



1401 H Street, NW, Washington, DC 20005-2148, USA  
202/326-5800 www.ici.org

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 Investment Company Institute (“ICI”)<sup>1</sup> appreciates the opportunity to comment on the Securities and Exchange Commission (“SEC” or the “Commission”) proposal to promote effective liquidity risk management throughout the open-end fund industry.<sup>2</sup> The proposal addresses matters of substantial importance and complexity that affect virtually all of our members, and we therefore appreciate the 90-day period that the Commission provided for comments.

As the SEC states in the Release, daily redeemability is a defining feature of mutual funds and other open-end management investment companies,<sup>3</sup> and has been such since passage of the Investment

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<sup>1</sup> The Investment Company Institute (ICI) is a leading, global association of regulated funds, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI’s U.S. fund members manage total assets of \$17.9 trillion and serve more than 90 million U.S. shareholders.

<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, 80 Fed. Reg. 62274 (Oct. 15, 2015) (the “Release”), available at [www.gpo.gov/fdsys/pkg/FR-2015-10-15/pdf/2015-24507.pdf](http://www.gpo.gov/fdsys/pkg/FR-2015-10-15/pdf/2015-24507.pdf).

<sup>3</sup> Unless otherwise indicated, references in this letter to “funds” include registered mutual funds and open-end ETFs, and exclude money market funds. References to “mutual funds” or “open-end funds” also exclude money market funds. In discussions of swing pricing, references to “funds” include only mutual funds.

Company Act of 1940 (the “1940 Act”).<sup>4</sup> Meeting shareholder redemptions is therefore integral to the successful management of any fund—and something to which fund managers must, and do, pay the closest attention. For 75 years, through bull and bear markets, long-term mutual funds have met redemptions with great success. Since 1984, for example, mutual funds and ETFs have accommodated gross redemptions totaling \$54 trillion.<sup>5</sup>

The proposal’s broad objectives are to reduce the risk that funds will be unable to meet redemptions, or will meet redemptions in ways that dilute interests of fund shareholders, and to enhance disclosure regarding fund liquidity and redemption practices.<sup>6</sup> The SEC seeks to achieve its stated goals by:

- Requiring each fund to establish a formal liquidity risk management program that is designed to: (i) assess and manage the fund’s liquidity risk; (ii) classify and monitor each portfolio asset’s level of liquidity; and (iii) designate a minimum amount of portfolio liquidity (the “proposed rule”);
- Requiring each fund to make public its liquidity classifications and information about redemptions and swing pricing (if applicable) through disclosure on Form N-1A, proposed Form N-PORT, and proposed Form N-CEN; and
- Permitting, but not requiring, mutual funds to use swing pricing in pricing their shares.

## **Summary of ICI’s Comments**

### **A. Proposed Liquidity Risk Management Program Rule—Areas of Support**

ICI strongly endorses the SEC’s proposal to require each fund to adopt a formal, written liquidity risk management program reasonably designed to assess and manage a fund’s liquidity risk. The fund industry long has employed sound liquidity risk management practices, but even more can be done to promote discipline, rigor, and formalized thinking about fund liquidity. A truly risk-based rule would require all fund managers to assess the liquidity characteristics of the strategies they employ and

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<sup>4</sup> Section 5(a)(1) of the 1940 Act defines an open-end fund as one that offers “redeemable securities.” Section 2(a)(32) of the 1940 Act defines “redeemable security” as “any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer’s current net assets, or the cash equivalent thereof.” Valuation is critically important for funds, and Section 2(a)(41) of the 1940 Act defines “value” for purposes of valuing the assets of a fund. Section 22(e) of the 1940 Act prohibits a fund from suspending the right of redemption or postponing the date of payment or satisfaction upon redemption of any redeemable security for more than seven days after the tender of such security for redemption, subject to certain exceptions.

<sup>5</sup> See Letter from Brian K. Reid, Chief Economist, Investment Company Institute, to Brent J. Fields, Secretary, Securities and Exchange Commission, dated January 13, 2016 (“ICI Research Letter”), at Section II.A and Figure 1.

<sup>6</sup> Release at 62274.

assets in their funds, which would lead to enhanced liquidity protocols, particularly for funds that invest in less liquid markets or instruments. Rule 38a-1 under the 1940 Act, the classic example of a program-based rule, successfully has enhanced a critical aspect of fund operations—compliance with the federal securities laws. Rule 38a-1’s general procedural framework requires, among other things: written policies and procedures; board approval of those policies and procedures; annual review of the adequacy of those policies and procedures; the submission of an annual written report to the board addressing the operation of those policies and procedures; and recordkeeping of those written policies and procedures and other materials provided to the board. The proposed rule includes clearly analogous provisions, and we applaud the SEC for looking to this successful model.

The proposed rule also includes substantive provisions that we support. We support a *general* requirement that funds classify and monitor the liquidity of their portfolio assets. We generally support requiring funds to assess and periodically review “liquidity risk,” and regard the proposed factors for making this assessment as practical. With respect to managing liquidity risk, we support codifying the 15% limit on illiquid assets, and requiring that funds adopt policies and procedures if they engage in, or reserve the right to engage in, redemptions in-kind. Broadly speaking, we agree with how the SEC has framed the fund board’s role within the proposed rule, *i.e.*, as one of oversight.

## **B. Proposed Liquidity Risk Management Program Rule—Areas of Opposition**

### **1. Asset Classification and Three-Day Liquid Asset Minimum**

We oppose the proposal’s very specific and prescriptive elements: the six-category asset classification scheme and the “three-day liquid asset minimum.” Those elements are quite problematic and simply do not comport with sound risk management practices. They also would divert resources toward a one-size-fits-all approach rather than encourage more diverse, risk-based liquidity management practices that have worked well for funds and their investors. These prescriptive elements, in turn, could introduce new risks to fund shareholders and the financial system.

We advance reasonable alternatives to these problematic elements for the Commission’s consideration, designed to achieve the primary goals of the rulemaking. We strongly recommend that, instead of the asset classification scheme, the SEC require each fund to formulate policies and procedures to determine how best to classify and monitor the liquidity of portfolio assets. In place of the three-day liquid asset minimum, we strongly recommend that the SEC require each fund to formulate policies and procedures to determine how best to reasonably ensure that the fund has sufficient liquidity to meet redemptions under normal and reasonably foreseeable stressed conditions, consistent with its investment objective. In connection with each of these alternatives, a fund would provide related monthly reporting to the SEC (on a non-public basis) on proposed Form N-PORT and enhanced public disclosure regarding how it assesses, classifies, and monitors liquidity risk on Form N-1A (the fund’s registration statement).

## **2. Public Disclosure of Liquidity Classifications**

We oppose the proposed requirement that funds publicly disclose their liquidity classifications because this disclosure would provide a misleading appearance of comparability among funds and naturally lead to unwarranted second-guessing. The disclosure also could reveal a key element of a fund's portfolio strategy—providing yet another means for third parties to dissect and abuse the fund's proprietary investment strategy. We strongly urge the SEC to reconsider the damaging effects public disclosure of this information would have on shareholders, if the Commission determines to adopt a mandatory liquidity classification scheme.

## **3. Aspects of “Liquidity Risk” Definition**

The proposal's definition of “liquidity risk” has two key elements. We agree with the first element, which appropriately focuses on a fund's ability to meet redemptions under normal and reasonably foreseeable stressed conditions. We fundamentally disagree, however, with the second element, which goes much further by requiring a fund also to assess the risk of meeting those redemptions “without materially affecting the fund's net asset value.” Likewise, we fundamentally disagree with the asset classification scheme's analogous requirement that a fund classify asset liquidity for regulatory purposes based on sales of portfolio assets “at a price that does not materially affect the value of that asset immediately prior to sale.”

*Any* market participant, including a fund, may engage in asset purchases and sales that affect the value of that asset (*i.e.*, result in market impact). And *any* market participant, including a fund, may experience losses or gains in connection with these transactions, for any number of reasons (*e.g.*, geopolitical developments, macroeconomic developments, general market sentiment, industry- and sector-wide developments, issuer-specific developments, *etc.*). Fund investors take on these various risks knowingly and willingly. Placing a regulatory demand on a fund to tease out the extent to which *fund activity* is affecting, or would affect, its net asset value (“NAV”) (or the values of its assets) as an element of liquidity risk management simply cannot be justified. Further, expert liquidity risk management cannot possibly be expected to buffer a fund from these larger market forces. As fiduciaries, fund managers are, and should be, sensitive to all costs associated with asset purchases and sales, including market impact. In assessing, reviewing, and managing liquidity risk, a fund manager's focus should be on meeting redemptions in normal and reasonably foreseeable stressed conditions, and doing so in a way that is prudent, cost-effective, and fair to shareholders. Any final liquidity risk management rule should reflect this expectation but go no further by seeming to suggest that funds should be managed in a manner that protects their NAVs from the market impact of portfolio asset sales.

### **C. Swing Pricing**

We urge the SEC to carefully explore the potential benefits, disadvantages, and operational challenges of swing pricing. ICI members do not share a uniform view on the desirability of the SEC authorizing swing pricing. Some ICI members (generally, those that use swing pricing in Europe) have

articulated potential benefits similar to those that the SEC has outlined in the Release, including mitigating dilution on days on which a fund experiences heavy purchases or redemptions. Other members have articulated potential disadvantages similar to those outlined in the Release, such as lack of transparency to investors, and application of a single adjusted NAV to all shareholder orders, regardless of order size. Beyond these varying conceptual views, fundamental differences in U.S. and European fund operations create quite severe challenges to implementing swing pricing in the U.S. These operational challenges must be addressed before swing pricing could ever be implemented in the U.S.

#### **D. Further Considerations**

In sum, there is a very clear path for the SEC to advance a final package of reforms that would enhance effective liquidity risk management practices—by building on the proposal’s strong foundational elements and existing sound liquidity management practices, adopting reasonable alternatives to the proposed liquidity classification scheme and three-day liquidity minimum, and avoiding public disclosure of liquidity classifications. ICI stands ready to assist in these efforts.

#### **Structure of the Comment Letter**

We set forth our views on each of the elements of the proposal in greater detail below. Our letter includes five parts and five appendices, as follows.

- *Part I* discusses the fund industry’s current liquidity risk management practices and historical experience with meeting redemptions.
- *Part II* provides comments on the liquidity risk management program proposal.
- *Part III* addresses the swing pricing proposal.
- *Part IV* provides comments on specific disclosure elements of the proposal.
- *Part V* provides comments on the SEC’s proposed implementation dates for the proposed rules and other requirements.
- *Appendix A* is an ICI Working Paper titled “Overview of Mutual Funds’ Liquidity Management Practices” (“ICI Liquidity Working Paper”), which we prepared in close collaboration with the ICI’s liquidity management working group and provided to the SEC staff in June 2015 to help inform them about our members’ current practices in this area.
- *Appendix B* summarizes the relevant orders that the SEC has granted under Section 22(e) of the 1940 Act.

- *Appendix C* summarizes liquidity risk management requirements for European Union (“EU”) funds.
- *Appendix D* outlines common European operational practices related to swing pricing in greater detail.
- *Appendix E* summarizes swing pricing rules and guidelines outside the U.S.

## **I. Funds’ Current Liquidity Risk Management Practices and Historical Experience With Meeting Redemptions**

In anticipation of the proposal, ICI established a liquidity management working group consisting primarily of chief risk officers and senior portfolio managers to inform us of their current liquidity risk management practices. Fifty mutual fund complexes—large, medium, and small—have contributed to this group’s work to date. While we understand that the SEC staff engaged in some limited outreach prior to the proposal’s issuance, we strongly urge the SEC staff to begin a dialogue with the liquidity management working group to obtain a broader perspective of views about the proposal and funds’ liquidity risk management more generally.

We provide below an overview of the liquidity management practices the group has conveyed to us.<sup>7</sup> We then turn to a discussion of funds’ experiences with meeting redemptions and minimizing shareholder dilution.

### **A. Funds’ Current Liquidity Risk Management Practices Are Fundamentally Sound**

Liquidity management is a major element of investment risk management, an intrinsic part of portfolio management, and a constant area of focus for fund managers. Many investment and operational practices are designed expressly to support fund liquidity and daily redeemability of fund shares.

There is no, and can be no, “one-size-fits-all” approach to liquidity management. A fund manager must manage liquidity taking into account the specific characteristics of each fund, including its portfolio holdings, investment objectives, policies, and strategies, and relevant market conditions. A large-cap U.S. equity fund differs from a high-yield bond fund, and the approach to liquidity management must account for those varying liquidity characteristics. Even if two funds have relatively

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<sup>7</sup> We also include, as Appendix A, the ICI Liquidity Working Paper. ICI also has been deeply engaged on the subject of liquidity in responding to requests for comment from the Financial Stability Oversight Council (“FSOC”) and the Financial Stability Board (“FSB”). *See, e.g.*, Letter to the Financial Stability Oversight Council from Paul Schott Stevens, President & CEO, ICI, dated March 25, 2015 (“FSOC Comment Letter”) at 10-49, available at [www.ici.org/pdf/15\\_ici\\_fsoc\\_ltr.pdf](http://www.ici.org/pdf/15_ici_fsoc_ltr.pdf); *see also* Letter to the Financial Stability Board from Paul Schott Stevens, President & CEO, ICI, dated May 29, 2015 (“FSB Comment Letter”) at 24-38, available at [www.ici.org/pdf/15\\_ici\\_fsb\\_comment.pdf](http://www.ici.org/pdf/15_ici_fsb_comment.pdf).

similar portfolios, a fund manager's approach to managing the liquidity of each could differ markedly depending on the characteristics of the funds' shareholder bases and their historical purchase and redemption patterns.

While there is no one-size-fits-all approach, currently there are common elements of day-to-day liquidity management.<sup>8</sup> These can provide a useful framework for a liquidity risk management rule that also provides funds with the necessary flexibility to implement in accordance with their particular circumstances:

- *Top-down assessment of a fund's portfolio.* Fund managers generally consider portfolio holdings to fall along a liquidity continuum or spectrum. Based in large part on the historical performance of particular assets in different market conditions, a fund manager may develop a general "macro"—or top-down—liquidity view of such holdings by class and sub-class, issuer domicile, duration, credit quality, and currency. This is a dynamic process, and the manager may modify its views on an ongoing basis as necessary. Specific quantitative and qualitative information may then generally contribute to the manager's view of asset level liquidity. To be clear, these assessment practices differ markedly from the proposed asset classification scheme.<sup>9</sup>
- *Understanding the fund's shareholder base and monitoring fund flows.* Fund managers review their funds' historical redemption patterns (particularly the highest historical levels of redemption activity), and many also review historical redemption activity data for similarly managed peer funds. Managers seek to understand the characteristics of a fund's shareholder base (including, for example, the percentage of the base that consists of typically long-term investors, and its diversity (with respect to both the overall number of investors and their reasons for investing)). Any information a manager can glean about its shareholder base can help the manager predict the potential magnitude of the fund's net redemption activity.<sup>10</sup>
- *Monitoring and managing the fund's overall portfolio.* Monitoring and managing portfolio liquidity is a fluid and collaborative process to which several groups within the fund

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<sup>8</sup> See the ICI Liquidity Working Paper, *infra* Appendix A, for additional detail. For more information on risk management practices of some fund managers, see The GARP Buy Side Risk Managers Forum, *Risk Principles for Asset Managers* (Sept. 2015), available at [go.garp.org/1/39542/2015-09-30/315zdc/39542/90066/BSRMF\\_Risk\\_Principles\\_2015.pdf](http://go.garp.org/1/39542/2015-09-30/315zdc/39542/90066/BSRMF_Risk_Principles_2015.pdf) ("Risk Principles for Asset Managers").

<sup>9</sup> See *infra*, Section II.E for a discussion of this aspect of the proposal, our objections to it, and our proposed alternative.

<sup>10</sup> The proposal recognizes these considerations in its conception of "liquidity risk," which would require a fund to consider, among other things, "[s]hort-term and long-term cash flow projections" and the "[f]und's shareholder ownership concentration." Proposed Rule 22e-4(b)(2)(iii)(A).

manager (*e.g.*, portfolio managers, traders, risk officers and analysts, legal and compliance personnel, and senior management) contribute. Among many other tools, funds often conduct forms of stress testing to determine the impact of certain changes (*e.g.*, changes in interest rates, credit quality, widening spreads, or currency fluctuations) on portfolio liquidity.<sup>11</sup>

## **B. Funds Have a Strong Record of Meeting Shareholder Redemptions**

Fund investors value their ability to redeem their fund shares and receive cash proceeds relatively quickly and easily. For their part, funds have been highly successful in honoring shareholder redemptions. The 75-year record of the modern fund industry provides compelling evidence of the effectiveness and skill with which funds have managed shareholder redemptions.

Meeting daily redemptions, in fact, is an area where the fund industry's practices generally far exceed minimum statutory requirements. Instead of paying redemption proceeds to investors within seven days, as is contemplated under the 1940 Act, funds generally meet redemptions and pay proceeds much more quickly, often in three days or less. The SEC frames this positive development as one warranting regulatory attention. But there is another, much greater and more obvious lesson to draw: this remarkable increase in efficiency, which clearly benefits investors, would not have been possible if meeting redemptions were a recurring challenge for funds.

The fund industry's record is the result of a sound regulatory framework and an industry that takes seriously its legal and compliance obligations, its need to manage investment and liquidity risk, and its fiduciary duties to those shareholders who entrust funds with their money. It is a credit also to the SEC—a regulator that is expert in asset management, provides effective oversight, and has taken great care when updating its rules and regulatory guidance to promote investor protection while fostering a dynamic industry.<sup>12</sup>

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<sup>11</sup> Monitoring and managing liquidity at the portfolio level also are reflected in the proposed rule's requirement that a fund assess and periodically review its liquidity risk (Proposed Rule 22e-4(b)(2)(iii)) and manage that risk (Proposed Rule 22e-4(b)(2)(iv)).

<sup>12</sup> The SEC's rules and related guidance under the 1940 Act fully reflect the requirement for daily redeemability. *See, e.g.*, Rule 2a-4 under the 1940 Act, which defines "current net asset value" for purposes of computing the current price of a redeemable security. Rule 22c-1 requires funds, their principal underwriters, and dealers in fund shares to sell and redeem fund shares at a price determined at least daily based on the current net asset value next computed after receipt of an order to buy or redeem. In addition, the SEC has defined an "illiquid asset" as "any asset which may not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the investment" and limits such assets to no more than 15% of a fund's net assets. The SEC imposes this limitation because funds must stand ready to redeem shares daily and pay redemption proceeds within seven days of the request. *See* Revisions of Guidelines to Form N-1A, SEC Release No. IC-18612, 57 Fed. Reg. 9828, 9829 (March 20, 1992) ("SEC Liquidity Guidelines Release").



Certainly, funds and their managers need to be vigilant—just last month, the SEC issued a temporary order to permit a mutual fund to suspend redemptions.<sup>13</sup> The SEC’s issuance of such an order has been quite a rare occurrence, as the SEC recounts in the Release.<sup>14</sup> This fact only serves to underscore the larger point that there is no evidence of an overarching failure or regulatory gap across the fund industry with respect to meeting redemptions.

We believe that the risk-based liquidity management program rule that we recommend would have gone a long way toward addressing the liquidity challenges that the fund that suspended redemptions last month encountered, perhaps even influencing the threshold decision of whether its strategy was appropriate for an open-end fund. This fund had a concentrated distressed debt portfolio.<sup>15</sup> Almost 90% of the debt in the fund’s portfolio was rated CCC or lower, or not rated at all.<sup>16</sup> A risk-based liquidity management program could require a fund manager, when launching a new mutual fund, to assess whether the fund’s investment strategy and permissible holdings are suitable for the open-end structure in light of these liquidity characteristics.<sup>17</sup> That program also could provide enhanced protocols for funds that invest in less liquid assets, including reporting to fund boards of any instances in which the fund’s holdings of illiquid assets exceed 15% of the fund’s NAV.

### **C. Funds Have Been Successful in Minimizing Shareholder Dilution**

The SEC states that one of its objectives is minimizing the impacts of redemptions on funds—in other words, mitigating dilution of the value of fund shares. In the 75 years since the enactment of the 1940 Act, fund managers have demonstrated ongoing attention and care in managing these impacts.

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<sup>13</sup> See *Third Avenue Trust and Third Avenue Management LLC*, SEC Release No. IC-31943 (Dec. 16, 2015) (Notice of application and temporary order under Section 22(e)(3) of the Investment Company Act).

<sup>14</sup> In the Release, the SEC cites only three examples since passage of the 1940 Act of it issuing orders permitting the suspension of redemptions. Release at 62283, n.82. Two of the three funds referred to were money market funds. Money market funds appropriately are excluded from the scope of the proposal, because the SEC separately adopted two substantial money market fund reform packages in the past five years. See *infra* Section II.I.1 for a further discussion of our views on suspensions of redemptions and Appendix B for a summary of orders that the SEC has granted under Section 22(e) of the 1940 Act.

<sup>15</sup> See Jeffrey Ptak, *Third Avenue Focused Credit Abruptly Shuttered*, Morningstar (Dec. 11, 2015), available at <http://news.morningstar.com/articlenet/article.aspx?id=733021>.

<sup>16</sup> In contrast, “the majority of high yield bond funds are far more diversified by issuer and hold substantial stakes in the higher quality and typically more liquid tiers of the junk bond market.” Sarah Bush, *Junk-Bond Funds Settle Down After a Rough Week*, Morningstar (Dec. 11, 2015), available at <http://news.morningstar.com/articlenet/article.aspx?id=733736>.

<sup>17</sup> See Risk Principles for Asset Managers at 13 (“Investment products should be designed and managed so that demand for liquidity incurred by investor subscription and redemption rights and patterns is aligned with the liquidity profile of the investments made by the product.”).

First and foremost, fund managers owe fiduciary duties to the funds they manage, and cannot favor the interests of one group of shareholders (*e.g.*, redeeming shareholders) over those of another (*e.g.*, remaining shareholders). And any dilution in a fund adversely affects the performance of that fund. In the highly competitive fund market, managers are strongly incented to minimize dilution to support strong fund performance. Managers have numerous tools and techniques at their disposal to minimize dilution. These include measures to discourage and limit excessive short-term trading;<sup>18</sup> redemptions in-kind; interfund lending exemptive relief; lines of credit; negotiated reductions in settlement times on certain transactions; the use of “bid” prices to value fixed income securities; and, where appropriate, fair value pricing.

More broadly, we demonstrate, in our companion ICI Research Letter that we are filing today<sup>19</sup> in response to the white paper prepared by the SEC’s Division of Economic and Risk Analysis (“DERA”) staff,<sup>20</sup> that there is no evidence that funds manage liquidity in ways detrimental to their shareholders.

## **II. Evaluation of Proposed Rule 22e-4**

Proposed Rule 22e-4 requires each fund to adopt a formal, written liquidity risk management program that is reasonably designed to assess and manage the fund’s liquidity risk.<sup>21</sup> The SEC proposes three general required program elements, under which each fund must:

- Classify, and conduct an ongoing review of, each portfolio position (or portion thereof)<sup>22</sup> using mandatory factors and a prescribed six-category classification scheme based on the number of days in which the fund’s position would be convertible to cash at a price that does not materially affect the value of that asset immediately prior to sale;<sup>23</sup>

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<sup>18</sup> For example, a fund may (i) impose a fee on redemptions of fund shares held for short periods; (ii) limit the number of trades an investor may make within a specified period; and/or (iii) reserve the right to reject purchase orders if it suspects that an investor intends to redeem the shares shortly after purchasing them.

<sup>19</sup> *See supra*, note 5.

<sup>20</sup> Securities and Exchange Commission, *Liquidity and Flows of U.S. Mutual Funds* (Sept. 2015) (the “DERA Paper”), available at [www.sec.gov/dera/staff-papers/white-papers/liquidity-white-paper-09-2015.pdf](http://www.sec.gov/dera/staff-papers/white-papers/liquidity-white-paper-09-2015.pdf).

<sup>21</sup> Under the proposed rule, the fund’s board would be required to: (i) approve the program, any material changes to the program, and the fund’s designation of the investment adviser or officers responsible for administering the program; and (ii) review a written report that reviews the program’s adequacy, provided at least annually from the program’s administrator. A fund would be required to maintain a written copy of the policies and procedures adopted by the fund under the rule and maintain copies of certain materials provided to the fund board.

<sup>22</sup> Throughout our discussion of the proposed rule’s asset classification scheme, references to “assets” or “positions” should be read to include “portions thereof.”

<sup>23</sup> Proposed Rule 22e-4(b)(2)(i) and (ii).

- Assess a fund’s liquidity risk using several mandatory factors;<sup>24</sup> and
- Manage liquidity risk, including by:
  - Establishing and investing in accordance with a “three-day liquid asset minimum;”<sup>25</sup>
  - Limiting investments in illiquid assets (referred to in the proposed rule as “15% standard assets”);<sup>26</sup> and
  - Adopting policies and procedures related to redemptions in-kind.<sup>27</sup>

ICI strongly endorses a rule requiring a fund to adopt a written liquidity risk management program that is risk-oriented and principles-based.<sup>28</sup> Any rulemaking that addresses liquidity must allow for multi-factor analysis and a focus on the particular risks that a fund presents, including its holdings and investment strategy, its historical purchase and redemption activity, and its shareholder base. Many aspects of the proposal follow this approach, but others (in particular the asset classification scheme and three-day liquidity minimum) are highly prescriptive and inconsistent with sound risk management principles.

We discuss below our specific comments on the proposed liquidity risk management program rule. We start with a discussion of the risk-based approach that we support and that sound liquidity risk management requires. We then evaluate the proposed definition of “liquidity risk” and recommend two key modifications. We discuss our support for the 15% standard assets limitation, and policies and procedures related to redemptions in-kind.

We then discuss the mandatory six-category asset classification scheme and the three-day liquid asset minimum, both of which we strongly oppose. We provide recommended alternatives to each.

We conclude this section with a discussion of some specific liquidity management tools (such as cross-trades) that the Release discusses and certain ETF-specific issues.

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<sup>24</sup> Proposed Rule 22e-4(b)(2)(iii).

<sup>25</sup> Proposed Rule 22e-4(b)(2)(iv)(A)-(C).

<sup>26</sup> Proposed Rule 22e-4(b)(2)(iv)(D).

<sup>27</sup> Proposed Rule 22e-4(b)(2)(iv)(E).

<sup>28</sup> We support excluding money market funds, closed-end funds, and unit investment trusts from this requirement for the reasons set forth in the Release.

### A. A Sound Approach to Liquidity Management

We support the SEC's adoption of a liquidity risk management requirement. We urge the SEC to recognize in its final rule that liquidity risk assessment and management will and should look very different by fund and should not be reduced to a "check the box" or one-size fits all exercise. In fact, liquidity risk is a complex, multifaceted concept<sup>29</sup> that cannot be captured adequately by any one management approach or any single measure or metric. This is particularly true when one considers the wide variety of stocks, bonds, and derivatives that funds hold, and the different markets and manners in which they trade (*i.e.*, either on an exchange or over-the-counter). We therefore recommend that the SEC make revisions so that the final rule is soundly risk-based.

Under a risk-based rule, a fund would develop and implement policies and procedures in a way most appropriate for its particular liquidity risk profile. A fund manager's approach to liquidity risk management within its program would include general principles and then elaborate on their application (*i.e.*, the specific means used for monitoring<sup>30</sup> and managing risk).

The Commission has had experience with this very type of principles-based rule—the fund compliance rule, Rule 38a-1 under the 1940 Act. This principles-based rule has successfully enhanced a critical aspect of fund operations—compliance with the federal securities laws. In adopting that rule, the SEC made a conscious choice to provide "fund complexes with flexibility so that each complex may apply the rule in a manner best suited to its organization."<sup>31</sup> Fund complexes may do so within a general procedural framework. And as a complement to the Rule itself, the SEC used the adopting release to describe the compliance topics that it expects a fund's compliance policies and procedures to address.

The SEC also can look to other jurisdictions for support for a principles-based program rule. The EU equivalent of a mutual fund—a publicly-sold collective investment scheme authorized as an undertaking for collective investment in transferable securities ("UCITS")—must have a liquidity risk management program. In the EU, the UCITS manager exercises a degree of latitude in managing liquidity risks. Similarly, retail investment funds under national rules and alternative investment fund

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<sup>29</sup> See, e.g., Abdourahmane Sarr & Tonny Lybek, *Measuring Liquidity in Financial Markets*, IMF Working Paper (Dec. 2002), available at [www.imf.org/external/pubs/ft/wp/2002/wp02232.pdf](http://www.imf.org/external/pubs/ft/wp/2002/wp02232.pdf). ("Market liquidity is a multifaceted concept. Many of the various dimensions of the characteristics of market liquidity—tightness, immediacy, depth, breadth, and resiliency—can be covered by traditional liquidity measures, such as bid-ask spreads, turnover ratios, and selected price-based indicators... However, these indicators are incomplete, and they may send mixed signals, particularly during a crisis.")

<sup>30</sup> As we explain below, fund managers may see some value in using certain summary scores or metrics voluntarily for internal purposes. This is quite different from making such scores or metrics the centerpiece of a regulatory approach to liquidity or, worse, requiring their disclosure to the public, which unduly exaggerates their precision and predictive abilities and risks misleading the public.

<sup>31</sup> *Compliance Programs of Investment Companies and Investment Advisers*, SEC Release No. IC-26299, 68 Fed. Reg. 74714, 74717 (Dec. 24, 2003).

managers must establish and implement liquidity risk management programs. These fund managers must establish procedures tailored to the nature of each fund. The International Organization of Securities Commissions (“IOSCO”), furthermore, identified principles against which industry and regulators should assess liquidity risk management practices and rules.<sup>32</sup> IOSCO eschewed developing or recommending any prescriptive standards.<sup>33</sup> In light of practices across jurisdictions, this is unsurprising—in its latest contribution to the subject of liquidity management in collective investment schemes,<sup>34</sup> IOSCO noted that “the majority of respondents to the survey pointed out that in their jurisdiction there is no formal definition of liquidity. Where some type of definition does exist, the definition could be considered to be more principle-based rather than prescriptive.” We urge the SEC to take into account these overseas regulatory experiences, and its own experience with the compliance rule, as it adopts any final rule in this area.

### **B. Assessment of Liquidity Risk**

Under the proposed rule, a fund would be required to assess, periodically review, and manage its “liquidity risk,” which the SEC proposes to define as “the risk that the 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.”<sup>35</sup> The proposed rule then provides a broad and practical set of factors for assessing liquidity risk that generally comport with sound risk management practices and principles.<sup>36</sup> We support this aspect of the rule, provided two key modifications are made.

