM recommends harmonizing those dates so that all funds have a compliance date of 30 months after the effective date of the rule. The operational complexities envisioned by the rule are no different for funds of different sizes, and while we acknowledge that fund companies of different sizes may have different resources available for compliance, we see no compelling reason to force larger companies to rush through a complex and costly implementation process.

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[34] 80 Fed. Reg., at 62367, note 759.

V. Conclusion

CSIM appreciates the Commission's effort to increase transparency and make more information available to investors about the liquidity risks posed by open-end funds. We believe requiring funds to have in place and publicly disclose the details of a liquidity risk management program will increase investor confidence. We support each fund reporting publicly its self-imposed minimum portion of net assets that must be convertible to cash within three days. We recommend a simplified liquidity categorization system that we believe will be more useful to investors than what has been proposed. We also support many of the requirements for enhanced disclosure, with the recommended division between what is reported to the public and what is provided to the Commission. And we urge the Commission to consider ways in which the reporting burden could be reduced for funds that invest primarily in liquid securities, with enhanced reporting required for funds that invest a significant portion of their assets in less liquid or illiquid securities. Finally, while we support the concept of swing pricing, we have concluded that swing pricing is operationally difficult and not feasible for most funds in the current US trading environment, and we recommend that the Commission and the industry work together to determine whether those operational hurdles can be overcome.

CSIM welcomes the opportunity to comment on the proposal. We would be pleased to respond to questions or provide any additional information that would be helpful to the Commission as it continues its consideration of the proposal.

Sincerely,

Marie Chandoha
President and Chief Executive Officer
Charles Schwab Investment Management, Inc.

cc: Mary Jo White, Chairman, Securities and Exchange Commission
Kara Stein, Commissioner, Securities and Exchange Commission
Michael S. Piwowar, Commissioner, Securities and Exchange Commission

David Grim, Director, Division of Investment Management, Securities and Exchange Commission