First, we recommend that the SEC eliminate the phrase “without materially affecting the fund’s net asset value” from the definition in any final rule. This definition (and a similar concept in the rule’s requirement regarding asset classification, which we evaluate below) has a misplaced focus on the

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<sup>32</sup> IOSCO, *Final Report on Principles of Liquidity Risk Management for Collective Investment Schemes*, 2 (Mar. 2013) (“IOSCO Principles”), available at [www.iosco.org/library/pubdocs/pdf/IOSCOPD405.pdf](http://www.iosco.org/library/pubdocs/pdf/IOSCOPD405.pdf).

<sup>33</sup> We have included, as Appendix C, a summary of liquidity risk management requirements for funds domiciled in certain non-U.S. jurisdictions.

<sup>34</sup> IOSCO, *Final Report on Liquidity Management Tools in Collective Investment Schemes: Results from an IOSCO Committee Survey to members* (Dec. 2015), available at [www.iosco.org/library/pubdocs/pdf/IOSCOPD517.pdf](http://www.iosco.org/library/pubdocs/pdf/IOSCOPD517.pdf).

<sup>35</sup> Proposed Rule 22e-4(a)(7).

<sup>36</sup> Specifically the proposed rule would require funds to consider: (i) short-term and long-term cash flow projections, taking into account: (a) size, frequency, and volatility of historical purchases and redemptions of fund shares during normal and stressed periods; (b) the fund’s redemption policies; (c) the fund’s shareholder ownership concentration; (d) the fund’s distribution channels; and (e) degree of certainty associated with the fund’s short-term and long-term cash flow projections; (ii) investment strategy and liquidity of portfolio assets; (iii) use of borrowings and derivatives for investment purposes; and (iv) holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources. The SEC indicates that this list is not meant to be exhaustive.

concept of “materially moving the market price” when selling portfolio holdings.<sup>37</sup> A sale of a portfolio asset very well may have a market impact, in normal or stressed market conditions. This is a fundamental aspect of investing in markets generally, through funds or otherwise. Investors understand that a future sale of portfolio assets in a declining market might result in the fund receiving less than the asset’s carrying value in proceeds—and that this type of risk and associated costs are fundamental attributes of investing, which are disclosed in prospectuses.<sup>38</sup> An undue emphasis on moving the market seems to stigmatize legitimate fund activity, *i.e.*, selling portfolio assets.

Moreover, this would be a new and unprecedented standard to which funds alone would be subject. Other pooled investment vehicles and institutional and retail investors with their own investment accounts sell assets when they (or their advisers) deem it appropriate, and they too can move market prices (potentially to their detriment, and that of others) with their selling activity. The Release offers no justification for why funds’ sales should be subject to this heightened responsibility.

We also are concerned that this responsibility could have unintended consequences. This misplaced focus could incentivize fund managers to meet redemptions first using cash and then by selling those assets that are least likely to have a market impact. Such an expedient approach could very well run counter the manager’s fiduciary duties, the fund’s investment objective, policies, and strategies, and the interests of the fund’s long-term investors. The SEC criticizes this very practice, stating that it could “leave remaining shareholders in a potentially less liquid and riskier fund until the fund rebalances.”<sup>39</sup> The SEC should carefully consider whether requiring funds to engage in this type of analysis would have the perverse effect of making this type of unwanted behavior more likely.

We also are concerned more generally with the focus on portfolio asset sales not affecting the fund’s NAV. Funds’ NAVs will fluctuate—due to factors much more significant (*e.g.*, geopolitical developments, macroeconomic developments, general market sentiment, industry- and sector-wide developments, issuer-specific developments, *etc.*) than a particular fund’s liquidity risk management practices—and investors understand that this makes funds fundamentally different from deposit accounts.<sup>40</sup> Investors should be under no illusion that they can redeem out of a fund at an NAV that is

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<sup>37</sup> Aside from our conceptual objection, neither the proposed rule itself nor the Release offers a definition of or guidance regarding “materiality.” Given its importance within the proposed rule, we recommend that the SEC at least provide guidance regarding materiality if it is retained in the final rule in any way.

<sup>38</sup> Under Item 3 of Form N-1A, a fund must include the following in the summary section of its prospectus: “The Fund pays transaction costs, such as commissions, when it buys and sells securities (or “turns over” its portfolio). A higher portfolio turnover rate may indicate higher transaction costs and may result in higher taxes when Fund shares are held in a taxable account. These costs, which are not reflected in annual fund operating expenses or in the example, affect the Fund’s performance.”

<sup>39</sup> Release at 62279.

<sup>40</sup> As IOSCO has noted, “CIS [i.e., collective investment schemes] differ fundamentally from banks in that ‘maturity transformation’ is not an inherent feature of their operation, and the majority of CIS do not engage in such transformation

protected or supported. We doubt that the Commission intends that. Still, the Commission should be very cautious about adopting any rule that shareholders might interpret in that way.

Investors knowingly and willingly assume this risk in exchange for seeking returns in excess of a risk-free rate that is otherwise available through other channels. Any regulation that does not appreciate and begin with this key premise, and instead seeks as an end some measure of NAV stability, risks distorting funds in ways that will limit their utility to investors.<sup>41</sup>

If the Commission's concern is that fund managers do not take sufficient care in mitigating the dilutive impact on the fund of portfolio transactions, we simply disagree.<sup>42</sup> That concern ignores the powerful incentives that fund managers have to minimize dilution to the extent possible. Market impact costs can harm fund performance, a most unwelcome outcome in a deeply competitive industry. As noted above, fund managers are fiduciaries to the funds they manage and have many tools and techniques at their disposal that they use to foster more equitable treatment of fund shareholders.<sup>43</sup>

IOSCO has expressed a different view on how managers should assess liquidity risk, stating that "the fundamental requirement of liquidity risk management is to '...ensure that the degree of liquidity of the open-ended CIS [the responsible entity] manages allows it in general to meet redemption obligations and other liabilities.'"<sup>44</sup> Conforming the proposal to IOSCO's formulation would result in a more workable assessment of liquidity risk, and we therefore urge the SEC to do so. Alternatively, the Commission could consider the definition of liquidity risk adopted in The Risk Principles for Asset Managers: "Liquidity risk is uncertainty about future liquidity cost, in particular uncertainty about the cost of transacting in a timely manner in order to update a portfolio to reflect changing views of

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to the extent that banks do. For example, many CIS use investors' subscriptions to invest in highly liquid large capitalization listed company shares, which can quickly be sold if necessary to provide liquidity for meeting redemption requests from investors in the CIS. Neither does the majority of CIS provide any 'promise' or guarantee that investors will get back (at least) the same amount of money as they initially invested. An investor in a CIS is a shareholder; as opposed to a depositor in a bank, who is a creditor." IOSCO Principles at 1.

<sup>41</sup> We also address this topic in the ICI Research Letter at Section IV.A.

<sup>42</sup> See ICI Research Letter at Section III (finding or noting, among other things, that (i) short-term asset ratios, even among funds typically thought of as holding less liquid assets, do not deteriorate much, if at all, in response to net cash outflows; (ii) the DERA study finds that as market liquidity declines, fund liquidity declines proportionately less; (iii) the DERA study finds that funds with more variable flows hold more liquidity; and (iv) fund flows and changes in fund liquidity may be correlated, but both could be caused by a third factor, specifically overall market conditions).

<sup>43</sup> See *supra*, Section I.C. If the SEC adopts swing pricing, this would be another tool to mitigate the costs that remaining shareholders otherwise might bear disproportionately by remaining shareholders when such "market moving" sales are the result of redemptions.

<sup>44</sup> IOSCO Principles at 2 (quoting IOSCO's Principles on Suspensions of Redemptions in Collective Investment Schemes). See also Section II.E, *infra*, for our discussion of position size and market impact as they relate to the proposed asset classification scheme and our alternative.

markets and securities; to meet funding obligations such as withdrawals from an investment vehicle; or to meet collateral calls.”<sup>45</sup> This definition takes into account potential future costs, but it does not assume, as the SEC proposal appears to do, that the transactions may not materially affect the fund’s NAV.

The proposed rule also provides a broad set of factors for assessing liquidity risk. A technical reading of the rule seems to require funds to consider *all* of the specified factors for assessing liquidity risk. Because not all of these factors are relevant to all funds, we request that the SEC clarify in any final rule (either in the rule text itself or the adopting release) that a fund only needs to consider factors relevant to its operations, which may include some or all of those outlined by the SEC or others not enumerated by the SEC. For example, the proposed rule would require a fund to consider “use of borrowings and derivatives for investment purposes” even if that fund does not engage in borrowing or use derivatives.

### **C. Limitation on Illiquid Assets**

Under current SEC guidance, a fund may not invest more than 15% of its net assets in “illiquid assets.”<sup>46</sup> The proposed rule would codify this current guidance, by prohibiting a fund from acquiring any “15% standard asset”<sup>47</sup> if immediately after the acquisition the fund would have invested more than 15% of its total assets in 15% standard assets. The SEC explains in the Release that the current guidance generally has caused funds to limit their exposures to particular types of securities that cannot be sold within seven days and that the Commission and staff have indicated may be illiquid (depending on the facts and circumstances), such as private equity securities, securities purchased in an initial public offering, and certain other privately placed or other restricted securities.<sup>48</sup>

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<sup>45</sup> The Risk Principles for Asset Managers at 13.

<sup>46</sup> SEC guidance defines an illiquid asset as “any asset which may not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the investment.” *See supra*, note 12.

<sup>47</sup> A “15% standard asset” would be defined as “an asset that may not be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund.” Proposed Rule 22e-4(a)(4). While there are slight wording differences, we interpret the two definitions (*i.e.*, those for “illiquid assets” and “15% standard assets”) to be substantively identical. The proposed definition further elaborates: “For purposes of this definition, the fund does not need to consider the size of the fund’s position in the asset or the number of days associated with receipt of proceeds of sale or disposition of the asset.” *Id.* This is consistent with how many in the industry apply the current definition of “illiquid assets” to their funds. We recommend that the SEC retain the existing term (*i.e.*, “illiquid assets”) in any final rule, because it is more descriptive.

<sup>48</sup> Release at 62284-85.



We strongly support the codification of this limit on illiquid assets (or 15% standard assets, in the proposal's terminology).<sup>49</sup> We agree that the large majority of a fund's assets should be liquid. If this discipline breaks down, and a fund's investment objective, policies, strategies, and permissible investments are not suited to the open-end fund structure, or if the portfolio otherwise becomes over-concentrated in illiquid assets,<sup>50</sup> then the fund runs the risk of encountering liquidity pressure. The 15% limit on illiquid assets is therefore an important investor protection measure.

Under our recommended risk-based approach to liquidity risk management, funds could do even more to monitor for and manage the risk presented by holding illiquid assets than what the proposed rule contemplates. For example, a fund could adopt protocols for reporting to its board if the fund exceeds certain thresholds of illiquid assets, even if it is in technical compliance with the 15% threshold, which is measured at the time of purchase. Fund policies also could require reporting to the board upon the occurrence of other events, such as unusually high redemption activity. In the release adopting any final rule, the SEC could encourage funds that invest primarily in markets with potential liquidity challenges (which could include under certain circumstances, for example, bank loans, municipal securities, emerging market debt, and high yield bonds) to adopt protocols of this kind.

#### **D. Redemptions In-Kind**

The proposed rule also would require that a fund adopt relevant policies and procedures if it engages in or reserves the right to engage in redemptions in-kind. We support this proposed requirement because it will promote focusing on any legal or operational issues in advance of funds' use this liquidity management tool.<sup>51</sup>

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<sup>49</sup> We recommend, as a technical correction to the rule text, that the 15% standard assets limitation apply to net assets, which we believe was the SEC's intention. Proposed Rule 22e-4(b)(2)(iv)(D) would limit a fund from acquiring any 15% standard asset if, immediately after the acquisition, the fund would have invested more than 15% of its *total* assets in 15% standard assets. Elsewhere in the Release and consistent with prior Commission positions, however, this limitation is described as one based on *net* assets. *See, e.g.*, Release at 62304 ("Proposed rule 22e-4(b)(2)(iv) would require a fund to manage its liquidity risk based on this assessment, including . . . (iii) prohibiting a fund from acquiring any 15% standard asset if the fund would have invested more than 15% of its *net* assets in 15% standard assets.") (emphasis added); *see also* the SEC Liquidity Guidelines Release, *supra* note 12.

<sup>50</sup> *See supra*, Section I.B.

<sup>51</sup> Mutual funds use redemptions in-kind sparingly because they are operationally more challenging than cash redemptions, and retail investors typically expect cash redemptions. *See, e.g.*, FSOC Comment Letter at 37.

## **E. Six-Category Asset Classification Scheme and Related N-PORT Disclosure**

We oppose the proposed six-category asset classification scheme and associated public disclosure requirements. In this section, we explain our objections to each. We then recommend an alternative to the proposed scheme, followed by other comments on this portion of the proposal.

### **1. Objections to the Proposed Asset Classification Scheme**

The proposed rule would require a fund to classify and engage in an ongoing review of the relative liquidity of each portfolio position, using a six-category classification scheme<sup>52</sup> based on the number of days in which the fund's position would be convertible to cash at a price that does not materially affect the value of that asset immediately prior to sale. The rule provides nine factors for a fund to consider for purposes of this classification and review process.<sup>53</sup>

We strongly oppose this proposed asset classification scheme for a number of reasons. First, and most fundamentally, it is not a recognized or sound liquidity risk management practice. Further, it seems designed to stigmatize funds' sales of portfolio holdings by placing undue emphasis on their potential to move the market. It would require funds to make highly subjective, unknowable projections about asset liquidity. It would provide a misleading illusion of comparability. It would mischaracterize larger, highly liquid funds. It would impose enormous operational burdens on funds and inevitably invite undue reliance on third-party vendors as liquidity "rating agencies." Finally, the costs of this element of the proposal far outweigh any potential benefits.<sup>54</sup>

*Relationship to Sound Risk Management Practices.* We agree with some basic observations in the Release regarding portfolio liquidity classification or scoring. Citing our letter to the Financial Stability

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<sup>52</sup> The six categories are: (i) convertible to cash within 1 business day; (ii) convertible to cash within 2-3 business days; (iii) convertible to cash within 4-7 calendar days; (iv) convertible to cash within 8-15 calendar days; (v) convertible to cash within 16-30 calendar days; and (vi) convertible to cash in more than 30 calendar days. A fund could determine that different portions of a single position could be converted to cash within different times—if so, it would categorize distinct portions accordingly.

<sup>53</sup> Specifically, the proposed rule would require a fund to consider: (i) existence of an active market for the asset, including whether the asset is listed on an exchange, as well as the number, diversity, and quality of market participants; (ii) frequency of trades or quotes for the asset and average daily trading volume of the asset (regardless of whether the asset is a security traded on an exchange); (iii) volatility of trading prices for the asset; (iv) bid-ask spreads for the asset; (v) whether the asset has a relatively standardized and simple structure; (vi) for fixed income securities, maturity and date of issue; (vii) restrictions on trading of the asset and limitations on transfer of the asset; (viii) the size of the fund's position in the asset relative to the asset's average daily trading volume and, as applicable, the number of units of the asset outstanding; and (ix) relationship of the asset to another portfolio asset (this could arise in connection with hedging or derivatives transactions). The SEC indicates that this list is not meant to be exhaustive, and not every factor will be relevant in each liquidity determination.

<sup>54</sup> The ICI Research Letter elaborates on many of these points, at Section IV.C.

Oversight Council, for example, the SEC states that “funds with relatively comprehensive liquidity classification procedures tend to view the liquidity of their portfolio assets in terms of a more-liquid to less-liquid spectrum.”<sup>55</sup> The Release notes, approvingly, that “[t]his ‘spectrum’-based approach to liquidity can enhance a fund’s ability to construct a portfolio whose liquidity profile is calibrated to reflect the fund’s specific liquidity needs.”<sup>56</sup> It then states that “some funds ‘score’ the liquidity of their portfolio holdings based on a variety of factors, including the period of time it takes to convert the holdings to cash... .”<sup>57</sup>

Quite regrettably, the proposal then makes an enormous leap from these observations to its proposed asset classification scheme, which focuses on CUSIP-specific quantitative data and requires funds to estimate how long it would take the fund to convert each asset to cash without materially affecting its market price. We recognize that some funds may use elements of this classification scheme in different contexts and for different purposes,<sup>58</sup> and that some asset types (particularly, exchange-traded instruments) are more amenable to asset classification methodologies that are more heavily quantitative. Based on extensive discussions with our members and their senior-most risk officers, however, we have identified *no* fund that utilizes the liquidity classification scheme exactly as the SEC has proposed for the entire industry.<sup>59</sup>

The proposed asset classification scheme places inordinate emphasis on this one component of overall liquidity risk assessment. It would very likely become in practice the *de facto* focal point of the proposed rule, diverting fund managers from the broader assessments of portfolio liquidity risk that historically have served funds so well. This would be highly counterproductive.

If adopted, the proposed asset classification scheme would not improve funds’ liquidity risk management practices. In fact, it would be quite misleading for, or at best irrelevant to, liquidity risk management. The proposed scheme would require fund managers to conduct a highly artificial analysis of a fund’s liquidity that ignores altogether information about the fund’s shareholders, historical redemption patterns, and other approaches to monitoring and managing liquidity risk.

Fund managers, instead, quite frequently base their asset level liquidity assessments on evaluations of asset types and certain key information about the asset (*e.g.*, issuer type, issuer domicile,

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<sup>55</sup> Release at 62291, citing FSOC Comment Letter at 23.

<sup>56</sup> *Id.* at 62291.

<sup>57</sup> *Id.* at 62294.

<sup>58</sup> Some fund managers may use certain “days to liquidate” measures as part of their liquidity risk management programs. We understand that they generally combine the information about the portfolio’s assets with the fund manager’s trading experience and use the output as data points, among many others, for assessing overall *portfolio* liquidity. More fundamentally, they recognize the limitations and subjective aspects of the exercise and do not view it as an end in itself.

<sup>59</sup> Third-party service providers may seek to develop mechanisms to assess liquidity along the lines proposed by the SEC, but this would be in response to any new regulatory requirement.

duration, credit quality, and currency). They use the type of CUSIP-specific quantitative metrics (such as trading data) called for by the proposal to a much lesser extent (particularly for instruments that trade over-the-counter). Put another way, when a fund manager conceptualizes its particular liquidity spectrum, it places asset classes and sub-asset classes (*e.g.*, U.S. Treasury bonds, agency bonds, investment grade corporate bonds, high yield corporate bonds, *etc.*) along it, while recognizing that further analysis may sometimes bring to light the asset-by-asset variability within the asset or sub-asset class. This known approach is entirely appropriate and effective because instruments with certain similar characteristics are often highly comparable and substitutable from a liquidity perspective.

*Undue Emphasis on Moving the Market Price and Requirement That Funds Make Highly Subjective, Unknowable Projections about Asset Liquidity.* As discussed above, both the definition of liquidity risk (with its “without materially affecting the fund’s net asset value” clause) and the asset classification scheme (with its requirement that a fund determine how quickly it can convert a position into cash “at a price that does not materially affect the value of that asset immediately prior to sale”) have a misplaced focus on “moving the market price” when selling portfolio holdings. This conceptual difficulty is compounded within the asset classification scheme because it requires hundreds of these determinations for a single fund (and possibly several determinations for a single asset), as opposed to one overall assessment at the fund level.

In effect, the scheme tries to answer the following question: If a fund decided to liquidate its entire portfolio today, how long would it take to do so in a way that would not materially affect the prices of its portfolio assets immediately prior to sale? But that question has little real-world import, because the likelihood that a fund, unexpectedly, would encounter gross redemptions equal to 100 percent of its shares and therefore be forced to liquidate all of its portfolio in a short time frame is far-fetched at best. Certainly, it defies what has been the consistent experience of the modern fund industry over its entire life. This is not to say that valuation has no place in considerations of liquidity. In applying the current 15% limit on illiquid assets, a fund must determine whether it can sell or dispose of an asset in the ordinary course of business within seven days at approximately the value at which the fund has valued it. Significantly, however, many in the industry currently assess asset liquidity by trading lot (*i.e.*, the test is not whether a fund can exit its position *entirely* within seven days—rather, the determination is made with respect to a normal trading lot for the holding in question), reflecting the more practical view that a fund generally would not need to liquidate an entire

large position—much less its entire portfolio— unexpectedly, in less than seven days.<sup>60</sup> The SEC wisely has codified this approach in its proposed definition of “15% standard asset.”<sup>61</sup>

The asset classification scheme would require funds to make highly subjective, forward-looking projections about market impact. For each asset, a fund would have to determine (i) how quickly and (ii) how much of it could be (iii) convertible to cash (iv) at a price that does not materially affect the value of that asset immediately prior to sale. It is extremely difficult to make judgments with any precision and confidence about how quickly an asset can be sold at a particular price prior to actually selling the asset, particularly for those instruments that trade over-the-counter.

Precisely determining the timing of the sale of any portfolio holding is particularly difficult because of the categories’ compressed, arbitrary time intervals.<sup>62</sup> Often, whether an asset can be sold in three business days or four calendar days without materially moving the market price cannot be determined with any real confidence for internal purposes, much less with the requisite confidence that should accompany regulatory filings and public disclosure.

The SEC states that this classification requirement is meant to reflect that the fund must determine whether the sale price the fund would receive for the asset is reasonably expected to move the price of the asset in the market, independent of other market forces affecting the asset’s value.<sup>63</sup> While the SEC also states that it does not expect a fund to determine in advance the *precise* current market price or fair value of an asset at the moment before the fund would sell the asset, this statement provides at best cold comfort to those tasked with making this determination for each fund asset. Even with this minor concession, a fund would have to determine (i) the asset’s price prior to sale (which could differ from the prior day’s closing price), (ii) the asset’s price after the sale, and (iii) whether the differential, if any, would be “material.” Whether the sale will have an impact on the asset’s price is highly subjective

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<sup>60</sup> See Investment Company Institute, *Valuation and Liquidity Issues for Mutual Funds*, 42 (Feb. 1997). Valuation of fund securities works in the same manner. That is, securities are valued based on trading lot (and not liquidation of the fund’s entire position). SEC staff guidance precludes application of a discount or premium to a readily available market price based on size of the fund’s holding. See 2001 Annual Industry Comment Letter to CFOs (February 14, 2001), available at: [www.sec.gov/divisions/investment/im021401.htm](http://www.sec.gov/divisions/investment/im021401.htm). While we are concerned that the SEC is considering a new tack with respect to liquidity and position size (at least with respect to its asset classification scheme and the three-day liquid asset minimum), we applaud the SEC for leaving analogous guidance on valuation and position size undisturbed.

<sup>61</sup> Proposed Rule 22e-4(a)(4) (“For purposes of this definition, the fund does not need to consider the size of the fund’s position in the asset or the number of days associated with receipt of proceeds of sale or disposition of the asset.”).

<sup>62</sup> In this regard, the Form PF filing requirements that the SEC has imposed on private funds differ in key respects: (i) the time intervals for Form PF’s 7-category scheme are far less compressed (1 day or less; 2 days – 7 days; 8 days – 30 days; 31 days – 90 days; 91 days – 180 days; 181 days – 365 days; Longer than 365 days), and thus require far less hair-splitting; (ii) private funds report aggregated figures at the portfolio level; and (iii) as discussed in greater detail below, Form PF filings are non-public. Item 32 of Form PF.

<sup>63</sup> Release at 62292.

and unknowable because it is impossible to determine the precise price impact a particular sales transaction would have prior to executing the trade. At the particular time a fund would dispose of an asset, there may be many buyers of that asset, which could fully offset any market impact and perhaps allow the fund to sell the asset at a premium to its carrying value—or not. There is no way for a fund to know in advance with any precision the market conditions that would greet an order. Indeed, even *after* a sale, it can be difficult to determine precisely how much of an asset's price decline was due to *that particular fund's* selling activity versus the selling activity of others and other market events. We explore this concern in greater depth in the ICI Research Letter.<sup>64</sup>

The variety of instruments that funds hold would make this four-pronged analysis even more challenging. This might be merely challenging and imprecise (and if publicly reported, potentially misleading) for exchange-traded instruments (*e.g.*, stocks and certain derivatives). But it would be nearly impossible for instruments that trade over-the-counter (*e.g.*, bonds and certain derivatives). The DERA Paper appears to acknowledge this difficulty.<sup>65</sup> Among other reasons, some of the nine prescribed factors (*e.g.*, frequency of trades or quotes for the asset and average daily trading volume of the asset, volatility of trading prices for the asset, and the size of the fund's position in the asset relative to the asset's average daily trading volume) are inapt. Of the large number of CUSIPs that trade over-the-counter, many simply do not trade very often.<sup>66</sup> And trading-related data for these instruments generally is not as readily available as that for exchange-traded investments.<sup>67</sup>

*Illusion of Comparability.* Because each classification would reflect a number of subjective judgments, the proposed scheme would present a beguiling *appearance* of objectivity and comparability across funds. That appearance quite simply would be false.

Large-cap U.S. equities illustrate this point. Other than cash and cash equivalents, large-cap U.S. equities are perhaps the asset type most amenable to this kind of classification scheme. We understand from our members that if they had to apply the classification scheme to their large-cap U.S. equity funds, they may give considerable weight to the size of an equity position relative to its average

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<sup>64</sup> ICI Research Letter at Section IV.A (showing that the price of Apple stock outperformed the S&P 500 index during a period in 2015 when funds, on a net basis, were selling this stock).

<sup>65</sup> DERA Paper at 31. The DERA Paper ultimately assessed municipal bond fund liquidity by using the percentage of municipal bonds that a fund holds as its portfolio liquidity proxy.

<sup>66</sup> See ICI Research Letter at Section IV.C (finding that over half of corporate bonds trade ten times or fewer per month).

<sup>67</sup> It does not follow from this lack of clear and convenient quantitative proxies for liquidity that these instruments are illiquid. Investors (including mutual funds) often view bonds as long-term “buy and hold” investments, and a lack of trading in bonds is often in no way indicative of an inability to trade those bonds. Bonds with similar broad characteristics (*e.g.*, issuer type, credit quality, maturity) are often seen by market participants as somewhat fungible, which helps sellers find buyers, notwithstanding scant prior trading activity for that particular CUSIP. A mechanical application of the asset classification scheme's factors would obscure, rather than highlight, these realities.

daily trading volume (the eighth of the nine prescribed factors). But funds almost certainly would *not* weigh the nine factors in precisely the same way. And even if their weightings of the nine factors were identical, funds still would need to determine *how* to apply each factor. Using the average daily trading volume factor as an example, funds might differ in how they defined “average daily trading volume” (*e.g.*, how many days to include in calculating the average). More significantly, one fund may believe that it could sell up to 20% of an equity’s average daily trading volume in a given day without materially affecting its market price; another may believe that 10% is a more appropriate target. How a fund resolves these matters would have a major impact on its classifications as reported to the SEC on Form N-PORT, and how investors would perceive it. This example also helps demonstrate the implications of position size in the asset classification scheme—even funds within a single complex likely would classify identical assets differently, because of differences in position size from fund to fund.

For instruments trading over-the-counter, these types of judgments would become even more complicated and subjective, and practices likely would vary to an even greater degree. In fact, the proposed rule’s factors related to trading activity have little or no value in assessing the liquidity of instruments that trade over-the-counter. We are concerned that their inclusion in the rule could create a presumption that funds consider each factor in evaluating each portfolio holding and therefore recommend that if the SEC were to adopt a final rule with an asset classification scheme, it should provide any factors in the adopting release and clarify that a fund is under no obligation to consider each factor. Rather, the adopting release should indicate that funds are expected to indicate in their policies and procedures the factors they typically would expect to consider.

While we understand the SEC’s preference for a single, uniform classification scheme, along with reliable, comparable, and concise summary data that it envisions collecting and aggregating through Form N-PORT filings, such a regulation simply is not realistic and would, we believe, bear very adverse consequences. To the extent that fund-furnished projections and value judgments are introduced into any mandatory classification scheme, comparability is sacrificed, and the value of any aggregated industry-wide data is compromised. Liquidity risk is too multifaceted, and attempts to monitor and manage it are, appropriately, too subjective and methodologically diverse, to be classified industry-wide in a uniform manner. Moreover, the SEC should not impose a fundamentally flawed asset classification scheme on the fund industry simply in the interest of convenient data reporting and scorekeeping.

*Misleading Characterization of Large Funds.* The classification scheme would misleadingly characterize larger, highly liquid funds. We address and demonstrate this at length in the ICI Research Letter.<sup>68</sup> A very large, diversified large-cap U.S. equity fund, heretofore considered highly liquid at both the asset and portfolio level, may not be viewed as such if that fund categorizes its assets using the proposed average daily trading volume factor. Indeed, such a fund almost certainly would look “worse” than a much smaller fund with the exact same *pro rata* portfolio makeup as the larger fund.

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<sup>68</sup> ICI Research Letter at Section IV.D.

Theoretically, such a large fund could look more liquid immediately by reorganizing into two (or more) smaller funds. Such a move would offer no benefit from a liquidity standpoint, and would prove costly to the fund and its shareholders because the fund would lose economies of scale that often result from increased size. This is an especially odd result when one considers DERA's conclusion that the variation in flows within a fund generally decreases as fund size increases.<sup>69</sup> Perhaps most importantly, these "false positives" that the asset classification scheme would produce risk distracting fund managers, the SEC, and investors from scrutinizing the far more limited number of funds that may face liquidity challenges.

*Unavoidable Operational Burdens.* The asset classification scheme would impose an enormous operational burden on funds. An individual fund may have hundreds of portfolio positions, and a fund complex may have tens of thousands. The larger the number of positions, the more burdensome this becomes. Establishing asset classification methodologies for so many different instruments and applying them in making initial determinations upon purchases of new assets (or across all fund holdings, when the rule would first take effect) would be an extremely challenging and resource-intensive endeavor. The proposed rule's requirement for "ongoing review" of each asset would place additional burdens on funds. The Release notes that, at a minimum, funds would have to review all liquidity classifications at least monthly in connection with Form N-PORT filings,<sup>70</sup> and that "a fund whose portfolio assets' liquidity could depend significantly on current market conditions should generally review the liquidity classifications of its portfolio assets relatively often (up to daily, or even hourly, depending on facts and circumstances)."<sup>71</sup>

Returning to the comparatively straightforward example of large cap U.S. equities, the quantitative factors that support an equity's classification (*e.g.*, average daily trading volume) will be in constant flux, and could push a portfolio position into a different liquidity category at any time. Consequently, funds would need platforms on which they could input their (potentially quite complex) methodologies; that could continuously receive quantitative data on which their methodologies rely (*e.g.*, trading data); and that could apply those methodologies to current portfolio holdings and all relevant quantitative and qualitative data to produce SEC-mandated classifications in real-time. Just as we know of no fund complex that employs the SEC's proposed methodology, so also we know of no existing platform capable of performing this analysis. Given their resources, small fund complexes would be particularly hard-pressed to build this infrastructure, and even for larger fund complexes the burdens would be enormous.

This conceptual complexity and enormous ongoing administrative burden, coupled with understandable concerns about being second-guessed by the SEC and the public, likely will impel funds to rely on third-party vendors. This may explain the enthusiasm with which third-party service

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<sup>69</sup> DERA Paper at 17.

<sup>70</sup> Release at 62303, n.253.

<sup>71</sup> *Id.* at 62303.



providers have supported the classification scheme. Indeed, the SEC seems to foresee reliance on third-party service providers as a positive outcome of its proposed rulemaking: it states that “some third-party service providers currently provide data and analyses assessing the relative liquidity of a fund’s portfolio assets, and we believe that a fund also appropriately could use this type of data to inform or supplement its consideration of the proposed liquidity classification factors.”<sup>72</sup> The SEC previously has crafted rules that effectively enshrined third parties as arbiters of credit quality. In 2010, Congress required the SEC to take a starkly different tack.<sup>73</sup> This regrettable historical experience should, in our view, make the SEC highly reluctant to do the same, at least implicitly, with respect to liquidity determinations.

These platforms and providers are untested, but the proposed classification scheme, if adopted, would make these largely unregulated third parties the *de facto* arbiters of liquidity. In its Guidelines for UCITS Liquidity Risk Management, the Association of the Luxembourg Fund Industry (“ALFI”) states a view with which many of our members concur: “There are many suggestions in current theory and practice particularly from software vendors about how to measure liquidity risk. However, no one is proved to be superior to all others yet, but many of them are even not widely accepted nor empirically tested in an acceptable and rigor [sic] manner in order to be regarded as a generally acceptable method.”<sup>74</sup>

Our broader and more important point is this: any required asset classification scheme whose complexity and burdensome nature practically forces funds to outsource to third-party vendors a function that fund managers view as fundamental to portfolio and risk management—and one about which *fund managers* have robust and proven expertise—demands serious rethinking.

While we object to the proposed liquidity classification scheme, we note that the SEC itself could analyze funds along the lines of that scheme if it perceives some merit in doing so. The SEC’s data modernization proposal, which we generally support, would provide the SEC with funds’ portfolio holdings data in a structured format. The proposal was premised in very large part on enabling the SEC staff to analyze that data. To satisfy regulatory oversight needs, the SEC staff could make its own determinations about portfolio liquidity of funds and the entire fund industry, devising its own protocols for this purpose as it sees fit.

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<sup>72</sup> *Id.* at 62297.

<sup>73</sup> Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) requires each federal agency to review regulations issued by such agency that require the use of an assessment of the creditworthiness of a security or money market instrument and any references to or requirements in such regulations regarding credit ratings. That section further provides that each such agency shall “modify any such regulations identified by the review . . . to remove any references to or requirements of reliance on credit ratings, and to substitute in such regulations such standard of creditworthiness as each respective agency shall determine as appropriate for such regulations.”

<sup>74</sup> *Guidelines for UCITS Liquidity Risk Management*, the Association of the Luxembourg Fund Industry, 10 n. 23 (Mar. 2013), available at [www.alfi.lu/sites/alfi.lu/files/Guidelines-for-UCITS-Liquidity-Risk-Management.pdf](http://www.alfi.lu/sites/alfi.lu/files/Guidelines-for-UCITS-Liquidity-Risk-Management.pdf).

## 2. Objections to Form N-PORT Disclosure of Asset Classifications

The proposal also would require each fund to report monthly on Form N-PORT each asset's liquidity classification and whether a holding is a 15% standard asset.<sup>75</sup> The SEC would make public the information contained in the filings for the third month of each fiscal quarter, sixty days after the end of the quarter.<sup>76</sup>

Public disclosure would greatly compound the concerns posed by the proposed classification scheme.<sup>77</sup> It would expose funds to continued second-guessing about determinations and judgments that in many cases lack objective certainty and in that sense are subjective in nature; may harm shareholders by adversely impacting portfolio management or revealing proprietary investment strategies and techniques; and is unnecessary for regulatory purposes and not in the public interest.<sup>78</sup> We discuss each of these concerns below.

*Second-Guessing Subjective Determinations.* As discussed above, the classification of each asset (along with any methodology for arriving at a classification) requires a number of underlying subjective judgments and results in a final liquidity classification that is fundamentally forward-looking. Given the number of factors to consider and judgments a fund has to make for each asset, reported asset classifications naturally will vary across funds. While the SEC appreciates that there will be some divergence in how funds classify identical assets, the SEC also states that "if a fund is an outlier with respect to its liquidity classifications, Commission staff would be able to identify such outlier classifications based on the fund's position-level liquidity disclosure on Form N-PORT and determine whether further inquiry is appropriate."<sup>79</sup> This statement appears to signal the SEC's intent to align liquidity risk-management determinations industry-wide according to its own classification scheme, and clearly suggests that funds risk regulatory rebuke if their assessments deviate more than some unknown amount from their peers.

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<sup>75</sup> Proposed Item C.13 (requiring funds to indicate the liquidity classification for each portfolio asset (or portion thereof)) and proposed Item C.7 of proposed Form N-PORT (requiring funds to identify whether each portfolio asset is a 15% standard asset).

<sup>76</sup> Proposed General Instruction F of proposed Form N-PORT.

<sup>77</sup> Indeed, we question how this kind of disclosure, absent the rule mandating it, would comport with the regulatory requirements under Rule 10b-5 under the Securities Exchange Act of 1934 ("Exchange Act").

<sup>78</sup> We raised similar concerns regarding the public disclosure of illiquidity determinations in our comment letter on the investment company reporting modernization proposal. See Letter from David W. Blass, General Counsel, Investment Company Institute to Brent J. Fields, Secretary, Securities and Exchange Commission, dated Aug. 11, 2015, available at [www.sec.gov/comments/s7-08-15/s70815-315.pdf](http://www.sec.gov/comments/s7-08-15/s70815-315.pdf) ("ICI Fund Reporting Comment Letter"). See also *Investment Company Reporting Modernization*, SEC Release No. IC-31610, 80 Fed. Reg. 33718 (June 12, 2015), available at [www.gpo.gov/fdsys/pkg/FR-2015-06-12/pdf/2015-12779.pdf](http://www.gpo.gov/fdsys/pkg/FR-2015-06-12/pdf/2015-12779.pdf) ("Fund Reporting proposal").

<sup>79</sup> Release at 62294.

Nor would this second-guessing be limited to the SEC. Individual asset-by-asset disclosure, especially appearing in a structured (XML) format, will highlight these fund-by-fund differences to third parties who would have the benefit of 20/20 hindsight. Third parties without the SEC's ability to conduct further examination would second-guess even funds that soundly determined liquidity classifications based on information obtained after reasonable inquiry, simply because the results of their analyses differed from that of others. The number of classifications, and the artificial precision required, increases the likelihood of second-guessing. As discussed above, this reality would fuel a need for funds to resort to liquidity rating agencies and the ostensibly expert, third-party inputs they provide.

*Impact on Portfolio Management Practices.* In addition, public disclosure may impact negatively portfolio management practices. Although the SEC seeks to promote more consistent liquidity classification practices, public disclosure potentially may incent funds to restructure their portfolios to be similar to their peer groups in liquidity profile, as outliers can well expect to be second-guessed. Public disclosure also may incent funds, as a matter of prudence, to take an extremely conservative approach to their liquidity determinations so they are not accused of providing an overly favorable outlook. All of this will lead to further commoditizing of mutual funds. Classifying assets this way may not always be the right answer, and the fund industry might lose the benefits of having diverse views of liquidity.

Public disclosure of asset-by-asset liquidity determinations also may lead funds to invest in assets that are deemed more liquid to improve the perception of their portfolios' liquidity. There may be a convergence of market interest (so-called herding) into those assets considered more liquid, and similar convergence whereby other assets fall out of favor, leading to "cliff events" and potentially increasing systemic risk. With this potential bias toward liquid assets, funds and their investors also could experience a loss in returns, because more liquid assets typically provide lower returns.

*Disclosure of Investment Strategies.* If a fund were to disclose its liquidity assessments, it would reveal another key element of its portfolio management strategy. These classifications when taken together could provide third parties with insight into a fund manager's view on liquidity, providing yet another means to dissect and replicate the fund manager's proprietary investment strategy.<sup>80</sup> Disclosure also would provide third parties with information about securities that the fund identifies as being less liquid or difficult to sell. When a fund is expected to encounter heavy redemptions due to market or other conditions, a third party could sell short those less liquid securities with knowledge that the fund

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<sup>80</sup> This is a long-standing issue of critical concern to the fund industry. See, e.g., Letters from Paul Schott Stevens, President, Investment Company Institute, to Christopher Cox, Chairman, Securities and Exchange Commission, dated September 14, 2005, August 29, 2006, and September 19, 2008; Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated April 30, 2013, available at [www.sec.gov/comments/4-659/4659-12.pdf](http://www.sec.gov/comments/4-659/4659-12.pdf).

might need to liquidate those positions to meet redemptions. The third party then could purchase those securities at a lower cost from the fund, harming the fund and its shareholders.

*Public Disclosure is Not in the Public Interest.* We note that the Commission has broad ability to determine not to publicly disclose information filed in reports required under the 1940 Act if it finds that public disclosure of such information is neither necessary nor in the public interest or for the protection of investors.<sup>81</sup> We previously have noted that certain proposed disclosures in the Fund Reporting proposal, which are primarily intended for the Commission's use, contain little benefit to investor decision making and do not warrant public disclosure. We compared our reasoning to the Commission's two-prong approach with Form ADV and Form PF, in which some private fund information was filed on Form ADV and publicly disclosed but other information was filed on Form PF and kept non-public.<sup>82</sup>

Under a similar analysis, the proposed asset-by-asset liquidity classification disclosures are neither necessary nor in the public interest or for the protection of investors. The Commission designed Form N-PORT primarily to provide information to the Commission for its oversight purposes, and Form N-PORT information should not be used to complement risk disclosures that are contained in a fund's registration statement to help investors make informed investment decisions.<sup>83</sup> Funds have operated without mandatory liquidity disclosures for over 75 years without major incident. In addition, public disclosure of the liquidity classifications could be deemed to be confusing or misleading. For example, third parties may not understand that funds within a complex could classify assets differently because of the requirement to consider position sizes. And even third parties cognizant of the nuance would not be able to reconcile differences in any meaningful way.

Additionally, as discussed above, public disclosure of the liquidity classifications could reveal sensitive and proprietary information about funds. In fact, the Commission made a similar determination for similar liquidity classifications that private funds are required to report along with other non-public information on Form PF,<sup>84</sup> stating that "the public disclosure of [Form PF information] could adversely affect the funds and their investors" and designing certain aspects of the Form PF reporting requirements to mitigate the potential risk of inadvertent or improper disclosure.<sup>85</sup>

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<sup>81</sup> See Section 45(a) of the 1940 Act and ICI Fund Reporting Comment Letter at 23-24.

<sup>82</sup> See ICI Fund Reporting Comment Letter at 25-30.

<sup>83</sup> In this regard, we noted that the SEC already has a comprehensive disclosure regime developed over the course of decades to help investors understand the material aspects of their investment without drowning them in information. See *id.* at 24-25.

<sup>84</sup> See Item 32 of Form PF, *supra* note 62.

<sup>85</sup> *Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisers on Form PF*, SEC Release No. IA-3308, 76 Fed. Reg. 71128 (Nov. 16, 2011), available at [www.gpo.gov/fdsys/pkg/FR-2011-11-16/pdf/2011-28549.pdf](http://www.gpo.gov/fdsys/pkg/FR-2011-11-16/pdf/2011-28549.pdf) at 71155-56.

There is no public policy justification, in our view, for treating mutual funds differently from private funds in this respect if the SEC ultimately chooses to mandate an asset classification scheme.

### **3. Recommended Alternative to the Proposed Six-Category Asset Classification Scheme**

*Policies and Procedures.* We strongly recommend that, instead of the six-category asset classification scheme, the SEC require each fund, as part of its written liquidity risk management program, to formulate policies and procedures to determine how best to classify and monitor the liquidity of portfolio assets. We believe this approach is superior to the SEC's because it: (i) is risk-based and therefore better reflects the industry's diverse and sound risk management practices; (ii) places proper emphasis on asset level liquidity assessment within the broader context of portfolio level liquidity risk assessment; and (iii) eliminates the need for funds to make subjective forward-looking statements about market impact.

We describe below, at a high level, some examples of liquidity classification methods that members either are using or have indicated that they would be interested in using under the approach suggested above. We recognize that the examples below include some terms that the funds themselves would have to define or clarify in their particular policies and procedures. We encourage the SEC and its staff to engage in a dialogue with the ICI's liquidity management working group<sup>86</sup> to learn in greater detail about the diverse means by which fund complexes assess asset liquidity in their fund portfolios.

*Liquidity Classification Examples.* A fund might implement this new requirement in a number of different ways as it best sees fit. Below we provide non-exclusive examples.

Under one specific approach (and for illustrative purposes only), a fund might assess and classify the liquidity of its portfolio using three categories, as follows:

- "Most Liquid Assets" would consist of any cash held by a fund and any asset that the fund believes is convertible into cash within three business days, within the context of normal trading;
- "Intermediate Liquidity Assets" would consist of assets that are not Most Liquid Assets or Illiquid Assets; and
- "Illiquid Assets" would consist of assets that are considered "15% standard assets," as defined in the proposal.

A fund might classify the assets based on a combination of both quantitative and qualitative considerations that it deems relevant. These might include, for example, trading volume, asset type,

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<sup>86</sup> See *supra*, note 7 and accompanying text.

market conditions, and investment professionals' expert understanding of trading conditions for the assets, among other factors.

Under other approaches (and, again, for illustrative purposes only), a fund might assess and classify the liquidity of its portfolio assets using four, five, or some other fixed number of categories. These categories might correspond to determinations about the fund's anticipated ability to sell an asset. A fund would include an "illiquid assets" category (which would not be reflected as a separate category under the proposal). A fund's policies and procedures would establish these categories and define the categories' key terms and concepts.

Using such a framework, a fund might assess the liquidity of its portfolio assets in a qualitative way using factors that it deems appropriate. For instance, a fund might assess and classify its assets based on a combination of security type (*e.g.*, investment grade corporate bonds) and other key characteristics. These characteristics might include issuer type, issuer domicile, duration, credit quality, currency, issuer's sector or industry, whether the instrument is "on the run" or "off the run,"<sup>87</sup> the instrument's place within the issuer's capital structure, its registration status, and other legal rights and restrictions.

A fund then could place different asset types (and thus particular assets sharing their characteristics) into one of the respective categories on a provisional basis, subject to monitoring the assets and re-categorizing particular assets as appropriate in light of specific facts and circumstances. This approach would acknowledge that, while assets of certain types (*e.g.*, large cap equities, investment grade corporate bonds, or municipal bonds) may have broadly similar liquidity profiles, the profile of particular assets may differ, and a fund should appropriately account for those differences. A municipal bond fund, for example, may generally invest in bonds with similar liquidity profiles and classify them similarly, but political or economic events affecting a particular municipality could in turn affect the liquidity of certain of its bonds, and the fund could review the liquidity of those bonds and classify them differently from its other municipal bond holdings.<sup>88</sup>

*Monitoring and Board Reporting.* In addition to calling for and outlining an approach to assessing and classifying the fund's assets, the fund's policies and procedures should be required to include protocols for continuous monitoring and oversight. For instance, a fund could presumptively classify certain specific asset types in a particular category in its policies and procedures, based on its

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<sup>87</sup> "On the run" bonds are more recently issued than older but otherwise comparable "off the run" offerings from the same issuer.

<sup>88</sup> This approach would be consistent with the IOSCO Principles, which suggest that "[t]he responsible entity should fully consider the liquidity of the *types* of instruments in which the CIS's assets will be invested, at an appropriate level of granularity..." IOSCO Principles at 3. (emphasis added) IOSCO elaborates on "the appropriate level of granularity," stating, "Consideration at the level of the asset class may not be sufficiently granular—for example, some equities can be liquid and some illiquid." *Id.* We agree, and we would expect considerably more granularity in these assessments than simple classifications of "equities," "bonds," and "cash."

analysis of their liquidity under normal trading conditions, and periodically review these classifications and underlying assumptions in light of factors such as changing market conditions. The protocols also could require such monitoring at required intervals, such as prior to monthly reporting on Form N-PORT. A fund's policies and procedures also could call for board reporting of the results of the periodic reviews in an aggregated manner as part of an annual written report to the fund board on the adequacy and effectiveness of the fund's liquidity risk management program.

*SEC Reporting and Public Disclosure.* We recommend, as part of our alternative, that a fund report related information on Form N-PORT and make related disclosures in its prospectus. In particular, a fund would be required to report to the SEC only on Form N-PORT, on an aggregated basis, the percentages in each of the categories that it establishes, and provide a description of those categories. We strongly recommend that this Form N-PORT information be kept non-public to avoid any investor confusion that may result from necessary and appropriate variations in categories among funds, as well as any predatory practices that could result from liquidity disclosures as described above.<sup>89</sup> In addition, each fund would provide additional disclosure in its prospectus about how it assesses, classifies, and monitors fund liquidity.<sup>90</sup>

*Rationale for Alternative Approach.* Our proposed alternative would accomplish the SEC's policy objectives in a more effective and far less burdensome manner. The requirement that funds would formulate policies and procedures to classify and monitor the liquidity of portfolio assets would ensure structure and rigor around liquidity risk management without occasioning the kinds of concerns that the proposed requirement does. The SEC's desire that investors understand how funds assess asset level liquidity and manage it would be met through our proposed enhancements to prospectus disclosure (which go farther than what the SEC has proposed).

The SEC's desire for better liquidity-related data for risk oversight purposes would be met through (i) enhanced information collected through future Form N-PORT filings, and (ii) our proposed aggregated liquidity classification information, which would provide useful periodic summaries of a fund manager's view of a fund's liquidity profile. Even if this proposal did not expand Form N-PORT in any way, the information that the SEC would collect through Form N-PORT filings (as initially proposed) still would help the SEC spot emerging liquidity trends at the fund or industry level. After the SEC adopts its reporting modernization rules, it will have the ability to assess fund liquidity using metrics it believes are most appropriate. Proposed Form N-PORT would require funds

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<sup>89</sup> As we suggested in the ICI Fund Reporting Comment Letter, there are a number of mechanisms for treating portions of Form N-PORT as non-public, including requiring funds to submit the non-public items under Part D or on a separate schedule to the Form. *See* ICI Fund Reporting Comment Letter at 30. If the SEC does require public disclosure of asset classifications, at an asset-by-asset or aggregated level, we recommend that such information be accompanied by disclosure that makes clear that the future liquidity of assets, or portfolios of assets, cannot be predicted with reasonable certainty, and that the liquidity classification breakdowns are not a forecast of future liquidity levels.

<sup>90</sup> This new disclosure requirement could appear under Item 11 of Form N-1A.

to report portfolio holdings and other information (*e.g.*, information about fund flows<sup>91</sup> and return information<sup>92</sup>) in a structured format on a monthly basis. With this information, the SEC would be well-positioned to (i) conduct its own analysis of individual funds and assess their liquidity profiles, and (ii) aggregate, analyze, and form its own judgments about fund liquidity at the individual fund or industry level, using whichever metrics or approaches it deems appropriate. For instance, the SEC could determine percentages of a fund's (and industry-wide) assets: by issuer or CUSIP; by asset type, issuer type, or country; or in illiquid assets, restricted securities, "Level 3" assets, or defaulted securities, among others.<sup>93</sup>

We believe our recommended approach (*i.e.*, requiring each fund to formulate policies and procedures to determine how best to classify and monitor the liquidity of portfolio assets) is far preferable, and preserves the various methods and disciplines that funds have employed in managing liquidity so successfully over so many years. Still, if the SEC insists instead on prescribing a single regime across the industry, we strongly urge that it (i) consider the information provided in this letter as a starting point, (ii) engage in dialogue with the industry before settling on a new one to propose, to help ensure that it would work in practice, in contrast to the scheme it has proposed,<sup>94</sup> and (iii) re-propose the prescribed approach to provide an opportunity for full consideration of its potential advantages and disadvantages, including its anticipated costs and benefits.

#### **4. Other Comments on Proposed Asset Classification Scheme**

While we object to the proposed asset classification scheme and recommend that it be abandoned, we make the following related points about this element of the proposed rule.

##### **a. Forward-Looking Statements**

As discussed above, the proposed asset liquidity classifications disclosed on Form N-PORT would be fundamentally forward-looking. Therefore, we strongly recommend that the SEC implement measures to shield from liability funds that in good faith make such future assessments of liquidity at

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<sup>91</sup> Form N-PORT would require funds to separately report, for each of the preceding three months, the total NAV of: (i) fund shares sold (including exchanges but excluding reinvestments of dividends and distributions); (ii) fund shares sold in connection with reinvestments of dividends and distributions; and (iii) fund shares redeemed or repurchased (including exchanges). Proposed Item B.6.

<sup>92</sup> Form N-PORT would require funds to provide monthly total returns for each of the preceding three months, along with other return-related information. Proposed Item B.5.

<sup>93</sup> See generally Proposed Item C of Form N-PORT.

<sup>94</sup> We also urge the SEC to carefully consider its authority for the proposed rule in light of commentary by some legal experts. See *infra*, note 106.



either the asset or portfolio level that subsequently turn out to materially differ from actual liquidity.<sup>95</sup> The Commission has precedent for using its authority to shield from potential liability certain forward-looking information that registrants are required to provide.<sup>96</sup> If the SEC either requires or permits funds to provide such forward-looking information about their liquidity, then it is only proper that it protect funds from any liability that could result from good faith projections that do not materialize.

#### **b. Relationship of an Asset to Another Portfolio Asset**

The proposed rule would require funds to consider the relationship of one portfolio asset to another when determining the liquidity classification of a position.<sup>97</sup> The Commission provides two examples of these considerations in the context of derivatives. First, the Commission notes that certain types of investments will implicate the senior securities provisions of the 1940 Act and will require funds to maintain liquid assets in a segregated account to “cover” the fund’s obligations for the investments based on the Commission’s positions for financing transactions and the Commission staff’s no-action positions for derivatives.<sup>98</sup> In these situations, the Commission states that funds would have to consider that the segregated assets are being used to cover other transactions and are “frozen” or “unavailable for sale or other disposition.”<sup>99</sup> Accordingly, the Commission notes that “[b]ecause these assets are only available for sale to meet redemptions once the related derivatives position is disposed of

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<sup>95</sup> Assuming the SEC permits funds to adopt their own means of classifying assets and requires related disclosure on Form N-PORT, such information still could include forward-looking elements.

<sup>96</sup> See, e.g., Rule 175 under the Securities Act of 1933 (the “Securities Act”) and Rule 3b-6 under the Exchange Act; see, e.g., Item 303(c) of Regulation S-K (applying the safe harbor provided in Section 27A of the Securities Act and Section 21E of the Exchange Act to forward-looking information related to off-balance sheet arrangements and certain contractual obligations contained in the “Management’s Discussion and Analysis” section of a registrant’s disclosure documents) and *Disclosure in Management’s Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations*, SEC Release No. 33-8182, 68 Fed. Reg. 5982 (Feb. 5, 2003).

<sup>97</sup> Proposed Rule 22e-4(b)(2)(ii)(I).

<sup>98</sup> See *Securities Trading Practices of Registered Investment Companies*, SEC Release No. IC-10666, 44 Fed. Reg. 25128 (Apr. 27, 1979) available at [www.sec.gov/divisions/investment/imseniorsecurities/ic-10666.pdf](http://www.sec.gov/divisions/investment/imseniorsecurities/ic-10666.pdf); See also *Use of Derivatives by Investment Companies Under the Investment Company Act of 1940*, SEC Release No. IC-29776, 76 Fed. Reg. 55237 (Sept. 7, 2011), available at [www.gpo.gov/fdsys/pkg/FR-2011-09-07/pdf/2011-22724.pdf](http://www.gpo.gov/fdsys/pkg/FR-2011-09-07/pdf/2011-22724.pdf). The Commission recently proposed a rule that could affect the types of collateral that funds use to cover their derivatives transactions. *Use of Derivatives by Registered Investment Companies and Business Development Companies*, SEC Release No. IC-31933, 80 Fed. Reg. 80884 (Dec. 28, 2015) (“Derivatives Proposal”), available at [www.gpo.gov/fdsys/pkg/FR-2015-12-28/pdf/2015-31704.pdf](http://www.gpo.gov/fdsys/pkg/FR-2015-12-28/pdf/2015-31704.pdf). We assume that the Commission’s position would apply to any new requirements that it adopts, and we urge the Commission to consider adopting any final liquidity risk management program rule together with the Derivatives Proposal and impose consistent compliance dates to ensure that funds can address any overlapping operational changes in a reasonable and cost-effective manner.

<sup>99</sup> Release at 62302, n.243 and surrounding text.

or unwound, a fund should classify the liquidity of these segregated assets using the liquidity of the derivative instruments they are covering.”<sup>100</sup>

Similarly, the Commission notes that a fund may purchase an asset in connection with its holding of another. It cites an example of a fund that purchases a debt security denominated in a foreign currency, then buys a derivative that hedges out the currency risk. In these situations, the Commission states that, when a fund purchases a more liquid asset in connection with a less liquid asset, and it plans to transact in the more liquid asset only in connection with the less liquid asset, the liquidity of both assets are linked, and the fund should consider the liquidity classification of the foreign securities when determining the liquidity of the currency derivative.

The Commission’s proposal to require funds to link assets raises difficult operational issues for funds, and may cause confusion if liquidity classifications are publicly disclosed. Each of these concerns is explained below.

In many cases, funds do not link segregated assets to a particular derivative but often only segregate assets equal to the aggregate obligations owed to a counterparty under *all* derivatives contracts. Similarly, funds typically do not link other types of securities to a particular derivative. For example, a currency-hedged balanced fund may purchase foreign debt and equity securities that are denominated in euros and may enter into multiple foreign currency contracts with various counterparties to hedge euro currency risk for the entire portfolio. The foreign currency contracts are not entered into daily with each euro-denominated investment but monthly based on the fund’s aggregate investments in euro-denominated securities. The fund may add or eliminate exposure to existing foreign currency contracts or enter into new contracts depending on the fund’s overall exposure to the euro and based on changes to the market value of the euro-denominated securities or the fund’s intra-month flows. Under the current system, it would be difficult, if not impossible, for the fund to determine which euro-denominated securities should link to which foreign currency contract with any certainty because it is putting on a hedge based on the portfolio’s exposure and its existing hedges, not on any particular investment. Linking assets may require a change to portfolio management or the creation of a complex system that could estimate, without complete accuracy or evident purpose, what portion of a derivatives agreement covered which underlying securities.

Moreover, the SEC’s position seemingly would require the liquidity determination of several assets to link to the liquidity determination of a particular asset. Thus, taking the example above, the liquidity classification of a euro-denominated debt security, its related derivatives contract (if the fund could identify a linkage) and the segregated assets associated with the derivatives contract would somehow have to link together and bear the same liquidity classification, which could differ from a euro-denominated equity security, its related derivative (if the fund could identify a linkage) and its

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<sup>100</sup> *Id.* at 62303, nn. 244 to 245 and surrounding text.

segregated assets. Funds would need to develop complex and costly systems to track these complicated linkages.

Under the proposal, a fund could deem an otherwise liquid but encumbered asset to be less liquid than it actually is. For example, a fund might classify a cash equivalent security that ordinarily could be converted to cash within one business day as an asset convertible to cash within 8-15 days, if it is used to “cover” an instrument that the fund classifies as convertible to cash within 8-15 days. This automatic classification belies the fact that the fund could replace the asset as cover with another liquid asset at any time, and sell the asset to obtain proceeds within one business day. In addition, currently, there are no mechanisms on Form N-PORT to explain these linkages and how assets are linked together for purposes of liquidity determinations. We are concerned that linking assets could confuse those viewing Form N-PORT and cannot envision how such disclosure could be designed in a manner that would be informative. This aspect of the proposal also makes asset classifications less comparable in an opaque manner that will be difficult for third parties to decipher.

For these reasons, the Commission should eliminate the requirement that funds determine the liquidity classifications of assets based on other related assets. Rather, if the SEC adopts the individual asset-by-asset classification approach, we recommend that the SEC add an item to the Form N-PORT’s Schedule of Portfolio Investments that permits a fund to note whether an asset (or portion thereof) is encumbered or linked to other assets as of the reporting date, without separately tying to or identifying a “linked” asset.

### **c. Funds’ Investments in Other Funds**

It is unclear to us how a fund would classify an investment in another fund under the proposed asset classification scheme. On the one hand, a fund generally can redeem (or sell on the secondary market, as applicable) and receive cash for shares of mutual funds, ETFs, and closed-end funds quickly and easily, which suggests that it generally would be appropriate to classify such assets entirely within the two most liquid categories. On the other hand, the Release discusses investments in ETFs (as a liquidity management tool) and states, “We therefore encourage funds to assess the liquidity characteristics of an ETF’s underlying securities, as well as the characteristics of the ETF shares themselves, in classifying an ETF’s liquidity under proposed rule 22e-4(b)(2)(i).”<sup>101</sup> If the SEC believes a similar approach is appropriate for other fund types (*e.g.*, mutual funds, closed-end funds, and unregistered funds), it is unclear how a fund should balance the liquidity of the underlying fund shares themselves with the liquidity of the underlying fund’s portfolio assets. Furthermore, if the underlying fund is unaffiliated, the fund may not have up-to-date information about the underlying fund’s portfolio assets, making this determination even more difficult. This is yet another example of the difficulties that would arise in applying a “one-size-fits-all” asset classification scheme across the fund universe, with its great diversity of holdings and strategies.

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<sup>101</sup> *Id.* at 62321.

#### **d. Classifying Assets Based on Settlement Periods**

Under the asset classification scheme, a fund would estimate expected settlement times for determining convertibility to cash. In providing examples of transactions with lengthy settlement periods, the Commission mentions “agency mortgage-backed securities (other than secondary market trades)” and notes in a related footnote that over ninety percent of agency mortgage-backed securities (“MBS”) trading occurs in the to-be-announced (“TBA”)<sup>102</sup> forward market, and that the trade date of a TBA trade will usually precede settlement by between two and sixty days.<sup>103</sup> We find this example of agency MBS and TBAs confusing and unhelpful. For purposes of assessing liquidity, the relevant determination is *not* how long it takes for the fund to come into possession of the actual agency MBS upon settlement of the TBA—it is how long it would take for the fund to *dispose of the TBA itself and reclaim its cash value*. We understand that the TBA market is highly liquid, and that funds generally are able to dispose of TBAs without delay prior to the designated forward settlement date. In this regard, the TBA market is similar to the futures market, in which physically-settled futures contracts may trade continuously (*e.g.*, daily) but the underlying reference assets are delivered at a later date (*e.g.*, once every three months). Perhaps the SEC meant to acknowledge all of this with the parenthetical (“other than secondary market trades”). Still, the SEC should drop this example. Otherwise, it risks casting a cloud over the liquidity of funds’ holdings in a well-functioning and critically important market.

#### **F. Three-Day Liquid Asset Minimum**

We oppose the proposed three-day liquid asset minimum. In this section, we explain our objections and recommend an alternative designed to achieve the SEC’s goals for this provision.

##### **1. Objections to the Three-Day Liquid Asset Minimum**

The SEC proposes to require each fund to determine a “three-day liquid asset minimum”<sup>104</sup> (considering the same factors used to assess liquidity risk), periodically review that minimum, and manage the portfolio in accordance with it. As part of its normal operations, a fund could fall below its

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<sup>102</sup> TBAs are securities in which the parties agree that the seller will deliver to the buyer a pool or pools of a specified face amount and meeting certain other criteria, but the pool or pools to be delivered at settlement are not specified at the time of execution.

<sup>103</sup> Release at 62295, n. 198 and accompanying text.

<sup>104</sup> The three-day liquid asset minimum would be “the percentage of the fund’s net assets to be invested in three-day liquid assets...” “Three-day liquid assets” would consist of “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.” In determining whether an asset (or portion thereof) would qualify, a fund would consider the same factors used in classifying portfolio assets. Proposed Rule 22e-4(a)(9); Proposed Rule 22e-4(b)(2)(iv)(A)-(C).

minimum, but then would be precluded from purchasing “less liquid assets”<sup>105</sup> until it once again met or exceeded its minimum.

The SEC justifies this new liquidity requirement on the basis that funds often represent that they will pay redemption proceeds in less than seven days, and Rule 15c6-1 under the Exchange Act establishes a three-day settlement period for security trades effected by a broker or a dealer.<sup>106</sup> The SEC also notes that, based on staff outreach to the industry, “targeting such a minimum [of assets similar to those included in the SEC’s definition of three-day liquid assets] appears to be a common practice for those funds that do establish a target.”<sup>107</sup>

For a variety of reasons, we do not support the proposed three-day liquid asset minimum, even assuming the SEC has authority to require it. It is excessively prescriptive and may quite negatively impact portfolio management practices and overall markets.

As an initial matter, the proposed three-day liquid asset minimum relies on the highly flawed asset classification scheme described above. In effect, those assets falling into the first two categories would qualify as three-day liquid assets. For assets other than cash, compliance testing around this requirement still would necessitate funds’ making forward-looking and highly subjective judgments about whether and how much of each asset could be (i) convertible to cash (ii) within three business days (iii) at a price that does not materially affect the value of that asset immediately prior to sale.

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<sup>105</sup> A “less liquid asset” would be any asset that is not a three-day liquid asset. Proposed Rule 22e-4(a)(6).

<sup>106</sup> We question whether the SEC’s authority to adopt rules for broker-dealers can be read to supersede express Congressional determinations, such as establishing a seven-day redemption timeframe in Section 22(e) of the 1940 Act. At the open meeting at which the Commissioners approved the release of the proposal, Commissioner Piwowar, quite appropriately, expressed concern about the three-day liquid asset minimum and its inconsistency with Section 22(e). *See Statement at Open Meeting on Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release*, Commissioner Michael S. Piwowar (Sept. 22, 2015), available at [www.sec.gov/news/statement/open-end-fund-liquidity-risk-management.html](http://www.sec.gov/news/statement/open-end-fund-liquidity-risk-management.html) (“While in practice many funds may make payment to shareholders for securities tendered for redemption in less than seven days, section 22(e) of the Investment Company Act only requires that the fund make payment within seven days of the securities being tendered. I would prefer that the rule track the statute and require a seven-day liquid asset minimum rather than the proposed three-day liquid asset minimum.”).

Our recommended alternatives would avoid the substantial legal questions about the Commission’s authority in this regard and in regard to other elements of the proposal. *See, e.g., SEC Proposes Minimum Liquidity Requirement for Open-End Funds; Raises Questions Regarding the Relationship Between Liquidity and Valuation*, Simpson Thacher & Bartlett LLP (November 2015)(questioning whether the SEC has authority under Sections 22(e), 22(c), or 38(a) of the 1940 Act to adopt Proposed Rule 22e-4), available at [www.stblaw.com/docs/default-source/Publications/registeredfundsalert\\_november2015.pdf](http://www.stblaw.com/docs/default-source/Publications/registeredfundsalert_november2015.pdf).

<sup>107</sup> Release at 62312.

Funds therefore would be saddled with this unworkable framework for setting and determining compliance with their minimums.

Compliance with the three-day liquid asset minimum would be exceedingly difficult for funds with multiple sub-advisers. These funds are able to monitor and comply with the current 15% limit on illiquid assets because they (i) communicate their policies and procedures (which generally call for classifying assets by trading lot (*i.e.*, without regard to position size)) to sub-advisers, and (ii) can impose limits on each individual sub-adviser's ability to invest in (reasonably identifiable) illiquid assets, thereby ensuring that the funds do not exceed these limits due to purchases of new portfolio assets. This process allows a fund to assure overall portfolio compliance. Because of the fluidity of what would constitute three-day liquid assets versus less liquid assets (subject to change daily, or even hourly), ongoing monitoring and compliance would become a much greater challenge. Consequently, funds and their sub-advisers would be hard-pressed to settle on some universe of assets that they could consistently treat as three-day liquid assets. To illustrate, two sub-advisers, in isolation, may apply accurately a fund's policies and purchase for the fund the same large-cap U.S. equity that by all measures would qualify as a three-day liquid asset. But because the three-day liquid asset definition requires consideration of position size at the *fund level*, such independent purchases could cause the fund to violate its three-day liquid asset minimum, through no fault of the sub-advisers, the adviser, or the fund.<sup>108</sup>

More fundamentally, a fund's compliance with its three-day liquid asset minimum could adversely affect its ability to adhere to its investment objectives, policies, and strategies, and deprive it of certain investment opportunities. While a fund that falls below its minimum would not be required to *dispose of* any "less liquid assets,"<sup>109</sup> it would be precluded from *acquiring* less liquid assets. Prohibiting such acquisitions could affect portfolio management in very real and negative ways. As a matter of policy and/or strategy, funds, whether actively or passively managed, often seek to maintain weightings in certain security types, countries, sectors, *etc.* Compliance with a three-day liquid asset minimum would at best complicate, and at worst severely undermine, these common approaches to portfolio management. It also could depress investment returns, to the extent that a fund's minimum affects the fund manager's decision-making process and investment choices. Index funds could experience increased tracking error, limiting their ability to fulfill investors' clear expectations. Actively-managed funds also could be hamstrung, if portfolio managers do not have discretion to purchase assets that they believe would maximize funds' risk-adjusted returns.

The minimum also could prove unnecessarily rigid in application. A fund could fall below its minimum, for example, yet be aware of a large pending purchase of fund shares that would add cash to

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<sup>108</sup> In the event that the individual sub-advisers, rather than the adviser, would have responsibility for asset classifications, similar difficulties would present themselves in connection with this responsibility.

<sup>109</sup> ETFs would face unique challenges in this regard. *See infra*, Section II.J.1 for a detailed discussion.

the portfolio. In such a case, the fund still would be precluded from investing in less liquid assets until it receives the new cash proceeds.

Beyond these more immediate and practical limitations, a fund's compliance with its three-day liquid asset minimum could limit its investment opportunities. During a market downturn a fund manager could view certain investments as undervalued, and therefore compelling buying opportunities for the fund. If these investments were "less liquid assets," a fund would be precluded from purchasing them if it were below its minimum. Thus, the minimum would reduce the fund's universe of potential investments and ability to invest in contrarian and countercyclical ways, thereby reducing its potential for gains in situations where market prices fall. Fund managers would be handcuffed in these situations, to the detriment of fund investors.

Nor would the "less liquid assets" unavailable to a fund consist only of genuinely illiquid assets. Suppose that a fund has a position in a highly liquid large cap stock that was sizable enough that at least a portion of it could not be disposed of within three days without materially affecting its market price (*i.e.*, at least a portion constituted "less liquid assets"). If the fund were below its three-day liquid asset minimum, it would be precluded from purchasing more of that stock, despite its high degree of liquidity and the fund manager's (potentially high) degree of conviction (or, in the case of an index fund, its investment mandate). In this way, the minimum could distort the portfolio management process and lead to sub-optimal results for fund shareholders.

Notably, the three-day liquid asset minimum even could induce herding behavior and cliff events and deprive the market of needed sources of liquidity. It is impossible to predict what percentage of its assets any particular type of fund would normally hold in three-day liquid assets, or how reporting requirements and market forces would influence the fund in setting and managing liquidity in relation to its minimum. It is likely that, all things being equal, the fund would be influenced to hold a larger percentage of its portfolio in assets widely acknowledged as liquid. The effects of this influence on portfolio management could extend well beyond funds themselves to the markets more broadly.

If the proposed regulatory mandates—*i.e.*, the asset classification scheme, the three-day liquid asset minimum, and the related reporting requirements—cause fund managers to prefer more liquid assets, then demand for these assets will increase. Those assets would become even more liquid. Inevitably, however, this increased demand would come at the expense of other types of assets, depressing demand for them and making them less liquid. This could increase illiquidity in various market segments or security types and make them less desirable as fund holdings. This regulatory-induced herding behavior could become especially pronounced and problematic during stressed periods. The Release's economic analysis recognizes these potential adverse effects; unfortunately, it did not attempt to quantify them.<sup>110</sup>

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<sup>110</sup> Release at 62362-63.

As discussed above, and as addressed at length in the ICI Research Letter, larger funds would be more likely to have lower percentages invested in three-day liquid assets compared to smaller funds holding similar instruments. This could incentivize larger bond funds, in an attempt to compensate, to concentrate their portfolios in more liquid securities and avoid smaller, less liquid securities. This in turn could adversely affect small and medium-sized enterprises' ability to obtain financing through the bond market, or else could increase their borrowing costs.

In increasing the limits on funds' illiquid assets from 10 to 15% in 1992, the SEC stated, "Allowing mutual funds to invest an additional 5% of their net assets in illiquid securities, including illiquid securities of U.S. small businesses, could make a significant amount of capital available to small business without significantly increasing the risk to any fund."<sup>111</sup> Thus, the SEC clearly believed that changing the limits on fund liquidity could have important consequences for capital formation. This certainly is no less true today.

These dynamics would be exacerbated if third-party vendors become influential in asset liquidity classifications. In cases of securities receiving "liquidity downgrades" on vendors' platforms, funds could feel compelled to sell these securities, to increase their percentages in three-day liquid assets and/or improve their reportable liquidity profiles. This could lead to selling pressures and/or cliff effects similar to those that occur when insurance companies must sell bonds that are downgraded to non-investment grade status, in order to meet their minimum capital requirements.

Markets in general also could be adversely affected. The three-day liquid asset minimum would potentially undermine, rather than bolster, market liquidity generally during stressed conditions. During market corrections, those assets falling most in value are often less liquid. If funds have the flexibility to purchase undervalued and temporarily less liquid assets, doing so could support market liquidity and prices by directing capital toward market segments under stress. Funds below their minimums, or funds concerned generally about their reported liquidity profiles, may be unable or unwilling to provide this countercyclical support.

To be clear, fund managers' responsibilities are to their funds and their shareholders. The SEC's focus in this liquidity-related rulemaking on investor protection is understandable. Nevertheless, rulemaking in this area that is overly-prescriptive runs a very real risk of adversely affecting capital formation, other market participants, and markets generally, in foreseeable if unintended ways. At a minimum, and consistent with its mission, the SEC should be mindful of alternatives that advance investor protection without posing risks to capital formation.

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<sup>111</sup> SEC Liquidity Guidelines Release at 9828.



## 2. Recommended Alternative to the Three-Day Liquid Asset Minimum

*Policies and Procedures.* In place of the three-day liquid asset minimum, we recommend that the SEC require each fund to formulate policies and procedures to determine how best to reasonably ensure that the fund has sufficient liquidity to meet redemptions under normal and reasonably foreseeable stressed conditions, consistent with its investment objective. Thus, each fund would determine how to most meaningfully achieve the SEC's policy objective (*i.e.*, that funds be equipped to satisfy redemption requests).

A fund might implement this policy in a number of different ways. By way of example only, a fund could establish "targets" or ranges for "highly liquid assets" (as defined by the fund, and about which the fund could provide narrative disclosure in its prospectus),<sup>112</sup> or a "liquidity coverage ratio" (*i.e.*, a measure of the extent to which a fund has sufficient liquidity to meet daily/weekly redemptions and other obligations based on average redemption activity and historically large redemptions for the fund). This would be less rigid than the proposal's three-day liquid asset minimum—there, a fund below its minimum would be precluded from purchasing "less liquid assets" until it was once again above its minimum. By using a target instead, a fund could continue to purchase non-"highly liquid assets" even after falling below its target. A fund could address in its policies and procedures how it would respond to falling below its target, outside of its range, or below any particular coverage ratio, which could include reviews by or escalation to personnel outside of portfolio management (*e.g.*, compliance personnel, an oversight committee, or senior management). The recommended approach is much more in keeping with current industry practice<sup>113</sup> and the IOSCO Principles, which suggest that responsible entities set "appropriate liquidity thresholds which are proportionate to the redemption obligations and liabilities of the CIS."<sup>114</sup>

*Monitoring and Board Reporting.* These policies would be part of the fund's board-approved program, and each fund would be required to report periodically to its board on the measure it uses. For example, a fund that adopts a liquidity target based on an estimate of redemptions under reasonably foreseeable stressed conditions, this could mean reporting the target and the fund's current level of

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<sup>112</sup> Similar to the SEC's understanding of three-day liquid assets, we envision this consisting of assets other than just cash and cash equivalents.

<sup>113</sup> See *supra*, Section I.A.

<sup>114</sup> IOSCO Principles at 3. The Principles continue: "The responsible entity should set appropriate internal definitions and thresholds for the CIS's liquidity, which are in line with the principle of fair treatment of investors and the CIS's investment strategy. The thresholds should act as a signal to the responsible entity to carry out more extensive in-depth, quantitative and/or qualitative liquidity analysis as part of the risk management process (with the intention that the responsible entity would then take appropriate remedial steps if the analysis revealed vulnerabilities)."

highly liquid assets. For a fund that uses a liquidity coverage ratio, this could mean reporting the current ratio and any changes to it.

*Stress Testing.* We recommend that the rule require each fund to consider whether to include stress testing as a component of its liquidity risk management program, based on an assessment of the fund's overall liquidity risk at the portfolio level. Designed appropriately, stress tests can be helpful to a fund and its manager in determining whether the fund has sufficient liquidity to withstand various events.<sup>115</sup> A fund that incorporates stress testing into its liquidity risk management program could consider developing tests that respond to the SEC's specified factors for assessing liquidity risk at the portfolio level.<sup>116</sup> Stress testing would complement and provide an additional check on the effectiveness of the other measures (such as a targeted amount of "highly liquid assets") that a fund could adopt to reasonably ensure that it has sufficient liquidity to meet redemptions under normal and reasonably foreseeable stressed conditions.

*Public Disclosure and SEC Reporting.* We recommend that each fund be required to describe in its prospectus in sufficient detail these aspects of its liquidity risk management program.<sup>117</sup> This would inform investors about how funds are seeking to ensure that they have sufficient liquidity to meet redemptions under normal and reasonably foreseeable stressed conditions.

We further recommend that the SEC incorporate in Form N-PORT reporting obligations that comport with our recommendations. Specifically, we recommend that a fund with a liquidity "target" or "range" disclose to the SEC only (i) that target or range, and (ii) where the fund stood in relation to it as of month end. A fund using a liquidity coverage ratio could disclose that as of month end. In each case, a fund would describe its approach in sufficient detail to provide context for the figures reported. We strongly recommend that the SEC keep this information non-public, as funds will differ in the means by which they satisfy this requirement. Even funds that take the same basic approach (*e.g.*, establishing a liquidity target) may differ in the way they determine "highly liquid assets" and/or set their targets. For instance, if a fund aggressively characterized assets as highly liquid assets and sets a higher target, it could appear superficially more liquid than a fund that conservatively characterized assets and sets a lower target. These differences would not facilitate an "apples-to-apples" comparison between funds and would likely lead to investor confusion.

*Rationale for Alternative Approach.* This alternative would accomplish the SEC's policy objectives. A requirement that a fund formulate policies and procedures to determine how best to ensure that the fund has sufficient liquidity to meet redemptions under normal and reasonably foreseeable stressed conditions (consistent with its investment objective) and, as the fund deems

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<sup>115</sup> We recognize that the SEC staff is also considering ways to implement the new requirements for annual stress testing by large investment advisers and large funds, as required by the Dodd-Frank Act.

<sup>116</sup> Proposed Rule 22e-4(b)(2)(iii)(A)-(D).

<sup>117</sup> This new disclosure requirement could appear under Item 11 of Form N-1A.

appropriate, perform related stress testing would create a new regulatory baseline where none exists, and ensure process and rigor in consideration of this essential fund responsibility (*i.e.*, meeting redemptions). The SEC's desire that investors understand how funds seek to ensure that they have sufficient liquidity to meet redemptions under normal and reasonably foreseeable stressed conditions would be met through our proposed enhancements to prospectus disclosure (which go farther than what the SEC has proposed). Finally, the SEC's desire for better liquidity-related data for risk oversight purposes would be met by (i) all of the information collected through future Form N-PORT filings (as discussed above, and with which the SEC could conduct its own stress tests on individual funds and make its own fund-specific or industry-wide assessments of liquidity risk), and (ii) our proposed portfolio level liquidity assessment (*e.g.*, a comparison of a fund's highly liquid assets to its liquidity target or range, or its liquidity coverage ratio) on Form N-PORT filings, which would provide a useful summary of the *fund's* own assessment of its ability to meet redemptions.

#### **G. Assessment of the Economic Analysis as It Relates to the Asset Classification Scheme and the Three-Day Liquid Asset Minimum**

The Release's economic analysis states, "A primary goal of the proposed liquidity regulations is to promote investor protection by reducing the risk that funds will be unable to meet their redemption obligations, elevating the overall quality of liquidity risk management across the fund industry, increasing transparency of funds' liquidity risks and risk management practices, and mitigating potential dilution of existing shareholders' interests."<sup>118</sup> As discussed above, the industry has a successful 75-year history in meeting redemptions and minimizing dilution,<sup>119</sup> and the ICI Research Letter demonstrates the absence of evidence that funds manage liquidity in ways detrimental to their shareholders.

Nonetheless, there may be room for incremental improvement across the industry, and a thoughtful rule could advance these goals. But costs clearly matter, and should be instrumental in guiding *how* the Commission pursues these goals. The SEC's analysis estimates that aggregate one-time costs to fund complexes to establish and implement a liquidity risk management program would be approximately \$1.4 billion, and aggregate annual costs associated with these programs thereafter would be \$240 million.<sup>120</sup> The analysis also recognizes that the proposed rule could result in (i) certain funds increasing their investments in relatively more liquid assets, which in turn could affect the performance and/or risk profiles of those funds; (ii) decreased investment options and investment returns; and (iii) a decrease in fund investments in relatively less liquid assets, making them even less liquid, and

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<sup>118</sup> Release at 62350.

<sup>119</sup> *See supra*, Sections I.B and C.

<sup>120</sup> Release at 62361.

discouraging new issuances of similar assets.<sup>121</sup> Regrettably, the analysis does not attempt to quantify these costs.

The analysis's discussion of reasonable alternatives also is deficient, in our view. With respect to the proposed asset classification scheme, the only alternative considered appeared to be a slightly enhanced version of the status quo, whereby funds would classify assets as either "liquid" or "illiquid" based on certain factors.<sup>122</sup> This was rejected out of preference for a more "spectrum-based" approach. With respect to the three-day liquid asset minimum, the staff considered more alternatives (some of which, in our view, would have been more detrimental). For example, the Commission considered but rejected required stress testing, because the Commission preferred having a certain set of factors to be considered in assessing and managing liquidity risk, and thought that stress testing might not adequately depict liquidity risk.

As outlined above, we have serious objections to the proposed asset classification scheme and three-day liquid asset minimum. We believe the asset classification scheme in particular would impose enormous direct costs on funds and their shareholders, which we would anticipate being greatly in excess of the Commission's estimate.

It does not appear as if the Commission considered alternatives similar to what we are recommending. Our alternatives would achieve the Commission's aims at a fraction of the proposed rule's initial and ongoing costs, primarily because of the high cost and complexity that would accompany the SEC's proposed asset classification scheme. For this reason alone, they deserve careful consideration, with potential costs and benefits in mind.

#### **H. Role of the Fund Board**

The proposed rule would require a fund board, including a majority of its independent directors, to review and approve a fund's written liquidity risk management program.<sup>123</sup> This would include approval of a fund's three-day liquid asset minimum and any material changes to the program, including any changes to the fund's three-day liquid asset minimum.<sup>124</sup> Directors could satisfy their obligations by reviewing summaries of the liquidity risk management program that provide the salient features of the program and provide them with an understanding of how the liquidity risk management program addresses the required assessment of the fund's liquidity risk.<sup>125</sup> The board also would oversee

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<sup>121</sup> *Id.* at 62362.

<sup>122</sup> *Id.* at 62364.

<sup>123</sup> Proposed Rule 22e-4(b)(3)(i).

<sup>124</sup> *Id.*

<sup>125</sup> Release at 62323, n. 399 and accompanying text.

the program by reviewing an annual written report by such adviser or officers about the adequacy of the program and effectiveness of its implementation.<sup>126</sup>

We generally agree with how the SEC has framed the fund board's role within the proposed rule, *i.e.*, as one of oversight. We are concerned, however, that this is insufficient if the proposed rule imposes on those that the board oversees responsibilities that are fundamentally unworkable. Because the more prescriptive elements of the proposed rule (*i.e.*, the asset classification scheme and the three-day liquid asset minimum) do just that, fund boards could be at the risk of being second-guessed if the day-to-day decisions overseen by the board prove to be wrong, and could be exposed to unwarranted potential liability. Moreover, there are aspects of the proposed rule where a board's responsibilities would venture past oversight and start to become more hands-on, including the approval of a fund's three-day liquid asset minimum (which the SEC does not foresee remaining static) and material changes to its program. We oppose those aspects and urge the SEC to eliminate them.

We believe the fund board has a valuable role to play in overseeing liquidity risk management, provided the SEC is careful in defining its scope. Once again, Rule 38a-1 provides a useful point of reference in considering a fund board's role in overseeing fund liquidity risk management. While a fund board will generally not be expert in how a fund and its key service providers comply with federal securities laws, it nevertheless provides meaningful oversight of those experts. Similarly, we would not expect a fund board to be expert in liquidity—this expertise lies with the fund manager, to which boards commonly delegate portfolio management responsibility.

### **I. Comment on Other Liquidity Risk Management Tools**

In its discussion of assessing and managing liquidity risk, the SEC provides guidance or asks for comment on a number of additional liquidity risk management tools, including suspension of redemptions and cross-trades. Below, we comment on some noteworthy aspects of those topics.

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<sup>126</sup> Proposed Rule 22e-4(b)(3)(ii).

## 1. Suspension of Redemptions

Section 22(e) of the 1940 Act permits a fund to suspend redemptions in specified unusual circumstances, including for any period during which an emergency exists (only as determined by the Commission) as a result of which it is not reasonably practicable for the fund to liquidate its portfolio securities, or fairly determine the value of its net assets. It also permits the Commission, by order, to permit a fund to suspend redemptions for the protection of fund shareholders. The Release requests comment on whether the Commission should consider proposing rules that would permit funds to suspend redemptions.

Given the fund industry has satisfied investor expectations by meeting redemption obligations successfully for over 75 years,<sup>127</sup> there is no need for the Commission to propose rules that would permit funds to suspend redemptions.<sup>128</sup> The right of shareholders to redeem fund shares at any time and receive their proceeds within seven days is a hallmark of open-end funds.<sup>129</sup> It is a core element of the value proposition that open-end funds offer to fund investors. It also establishes a strong incentive for fund sponsors to manage fund liquidity successfully. That said, we recognize that there may be future circumstances in which it is necessary for an individual fund to suspend redemptions to protect its shareholders. In those instances, the Commission has ample authority to grant permission to do so, can appropriately condition any such permission, and has proven its ability to act quickly in exigent circumstances.<sup>130</sup>

Reserving to the Commission the sole authority to determine whether a fund may suspend redemptions coupled with the high hurdles funds must overcome to obtain this relief impose a market discipline on fund managers to ensure that their funds have sufficient liquid assets to meet redemption requests on a timely basis. Requiring funds to seek exemptive relief informs the Commission about possible liquidity risks that could impact the market and provides real incentive to funds to ensure the effectiveness of their liquidity risk management programs. Accordingly, the current approach strikes

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<sup>127</sup> See *supra*, Section I.B. Over this period, we identified six instances where the Commission granted an exemptive order permitting one or more long-term funds to suspend redemptions (excluding emergency situations outside the control of a fund's adviser, such as weather-related issues). Each of these is idiosyncratic and without systemic implications. Further, they demonstrate the limited and unusual circumstances under which the Commission has granted exemptive orders under Section 22(e)(3). We describe each instance in Appendix B.

<sup>128</sup> We took a different position on permitting money market funds, a significantly different type of product than long-term mutual funds and ETFs, to impose temporary suspensions or liquidity gates. See Letter from Paul Schott Stevens, CEO & President, Investment Company Institute to Elizabeth M. Murphy, Secretary, SEC, dated September 17, 2013, available at [www.sec.gov/comments/s7-03-13/s70313-200.pdf](http://www.sec.gov/comments/s7-03-13/s70313-200.pdf).

<sup>129</sup> See, e.g., Release at 62277, n. 18 and surrounding text.

<sup>130</sup> See Section 22(e)(3) of the 1940 Act. The Commission recently demonstrated its ability to act quickly under Section 22(e) when it granted temporary exemptive relief to the Third Avenue Trust and Third Avenue Management LLC permitting the suspension of redemptions. See *supra*, notes 13 and 127.

the right balance, is supported by the industry's track record, and is consistent with fund investors' expectations.

## 2. Cross-Trades

The proposal recognizes the benefits of cross-trading as an additional liquidity management tool and proposes to issue cross-trading guidance to limit the potential for abuse.<sup>131</sup> Rule 17a-7 under the 1940 Act permits funds to cross-trade over-the-counter securities that have readily available market quotations and are priced at the average of the highest independent bid and lowest independent offer. The Release proposes guidance that suggests that the conditions of Rule 17a-7 may make certain less liquid assets ineligible to trade under Rule 17a-7, and that "the less liquid an asset is, the more likely it may not satisfy Rule 17a-7."<sup>132</sup> The guidance also would state that, for assets that do not trade in active secondary markets, a fund should consider whether "market quotations are readily available" and a "current market price" is available and thus whether the asset may be cross-traded in accordance with Rule 17a-7. In addition, the guidance would state that a fund manager must consider its duty to seek best execution for each fund potentially involved in the cross-trading transaction, as well as its duty of loyalty to each fund.

We have concerns that the SEC's proposed guidance about cross-trading certain less liquid securities imposes a new restriction on funds outside the confines of Rule 17a-7. The rule's provisions regarding readily available market quotations and independent bid and offers require a fund manager to review the *price* of a security before it is cross-traded, not necessarily its *liquidity*. The guidance seems more bluntly to require fund managers consider the liquidity of the security. By citing to the proposed liquidity classification factors, the Commission appears to imply that all such factors bear on the determinations under Rule 17a-7 whether an asset is eligible to cross-trade. This could significantly, and inappropriately, expand the Rule 17a-7 requirements for cross-trades. Additionally, while it is true that securities that are less liquid may be less likely to have a readily available market price or independent bids and offers, that will not always be the case. Even an instrument that is less liquid may have a readily available market quotation, and a fund reasonably may determine that it has independent bid and offer prices. Yet the SEC's proposed guidance seems to suggest, contrary to the conditions explicitly set forth in Rule 17a-7, that funds cannot cross-trade less liquid assets or must overcome a presumption that less liquid assets are not eligible for cross-trading in reliance on the rule. Accordingly, we recommend eliminating the guidance tying a fund's ability to cross-trade assets to the assets' liquidity.

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<sup>131</sup> "Cross-trading" is the act of engaging in securities transactions with certain affiliated persons, including other funds within a fund family.

<sup>132</sup> Release at 62323, n. 396 and surrounding text.

We agree, however, that the funds' manager must consider its duty to obtain best execution for each fund involved in the cross-trade and its duty of loyalty to each fund. This protects against favoring one fund over the other and is consistent with past SEC staff guidance issued in the context of its no-action and interpretive letters.<sup>133</sup>

Further, we see no reason for the SEC not to reaffirm the validity of the SEC staff's no-action and interpretive positions that the proposed guidance seemingly calls into question. Specifically, the proposal states that "before cross-trading with an affiliated fund, a fund must obtain exemptive relief from the Commission or execute such transactions pursuant to Rule 17a-7 under the 1940 Act." We are concerned that the Release could be read to limit cross-trades only to those instances in which a fund relies on exemptive relief or Rule 17a-7 and would preclude cross-trades in other instances, such as those covered by existing no-action positions. For example, no-action letters permit funds to cross-trade certain securities based on independent pricing services prices or on NASDAQ official closing prices rather than the "current market price" set forth under the rule.<sup>134</sup> The types of cross-trades described in those and other no-action letters technically do not meet the conditions of Rule 17a-7, but the SEC staff granted no-action relief for funds to engage in cross-trades presumably because of the benefits of the transactions and the ample protections surrounding them. Other funds with substantially identical facts rely on these SEC staff positions as precedent and have developed compliance systems to ensure that cross-trades are performed in accordance with this guidance.<sup>135</sup> In addition, funds seeking to rely on these positions remain subject to the duty of best execution and the duty of loyalty to each fund in the trade. We therefore seek confirmation that the guidance provided by the Commission is not intended to revoke or modify these existing staff positions.

## **J. Additional ETF-Related Matters**

### **1. Application of the Three-Day Liquid Asset Minimum**

As discussed previously, a fund would be required to establish a three-day liquid asset minimum, periodically review that minimum, and manage the portfolio in accordance with the minimum. As part of its normal operations, a fund could fall below its minimum, but would then be precluded from purchasing "less liquid assets" until it once again exceeded its minimum.

Due to various unique features relating to their ability to trade on an exchange at market prices, ETFs require an SEC exemptive order to operate. Because of that, the three-day liquid asset minimum

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<sup>133</sup> See, e.g., Federated Municipal Funds (pub. avail. Nov. 20, 2006).

<sup>134</sup> See *id.*; United Municipal Bond Fund (pub. avail. Jan. 27, 1995); United Municipal Bond Fund and United Municipal High Income Fund, Inc. (pub. avail. July 30, 1992) (allowing funds to enter into such cross-trades in limited circumstances and based on certain representations).

<sup>135</sup> Cf. Thomas P. Lemke, *The SEC No-Action Letter Process*, 42 BUS. LAW 1019-1044 (Aug. 1987).



would be particularly problematic for some ETFs.<sup>136</sup> For these ETFs, adherence to their minimums presents them with a Hobson's choice: refuse in-kind purchase requests or, in some cases, violate the conditions of their exemptive orders. We further explain this dilemma immediately below.

Most investors trade ETFs on stock exchanges in the secondary market; however, authorized participants ("APs"), generally large financial institutions, transact directly with ETFs, in large amounts called "creation units" (typically involving 25,000 to 200,000 ETF shares) based not on market prices but on the ETF's daily net asset value.<sup>137</sup> ETFs create shares when an AP submits an order for one or more creation units. The AP provides a specified list of names and quantities of securities, cash, and/or other assets (the "creation basket") in exchange for the creation unit(s). ETF exemptive orders can require that such transactions occur in-kind and include provisions that govern the composition of creation baskets.<sup>138</sup> For example, the most recent exemptive orders typically require creation baskets to correspond *pro rata* to the positions in the ETF's portfolio.<sup>139</sup> Thus, if an ETF is designed to track an index and only holds each security of the index, the AP generally must provide a creation basket with portfolio securities in the exact same weights as the ETF holds. In exchange, the AP receives creation units from the ETF.

If the ETF falls below its three-day liquid asset minimum, the proposal would preclude the ETF from accepting any security deemed a less liquid asset. This restriction may conflict with the ETF's exemptive order, which may preclude the ETF from accepting an in-kind purchase that does not

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<sup>136</sup> ETFs are similar to mutual funds, except that ETFs list their shares on a stock exchange, thereby allowing retail and institutional investors to buy and sell shares throughout the trading day at market prices. For more detailed information on the structure and regulatory framework of ETFs in the United States, see *Understanding Exchange Traded-Funds: How ETFs Work*, ICI Research Perspective, September 2014, available at [www.ici.org/pdf/per20-05.pdf](http://www.ici.org/pdf/per20-05.pdf).

<sup>137</sup> How these transactions must take place, and the substantial daily disclosures that the ETF must make to facilitate them, are spelled out in the SEC order pursuant to which the ETF operates. ETFs comply with all of the key investor protection provisions in the 1940 Act, including, among others, those regarding leverage, conflicts of interest, and corporate governance.

<sup>138</sup> See, e.g., *SPDR Series Trust, et al.*, SEC Release No. IC-31917 (November 24, 2015) (order), available at [www.sec.gov/rules/ic/2015/ic-31917.pdf](http://www.sec.gov/rules/ic/2015/ic-31917.pdf) and IC-31884 (October 28, 2015) (notice), available at [www.sec.gov/rules/ic/2015/ic-31884.pdf](http://www.sec.gov/rules/ic/2015/ic-31884.pdf) (restricting the circumstances under which a fund may take a cash order and limiting the constitution of creation baskets) ("SPDR Exemptive Order").

<sup>139</sup> Many ETFs can accept non-*pro rata* in-kind purchases from APs only: (a) in the case of bonds, for minor differences when it is impossible to break up bonds beyond certain minimum sizes needed for transfer and settlement; (b) for minor differences when rounding is necessary to eliminate fractional shares or lots that are not tradeable round lots; (c) for TBA transactions, short positions, derivatives and other positions that cannot be transferred in-kind; (d) to the extent the fund determines, on a given business day, to use a representative sampling of the fund's portfolio; or (e) for temporary periods, to effect changes in the fund's portfolio as a result of the rebalancing of its underlying index. For index-based ETFs that use representative sampling, condition (d) is further limited by requiring that the basket: (i) be designed to generate performance that is highly correlated to the performance of the ETF's portfolio; (ii) consist entirely of instruments that are already included in the ETF's portfolio; and (iii) be the same for all APs on a given day. See, e.g., *id.*

contain less liquid assets held by the ETF because the creation basket would not reflect a *pro rata* slice of the ETF's holdings.<sup>140</sup> Even if circumstances under an ETF's exemptive order permitted the ETF to accept a non-*pro rata* slice of the ETF's portfolio securities, the ETF might still need to get exposure to less liquid assets to meet its investment objective and/or appropriately track its index. For example, index-based ETFs often are expected to have an annual tracking error relative to the performance of their indices of less than five percent.<sup>141</sup> ETFs that cannot acquire less liquid assets, therefore, may need to get exposure to those assets synthetically to meet this expectation; however, their ability to use derivatives for this purpose may be limited by the terms of their exemptive orders.<sup>142</sup> This could result in tracking issues that could cause an ETF to fail to meet its annual tracking error expectation.

Therefore, if the SEC adopts this three-day liquid asset requirement, we recommend that it permit ETFs to accept in-kind purchases with less liquid assets even if the ETF has fallen below its three-day liquid asset minimum. We note that if the SEC follows our earlier recommendation to permit funds to formulate their own policies and procedures to determine how best to reasonably ensure that funds have sufficient liquidity to meet redemptions under normal and reasonably foreseeable stressed conditions, this regulatory conflict would be eliminated.

## 2. **ETF Basket Flexibility**

The Release requests comment on whether increased flexibility in determining the composition of ETF portfolio creation and redemption baskets would result in favorable or unfavorable changes in how ETFs manage the liquidity of their holdings. Although basket flexibility is not an issue directly related to liquidity, increased basket flexibility would help an ETF meet its investment objective (*e.g.*, improving its ability to track its index) more efficiently, and improve its tradability, pricing, and tax efficiency. Better overall functioning of the creation/redemption process translates into increased liquidity of the ETF and lower investor costs via a tightening of bid/ask spreads.

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<sup>140</sup> If an ETF were to refuse to accept purchases, the arbitrage mechanism that keeps ETF market prices close to their underlying value would not function properly, which could lead to large price dislocations between the ETF's market price and net asset value. In addition, APs that acquire less liquid securities with the intention of delivering them to the ETF in exchange for a creation basket would be left with long positions in those securities that they would likely want to sell back to the market. This may lead to increased spreads in the secondary market for the underlying securities and, potentially, the ETF, as market makers would re-price their primary market risk.

<sup>141</sup> *See, e.g.*, SPDR Exemptive Order.

<sup>142</sup> For example, the ETF could accept cash in lieu of certain portfolio securities and obtain exposure to its benchmark index through three-day liquid derivatives instruments (*e.g.*, a total return swap on the index or portion of the index). Yet, in this regard, certain exemptive relief may restrict funds from more closely tracking their index because their exemptive orders require the ETFs to invest at least 80 percent of their assets in the component securities of their respective underlying index, which do not include derivatives instruments.

**a. Background**

As noted above, ETFs create shares when an AP submits an order for one or more creation units. The ETF delivers those shares to the AP when the AP transfers the specified daily creation basket to the ETF. The redemption process is simply the reverse. An AP delivers the specified number of ETF shares that comprises a creation unit to the ETF and, in return, receives the daily redemption basket.<sup>143</sup>

ETF exemptive orders often include provisions that restrict the composition of portfolio creation and redemption baskets. For example, the most recent exemptive orders generally require creation and redemption baskets to represent a *pro rata* slice of the ETF's underlying securities in their corresponding proportionate weights<sup>144</sup> and require that each creation basket contain the same assets as each redemption basket on any given day.<sup>145</sup> The SEC should consider increasing an ETF's basket flexibility by modifying or eliminating certain of these exemptive order restrictions and permitting the ETF to accept baskets that are designed to generate performance that is highly correlated to the performance of its index or that is consistent with its investment objective or its primary benchmark, but can vary from what the ETF currently holds, and can vary between creation and redemption baskets.

**b. Increased Basket Flexibility Provides Important Investor Benefits**

Increased basket flexibility could help ETFs manage their portfolios and meet investment objectives (*e.g.*, with respect to an index-based ETF, facilitating better index tracking) at a lower cost. For example, an investment adviser to a recently launched ETF may determine that holding more index components or highly correlated portfolio holdings would help the ETF meet its investment objective. In so doing, it may want to invest in an index component, or, with respect to an actively-managed ETF, another highly correlated security, that the ETF currently does not hold. Restricting creation baskets only to securities the ETF holds does not permit the ETF to obtain the exposure it wants through the in-kind transaction process. Rather, the ETF would receive the creation basket and would need to sell

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<sup>143</sup> When an AP redeems ETF shares and receives a basket of securities from the ETF, an AP (if acting on its own behalf) or other market participant (if an AP is acting as an agent) becomes a direct holder of the securities and must make the decision to hold or sell the securities into the market. If the AP or other market participant decides to sell, it bears the full cost (commissions and bid/ask spreads) of liquidating the securities; the remaining ETF shareholders do not bear any portion of these costs. An ETF may conduct transactions in cash, in whole or in part, under limited circumstances. *See, e.g.*, SPDR Exemptive Order. For example, an ETF may substitute cash in a basket when an instrument in the basket is difficult to transfer as is the case with some foreign securities. An ETF often charges APs a cash adjustment and/or a transaction fee for the cash component of the basket to offset any transaction expenses the ETF incurs.

<sup>144</sup> *See supra* note 139 (describing the limited instances under which many ETFs can accept non-*pro rata* slices).

<sup>145</sup> *See* SPDR Exemptive Order (requiring that on any given business day, the names and quantities of the instruments that constitute the creation and redemption baskets be identical, unless the fund is rebalancing).

certain unwanted securities of the creation basket, using the money it receives to purchase the desired index components. Eliminating this unnecessary step would reduce costs and allow the ETF to accept substitute securities (that are desired by the investment adviser and consistent with the fund's investment objectives).<sup>146</sup>

Similarly, an ETF's investment adviser may determine to redeem in-kind baskets of securities that have imbedded capital gains. In so doing, the ETF could avoid the capital gains that would be incurred if those securities were sold using the proceeds to purchase desired securities. Providing ETFs with the flexibility to accept and redeem varying baskets therefore also could increase the ETFs' tax efficiency. Further, ETF basket flexibility could allow funds to retain portfolio securities that the ETF's investment adviser believes the ETF should continue to hold. For example, fixed-income ETFs may determine that retaining certain liquid bonds that are difficult to acquire may assist the ETF to better meet its investment objective. Rather than tendering those bonds to meet redemption requests (or being forced to redeem with cash), the ETF can retain those assets and simply choose another basket composition to redeem, better protecting the fund's long-term interest and more cost-effectively achieving its investment objective.

Increased basket flexibility also would facilitate creation and redemption of ETF shares, improving tradability, pricing, and thereby reducing investor costs. An ETF may have thousands of securities in its portfolio. Requiring an AP to provide each of those securities in a *pro rata* amount to the ETF's holdings may dissuade APs from trading in ETF shares that would require transactions in smaller, more costly lot sizes. Baskets with fewer securities, but that still produce performance consistent with its investment objective, could enable APs to trade portfolio securities in larger, more cost effective lot sizes, especially for smaller orders. Reduced transaction costs make arbitrage more efficient by reducing premiums and discounts and narrowing bid/ask spreads. Reduced transaction costs also may attract more APs, which could increase competitiveness of markets and lower costs to investors.

We recognize that the SEC may have concerns that increased basket flexibility could somehow compromise the arbitrage mechanism at the expense of the ETF's shareholders, particularly if an ETF sponsor showed preferential treatment to one or more of the APs. Such transactions, however, are contrary to an ETF's business interests. Similarly, there is little incentive for an ETF sponsor to construct a redemption basket with its most liquid assets, leaving the most illiquid in the ETF. These actions would have an observable effect on the ETF's bid/ask spreads. Indeed, it is not in the interests of ETF sponsors to operate an ETF in a manner that increases the bid/ask spread or the premium or discount of the market price relative to the ETF's net asset value. The bid/ask spread adds to the implicit costs that an investor incurs when buying and selling ETF shares. In the highly competitive

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<sup>146</sup> To provide for this, the SEC also should permit ETFs to have creation baskets that vary from the redemption baskets in instances other than for simple rebalancing.

and growing ETF market, diluting shareholder interests and reducing share value are not conducive to the growth or long-term success of an ETF.

Using flexible baskets can benefit investors by helping the ETF meet its investment objective more efficiently, improving its tradability and thereby allowing its investors to enjoy lower costs and better tax treatment. As such, all ETF sponsors should have the ability to deliver these important investor benefits by determining the composition of ETF portfolio creation and redemption baskets.

### **3. Eliminate Restriction on ETF Redemption Transaction Fees**

To offset certain processing and brokerage costs incurred when APs purchase or redeem creation units, ETFs typically impose fees on each transaction (“Transaction Fees”). Transaction Fees are intended to cover transaction costs (more commonly associated with cash creations and redemptions when portfolio securities must be purchased or sold), thus preventing possible dilution of the interests of the ETF’s remaining shareholders. The purchasing or redeeming AP remits the fees to the ETF.<sup>147</sup> ETF exemptive applications typically include provisions that tie Transaction Fees to the SEC’s limits applicable to management investment companies offering redeemable securities. Those limits, as discussed below, are typically tied to 1940 Act Rule 22c-2—a rule designed to address short-term trading abuses in mutual funds, not transaction costs associated with the ETF creation and redemption process.<sup>148</sup>

Rule 22c-2 provides that if a fund issues redeemable securities, its board must consider whether to impose a redemption fee of up to two percent of the value of shares redeemed shortly after their purchase.<sup>149</sup> According to the SEC, the redemption fee is designed to discourage market timing and other types of short-term trading strategies and to protect long-term shareholders who would otherwise bear the costs imposed on the fund by short-term traders.<sup>150</sup> Moreover, Rule 22c-2 redemption fees are

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<sup>147</sup> Often, Transaction Fees consist of a fixed fee (*e.g.*, a specified dollar amount typically reimbursing the fund for a fee paid to the administrator or custodian for processing) and a variable fee (*e.g.*, an asset-based fee designed to offset actual transaction costs). Variable fees may differ depending on whether the transaction is made in cash or in-kind. For cash transactions, APs typically pay a higher fee to cover brokerage and certain other costs associated with purchasing or selling portfolio securities. The maximum Transaction Fees, including the methods of determining the Transaction Fees, typically are disclosed in the ETF’s prospectus or Statement of Additional Information.

<sup>148</sup> Rule 22c-2 only provides limits on redemption transactions and not on any purchase or creation transactions.

<sup>149</sup> Under the rule, the board of directors must either (i) approve a fee of up to two percent of the value of shares redeemed, or (ii) determine that the imposition of a fee is not necessary or appropriate. The rule does not apply to money market funds, ETFs, and funds that affirmatively permit short-term trading of their securities, unless the fund elects to impose a redemption fee.

<sup>150</sup> *Mutual Fund Redemption Fees*, SEC Release No. IC-26782, 70 Fed. Reg. 13328 (March 18, 2005), available at [www.sec.gov/rules/final/ic-26782fr.pdf](http://www.sec.gov/rules/final/ic-26782fr.pdf). The release notes that any staff no-action positions concerning redemption fees before the adoption of Rule 22c-2 are terminated.

assessed based on the fund board's judgment rather than on a strict assessment of administrative and processing costs, which the SEC acknowledges may vary from period to period. The two percent limit is "designed to strike a balance between two competing goals of the Commission—preserving the redeemability of mutual fund shares while reducing or eliminating the ability of shareholders who rapidly trade their shares to profit at the expense of their fellow shareholders."<sup>151</sup> The SEC expressed concern that a fee higher than two percent "could harm ordinary shareholders who make an unexpected redemption as a result of a financial emergency."<sup>152</sup>

The inability to fully recoup transaction costs adversely impacts the ETF's performance (both on an absolute basis and in relation to the performance of its underlying index) and, ultimately, dilutes the interests of the remaining ETF shareholders.<sup>153</sup> Any difference between the actual price at which an ETF sells the securities, and the value of those securities when the ETF next strikes its NAV, if not absorbed by the AP (or its clients), will result in a mismatch between the amount of proceeds paid to the redeeming AP (or its clients) and the actual proceeds the ETF collects from the sale of its portfolio securities. The difference will be borne by remaining shareholders and can be significant, particularly in volatile markets. This is directly contrary to the policies underlying the SEC's swing pricing proposal, which is designed to protect remaining shareholders from absorbing high transaction costs caused by transacting shareholders.

Although Rule 22c-2 is intended to inhibit short-term traders from diluting fund shares, an ETF encourages short-term trading of its shares. Indeed, an ETF needs robust trading and arbitrage, through the creation and redemption process, to help keep the market value of its shares aligned with the value of its portfolio. The transaction costs associated with this trading, however, should be borne by the redeeming APs, large institutions that can hedge or pay such costs, rather than the fund. Furthermore, although the SEC may view redemption fees that exceed two percent as impinging upon the redeemability of ETF shares, ETFs already have relief to redeem shares only in large creation units with APs. For these reasons, we believe that the *de facto* two percent limitation on redemption fees should not apply to ETFs.

### **III. Comments Regarding the Swing Pricing Proposal**

The SEC's swing pricing proposal would permit, but not require, open-end funds (except for money market funds and ETFs) to engage in swing pricing pursuant to certain specified terms. The proposal's key provisions would include the following:

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<sup>151</sup> *Id.* at 13331.

<sup>152</sup> *Id.*

<sup>153</sup> For example, trading costs associated with securities in certain restricted foreign markets may exceed two percent.

- Policies and Procedures. A fund would be required to adjust its NAV per share by a specified swing factor<sup>154</sup> once the level of net purchases into or net redemptions<sup>155</sup> from the fund exceeds a specified swing threshold.<sup>156</sup>
- Board review and approval. The fund's board, including a majority of the independent directors, would be required to approve the fund's swing pricing policies and procedures, along with any material changes to them. The fund's board also would designate the fund's investment adviser or officers responsible for administering the swing pricing policies and procedures.
- Reporting. For purposes of performance reporting, calculations of NAV-based performance fees, and financial statements, a fund would use NAVs as adjusted pursuant to its swing pricing policies and procedures.
- Recordkeeping. A fund that uses swing pricing would be required to create and maintain a record of support for each computation of an adjustment to the NAV of the fund's shares based on the fund's swing pricing policies and procedures.<sup>157</sup>

In effect, swing pricing involves a second step in the valuation process, whereby a fund measures daily net purchase or redemption activity and adjusts (or "swings") the NAV upward (in the case of a net purchase of fund shares, so that transacting shareholders bear the transaction costs from resulting

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<sup>154</sup> The swing factor would be the amount, expressed as a percentage of the fund's NAV and determined pursuant to the swing pricing procedures, by which the fund adjusts its NAV per share when net purchases or redemptions exceed the swing threshold. Factors required to be considered include: (i) any near-term costs expected to be incurred by the fund as a result of net purchases or net redemptions that occur on the day the swing factor is used (including any market impact costs, spread costs, and transaction fees and charges arising from asset purchases or asset sales); and (ii) the value of assets purchased or sold by the fund as a result of net purchases or net redemptions that occur on the day the swing factor is used, if that information would not be reflected in the current NAV of the fund computed that day. A fund could impose an upper limit on the swing factor, effectively capping the amount by which the fund could adjust its NAV on a given day.

<sup>155</sup> A fund would need net fund flow information prior to its deadline for calculating its NAV, so that it could make any necessary NAV adjustments.

<sup>156</sup> The swing threshold would be the amount of net purchases or redemptions of fund shares, as expressed as a percentage of the fund's NAV, that triggers swing pricing. The proposal envisions a partial swing pricing methodology, although it does not stipulate a minimum threshold amount. Factors required to be considered include: (i) the size, frequency, and volatility of historical net purchases or net redemptions of fund shares during normal and stressed periods; (ii) the fund's investment strategy and the liquidity of the fund's portfolio assets; (iii) the fund's holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources; and (iv) the costs associated with transactions in the markets in which the fund invests. A fund would be required to review at least annually its swing threshold.

<sup>157</sup> See proposed amendments to Rule 31a-2 under the 1940 Act.

fund purchases of portfolio assets) or downward (in the case of a net redemption of fund shares, so that transacting shareholders bear the transaction costs from resulting fund sales of portfolio assets).<sup>158</sup>

The SEC believes that swing pricing could be a useful tool in mitigating potential dilution of fund shareholders, and the swing pricing proposal is designed to promote *all* shareholders' interests, as well as practices that seek to ensure that a fund's shares are purchased and redeemed at a fair price.<sup>159</sup>

The SEC identifies as potential benefits to swing pricing: (i) mitigation of potential dilution arising from fund share purchase and redemption activity and promotion more equitable treatment of fund shareholders; (ii) preservation of investment returns (by externalizing transaction costs); (iii) comparative simplicity (unlike other anti-dilution measures (*e.g.*, redemption fees) that might have similar benefits, swing pricing would not require coordination with service providers); and (iv) potential deterrence of redemptions motivated by any first-mover advantage.

The SEC also identifies potential disadvantages to swing pricing, including: (i) increased performance volatility and tracking error (in addition to changes in the values of portfolio assets, a fund's NAV would be affected by flow-driven swing pricing adjustments); (ii) inability to know in advance the precise impact of swing pricing on particular purchase and redemption requests, and resulting lack of transparency to investors; and (iii) all orders on a given day receive the same adjusted NAV, regardless of whether the size of an individual shareholder's order alone would create material trading costs for the fund.

In the section that follows, we discuss the range of ICI member views on swing pricing and operational and legal impediments to implementing swing pricing in the U.S., and provide specific comments on the swing pricing proposal.

#### **A. ICI Members' Views on Swing Pricing**

We have conducted extensive outreach to discern the range of member views on swing pricing. Collectively, members raised points similar to the SEC's in its assessment of potential advantages and disadvantages related to swing pricing, and identified the following additional potential disadvantages: (i) it creates the potential for inappropriate disclosure of a new type of material non-public information (*i.e.*, information about the swing pricing methodology and fund flows); (ii) it can create a disincentive for large institutional investors to provide advance notice of large redemptions or purchases (large shareholders might instead stagger large purchases or redemptions over a number of days in an effort to

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<sup>158</sup> A fund has discretion in creating and operating the swing pricing methodology that it uses, which when applied to daily fund flows determines the amount and frequency of its NAV adjustments. *See generally Swing Pricing*, Association of the Luxembourg Fund Industry (Dec. 2015) ("ALFI Swing Pricing Guidelines"), available at [www.alfi.lu/sites/alfi.lu/files/Swing-Pricing-guidelines-final.pdf](http://www.alfi.lu/sites/alfi.lu/files/Swing-Pricing-guidelines-final.pdf).

<sup>159</sup> Release at 62328.



avoid swinging the NAV to its detriment); and (iii) it may be imprecise in accounting for the transaction costs that result from shareholder purchase and redemption activity.

Importantly, however, our members do not share a singular view on the desirability of the SEC authorizing swing pricing. Several currently use swing pricing for certain of their overseas funds, have had positive experiences with it, and were pleased to see it included in this proposal. Others do not currently use swing pricing in jurisdictions in which it is permitted, but see merit in the practice, and would consider using it in the U.S. if certain operational and legal hurdles can be cleared. Others appreciate the conceptual case for swing pricing and the need to be sensitive to dilution, but question why other anti-dilution options were not presented in addition to swing pricing. Still others believe that, on balance, investor protection concerns weigh in favor of the status quo. All members expressing their views to us recognize the significant operational challenges to implementing swing pricing in the U.S., and such challenges may be especially daunting for smaller fund complexes.

Below, we discuss certain operational and legal hurdles and deficiencies with the swing pricing proposal. If changes in market practice and/or applicable regulations do not remove these obstacles, funds will not be able to implement swing pricing, even if the SEC authorizes it.

### **B. Operational Impediments to Implementing Swing Pricing in the U.S.**

A fund wishing to adopt swing pricing in the U.S. would need some means of obtaining timely and reasonably accurate daily fund flow information. Without it, a fund would be unable to determine with any confidence whether and how to adjust its NAV on a given day.

Generally speaking, Rule 22c-1 under the 1940 Act requires funds, their principal underwriters, and dealers in fund shares to sell and redeem fund shares at a price determined at least daily based on the current NAV next computed after receipt of an order to buy or redeem, and the Rule provides funds with some flexibility regarding when and how often they must price their shares.<sup>160</sup> In calculating a fund's NAV, the fund manager follows established, board-approved valuation policies and procedures. In practice, it is quite common for funds to cut off orders, value all portfolio assets, and price their shares as of 4:00 p.m. Eastern Time ("ET").<sup>161</sup>

Near the end of each business day (typically 4:00 p.m. ET), the fund manager or service provider transmits a file listing the fund's portfolio assets to a pricing vendor. The vendor inserts the

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<sup>160</sup> Specifically, Rule 22c-1(b)(1) states, "The current net asset value of any such security shall be computed no less frequently than once daily, Monday through Friday, at the specific time or times during the day that the board of directors of the investment company sets..."

<sup>161</sup> Some funds stipulate a fixed time (*e.g.*, 4:00 p.m. ET); others stipulate that they will stop accepting orders and price their shares as of the close of trading on the New York Stock Exchange ("NYSE"). Most of the time, these policies will yield the same result, because the NYSE ordinarily closes at 4:00 p.m. ET.

current market price for each asset into the file<sup>162</sup> and transmits it to the fund manager or service provider. The fund manager or service provider then applies a series of controls to validate the prices received. After researching and resolving any exceptions generated by the controls, the fund manager uses market prices (and fair values, as necessary) to value the fund's assets and calculate its NAV. The NAV then is disseminated to the fund's transfer agent, intermediary distribution partners, and shareholders, ordinarily sometime between 6:00 p.m. and 8:00 p.m. ET.<sup>163</sup>

Currently, intermediaries such as broker-dealers, retirement recordkeepers, and bank trust departments generate significant order volume and fund flow activity.<sup>164</sup> Typically, the intermediary transmits aggregated trades following the fund's specified trade cut-off time, in accordance with applicable regulations and agreements with the fund. Intermediaries provide, at most, limited intraday order flow information<sup>165</sup> to funds. Some mutual funds may have developed a process with their transfer agents to receive intraday order flow information, although generally this data reflects only activity from shareholders that place orders directly with the transfer agent and would exclude most, or all, of the activity from intermediary-serviced shareholders.<sup>166</sup>

Significantly, daily information does not flow only from intermediaries to funds—intermediaries also require and receive daily information from funds. Intermediary systems typically first require receipt of the daily closing NAV from funds to initiate transaction processing, and they do not currently support the generation of intraday flow estimates.<sup>167</sup> This is because not all orders that intermediaries receive from their clients are in dollars—they also may be denominated in shares or percentages of holdings. Asset allocation strategies (used in both taxable and retirement accounts) involving percentage-based portfolio rebalancing instructions require NAVs for each fund in the

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<sup>162</sup> If a pricing vendor does not have a price for an asset, the fund would “fair value” the asset (*i.e.*, make a good faith determination of the amount for which the asset could be sold in a current transaction).

<sup>163</sup> For the month of September 2015, Depository Trust and Clearance Corporation (“DTCC”) reported to the ICI Broker/Dealer Advisory Committee that, on average, approximately 95 percent of all daily NAV and/or daily dividend accrual records were received (from funds) and delivered (to intermediaries) by approximately 8:00 p.m. ET.

<sup>164</sup> Fund/SERV®, a solution of the National Securities Clearing Corporation (“NSCC”), a subsidiary of DTCC is most commonly used for clearance and settlement of mutual fund share transactions submitted by intermediaries to funds. In 2014, Fund/SERV® settled \$4.9 trillion in over 217 million mutual fund share transactions. (Source: 2014 Annual Report - DTCC)

<sup>165</sup> Large trade notifications from intermediaries may occur if an order exceeds a previously-communicated fund dollar threshold. These notifications typically are handled through manual procedures, are provided on a best-efforts-only basis, and may reflect activity that has not yet occurred (*e.g.*, a future-dated retirement plan rebalancing or lineup change).

<sup>166</sup> Omnibus intermediaries submit many of the Fund/SERV® transactions (*see infra*, note 170 and accompanying text for a description of the omnibus processing model) as consolidated transactions of all of their customers that purchase or redeem shares of the same fund on any given day.

<sup>167</sup> Although trade processing is dependent upon receipt of a fund's closing NAV, intermediaries comply with Rule 22c-1 regarding the receipt of trade instructions in good order by the required fund cut-off time.

investor account, so that a series of calculations can be completed involving multiple investor account balances to determine final transaction amounts. Availability of a fund's NAV is essential to process these share- and percentage-based transactions.

The system reengineering required of intermediaries to create and disseminate cash flow estimates prior to receipt of the NAV would be massive. Currently, systems use a transaction's effective date to select the corresponding NAV (by date) that should be used to create and process a shareholder transaction. Prior to receipt of a given day's NAV, the system processing a transaction effective as of that day would not find a corresponding daily NAV, rendering it incapable of determining estimated cash flows. Likewise, systems now bundle transaction creation with other functions<sup>168</sup> that cannot occur as part of a cash flow estimation routine because the transaction is not actually processed.

To provide cash flow estimates, an intermediary would need to create systems to overcome the lack of a current day NAV and the other dependencies<sup>169</sup> to derive estimated transaction amounts, especially for share- and percentage-based orders. Building and maintaining additional systems would be quite costly, and even assuming that intermediaries at large would rework their systems to support swing pricing, they can be expected to seek the substantial costs of doing so from funds (and thus their shareholders).

Furthermore, the omnibus processing model<sup>170</sup> that many intermediaries use completes transaction processing after receipt of that day's NAV from the fund and prior to market open the next morning.<sup>171</sup> Most intermediary systems do not initiate their end-of-day batch processing until all NAVs are received for the funds offered on the intermediaries' platforms. A complete set of NAVs is necessary

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<sup>168</sup> These functions include updating shareholder account data (transaction history, share balance, ending account value), and triggering trade confirmations and payments (*e.g.*, check or wire instructions).

<sup>169</sup> An intermediary cannot use the previous day's NAV as the current day's NAV to generate estimates in today's system configuration. Such action would process today's transaction at yesterday's NAV and trigger creation of incorrect shareholder account updates, transaction confirmations, and payment instructions. An estimation routine would need to be completely separate from existing systems capabilities.

<sup>170</sup> Under this model, an omnibus account includes the shares of multiple investors – sometimes numbering in the thousands – that are customers of the intermediary. Omnibus accounts are held on the books of a fund in the name of the intermediary, acting on behalf of its customers. When an intermediary submits its transactions for an omnibus account, it usually consolidates the transactions of all customers that are purchasing or redeeming shares of the same fund that day into one or a few “summary” transactions for processing by the fund.

<sup>171</sup> Defined Contribution Clearance & Settlement (“DCC&S”) processing through the NSCC Fund/SERV<sup>®</sup> mutual fund trading service facilitates delivery of intermediary transactions, received in compliance with the timing provisions of Rule 22c-1 but finalized in the overnight hours, on the morning of trade date plus one business day (T+1), for posting as of the previous trade date. According to DTCC, in 2014 over 54% of all Fund/SERV<sup>®</sup> transactions were DCC&S. (Source: 2014 Annual Report – DTCC)

to process exchange transactions.<sup>172</sup> In addition, many intermediaries use the trading and technology capabilities of other intermediaries (*e.g.*, clearing dealers, retirement platforms) to deliver transactions to funds. These clearing entities first must incorporate all activity from underlying tier(s) of intermediaries, prior to creating aggregate purchase and/or redemption transactions for transmission to funds during the overnight hours. Thus, a delay in transmitting an NAV for a single fund can adversely affect the ability of intermediaries or clearing entities to disseminate final transaction data to all of the funds on their platforms. Funds typically receive most aggregate purchase and redemption transactions reflecting omnibus intermediary customers' activity no later than 6:00 a.m. ET the following morning for processing.

A unique version of omnibus intermediary processing occurs for non-taxable qualified retirement plan accounts (*e.g.*, 401(k), 403(b), *etc.*). For example, retirement recordkeepers receive instructions<sup>173</sup> from plan participants to buy or sell shares held in the plan. These instructions require the current-day NAV for conversion into purchase and redemption transactions. Once the orders are created, these transactions must be evaluated against the retirement plan's unique rules for determining a valid transaction; the applicability of a plan rule could vary based on the NAV used for the order calculation.<sup>174</sup> It is only when the order complies with plan guidelines that the transaction can be submitted to the fund for processing.

Because of these current operational conventions in the U.S., funds wishing to incorporate swing pricing face a classic "chicken-and-egg" conundrum: A fund needs timely and accurate fund flow information from intermediaries to calculate and disseminate its daily NAV, but intermediaries need an NAV from the fund prior to finalizing and disseminating final daily flow information to the fund. Without fundamental changes to current operations, it is inconceivable to expect wide-spread implementation of swing pricing in the U.S.

### **C. Comparing the U.S. Mutual Fund Operational Model to Europe's Model**

In Europe (especially for UK-, Ireland-, and Luxembourg-domiciled funds), many funds successfully use swing pricing in part because their operating models and distribution infrastructure permit them to obtain or derive accurate estimates or actual details on capital flows prior to the time they calculate their NAVs. Factors such as the timing of order receipt, the types of orders received, and

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<sup>172</sup> The sale proceeds from one fund are used to acquire shares of a second fund.

<sup>173</sup> An example of an instruction would be to rebalance an investor's 401(k) holdings to a target asset allocation or model portfolio. First, each position must be valued, and then appropriate buy/sell/exchange transactions are created and processed to align the investor's account balances to the allocation model targets.

<sup>174</sup> Retirement plan documents identify the specific criteria that must be applied to orders before the order can be released to the fund for processing. (*e.g.*, applying contribution limits, loan transaction guidelines, hardship distribution eligibility, *etc.*)

the time at which fund valuation occurs all contribute to successful use of swing pricing.<sup>175</sup> These conditions or practices differ markedly from those in the U.S., as described above.

In many instances, European funds employ multiple trading cut-off times. Earlier times apply to manual and intermediary orders, as well as orders requiring foreign currency exchange. These constitute the majority of fund orders.<sup>176</sup> Thus, funds know most trading activity in their shares shortly after the market close, which creates far greater certainty in cash flow estimates than the U.S. mutual fund market allows (where details are not known until after overnight processing is completed on the majority of fund orders).

The greater use of currency-based orders in Europe (compared to the greater prevalence of share- or percentage-based transactions in the U.S.) also contributes to confidence in the accuracy of fund flow details. Funds have sufficient time to estimate unit-based orders because, although fund valuation can begin concurrently with the fund's final trading cut-off, it often does not begin until net capital flow estimates are well under way.

Finally, the fund valuation process culminates in the dissemination of NAVs, a number of hours later, at the end of the business day. Overall, the process from trade cut-off to final NAV dissemination tends to be longer in Europe than in the U.S. This can be attributed to an earlier start, through staggered (and earlier) trading cut-offs, an expanded valuation process that allows for time to determine swing pricing applicability, and a later end point due to lesser urgency for NAV dissemination to facilitate intermediary processing of fund orders. In contrast, the shortened window employed in the U.S. mutual fund market is geared toward supporting the omnibus trading model, which typically requires funds to support intermediary trading until market close and prompt dissemination of NAVs to intermediaries as soon as possible thereafter to support the NAV- and batch-dependent processing environment.

Appendix D outlines common European operational practices related to swing pricing in greater detail. Appendix E includes a summary of swing pricing rules and guidelines outside the U.S.

#### **D. Legal Impediments to Implementing Swing Pricing in the U.S.**

Current fund valuation policies typically provide that a fund should correct pricing errors "... when discovered, and fund sponsors should reimburse shareholders experiencing a material economic

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<sup>175</sup> ICI members consistently identified these factors when describing the use of swing pricing for their European-domiciled fund products.

<sup>176</sup> Funds manage trades received after the trading cut-off/market close in accordance with their policies and procedures and any agreements with intermediaries, and these reflect only a small portion of funds' daily orders.

loss due to the errors.”<sup>177</sup> In response, funds and intermediaries have created robust error correction procedures<sup>178</sup> that ensure shareholders are “made whole” in the event of a material pricing error.

Swing pricing would introduce a new potential source of pricing error, because fund flow estimates used to determine the NAV, if materially incorrect, could cause a fund to misstate its NAV. A fund would know whether its NAV was in fact correct only after receipt of *all* fund orders, which would typically occur after calculation and dissemination of the NAV. If NAV misstatements due to incorrect or incomplete fund flow information require reprocessing of all affected shareholder transactions, then this could require significant correction processing under existing error correction policies.<sup>179</sup>

The swing pricing proposal would require that those responsible for implementing swing pricing make a “reasonable inquiry” of fund flow information to determine whether the swing threshold has been exceeded. This indicates at least general recognition on the part of the SEC of the challenge that funds adopting swing pricing would face (*i.e.*, they would need net fund flow information prior to their deadlines for calculating their NAVs, so that they could make any necessary NAV adjustments, but do not currently receive complete information in time to do so). In fleshing out how fund personnel might make such “reasonable inquiry,” the SEC’s guidance is rather limited.<sup>180</sup>

Given the operational conditions characteristic of the U.S. fund industry, additional SEC guidance and clarification is necessary regarding what constitutes “reasonable inquiry,” along with what

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<sup>177</sup> *SEC Valuation and Liquidity Guidance for Registered Investment Companies – Compendium, Volume 1*, Investment Company Institute 203 (Aug. 2015) available at [www.ici.org/pdf/pub\\_15\\_valuation\\_update\\_vol1.pdf](http://www.ici.org/pdf/pub_15_valuation_update_vol1.pdf).

<sup>178</sup> Error correction may be completed by first cancelling and then reprocessing all transactions at the correct price. In most instances, funds and intermediaries process adjusting transactions for shareholders that suffered a loss due to the error (*e.g.*, an investor purchasing fund shares on a day when the fund’s NAV was overstated). The fund manager compensates the fund for any loss imposed on the fund by the error (*e.g.*, an investor redeeming all shares on a day where the fund’s NAV was overstated receives a larger payment than entitled). Even with detailed and thoughtful procedures, correcting these errors is typically a costly, time-consuming, and disruptive process for funds and intermediaries alike. Shareholders requiring transaction correction are impacted during the correction period, and account balances are not completely accurate until the corrections are finalized.

<sup>179</sup> NAV misstatements may inadvertently disadvantage some shareholders and benefit others. For example, an NAV that is incorrectly swung upward would cause purchasing shareholders to buy shares at an overstated price (to their disadvantage) and redeeming shareholders to sell at that same overstated price (to their advantage).

<sup>180</sup> Release at 62328-29. (“Because the deadline by which a fund must strike its NAV may precede the time that a fund receives final 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. A fund also may wish to implement formal or informal policies to encourage effective communication channels between the persons charged with implementing the fund’s swing pricing policies and procedures, the fund’s investment professionals, and personnel charged with day-to-day pricing responsibility (to the extent different persons comprise each of these groups).”)

would constitute an “error” in this context. In particular, we would ask that the SEC expressly provide in any adopting release that if a fund adopts swing pricing policies and procedures that comply with the final rule amendments, applies them reasonably, and any NAV misstatements that occur are due solely to limitations in the fund flow information that the fund reasonably has available to it, then such misstatements would neither necessitate order reprocessing nor expose the fund, its manager, or its board to any type of liability. This would be consistent with the approach outlined in the ALFI Swing Pricing Guidelines: “If acting in good faith, the fund is swung based on a flow estimate which is subsequently found to be inaccurate, this in itself would not normally be considered an error if the fund’s standards and appropriate policies and procedures have been followed.”<sup>181</sup> Without this type of assurance, funds likely would simply eschew swing pricing to avoid the potential risks and costs that could result.

### **E. General Considerations Regarding Swing Pricing**

As the Commission continues to evaluate swing pricing, we believe that it should keep certain broad principles in mind.

First, as the Commission evaluates anti-dilution tools (including swing pricing) generally, we would encourage it to consider carefully operational feasibility, particularly in light of funds’ reliance on intermediaries for their distribution. The Release identifies Rule 22c-2 redemption fees as an anti-dilution tool available to funds, but points out that implementation of a redemption fee requires coordination with a fund’s service providers, which could entail operational complexity.<sup>182</sup>

This is certainly consistent with our members’ experience with Rule 22c-2. If intermediaries are not obligated to furnish timelier fund flow information to funds, then funds would have to rely on them to provide it voluntarily. The industry’s experience with unilateral fund requirements to pursue updated contractual agreements with intermediaries to achieve compliance with Rule 22c-2 has been a costly, burdensome, and frustrating process for funds. Indeed, in the interest of operational effectiveness and cost containment for funds and their shareholders, the Commission was required to further amend the Rule shortly after its initial adoption (and prior to its compliance date), to (i) limit the types of intermediaries with which funds must enter into shareholder information agreements, (ii) address the rule’s application when there are chains of intermediaries, and (iii) clarify the effect of a fund’s failure to obtain an agreement with any of its intermediaries.<sup>183</sup>

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<sup>181</sup> ALFI Swing Pricing Guidelines at 30.

<sup>182</sup> Release at 62327-28. Swing pricing also would require coordination with intermediaries, with different but very real challenges, as outlined above.

<sup>183</sup> See *Mutual Fund Redemption Fees*, SEC Release No. IC-27504, 71 Fed. Reg. 58257 (Oct. 3, 2006), available at [www.sec.gov/rules/final/2006/ic-27504.pdf](http://www.sec.gov/rules/final/2006/ic-27504.pdf).

Second, not all funds will be positioned to implement swing pricing with equal confidence if it is adopted. Even if the SEC required those intermediaries it regulates (*e.g.*, broker-dealers and registered investment advisers) to provide flow information to funds on a more timely basis, many funds undoubtedly still would experience timing lags in receiving flow information from those intermediaries over which the Commission *lacks* regulatory authority (most notably retirement recordkeepers).<sup>184</sup> Thus, even with the SEC's intervention, the timeliness and quality of a fund's daily flow information would depend to a large extent on the *types* of intermediaries through which it distributes its shares. Additionally, funds that sell all or a large portion of their shares directly (and therefore are less reliant on intermediaries) would be better positioned to estimate fund flows than those that do not. Finally, certain larger fund complexes with more influence over their distribution partners likely would be more successful than smaller fund complexes in obtaining intraday (or more timely) flow information. The funds with better access to flow information will be better positioned to adopt swing pricing. This in turn could affect the relative performance of funds: all things being equal, a fund that adopts swing pricing—and actually swings its NAV over the course of a performance period—would be expected to perform better than one that does not. The SEC should take into account the potential implications for the competitive dynamics in the fund industry before determining whether to permit swing pricing.

Third, if the SEC adopts swing pricing, it should maintain the proposal's permissive approach. The SEC should emphasize that it is reasonable and appropriate for funds (even those within a single complex) to come to very different conclusions about swing pricing's utility and appropriateness based on their particular facts and circumstances. The degree of potential dilution that funds encounter is not uniform, and in many cases is *de minimis* (*e.g.*, particularly for those funds with stable shareholder bases, relatively stable fund flows, and relatively low transaction costs for buying and selling portfolio assets). Given the limited nature of its potential benefits in those cases, those funds should not be expected to adopt swing pricing. In any event, notwithstanding its availability (and the reasons the SEC has provided for making it available), there should be no presumption that funds *ought* to adopt swing pricing, and the SEC should take great care to clarify that no liability will result from a decision *not* to use swing pricing.<sup>185</sup>

Finally, if the SEC adopts swing pricing, it should delay effectiveness for at least two years. As a practical matter, implementation of swing pricing would require funds and their distribution partners

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<sup>184</sup> Recordkeepers of defined contribution retirement plans (*e.g.*, 401(k), 403(b), 457, *etc.*) are not under the Commission's regulatory purview, despite such plans holding twenty-seven percent of long term mutual fund assets. Source: Investment Company Institute, *The U.S. Retirement Market, Second Quarter 2015*, Tables 20 and 24 (Sept. 2015) available at [www.ici.org/info/ret\\_15\\_q2\\_data.xls](http://www.ici.org/info/ret_15_q2_data.xls). Among ICI member mutual fund complexes with more than \$50 billion in long-term mutual fund assets, which represent 90% of member long-term mutual fund assets, one-third have defined contribution retirement plans holding more than 25% of their long-term mutual fund assets.

<sup>185</sup> Based on our reading of the proposal, a fund board would be under no obligation to even *consider* swing pricing. If the SEC adopts swing pricing, we request that it clarify this point in the adopting release.



to overcome significant operational issues, and we do not envision this being quick or easy. Furthermore, assuming funds *can* work through these issues, fund complexes vary in their knowledge of and experience with swing pricing, and as the SEC notes, use of swing pricing may have a performance-enhancing effect. A delay in effectiveness would provide all mutual fund complexes with sufficient time to evaluate the final rules, consider whether to adopt swing pricing, and work through legal, business, and operational issues in preparing for implementation, thereby reducing the potential competitive disadvantage for those funds that may be positioned to adopt it less readily. The added time would be particularly beneficial to smaller fund complexes that may not have experience with swing pricing.

## **F. Specific Comments on the Swing Pricing Proposal**

### **1. Policies and Procedures**

The swing pricing proposal clearly borrows from the ALFI framework.<sup>186</sup> In a few notable respects, however, the SEC proposal is more restrictive than practices in Luxembourg, and these differences could create disincentives for funds to adopt swing pricing. We therefore recommend that if the SEC adopts swing pricing, it revise the proposal in the following ways.

As a general matter, the SEC should permit funds more flexibility in setting their swing thresholds. The proposal contemplates that a fund would adopt a single numerical swing threshold, and that it would apply equally to net redemptions and purchases of fund shares. This is unduly restrictive in at least a couple of respects. Some funds may wish to apply swing pricing to net redemptions only. We understand that large net purchases of fund shares could have dilutive effects for existing shareholders. But net purchases differ from net redemptions in one critical way—purchasing fund shareholders will bear their *pro rata* share of transaction costs associated with the fund's investment of this new cash, in a way that redeeming shareholders may not, depending on when related sales of portfolio assets occur. Furthermore, receipt of new cash in a portfolio may not be as disruptive or problematic as large net redemptions.

Additionally, the SEC should permit a fund to adopt multiple swing thresholds.<sup>187</sup> For instance, a fund could apply one (lower) threshold to net redemptions, and another (higher) threshold to net purchases. A fund may find this attractive if it is more concerned with net redemptions and yet sees some benefit to adjusting its NAV upward in the case of very large inflows. Other funds may wish to apply more than one threshold to net redemptions (or purchases), and apply different swing factors

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<sup>186</sup> See *supra*, note 158.

<sup>187</sup> According to ALFI's 2015 Swing Pricing Survey, "[t]wo-thirds of asset managers (67%) use asymmetric swing factors for net subscription versus redemption flows... . One asset manager confirmed they use multiple factors on a fund depending on size of flow, while a further respondent stated they are evaluating multiple thresholds with tiered swing factors on their fund range with a view to implementation in the short-term." Association of the Luxembourg Fund Industry, *Swing Pricing Update 2015*, 13 (Dec. 2015), available at [www.alfi.lu/sites/alfi.lu/files/ALFI-Swing-Pricing-Survey-2015-FINAL.pdf](http://www.alfi.lu/sites/alfi.lu/files/ALFI-Swing-Pricing-Survey-2015-FINAL.pdf).

depending on which threshold the net redemption (or purchases) exceeds. This could enhance the precision of a swing pricing methodology, allowing a fund to make larger downward adjustments to its NAV when it experiences larger net outflows.<sup>188</sup>

Moreover, the SEC should permit funds to exclude certain types of purchases or redemptions from application of the swing threshold. For instance, many shareholders voluntarily choose to reinvest dividend and capital gains distributions. In some cases these could represent sizable net purchases for a fund, and a fund may believe that these purchases do not raise substantive concerns regarding dilution or equitable treatment of fund shareholders (particularly where a large percentage of long-term shareholders ordinarily reinvests these distributions).<sup>189</sup>

The SEC should be less prescriptive in establishing within Rule 22c-1 the factors for a fund to consider in determining its swing threshold and swing factor. The more complex a methodology must be, the less appealing swing pricing will be to adopt, particularly for those complexes with no experience with it. For instance, the SEC should not mandate that a fund consider market impact costs in determining its swing factor. According to ALFI's 2015 Swing Pricing Survey,<sup>190</sup> only 10% of asset managers include market impact costs in their swing factors. While we see the rationale for including market impact costs, estimating market impact costs *a priori* is very difficult, and requires judgments in which some fund managers may not have a high degree of confidence.<sup>191</sup> If accounting for all prescribed factors (including market impact costs) is, in effect, a requirement for using swing pricing, then some funds that would otherwise be interested in it may forego the option for that reason alone.

Instead, the SEC should permit funds to build their own methodologies, shaped broadly by SEC guidance within the adopting release. Under this approach, a fund's swing pricing methodology initially may capture only those variables that it may estimate with greater confidence, such as transaction costs (more narrowly understood) and certain other fees. A fund could reasonably conclude that a more basic swing pricing methodology is better than no swing pricing methodology. Over time, as funds become more experienced and comfortable with swing pricing, it is likely that they

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<sup>188</sup> We understand that establishing multiple swing thresholds may not be the only means to accomplish this. As we understand the proposal, a fund's swing factor need not be a fixed number, and could therefore result in a different number depending on the magnitude of the daily fund flow. The SEC states, "We anticipate that, because these considerations could vary depending on the facts and circumstances, the swing factor that a fund would determine appropriate to use in adjusting its NAV also could vary." Release at 62336. Nevertheless, we believe that funds should be permitted to more precisely reflect expected transaction costs by having the flexibility to vary both swing factors and swing thresholds.

<sup>189</sup> Dividend income and capital gains are accumulated in the fund over time and invested in additional portfolio assets. In this regard, they can be distinguished from large cash flows attributable to issuance of fund shares, and do not present the dilution issue that the swing pricing proposal intends to address.

<sup>190</sup> See *supra*, note 187.

<sup>191</sup> See *supra*, Section II.B and E.1.

will refine and improve upon their existing methodologies.<sup>192</sup> The SEC could help foster this type of development in how it frames the factors for consideration.

## **2. Financial Statement Reporting**

The swing pricing proposal would affect a fund's financial statements and disclosures in several areas, including the fund's statement of assets and liabilities, statement of changes in net assets, financial highlights, and notes to the financial statements. We generally support these provisions.

*NAV Reporting.* The proposal would require the fund to report one NAV in its financial statements (*i.e.*, the NAV as adjusted pursuant to the fund's swing pricing policies and procedures). We support the SEC's approach, because if funds had to report both an adjusted NAV and an unadjusted NAV, shareholders would be confused, and operational complexity would be introduced. Our support extends to the proposed amendment to Regulation S-X rule 6-04.19 to require a fund to disclose, if applicable, the NAV as adjusted (*i.e.*, the fund's NAV swung on the last day of the period) on the statement of assets and liabilities. We also support the proposed amendments to the financial highlights table that would specify that the "Net Asset Value, Beginning of Period" and "Net Asset Value, End of Period" are each the NAV as adjusted pursuant to the fund's swing pricing policies and procedures. We recommend that the SEC clarify whether, if the fund adjusts its NAV on the last day of the reporting period, the NAV reported should be the NAV used to process shareholder transactions on the last day of the period (calculated on a T+1 basis) or the NAV used to process shareholder transactions calculated pursuant to generally accepted accounting principles (calculated on a T+0 basis).

*Shares Issued and Redeemed.* Swing pricing also would affect the number and dollar amount of shares issued and redeemed that are reported in the statement of changes in net assets, or in the notes to the financial statements. The Release explains that the number and the dollar amount of shares issued and redeemed should be based on the adjusted NAV. It goes on to state that the difference between the adjusted NAV and the unadjusted NAV on shares issued and redeemed would be retained by the fund to offset transaction and liquidity costs, and that amounts retained attributable to the per share difference should be accounted for as a capital transaction, and not included as income to the fund. We agree with this approach.

The Release requests comment on whether the dollar amount of purchases and redemptions disclosed in the fund's financial statements should be presented based on the unadjusted NAV, with separate disclosure of the dollar amount retained by the fund attributable to swing pricing. We believe separate disclosure of the dollar amount retained by the fund attributable to swing pricing is

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<sup>192</sup> Indeed, ALFI's interpretation of its 2015 Swing Pricing Survey indicates that this is happening overseas: "It is apparent that the techniques used by some asset managers have become more sophisticated, for example, with regard to the components of the swing factor and the consideration of how swing thresholds are determined. It is safe to say that a healthy evolution of both theory and practice continues..." *Id.* at 21.

unnecessary, and that the proposed change to the financial highlights table (requiring disclosure of the per share amount retained) will communicate more effectively the effects of swing pricing to financial statement users than a gross dollar amount reported in the statement of changes in net assets.

*Financial Highlights Table.* As noted above, the proposal specifies that the NAVs reported in the financial highlights table are NAVs as adjusted (if applicable). It also would require a new financial highlights line item—Capital Adjustments Due to Swing Pricing—that would represent the per share amount the fund retains pursuant to its swing pricing policies and procedures. We support these proposed changes to the financial highlights table.<sup>193</sup> We recommend that the SEC specify how the per share amount of capital adjustments due to swing pricing should be calculated.

*Notes to Financial Statements.* The proposal would require a fund that adopts swing pricing to disclose in a note to its financial statements the general methods used in determining whether the fund's NAV per share will swing, whether the fund's NAV per share has swung during the reporting period, and a general description of the effects of swing pricing on the fund's financial statements. We support the proposed disclosures, particularly the absence of any requirement to disclose the swing threshold or the swing factors applied during the reporting period.<sup>194</sup>

### **3. Performance Reporting**

Under the swing pricing proposal, a fund would calculate its total return<sup>195</sup> performance based on NAVs as adjusted pursuant to its swing pricing policies and procedures. This would affect total returns included in a fund's prospectus risk/return summary, financial highlights, Rule 482 advertisements, and Rule 34b-1 sales literature. Calculating total returns using adjusted NAVs would result in total returns that reflect the total return experienced by a shareholder that purchases into the fund on the last day of the period preceding the performance measurement period and redeems out of the fund on the last day of the performance measurement period.

We support calculation of total return performance data based on NAVs as adjusted pursuant to the fund's swing pricing policies and procedures. Incremental monies collected by the fund when its NAV swings up, and monies retained by the fund that otherwise would have been paid out to redeeming shareholders when its NAV swings down, will offset portfolio transaction costs attributable to shareholder purchase and redemption activity. The ability to offset transaction costs through swing pricing should result in a higher total return to long-term fund shareholders over time, and we believe that higher total return should be reflected in the fund's total return performance data.

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<sup>193</sup> Our comments on the proposed change to total return included in the financial highlights table are discussed below.

<sup>194</sup> See *infra*, Section IV.A, for a discussion of why confidentiality of this information is important.

<sup>195</sup> Generally, total returns are calculated pursuant to an SEC-prescribed formula that compares an initial investment in the fund to the ending redeemable value of that investment, and assuming reinvestment of distributions.

We understand certain funds that may adopt swing pricing may wish to calculate and disclose total return performance data based on unadjusted NAVs. Such total returns, which would exclude the effects of swing pricing, may be useful in evaluating the fund's performance in relation to its benchmark index. For example, an index fund that adopts swing pricing may wish to calculate and disclose total return data based on unadjusted NAVs to illustrate how well the fund tracked its benchmark index. Rule 482 under the Securities Act permits non-standard performance data that meets specified conditions and reflects all elements of return. It is not clear that total return performance data that excludes the effects of swing pricing would reflect all elements of return. For this reason, we recommend that the SEC specify that a fund that adopts swing pricing may calculate and disclose total return performance data based on unadjusted NAVs.

#### **IV. Other Proposed Disclosure Changes**

The proposal would require funds to provide additional disclosures about redemptions, swing pricing (if applicable), and liquidity on Form N-1A, proposed Form N-PORT, and proposed Form N-CEN. We summarize and comment on these proposed changes below.

##### **A. Form N-1A**

The proposal would amend Form N-1A to require funds to provide additional information on swing pricing, the redemption of fund shares, and lines of credit. These provisions and our views on each are provided below.

*Swing Pricing.* The proposed amendments would require a fund that uses swing pricing to explain when its policies would require the fund to use swing pricing as well as the effects of using swing pricing.<sup>196</sup> We support the proposed swing pricing disclosures. General disclosures about swing pricing will provide investors with important information about why and under what circumstances a fund would adjust its NAV and would complement existing disclosures about how fund shares are priced.<sup>197</sup> We also strongly support the SEC's determination not to require that funds disclose their swing pricing threshold or swing factor. Investors with knowledge of a fund's swing threshold could attempt to

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<sup>196</sup> Proposed Item 6(d) of Form N-1A. For a fund that invests in other funds (*e.g.*, fund-of-funds, master-feeder funds), the fund would be required to include a statement that its NAV is calculated based on the NAVs of the funds in which the fund invests and that the prospectuses for those funds explain the circumstances under which those funds will use swing pricing and the effects of using swing pricing. *Id.*

<sup>197</sup> *See* Item 11(a) of Form N-1A (requiring funds to describe the manner in which they price fund shares).

stagger their purchases and redemptions over time to avoid triggering a detrimental NAV adjustment, thereby circumventing the purpose of swing pricing.<sup>198</sup>

*Redemption Requests.* The proposed amendments would require a fund to disclose the number of days in which the fund will pay redemption proceeds, including the number of days for each distribution channel (if different),<sup>199</sup> and methods that the fund uses to meet redemption requests (*e.g.*, sales of portfolio assets, holdings of cash or cash equivalents, lines of credit, interfund lending and in-kind redemptions).<sup>200</sup> We support providing information on the typical number of days and the methods and funding sources for meeting redemption requests, which would provide meaningful information about the general time taken to meet redemptions and the fund's approaches to liquidity risk management. Because settlement times for redemptions within a single distribution channel can vary, however, it may not be possible for funds to state the specific number of days in which typical redemptions proceeds are paid for each channel. We, therefore, do not support imposing this requirement on a distribution channel-by-distribution channel basis.

*Line of Credit Agreements.* The proposed amendments would require a fund to file as an exhibit to its registration statement any line of credit agreements for the benefit of the fund.<sup>201</sup> We strongly oppose the proposed requirement. Line of credit agreements are heavily negotiated documents that permit funds to draw upon bank lines of credit under certain circumstances and at certain rates. We appreciate that funds would be permitted to exclude the fees associated with the lines of credit,<sup>202</sup> but we do not believe this goes far enough to protect a fund's proprietary and sensitive information reflected in the terms and conditions of these agreements. The disclosure of material terms, such as the borrowing rate, events of default, acceptable collateral and how collateral haircuts are applied, may impair a fund's negotiating ability with banks to get the best terms available. Banks that otherwise would make concessions to one fund may not do so if they know that third parties will point to those terms in their negotiations with the banks. A requirement to disclose these terms may make it more difficult and expensive for funds to obtain lines of credit from banks. In addition, in certain cases, the documentation for certain line of credit agreements is massive. For example, some funds engage in syndicated loans with multiple underlying banks that could include several amendments, many of which may not be material. The requirements to file and update publicly available line of credit

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<sup>198</sup> We also agree with the concerns the SEC raises about selective disclosure of a fund's swing pricing threshold (which it analogizes to selective disclosure of portfolio holdings information), and we would expect funds that adopt swing pricing to modify their selective disclosure policies accordingly. *See* Release at 62335, n. 483 and surrounding text.

<sup>199</sup> Proposed Item 11(c)(7) of Form N-1A. If the number of days in which the fund will pay redemption proceeds differs by distribution channel, the fund also would be required to disclose the number of days for each distribution channel. *Id.*

<sup>200</sup> Proposed Item 11(c)(8) of Form N-1A.

<sup>201</sup> Proposed Item 28(h) of Form N-1A.

<sup>202</sup> Proposed Instruction to Item 28(h) of Form N-1A.

agreements would be onerous.<sup>203</sup> Therefore, we recommend eliminating this requirement from any final rule.

The SEC's goal of increasing Commission, investor and market participant knowledge about a fund's line of credit arrangements still would be achieved but in a less onerous manner for funds and a more understandable way for shareholders if the SEC adopts the proposed requirement regarding disclosure of new summary information on lines of credit on Form N-CEN. Funds would be required to disclose on Form N-CEN whether the fund has a committed line of credit, the size of the line of credit, the name of the institution with which the fund has the line of credit, whether the line of credit is shared among other funds, whether the line of credit was drawn on, the average amount of credit that was in use, and number of days it was outstanding.<sup>204</sup> This type of summary information will be more useful to shareholders – at a more understandable level and we therefore support its inclusion on Form N-CEN. To further draw investors' attention to this information, we would not object to the SEC requiring funds to include the information in the Statement of Additional Information in the fund's registration statement instead of in the Form N-CEN.

## **B. Form N-PORT**

The proposal would require funds to identify the liquidity classification of each of its assets under one of the six categories in which the fund could convert the asset to cash.<sup>205</sup> It also would amend Form N-PORT to replace the term "illiquid assets" with "15% standard assets."<sup>206</sup> Finally, the proposal would require each fund to provide its "three-day liquid asset minimum."<sup>207</sup>

As discussed above, we strongly oppose the SEC's proposed classification scheme and likewise oppose disclosing asset-by-asset liquidity classifications.<sup>208</sup> Similarly, we oppose requiring public disclosure of asset-by-asset illiquidity determinations under the new category "15% standard asset."<sup>209</sup> Instead, we recommend requiring that funds report on Form N-PORT, on an aggregated and non-public basis, the relevant percentages of the fund's [net] assets in each of the categories that it

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<sup>203</sup> Funds also may have line of credit agreements whose coverage timeframes do not coincide with the funds' annual update timeframes. In these cases, additional filings may be required between annual updates to provide new or revised line of credit agreements, taking additional time from, and imposing additional costs on, funds.

<sup>204</sup> Proposed Item 44(a) of Form N-CEN. Because line of credit arrangements can be shared with several types of entities, proposed Form N-CEN also should permit disclosure of non-SEC registered borrowers in Item 44a.iii.1.

<sup>205</sup> Proposed Item C.13 of Form N-PORT.

<sup>206</sup> Proposed Item C.7 of Form N-PORT; revised General Instructions to proposed Form N-PORT.

<sup>207</sup> Proposed Item B.7 of Form N-PORT.

<sup>208</sup> *See supra*, Section II.E.

<sup>209</sup> *See* ICI Fund Reporting Comment Letter at 42-43, 60-61.

establishes, and provide a description of those categories.<sup>210</sup> We also recommend that the Commission retain the term “illiquid assets” in favor of the proposed term “15% standard assets” to avoid any confusion of what a “15% standard asset” is.<sup>211</sup>

Additionally, consistent with our recommended alternatives to the three-day liquid asset minimum, we oppose disclosure of a three-day liquid asset minimum but support requiring funds with liquidity “targets” or “ranges” of “highly liquid assets” to report non-publicly (i) that target or range, and (ii) where the fund stood in relation to it as of month end.<sup>212</sup> In each case, a fund would describe its approach in sufficient detail to provide context for the figures reported.

### **C. Form N-CEN**

The proposal would amend Form N-CEN to require funds to provide information about: (i) lines of credit; (ii) interfund lending and borrowing; (iii) swing pricing; and (iv) certain ETF collateral posting information, as applicable. As discussed earlier, a fund would disclose summary information regarding lines of credit.<sup>213</sup> A fund also would disclose whether it engaged in interfund lending or borrowing during the period and information about those activities.<sup>214</sup> Funds that engage in swing pricing would disclose whether they engaged in swing pricing during the period.<sup>215</sup> In addition, an ETF would disclose whether it required an authorized participant to post collateral to the fund or any of its designated service providers in connection with the purchase or redemption of fund shares.<sup>216</sup> We do not object to providing any of the requested Form N-CEN information. The requested information regarding lines of credit, interfund lending and borrowing, and swing pricing could provide the Commission with useful information about various liquidity risk tools that funds have available to them or have used during the reporting period, and the requested information regarding ETF collateral would inform the Commission as to the AP framework.<sup>217</sup>

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<sup>210</sup> See *supra*, Section II.E.3.

<sup>211</sup> See *supra*, Section II.C.

<sup>212</sup> See *supra*, Section II.F.2.

<sup>213</sup> See *supra*, notes 202 and 203 and surrounding text; See also proposed Item 44(a) of Form N-CEN.

<sup>214</sup> Proposed Item 44(b) of Form N-CEN (requiring funds to disclose whether it engaged in interfund lending or borrowing during the period and the average amount of the interfund loan and average number of days when the loan was outstanding).

<sup>215</sup> Proposed Item 44(c) of Form N-CEN.

<sup>216</sup> Proposed Item 60(g) of Form N-CEN.

<sup>217</sup> The SEC notes that the requirement to post collateral for creating and redeeming ETF shares impacts an AP's operating capital, which could affect the ability and willingness of APs to serve such ETFs or other market makers on an agency basis. Accordingly, the SEC believes that this information along with other proposed information would help in understanding



## V. Compliance and Effective Dates

We summarize and comment on the proposal's compliance and effective dates below.

### A. Liquidity Risk Management Programs and Form N-PORT Amendments

The Commission proposes a tiered set of compliance dates for funds to implement liquidity risk management programs and to make related Form N-PORT disclosures. Larger entities, those funds that together with other investment companies in the same "group of related investment companies" have net assets of \$1 billion, would have 18 months from the effective date to adopt and implement a written liquidity risk management program and to report the related form N-PORT information.<sup>218</sup> Smaller entities would have a 30-month compliance period from the effective date.

We believe that *all* funds would need at least a 30-month compliance period from the later of (i) the date Form N-PORT is adopted or (ii) the effective date for purposes of reporting the liquidity of fund portfolio holdings on Form N-PORT, to adopt and implement liquidity risk management programs and to make related Form N-PORT disclosures.<sup>219</sup> The recommended implementation periods would better recognize the tremendous operational challenges, both from a cost and personnel perspective, that funds will face particularly if the Commission simultaneously adopts rules on derivatives risk management, liquidity risk management and new reporting requirements on Forms N-PORT and N-CEN.<sup>220</sup> These challenges are exacerbated by the fund industry's current efforts to implement major operational changes to comply with recent money market fund amendments.

Although many funds already have some form of liquidity management program in place, all funds will need time to prepare internal liquidity risk management processes, policies and procedures, have boards approve those policies and procedures, and implement a program that complies with SEC

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whether, and to what extent, there may be concentration in the authorized participant framework for ETFs. Release at 62348, n. 585 and surrounding text.

<sup>218</sup> The Commission would base the term "group of related investment companies" on the definition in Rule 0-10 under the 1940 Act defining the term as "two or more management companies (including series thereof) that: (i) Hold themselves out to investors as related companies, for purposes of investment and investor services; and (ii) Either: (A) Have a common investment adviser or have investment advisers that are affiliated persons of each other; or (B) Have a common administrator. . ." See Rule 0-10 under the 1940 Act.

<sup>219</sup> This recommendation is consistent with our recommended compliance periods for the Fund Reporting proposal. See ICI Fund Reporting Comment Letter at 87-88. The reference to the date Form N-PORT is adopted is necessary in the unlikely scenario that the Commission adopts the proposal prior to adopting the Fund Reporting proposal and would give funds time to implement the liquidity risk management program and incorporate related disclosures under the Form N-PORT reporting regime.

<sup>220</sup> In this regard, we urge the Commission to consider these proposals together and impose consistent compliance dates to ensure that fund sponsors can consider and address any overlapping operational issues as efficiently as possible. See, e.g., *supra*, note 98 (discussing overlapping operational issues in the context of derivatives).

requirements. Again, the implementation of these programs would occur simultaneously with the creation of systems and operational plans to comply with the proposed Form N-PORT requirements.

As proposed, the Commission would impose a significant burden on all funds to classify each of their assets into the six proposed liquidity categories—a process that, as we understand, no fund currently undertakes as proposed. Reporting the classification requirements would necessitate the development of new liquidity management systems that would permit funds to receive and evaluate third-party classifications or would allow funds to assign classifications to each individual asset (and portions thereof). All funds would face tremendous operational and resource challenges to develop these systems, and larger funds would be impacted as much, if not more, than smaller funds given their volumes of liquidity data and the complexity of their systems.

### **B. Form N-CEN Amendments**

The Commission proposes an 18-month compliance period from the effective date for funds to comply with the proposed amendments to Form N-CEN. Similar to our recommendation for liquidity risk management programs, we recommend the Commission give funds the later of (i) a 30-month compliance period from the date Form N-CEN is adopted or (ii) an 18-month compliance period from the effective date, to comply with the amendments to Form N-CEN.<sup>221</sup> We agree that an 18-month compliance date from the effective date typically should suffice for funds to comply with the proposed Form N-CEN amendments.

### **C. Form N-1A Amendments**

The Commission proposes that all initial registration statements and all post-effective amendments that are annual updates to effective registration statements filed six months or more after the effective date comply with the proposed amendments to Form N-1A (other than those related to swing pricing). We agree that imposing the Form N-1A amendments on fund filings that occur six months after the effective date should give funds sufficient time to add the proposed disclosures required for Form N-1A.

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<sup>221</sup> Similar to the compliance dates for the liquidity risk management program and Form N-PORT amendments, the reference to the 30-month compliance period from the date Form N-CEN is adopted is necessary in the unlikely scenario that the Commission adopts the proposal prior to the Fund Reporting proposal. In that case, funds should be permitted at least 30 months from the date Form N-CEN is adopted to comply with all Form N-CEN requirements, including the proposed amendments to Form N-CEN, consistent with our recommendation in the ICI Fund Reporting Comment Letter.

#### **D. Swing Pricing**

Finally, the Commission proposes that the provisions related to swing pricing take effect immediately, with no compliance period necessary. For the reasons set forth above, if the SEC adopts swing pricing, we request that it delay effectiveness for at least two years.<sup>222</sup>

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<sup>222</sup> *See supra*, Section III.E.

Mr. Brent J. Fields

January 13, 2016

Page 76

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We appreciate the opportunity to comment on the proposal. If you have any questions regarding our comment letter or would like additional information, please feel free to contact me at 202-326-5815 or [david.blass@ici.org](mailto:david.blass@ici.org); Dorothy Donohue, Deputy General Counsel—Securities Regulation, at (202) 218-3563 or [ddonohue@ici.org](mailto:ddonohue@ici.org); Matthew Thornton, Assistant General Counsel—Securities Regulation, at (202) 371-5406 or [matt.thornton@ici.org](mailto:matt.thornton@ici.org); or Kenneth Fang, Assistant General Counsel—Securities Regulation, at (202) 371-5430 or [kenneth.fang@ici.org](mailto:kenneth.fang@ici.org).

Sincerely,

/s/ David W. Blass

David W. Blass  
General Counsel

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

David W. Grim, Director  
Diane C. Blizzard, Associate Director  
Sarah G. ten Siethoff, Assistant Director  
Division of Investment Management

**Appendix A**



1401 H Street, NW, Washington, DC 20005-2148, USA  
202/326-5800 [www.ici.org](http://www.ici.org)

**INVESTMENT COMPANY INSTITUTE WORKING PAPER:  
OVERVIEW OF MUTUAL FUNDS' LIQUIDITY MANAGEMENT PRACTICES**

**TO THE  
STAFF OF THE  
SECURITIES AND EXCHANGE COMMISSION**

**JUNE 12, 2015**

# Investment Company Institute Working Paper: Overview of Mutual Funds' Liquidity Management Practices

## Introduction and Background

The purpose of this working paper is to assist the staff of the Securities and Exchange Commission (SEC) as it considers (i) whether to recommend that the SEC propose rules requiring “broad risk management programs . . . for mutual funds and ETFs to address risks related to their liquidity and derivatives use . . .”<sup>1</sup>, and (ii) if so, how to approach this rulemaking. Specifically, this paper provides information about the liquidity management practices of investment funds, with a particular focus on US mutual funds. This paper was prepared with significant input from industry participants, and draws on letters ICI has submitted to certain regulatory bodies focusing on systemic risk generally and liquidity risk in particular.<sup>2</sup>

Daily redeemability is a defining feature of mutual funds.<sup>3</sup> While we are firmly of the view that US mutual funds do not pose systemic risks because of their daily redeemability, we support the SEC’s careful review of existing regulation and guidance concerning mutual fund redeemability and liquidity. We believe the SEC will find that, broadly speaking, mutual funds and their managers have developed sound liquidity management practices. These practices extend well beyond mere compliance with

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<sup>1</sup> Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, Speech by SEC Chair Mary Jo White at The New York Times Dealbook Opportunities for Tomorrow Conference, New York, NY (Dec. 11, 2014), available at [www.sec.gov/News/Speech/Detail/Speech/1370543677722#.VIoGhTHF884](http://www.sec.gov/News/Speech/Detail/Speech/1370543677722#.VIoGhTHF884). Chair White added that the staff also is reviewing options for specific requirements, such as updated liquidity standards and disclosure of liquidity risks.

<sup>2</sup> See Letter to the Financial Stability Oversight Council from Paul Schott Stevens, President & CEO, ICI, dated March 25, 2015 (2015 ICI FSOC Letter), at 10-49, available at [www.ici.org/pdf/15\\_ici\\_fsoc\\_ltr.pdf](http://www.ici.org/pdf/15_ici_fsoc_ltr.pdf); Letter to the Financial Stability Board from Paul Schott Stevens, President & CEO, ICI, dated May 29, 2015 (2015 ICI FSB Letter), available at [www.ici.org/pdf/15\\_ici\\_fsb\\_comment.pdf](http://www.ici.org/pdf/15_ici_fsb_comment.pdf).

<sup>3</sup> Section 5(a)(1) of the Investment Company Act of 1940 (Investment Company Act) defines an open-end investment company (*i.e.*, a mutual fund) as one that offers any “redeemable security” of which it is the issuer. Section 2(a)(32) defines a redeemable security as one that entitles the holder to receive approximately his proportionate share of the fund’s current net assets. Under Section 22(e), a fund has by law up to seven days to pay proceeds to redeeming investors, although as a matter of practice, funds typically pay proceeds within one to two days of a redemption request. In support of this requirement, at least 85% of a fund’s portfolio must be invested in “liquid assets”—namely, assets that can be “sold or disposed of in the ordinary course of business within seven days at approximately the value at which the fund has valued the investment.” See *Revisions of Guidelines to Form N-1A*, SEC Release No. IC-18612, 57 Fed. Reg. 9828 (March 20, 1992); and SEC Division of Investment Management, IM Guidance Update No. 2014-1 at 6 (January 2014) (explaining that the 1992 Guidelines are Commission guidance and remain in effect).

existing legal and regulatory requirements, as they have also developed as important elements of prudent portfolio and risk management.

We summarize below many key elements of the liquidity management practices relating to mutual funds.<sup>4</sup> We believe that this will be particularly valuable to the staff in considering rulemaking related to the programmatic approach to liquidity management that Chair White suggested in her December speech. In this regard, we encourage the SEC and the staff to ensure that any proposed rulemaking further clarifies and strengthens, rather than undermines, the key features of mutual funds (such as daily redeemability<sup>5</sup>) that have made them so popular among millions of retail investors. ICI and its members stand ready to assist the SEC staff further with this initiative.

## **Summary of Practices**

### ***1. Liquidity management generally.***

Liquidity management is a major element of investment risk management, an intrinsic part of portfolio management, and a constant area of focus for fund managers.<sup>6</sup> Generally speaking, liquidity management is not compartmentalized. Key personnel across divisions (*e.g.*, portfolio managers, traders, risk managers, legal and compliance personnel, and senior management) all can have unique,

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<sup>4</sup> Unless the context otherwise indicates, references throughout this document to “funds” are to US stock and bond mutual funds. Exchange-traded funds (ETFs) operate differently, with secondary market trading providing a share of the liquidity in ETF shares (*i.e.*, investors buy and sell ETF shares on an exchange rather than transacting directly with the fund). *See* Appendix A of the 2015 ICI FSOC Letter for a detailed discussion of the ETF primary and secondary markets and the behavior of bond ETFs during the summer of 2013, a period in which bond prices moved down sharply.

<sup>5</sup> The SEC has in the past shown appreciation for and sensitivity to this key statutory feature of mutual funds. For instance, in the release adopting Rule 22c-2 under the Investment Company Act (allowing mutual funds to impose redemption fees), the SEC stated, “This [daily] redemption right makes funds attractive to fund investors, most of whom are long-term investors, because it provides ready access to their money if they should need it.” Further, “it [*i.e.*, a higher redemption fee] would in our judgment impose an undue restriction on the redeemability of shares required by the [Investment Company] Act.” *Mutual Fund Redemption Fees*, SEC Release No. IC-26782 (March 11, 2005) (“Redemption Fee Rule Release”), at 4 and 12.

<sup>6</sup> Fund managers use different models of internal organization. Some have distinct and dedicated risk management units and personnel, while others subsume this function within other groups, such as portfolio management or, less commonly, compliance. The interaction among portfolio management, trading, legal, compliance, risk management (if applicable), and senior management will vary from firm to firm. There is similar variety with respect to the means of oversight, the resources available, and the formality of liquidity management programs generally.

complementary, and ongoing contributions to make with respect to monitoring and managing liquidity risk.<sup>7</sup>

Liquidity management is a nuanced, fund-specific, and fluid process, and there is no “one size fits all” approach. Fund managers generally take a risk-based approach to managing liquidity risk across their funds. In accordance with that approach, some categorize or assign liquidity “scores” to each fund<sup>8</sup> and pay particular attention to those funds with less liquid profiles. Based on these categorizations/scores and a range of other factors, funds’ portfolio holdings may be adjusted accordingly, and the fund manager may arrange for certain tools to mitigate liquidity risk further (*e.g.*, access to an external line of credit). While a fund manager’s approach to liquidity management may start with general principles, its application of those principles (*i.e.*, the specific means used for monitoring and managing risk) varies by fund, in recognition of each fund’s unique characteristics (*e.g.*, the nature of its investment objectives and strategies, portfolio holdings (including the means and frequency of trading in those holdings), potential obligations, historical fund flows, and the composition of the investor base).

***2. Initial due diligence—features of internal processes for considering whether specific types of investments or strategies are appropriate for a new mutual fund.***

Even before launching a new mutual fund, the fund manager and fund board consider whether the fund’s proposed strategies and investments are suitable for the mutual fund structure, including whether the fund would be able to satisfy applicable regulatory requirements (including daily redeemability and the SEC’s liquidity standard) on an ongoing basis. If not, the fund manager may decide to offer that strategy through a different vehicle (*e.g.*, a closed-end fund or a private fund). Some fund managers rely on “new products committees” or analogous bodies to carefully vet potential strategies and product offerings. These committees are often multi-disciplinary, with members representing the portfolio management, trading, risk, legal, compliance, accounting, and operations departments, each of whom brings specific knowledge and expertise to bear in evaluating new products. In some cases, the vetting process will lead to changes to the product or the implementation of additional safeguards, such as internal liquidity management guidelines.

New funds receiving internal approval are then taken to the fund board for review and approval. Before approving the creation and launch of a fund, boards will often inquire about the expected liquidity profile of the fund, particularly for those funds investing primarily in assets other than equities with a high trading volume (*e.g.*, high-yield bond funds). In addition, SEC rules require

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<sup>7</sup> As noted below under paragraph 6, the SEC’s binary liquidity standard provides one way of evaluating fund liquidity, which may be the primary focus for certain legal and compliance personnel. Other personnel may view fund liquidity in a different, multi-faceted way.

<sup>8</sup> See n. 23 and accompanying text, below.



that fund boards either approve a redemption fee on certain fund share redemptions, or else determine that the imposition of such a fee is either not necessary or not appropriate.<sup>9</sup>

### ***3. Pursuit of investment objectives and liquidity management.***

Liquidity management for a mutual fund differs from the approach(es) a fund manager might take in managing other vehicles offering fewer or no redemption rights. For mutual funds, the central importance of meeting daily redemptions means that liquidity management is a constant area of focus for fund managers, one that coexists with seeking to achieve a fund's investment objectives. This dynamic is inherent in the mutual fund structure, and funds consider a range of factors, including cash flows. While funds are receiving redemption requests, funds typically receive: cash from investor purchases of new fund shares (even during periods of net redemptions); interest payments and dividends on portfolio holdings that are distributed to and reinvested by shareholders; and (in the case of bond funds) the maturation, prepayment, and calling of bonds. These inflows provide a ready source of cash to meet redemptions before a fund has to consider other means of meeting redemptions and other fund obligations. Of course, these incoming sources of cash do not always fully offset redemption requests. In paragraphs 4 and 5 below, we describe how fund managers position their funds in advance of, and in response to, redemption requests.

Funds may have certain tools at their disposal for satisfying redemption requests and other obligations when more typical means (*e.g.*, use of new or existing cash or sales of portfolio holdings) are unavailable or otherwise sub-optimal, including: (i) reserving the right to redeem in kind;<sup>10</sup> (ii) interfund lending arrangements, in reliance on SEC exemptive orders, for temporary liquidity management purposes;<sup>11</sup> and (iii) lines of credit from banks for temporary liquidity management purposes.<sup>12</sup>

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<sup>9</sup> Rule 22c-2(a)(1) under the Investment Company Act. In the Redemption Fee Rule Release at 12-14, the SEC stated that a fund board could consider the imposition of a redemption fee to discourage short-term trading in fund shares and offset its costs, and could also "take into consideration indirect costs to the fund that arise from short-term trading of fund shares, such as liquidity costs, *i.e.*, the cost of investing a greater portion of the fund's portfolio in cash or cash items than would otherwise be necessary."

<sup>10</sup> This tool is used sparingly in practice today by fund managers because it is operationally more challenging than cash redemptions and because cash redemptions are what investors typically expect. Nevertheless, depending upon the particular circumstances, redemptions in kind may help a fund manage certain redemption requests (*e.g.*, large redemptions by institutional investors) in a way that minimizes negative effects to investors remaining in the fund.

<sup>11</sup> Some member firms have found that, at times, interfund loans provide a useful alternative source of short-term liquidity. Nevertheless, we understand from most ICI members that have secured these interfund lending orders that they do not routinely rely on them.

<sup>12</sup> These lines may be committed (offering greater certainty to borrowers, at a cost) or uncommitted. Additionally, some fund complexes have arranged them for certain funds only (based on perceived potential need and/or cost considerations), while others share lines across all funds in the complex.

#### ***4. Use of cash and other highly liquid assets in managing overall portfolio liquidity.***

Fund managers generally maintain some cash and/or other highly liquid assets (*e.g.*, Treasury securities) in their funds, upon which they can draw if necessary to meet redemptions and other fund obligations. The percentage of such assets in proportion to the overall portfolio is likely to vary across different types of funds, based on factors such as the nature of a fund's investment objective and strategies, its portfolio holdings, its historical cash flows, the composition of its investor base, and other liquidity management tools<sup>13</sup> that it may have at its disposal. The amount held in highly liquid assets also may vary within a given fund at times, *e.g.*, due to market movements or anticipated investor activity. These factors are evaluated in light of the fund's overarching legal obligations to satisfy daily redemption requests and other obligations.

A potential drawback to holding a portion of portfolio holdings in cash or other highly liquid assets is that doing so could act as a drag on fund performance and introduce tracking error—a deviation from the performance of a targeted benchmark. In response, some funds still opt to hold highly liquid assets as one element of their liquidity management approach, but also invest in highly liquid derivatives to counterbalance the effects of those assets on performance. In this particular context,<sup>14</sup> derivatives may provide efficient and cost-effective investment exposure(s) designed to help a fund meet its investment objectives<sup>15</sup> while the highly liquid assets would remain available to meet redemptions and other fund obligations, (including those related to the derivatives). Derivatives do not obviate the need to hold highly liquid assets, and may in fact require a fund to hold more in highly liquid assets to meet margin requirements, but together they help position a fund towards its twin goals of managing potential cash flows and seeking to achieve its investment objectives.<sup>16</sup>

#### ***5. Responding to redemptions.***

Managing liquidity as part of overall portfolio management is a dynamic process requiring fund managers to make daily adjustments to accommodate cash inflows and outflows. Even during periods of market stress, some investors continue to purchase fund shares, providing a source of liquidity to help meet redemptions. Another source of liquidity is the income that portfolio holdings generate throughout the year, a high percentage of which investors choose to reinvest when distributed to them.

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<sup>13</sup> See paragraph 3, above.

<sup>14</sup> As described in this context, this use of derivatives does not introduce leverage to the overall portfolio. The use of derivatives generally is subject to the asset coverage requirements under Section 18 of the Investment Company Act.

<sup>15</sup> Derivatives providing broad market or sector exposures (*e.g.*, certain futures contracts, index swaps, and credit default swaps written on broad indices) are often particularly liquid and cost-efficient.

<sup>16</sup> In a somewhat similar way, some funds use certain ETFs to as a means of pursuing both of these goals. Like certain derivatives, these ETFs are highly liquid, cost-efficient, and provide broad market or sector exposures. Unlike derivatives, ETFs would not be subject to margin or asset coverage requirements, but their purchase would reduce cash on a dollar-for-dollar basis.

For bond funds, bonds maturing, the normal return of principal on mortgage-backed or other securities, prepayments of principal such as on bank loans, home mortgages, and calls of debt securities also generate cash to meet redemptions. Portfolio managers and traders typically receive data on cash flows at least daily and thus have a strong sense of whether additional actions (including the sale of portfolio holdings) would be needed to meet redemption requests or otherwise adjust a fund's liquidity profile.

When necessary or appropriate, fund managers may carefully select and sell portfolio holdings to raise cash, weighing a number of factors in doing so.<sup>17</sup> Contrary to suggestions made by some,<sup>18</sup> fund managers do *not* automatically sell their funds' most liquid portfolio holdings to meet redemption requests. Concerns beyond liquidity strongly influence portfolio sales decisions. While fund managers are obligated to satisfy redemption requests, they are also fiduciaries and parties to management agreements that require adherence to specific fund policies, restrictions, and legal requirements. As such, fund managers have ongoing duties and obligations to the fund and its remaining shareholders. These include ensuring that the fund remains in compliance with its investment policies and guidelines; is properly diversified; is properly balanced with respect to (as applicable) asset types, holdings, issuers, industries, sectors, regions, countries, and currencies; has an appropriate risk profile; and, if applicable, is appropriately situated vis-à-vis its benchmark. On an ongoing basis and with the information available to them, portfolio managers seek to ensure that the fund's portfolio is well-positioned to

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<sup>17</sup> Such factors may include other tools available to meet short-term liquidity needs, discussed above in paragraph 3.

<sup>18</sup> The Financial Stability Oversight Council, for example, recently asked whether mutual funds pose unique and systemic risks because of their daily redeemability, along with a number of related questions that seem to presuppose that they do. Financial Stability Oversight Council, Notice Seeking Comment on Asset Management Products and Activities (the Notice"), at 6-12, available at: [www.treasury.gov/initiatives/fsoc/rulemaking/Documents/Notice%20Seeking%20Comment%20on%20Asset%20Management%20Products%20and%20Activities.pdf](http://www.treasury.gov/initiatives/fsoc/rulemaking/Documents/Notice%20Seeking%20Comment%20on%20Asset%20Management%20Products%20and%20Activities.pdf). The Notice suggests a "waterfall" theory of liquidity management, positing that in times of stress, a fund may sell off the more liquid part of its portfolio first to meet investor redemptions, thereby concentrating liquidity risk on investors remaining in the fund. It then lays out a hypothesis in which mutualization of trading costs creates a unique incentive for fund investors to redeem heavily in the face of a market decline. In our comment letter, we debunked both theories and demonstrated that the structure and regulation of mutual funds, the nature of their investor base, and the empirical evidence provide no support for the supposition that mutual funds pose unique and systemic risks to financial stability. 2015 ICI FSOC Letter at 10-49.

Along somewhat similar lines, the Financial Stability Board recently expressed concerns about forced asset sales by individual investment funds (so-called "fire sales") and their negative spillover effects on other investment funds, fund counterparties or particular markets—effects that the FSB describes as occurring through the "asset liquidation/market channel." Consultative Document (2<sup>nd</sup>), *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies* (4 March 2015), at 33-34, available at [www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf](http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf). In our comment letter, we demonstrated why these hypothetical concerns are not relevant for regulated funds generally and US mutual funds specifically. We also explained how regulated funds are able to meet redemptions—including during exceptional market conditions—and employ a variety of means to reduce the impact of such redemptions on remaining shareholders. 2015 ICI FSB Letter at 24-38.

pursue its investment objective, irrespective of whether at any given time there are net inflows or outflows.

If shareholders redeem, a fund manager may dispose of holdings in which the manager has less conviction, which may or may not be the most liquid in the portfolio. When a fund manager opts to sell portfolio holdings, it works with traders and dealers to trade efficiently and minimize the market impact of its sales. At the same time, even if some shareholders redeem because of a market downturn, portfolio managers may maintain or even add to the fund's holdings of less liquid holdings to ensure continued exposure to particular asset classes, consistent with fund policies, and in an effort to benefit the fund's remaining investors in the event that the market rebounds. Thus, adept cash management, or even just the natural consequences of a downturn in the market (*i.e.*, an increase in the fund's cash position relative to the value of its other holdings), can allow a fund to take advantage of attractive portfolio purchase opportunities in times of stress, and funds are quite frequently buyers in such situations.

#### ***6. Assessing and monitoring liquidity of particular fund holdings.***

A fund manager's liquidity management practices typically will include active monitoring of the liquidity profile of individual portfolio holdings. While the SEC's liquidity standard<sup>19</sup> requires binary determinations for each portfolio holding (*i.e.*, for purposes of compliance testing, all assets are either "liquid" or "illiquid"), for broader liquidity management purposes fund managers think of portfolio holdings as falling along a liquidity continuum.

Based in large part on the historical performance of particular holdings in different market conditions, a fund manager may develop general "macro" liquidity views of such holdings by asset class and sub-class. The fund manager may further refine its view of a holding depending on, as applicable, issuer domicile, duration, credit quality, and currency (*e.g.*, U.S. Treasury securities are generally considered to be the most liquid of all securities), and modify its view on an ongoing basis as necessary.

Specific information that may contribute further to a fund manager's view of a holding's liquidity may include:

- assessments of bid-ask spreads, trading volumes, trading frequency,<sup>20</sup> depth of the secondary market for the asset, market impact, information from pricing vendors, and other data;
- analysis of the capital structure and credit quality of the asset;

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<sup>19</sup> See n. 3, above.

<sup>20</sup> Trading data may be particularly useful for exchange-traded investments, and have less importance for those investments that trade over-the-counter.

- repurchase agreement “haircuts” by collateral type (*i.e.*, for repurchase agreements, the difference between the value of the cash lent and the collateral accepted, with larger haircuts for less liquid or creditworthy collateral);
- haircuts set by central counterparties by asset type;
- as a type of proxy, trading activity for ETFs (*e.g.*, volumes and spreads) investing primarily in the asset class of interest;
- for equities, a fund’s position size relative to its average daily trading volume;
- for certain fixed income securities, the “newness” of an issue (newer issues tend to be more liquid);
- for certain fixed income securities, TRACE data;<sup>21</sup> and
- liquidity data provided by third parties (*e.g.*, data provided by Markit, IDC, and Bloomberg).

While the examples listed above are largely quantitative in nature, assessing liquidity is not a purely mechanistic exercise—far from it. Qualitative information and judgments also play a critical role in arriving at a view of a holding’s liquidity. For instance, recognizing that asset classes differ in the type and quantity of available data (*e.g.*, certain debt securities do not trade frequently, and may therefore have limited trading data), some fund managers will reach out to traders for qualitative feedback regarding market conditions, valuation, and liquidity. Some fund managers, as a final step, assess all of this information and categorize or assign liquidity “scores” to particular holdings.

### ***7. Considerations regarding a holding’s position size in determining its liquidity.***

A holding’s position size within the fund’s portfolio may not be a factor for fund managers for purposes of applying the SEC’s liquidity standard (*i.e.*, for these fund managers, the test is not whether a fund can exit its position *entirely* within 7 days—rather, the determination is made with respect to a normal trading lot for the holding in question). Fund managers, however, consider position size more broadly as part of liquidity management. As discussed below in paragraph 8, some fund managers calculate how long it would take to raise specified amounts of cash through sales of portfolio holdings in both normal and stressed conditions, and some incorporate position size in other ways in their liquidity

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<sup>21</sup> TRACE (Trade Reporting and Compliance Engine) is FINRA’s over-the-counter real-time price dissemination service for the fixed income market. TRACE currently consolidates and disseminates transaction data for all eligible corporate bonds, all U.S. agency debentures, agency pass-through mortgage-backed securities (TBA and specified pool transactions), certain asset-backed securities (including those backed by auto loans, credit card receivables, and student loans), and SEC Rule 144A transactions.

management. Some fund managers also will apply position limits both within a fund and across all funds and accounts that they manage.

**8. *Approaches fund managers take in assessing and monitoring the liquidity of the overall fund portfolio.***

A fund's liquidity management practices typically include active monitoring of the overall portfolio's liquidity profile, informed in large part by the "bottom up" asset-level liquidity monitoring discussed above. Portfolio monitoring also must account for potential liquidity needs (*e.g.*, meeting potential redemption requests and other fund obligations), in both normal and stressed conditions. Evaluation of portfolio liquidity is a fluid and collaborative process that features qualitative and quantitative contributions from several functional areas within the fund manager (*e.g.*, portfolio managers, traders, risk officers and analysts, legal and compliance personnel, and senior management). As with individual holdings, the fund manager may develop a "macro" view on a portfolio's liquidity profile based on past experience.

Fund managers frequently use quantitative analysis, designed to measure the liquidity of the overall portfolio, to complement and inform their views. This analysis may include:

- comparing a portfolio's liquidity to that of a benchmark;
- calculating "coverage ratios," *i.e.*, measures of the extent to which the fund has sufficient liquidity to meet daily/weekly redemptions and other obligations based on average redemption activity and historically large redemptions for the fund, and/or historically large redemptions for the fund's peer group (the latter may be particularly useful for newer funds);<sup>22</sup>
- calculating how long it would take to raise specified amounts of cash through sales of portfolio holdings; and
- conducting forms of stress testing to determine the impact of certain changes (*e.g.*, potentially heavy redemption activity, changes in interest rates, credit quality, widening spreads, currency fluctuations) on portfolio liquidity.<sup>23</sup>

Some fund managers also use "dashboards" as a convenient way to pull together all relevant liquidity-related information in a succinct manner. In addition to monitoring these quantitative

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<sup>22</sup> Some fund managers seek to maintain multiples of coverage (*e.g.*, 3x liquidity coverage assuming the highest historical redemption activity), or otherwise target some amount *above* the historical highs, each as a way of accounting for stressed conditions.

<sup>23</sup> Based on the above factors, some fund managers then categorize or assign liquidity "scores" to portfolios.

metrics, some managers impose internal portfolio targets around these or other metrics, taking action if a metric deviates from the pre-established target.

### ***9. Assessing and monitoring fund flows and the investor base.***

A critical component of liquidity management is understanding a fund's historical patterns of purchases and redemptions and its investor base. Fund managers review their funds' historical redemption patterns, and many also review historical redemption activity data for similarly-managed peer funds (the latter may be particularly useful for newer funds). Information about fund flows during stressed periods can be quite useful for fund managers. Stressed periods may be experienced across similar fund types in response to certain events or markets conditions (*e.g.*, the 2008 financial crisis), or may be fund-specific (*e.g.*, an idiosyncratic event affecting a fund manager). Patterns may vary by fund type, by fund complex (*e.g.*, depending on the method(s) of distribution and the types of investors who purchase shares), and as market conditions change (despite the generally long-term nature of most fund investors, there is some correlation between fund performance and fund flows).

To the extent possible, a fund manager tries to understand the composition of a fund's investor base. Several characteristics of a fund's investor base help predict the potential magnitude of the fund's net redemption activity, including:

- the percentage of the base that consists of typically long-term investors (*e.g.*, investors in retirement plans);
- concentration (the less concentrated the investor base, the less likely a fund will encounter large aggregate outflows);
- heterogeneity (*e.g.*, fund investors differ in their personal financial goals, time horizons, and risk tolerances, and these differences mitigate against large aggregate outflows); and
- the manner in which investors purchase fund shares (*i.e.*, directly from the fund complex, through intermediaries (such as broker-dealers), or some combination thereof).

For funds sold through intermediaries, developing this understanding involves evaluating how intermediaries use those funds within their clients' portfolios. Based on past experience with an intermediary, or with certain types of platforms or account types across intermediaries, fund management formulates views as to how stable a fund's asset base is likely to be, particularly in times of stress. However, many fund complexes face very real limits on their ability to obtain specific information about their funds' beneficial shareholders, largely because many investors own their fund shares indirectly through "omnibus" accounts that the relevant intermediaries maintain directly with the funds. Omnibus accounts may offer limited transparency to fund complexes about the ultimate beneficial shareholders and the way in which they invest.

More generally, funds seek to maintain open lines of communication with their intermediaries. As a matter of contract or courtesy, fund management may request that intermediaries (or large shareholders generally) provide advance notice of large redemptions, thus providing the fund manager with greater ability to plan for those redemptions.<sup>24</sup> Fund management often receive considerable notice in connection with certain intermediary actions that will result in significant fund redemptions (*e.g.*, the removal of a fund as an investment option from a 401(k) plan). It is generally in an intermediary's interest to provide as much notice as possible of large redemptions, to (i) ensure that redemptions are accommodated as efficiently as possible for exiting shareholders; and (ii) protect remaining shareholders (if, for example, some of an intermediary's clients remain in the fund). Continued and active involvement by fund management's sales and distribution personnel can help limit the frequency and impact of unexpected large redemption.

### ***10. Other portfolio and risk management techniques.***

Fund managers employ many portfolio and risk management techniques that mitigate different forms of risk to which funds may be subject. These risk mitigation techniques have indirect benefits with respect to liquidity management, insofar as they may make funds less susceptible to sharp declines in their share prices. This in turn reduces any marginal incentive for fund shareholders to redeem. To cite just a few examples, fund managers may diversify across asset types, holdings, issuers, industries, sectors, regions, countries, and currencies within their funds to varying degrees. Some fund managers use derivatives to mitigate certain forms of portfolio risk (*e.g.*, to hedge exposure to a market, sector, security, or other target exposure, or, for fixed income funds, to adjust portfolio duration).<sup>25</sup> Finally, fund managers carefully evaluate counterparties and may limit a fund's exposure to a particular counterparty, beyond any limits that may apply under applicable law.

### ***11. Disclosure regarding liquidity management.***

Funds typically do not provide comprehensive and consolidated disclosure about their liquidity management programs in a single place in their prospectuses or statements of additional information (SAIs), because doing so is not currently required under Form N-1A. However, Form N-1A contains a number of disclosure items that are relevant to funds' liquidity management programs. To the extent applicable, a fund's prospectus and SAI may contain disclosure about:

- liquidity-related risks to which the portfolio itself or certain permitted investments may be subject;<sup>26</sup>

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<sup>24</sup> Redemptions in kind would might be one means of handling these large redemptions. *See* n. 10 and accompanying text, above.

<sup>25</sup> *See also* paragraph 4, above, for a discussion of how some funds use derivatives more explicitly as part of liquidity management.

<sup>26</sup> Items 4(b)(1), 9(c), and 16(b) of Form N-1A.



- any formal policy limiting the fund’s ability to invest in illiquid assets;<sup>27</sup>
- the fund’s ability to redeem shares in kind;<sup>28</sup>
- the fund’s policies and procedures with respect to frequent purchases and redemptions of fund shares;<sup>29</sup>
- the fund board’s role in risk oversight;<sup>30</sup>
- any lines of credit in place; and
- any interfund lending arrangements in place.

## ***12. Board oversight.***

While fund managers monitor and manage liquidity on a day-to-day basis, fund boards of directors also play a role in oversight of risk management (including liquidity management) and portfolio management generally. Fund boards must (i) review and approve funds’ and fund managers’ compliance policies and procedures, and (ii) receive annual written reports from funds’ chief compliance officers regarding the operation of those policies and procedures. Consequently, a fund board would be responsible for reviewing and approving compliance-related liquidity procedures, along with any proposed material changes.

Fund managers also typically keep a fund’s board apprised of the manager’s general approach to monitoring and managing liquidity risk. As needed or appropriate, boards receive more specific information on fund liquidity as market conditions and redemption activity warrant. In addition, liquidity is related to valuation, which the board also oversees.

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<sup>27</sup> See n. 3, above. Some funds may have more stringent policies that they abide by and disclose to their investors, pursuant to, *e.g.*, Items 9(b) or 16(c) of Form N-1A.

<sup>28</sup> Item 11(c)(3) of Form N-1A.

<sup>29</sup> Item 11(e) of Form N-1A.

<sup>30</sup> Item 17(b)(1) of Form N-1A.

## **Appendix B: Summary of Relevant Section 22(e) Orders**

The following is a summary of the six instances we identified where the Commission granted an exemptive order permitting one or more long-term funds to suspend redemptions (excluding emergency situations outside the control of a fund's adviser):

### **1. *Shamrock Fund*<sup>1</sup>**

The SEC granted a temporary order after the Shamrock Fund's independent directors requested from management, but were denied, information about the fund's portfolio securities. The SEC determined that it was not reasonably practical for the fund to determine the value of its assets. Subsequently, a portfolio manager of the fund and various other related parties were found guilty of violating various federal securities laws, in connection with a scheme whereby the portfolio manager would cause the fund to purchase several large blocks of high risk securities in exchange for secret payments of large amounts of cash.

### **2. *Vanguard Fund, Inc.*<sup>2</sup>**

The SEC granted an order retroactively permitting the Vanguard Fund, Inc. to postpone the full payment of redemption proceeds. The fund had adopted a plan of partial postponement of payment of redemption proceeds after the SEC ordered the suspension of trading in over-the-counter securities that represented 17.7% of the fund's net assets. The fund maintained that because of the suspension of trading of the securities, it was not reasonably practicable for the fund to fairly value its net assets. The SEC granted relief based on a determination that the plan of partial postponement was for the protection of investors.

### **3. *The OTC-100 Fund, Inc.*<sup>3</sup>**

The SEC granted a temporary order to The OTC-100 Fund Inc. after the fund determined that processing a redemption request from a controlling shareholder for approximately 80% of the fund's outstanding shares within a seven-day period would significantly harm the remaining shareholders of the fund. The temporary suspension allowed the fund time to work with the redeeming shareholder, who rescinded the redemption requests, and permitted the fund to engage in an orderly liquidation.

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<sup>1</sup> See In the Matter of Shamrock Fund, Investment Company Act Release No. 7044 (Mar. 7, 1972) (order).

<sup>2</sup> See In the Matter of Vanguard Fund, Inc., Investment Company Act Release No. 8413 (July 3, 1974) (order).

<sup>3</sup> See In the Matter of The OTC-100 Fund, Inc., Investment Company Act Release No. 16846 (Mar. 3, 1989) (notice and temporary order) and In the Matter of The OTC-100 Fund, Inc., Investment Company Act Release No. 16866 (Mar. 15, 1989) (extension of temporary order).

#### **4. *Steadman Financial Fund, et al.***<sup>4</sup>

The SEC granted an order when, based on the results of an inspection by SEC staff, it was determined that certain Steadman Financial Funds could not reasonably or practicably determine the value of their net assets. Subsequently, the SEC brought a civil suit against the funds, the investment adviser and chairman of the funds' board, alleging that the funds incurred material liabilities by failing to register the funds' securities under "blue sky" laws in states where shares were offered and sold for approximately 17 years. As a result, the funds calculated net asset value without taking into account certain liabilities associated with such registrations, including unpaid fees, penalties and possible shareholder suits. These liabilities were not disclosed to investors. The U.S. District Court for the District of Columbia held that the parties violated securities laws related to antifraud, share pricing and reporting.

#### **5. *Municipal Lease Securities Fund***<sup>5</sup>

The SEC granted a temporary order to the Municipal Lease Securities Fund when, based on the results of an inspection by SEC staff, it determined that it was not reasonably practicable for the fund to determine the value of its net assets. The fund experienced difficulties in valuing the large number of municipal lease interests it held. Subsequently, the SEC obtained injunctive and ancillary relief against the fund, its investment adviser, a related broker-dealer and a control person for antifraud, pricing, and books and records violations of the 1940 Act. The complaint alleged that the relevant parties sold and redeemed fund shares during a period in which the fund was not calculating net asset value, and the parties falsely stated that the fund's share prices were based on their calculated net asset value.

#### **6. *Third Avenue Trust***<sup>6</sup>

Third Avenue Focused Credit Fund experienced a significant level of redemption requests and an ongoing reduction in the liquidity of its portfolio securities, which consisted largely of junk bonds issued by lower rated (or unrated) issuers. The SEC granted a temporary order under Section 22(e)(3) after expressing concerns with a board-approved plan of liquidation that provided for distribution to shareholders of the fund's remaining net cash and a separate transfer of the fund's other assets into a liquidating trust. These two distributions would have constituted the full redemption of all shares of the fund, and no further subscriptions or redemptions would be accepted after the record date for the distributions.

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<sup>4</sup> See *In the Matter of Steadman Financial Fund, et al.*, Investment Company Act Release No. 16958 (May 16, 1989) (order) and *In the Matter of Steadman Financial Fund, et al.*, Investment Company Act Release No. 17010 (June 15, 1989) (extension of order).

<sup>5</sup> See *In the Matter of Municipal Lease Securities Fund*, Investment Company Act Release No. 17245 (Nov. 29, 1989) (temporary order) and *In the Matter of Municipal Lease Securities Fund*, Investment Company Act Release No. 17258 (Dec. 8, 1989) (extension of temporary order).

<sup>6</sup> See *Third Avenue Trust and Third Avenue Management LLC*, Investment Company Act Release No. 31943 (Dec. 16, 2015) (notice and temporary order).

The SEC order includes specific conditions regarding the plan of liquidation and a representation that the fund would engage in no business activities aside from the winding up of its affairs. The order requires the fund and the adviser to promptly make available to the SEC staff all files, books, records and personnel as requested by the SEC staff relating to the fund and the liquidating trust.

## **Appendix C: Liquidity Risk Management Requirements for EU Funds**

We describe below the liquidity risk management requirements applicable to collective investment schemes domiciled in the European Union (“EU”). The legal rules governing liquidity risk management vary depending on the type of fund and its regulated status.

### **I. UCITS**

In Europe, a collective investment scheme that qualifies as an undertakings for collective investment in transferable securities (“UCITS”) and is therefore able to be sold publicly throughout the EU, must comply with the liquidity management requirements specified in the UCITS Directive, as implemented by the European Member State in which the UCITS is domiciled. We describe below the provisions contained in the UCITS Directive, as well as the UCITS Implementing Directive and any relevant EU guidance.

As a general matter, a UCITS is required to have sufficient liquid assets to meet potential redemptions and, based on this general obligation, a UCITS needs to operate an effective liquidity risk management system. For UCITS, liquidity risk management is part of the more general risk management framework to which UCITS are subject.

#### *Liquidity Risk Management Requirements*

The liquidity risk management requirements to which UCITS and their management companies are subject stem from a UCITS’s high-level obligation to repurchase or redeem its units at the request of any unit-holder and to engage in the sale or redemption of shares at least twice a month (unless competent authorities have permitted the UCITS to reduce the frequency to one a month).<sup>1</sup>

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<sup>1</sup> The Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) is available at [www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&cad=rja&uact=8&ved=0ahUKEwiBoIHvxJ\\_JAhUBLyYKHUEMDQgQFggdMAA&url=http%3A%2F%2Fec.europa.eu%2Finternal\\_market%2Finvestment%2Fdocs%2Fucits-directive%2Fdirective\\_2009\\_65\\_ec\\_en.pdf&usg=AFQjCNG7DgasxjWEU5tkGRUnBsOKEPZ\\_jQ&sig2=EK9zXJtZ2bCS8Xf\\_SGc5sQ](http://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&cad=rja&uact=8&ved=0ahUKEwiBoIHvxJ_JAhUBLyYKHUEMDQgQFggdMAA&url=http%3A%2F%2Fec.europa.eu%2Finternal_market%2Finvestment%2Fdocs%2Fucits-directive%2Fdirective_2009_65_ec_en.pdf&usg=AFQjCNG7DgasxjWEU5tkGRUnBsOKEPZ_jQ&sig2=EK9zXJtZ2bCS8Xf_SGc5sQ).

Articles 84(1) states that “A UCITS shall repurchase or redeem its units at the request of any unit-holder.” Article 84(2) further provides that “By way of derogation from paragraph 1: (a) a UCITS may, in accordance with the applicable national law, the fund rules or the instruments of incorporation of the investment company, temporarily suspend the repurchase or redemption of its units and; (b) a UCITS home Member State may allow its competent authorities to require the suspension of the repurchase or redemption of units in the interest of the unit-holders or of the public.”

Article 76 states that “A UCITS shall make public in an appropriate manner the issue, sale, repurchase or redemption price of its units each time it issues, sells, repurchases or redeems them, and at least twice a month. The competent authorities

Significantly more detail on this obligation is provided in the 2010 directive implementing the UCITV IV Directive (“UCITS Implementing Directive”).<sup>2</sup> Under the UCITS Implementing Directive, the management company of a UCITS (“ManCo”) (or its Board of Directors if the UCITS is “self-managed”) is required to establish, implement and maintain policies and procedures, including an adequate and documented risk management policy, that identifies the risks that the UCITS are and/or may be exposed to.<sup>3</sup> These policies are required to include the procedures necessary to enable the ManCo (or the Board) to assess the exposure of a UCITS to various risks, including liquidity risk. “Liquidity risk” is defined as the risk that a position in the UCITS portfolio cannot be sold, liquidated or closed at limited cost in an adequately short time frame and that the ability of the UCITS to comply at any time with its obligation under Article 84(1) of the UCITS Directive to redeem shares is thereby compromised.<sup>4</sup>

A risk management policy must, in turn, address at least:

- (1) the tools that enable the ManCo to comply with its obligations regarding the measurement and management of risk and calculation of global exposure relating to the UCITS, and
- (2) the allocation of responsibilities within the ManCo pertaining to risk management.

With respect to the risk management policy, a ManCo (or its Board of Directors, if the UCITS is “self-managed”) is required to assess, monitor and periodically review:

- (1) the adequacy and effectiveness of the risk management policy and of the measurement and management of risk and calculation of global exposure,
- (2) the level of compliance with the risk management policy and arrangements, and
- (3) the adequacy and effectiveness of measures taken to address any deficiencies in the performance of the risk management process.<sup>5</sup> A ManCo (or its Board of Directors, if the

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may, however, permit a UCITS to reduce the frequency to once a month on the condition that such derogation does not prejudice the interests of unit-holders.”

<sup>2</sup> Commission Directive 2010/43/EU of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council, available at

[www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&cad=rja&uact=8&ved=0ahUKEwjfjMmYanJAhWM5iYKHW6YBo4QFggdMAA&url=http%3A%2F%2Feur-lex.europa.eu%2FLEXUriServ%2FLEXUriServ.do%3Furi%3D0J%3AL%3A2010%3A176%3A0042%3A0061%3AEN%3APDF&usq=AFOjCNGDscjsteBHxxjZpRVaxZoisZxn2w&sig2=oS5MGvyatbOhZ3rNXxeaQA&bvm=bv.108194040.d.dmo](http://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&cad=rja&uact=8&ved=0ahUKEwjfjMmYanJAhWM5iYKHW6YBo4QFggdMAA&url=http%3A%2F%2Feur-lex.europa.eu%2FLEXUriServ%2FLEXUriServ.do%3Furi%3D0J%3AL%3A2010%3A176%3A0042%3A0061%3AEN%3APDF&usq=AFOjCNGDscjsteBHxxjZpRVaxZoisZxn2w&sig2=oS5MGvyatbOhZ3rNXxeaQA&bvm=bv.108194040.d.dmo).

<sup>3</sup> Article 38(1) of UCITS Implementing Directive.

<sup>4</sup> Article 3(8) of UCITS Implementing Directive.

<sup>5</sup> Article 39(1) of UCITS Implementing Directive.

UCITS is “self-managed”) is required to notify its Member State competent authority of any material changes to the risk management process.<sup>6</sup>

Specific to liquidity risk management, a ManCo (or its Board of Directors, if the UCITS is “self-managed”) must have an appropriate liquidity risk management process in order to ensure that each UCITS that it manages is able to comply, at any time, with its purchase/redemption requirement.<sup>7</sup> Further, the ManCo is required to conduct, where appropriate, stress tests that enable assessment of the liquidity risk of the UCITS, including under exceptional circumstances. To ensure that it can meet its obligations, a ManCo must, for each UCITS it manages, ensure that the liquidity profile of the investment of the UCITS is appropriate to the UCITS’ redemption policy as specified in the fund rules, the instruments of incorporation, or the prospectus.<sup>8</sup> As a matter of administrative practice, the UCITS also must include in its liquidity risk management process provisions regarding the daily monitoring of shareholder concentration for purposes of assessing liquidity risk.

The 2009 Risk Management Principles for UCITS issued by the Committee of European Securities Regulators (which became the European Securities and Markets Authority, “ESMA”) state that ongoing risk management operations involve the computation of a number of quantitative measures (the risk measurement framework), which generally aim to address the effects of market risk, credit (including issuer risk and counterparty risk) and liquidity risk.<sup>9</sup> However, there is no specific regulatory requirement to quantify liquidity risk.<sup>10</sup>

### *UCITS Regulatory Reporting*

In addition to the requirements described above, UCITS must also report certain statistics to their respective regulatory authority or central bank. For example, Irish UCITS must report certain statistics to the Central Bank of Ireland on a quarterly basis ten working days after the last day of the quarter.<sup>11</sup> Among the information that must be provided is an estimate of the fund’s liquidity, indicated as a percentage of the fund’s assets by value that can be disposed of at a price within 10% of its current market price in one of three time frames:

- (1) within 7 days,

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<sup>6</sup> Article 39(2) of UCITS Implementing Directive.

<sup>7</sup> Article 40(3) of UCITS Implementing Directive.

<sup>8</sup> Article 40(4) of UCITS Implementing Directive.

<sup>9</sup> CESR Guidelines Recital 31.

<sup>10</sup> The UCITS VI consultation requested feedback on whether UCITS requirements should be aligned with the AIFMD requirements (described below) on certain matters, such as liquidity management.

<sup>11</sup> Information about this investment fund return reporting obligation, referred to as the MMIF, is available at [www.centralbank.ie/polstats/stats/reporting/Pages/RevisedOFIReportingMMIFQuarterlyReturn.aspx](http://www.centralbank.ie/polstats/stats/reporting/Pages/RevisedOFIReportingMMIFQuarterlyReturn.aspx).

- (2) within one month but greater than 7 days, and
- (3) that cannot be sold within one month.<sup>12</sup>

## II. Alternative Investment Funds

The liquidity risk management requirements applicable to collective investment schemes that are not UCITS are contained in the Alternative Investment Fund Manager Directive (“AIFMD”), which outlines the responsibilities of alternative investment fund managers (“AIFM”) with respect to the alternative investment funds (“AIFs”) they manage.<sup>13</sup> The AIFMD, and its implementing regulation, contain detailed requirements regarding an AIFM’s liquidity risk management system, as well as disclosure to both investors and Member State regulators.

### *Liquidity Risk Management Requirements*

Under the AIFMD, an AIFM is required, with respect to each AIF it manages that is not an unleveraged closed-ended AIF, to:

- (1) employ an appropriate liquidity management system,
- (2) adopt procedures in order to monitor the liquidity risk of the AIF, and
- (3) ensure that the liquidity profile of the investments of the AIF complies with its underlying obligations.<sup>15</sup>

In addition, an AIFM must conduct stress tests under normal and exceptional liquidity conditions in order to enable the AIFM to assess and monitor the liquidity risk of the AIF accordingly.<sup>16</sup> Finally, an AIFM must ensure that, for each AIF that it manages, the investment strategy, the liquidity profile, and the redemption policy are consistent.<sup>17</sup>

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<sup>12</sup> Items 1.4.1, 1.4.2 and 1.4.3 of the MMIF.

<sup>13</sup> Article 4(1)(a) of the AIFMD defines an alternative investment fund as: any collective investment undertaking, including investment compartments thereof, which raises capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors and which does not require authorisation pursuant to the UCITS Directive.

<sup>14</sup> Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers (“AIFMD”), available at [eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32011L0061](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32011L0061).

<sup>15</sup> Article 16(1) of AIFMD. *See also* Articles 40 and 41 of the AIFMD Delegated Regulation providing more detail regarding the requirements for an AIFM’s risk management policy and the assessment, monitoring and review of the risk management system.

<sup>16</sup> Article 16(2) of AIFMD.

<sup>17</sup> Article 16(2) of AIFMD. The AIFMD Delegated Regulation further provides that these are considered to be aligned when investors have the ability to redeem their investments in a manner consistent with the fair treatment of all AIF investors and in accordance with the AIF’s redemption policy and its obligations. In making this assessment, an AIFM must



More detail on the measures that an AIFM is required to take are contained in the AIFMD Delegated Regulation.<sup>18</sup> First, an AIFMD must be able to demonstrate to its Member State regulator that it has implemented an appropriate liquidity management system and effective procedures that take into account the investment strategy, liquidity profile, and redemption policy of each AIF.<sup>19</sup> This liquidity management system (or programme of activity)<sup>20</sup> needs to ensure that:

- (1) the level of liquidity maintained in the AIF is appropriate to its underlying obligations,<sup>21</sup>
- (2) the liquidity profile of the portfolio of assets of the AIF is monitored on an ongoing basis,<sup>22</sup>
- (3) where the AIF invests in other collective investment undertakings, the AIFM monitors the approach adopted by the managers of those entities with respect to liquidity,<sup>23</sup>
- (4) appropriate liquidity measurement arrangements and procedures to assess quantitative and qualitative risks of positions with a material impact on the liquidity profile are maintained,<sup>24</sup> and
- (5) the AIFM puts into place the tools necessary to manage the liquidity risk of each AIF under its management.<sup>25</sup>

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also consider the impact that redemptions may have on the underlying prices or spreads of the individual assets of the AIF. Article 49(1) of AIFMD Delegated Regulation.

<sup>18</sup> Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision, available at [eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013R0231](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013R0231) (“AIFMD Delegated Regulation”).

<sup>19</sup> Article 46 of AIFMD Delegated Regulation.

<sup>20</sup> This is memorialized in a document submitted to the regulator for approval prior to fund launch.

<sup>21</sup> This determination is to be made based on an assessment of the relative liquidity of the AIF’s assets in the market, taking account of the time required for liquidation and the price or value at which those assets can be liquidated, and their sensitivity to other market risks or factors. Article 47(1)(a) of AIFMD Delegated Regulation.

<sup>22</sup> This monitoring should consider the marginal contribution of individual assets that may have a material impact on liquidity, and the material liabilities and commitments, contingent or otherwise, that the AIF may have in relation to its underlying obligations. Further, for these purposes the AIFMD must take into account the profile of the investor base of the AIF, including the type of investors, the relative size of investments and the redemption terms to which these investments are subject. Article 47(1)(b) of AIFMD Delegated Regulation.

<sup>23</sup> This review should include periodic reviews to monitor changes to the redemption provisions of the underlying collective investment scheme. Article 47(1)(c) of AIFMD Delegated Regulation.

<sup>24</sup> Specifically, the procedures need to ensure that the AIFM has the appropriate knowledge and understanding of the liquidity of the assets in which the AIF has invested or intends to invest including, where applicable, the trading volume and sensitivity of prices and, as the case may be, or spreads of individual assets in normal and exceptional liquidity conditions.

<sup>25</sup> The AIFM must identify the types of circumstances where the tools may be used in both normal and exceptional circumstances, taking into consideration the fair treatment of all investors. Further, the AIFM may use such tools only in the designated circumstances and if appropriate disclosures have been made.

The liquidity management system policy and procedures need to be documented, updated for any changes, and reviewed on at least an annual basis.<sup>26</sup> Lastly, the liquidity management system must include appropriate escalation measures to address anticipated or actual liquidity shortages or other distressed situations of the AIF.<sup>27</sup>

The AIFMD Delegated Regulation also specifies certain actions an AIFM must take with respect to liquidity management limits and stress tests. Where appropriate, considering the nature, scale, and complexity of an AIF, and AIFM needs to implement adequate limits for the liquidity or illiquidity of the AIF, and monitor for compliance with those limits.<sup>28</sup> An AIFM is also required to regularly conduct stress tests, both under normal and exceptional liquidity conditions, to enable it to assess the liquidity risk of each AIF under its management.<sup>29</sup>

### *Disclosure Requirements*

The AIFMD requires disclosure to both investors and regulators regarding liquidity risk management. Specifically, an AIFM is required to make available to AIF investors before they invest in the AIF, in accordance with the rules of the AIF or its instruments of incorporation (including any material changes thereto), a description of the AIF's liquidity risk management, including the redemption rights both in normal and in exceptional circumstances, and the existing redemption arrangements with investors.<sup>30</sup> In addition, for each AIF, an AIFM must periodically disclose to investors:

- (1) the percentage of the AIF's assets that are subject to special arrangements arising from their illiquid nature,
- (2) any new arrangements for managing the liquidity of the AIF, and
- (3) the current risk profile of the AIF and the risk management systems employed by the AIFM to manage those risks.<sup>31</sup>

Such disclosure must be made annually at a minimum.<sup>32</sup>

### *AIF Regulatory Reporting*

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<sup>26</sup> Article 47(2) of AIFMD Delegated Regulation.

<sup>27</sup> Article 47(3) of AIFMD Delegated Regulation.

<sup>28</sup> Article 48(1) of AIFMD Delegated Regulation.

<sup>29</sup> These stress tests must meet certain specified requirements. Article 48(2) of AIFMD Delegated Regulation.

<sup>30</sup> Article 23(1)(h) of AIFMD.

<sup>31</sup> Article 23(4) of AIFMD. Article 108 of AIFMD Delegated specifies further the actions and AIFM must take to comply with the investor disclosure required under Article 23(4) of the AIFMD.

<sup>32</sup> Article 108(4) of AIFMD Delegated Regulation.

An AIFMD also has an obligation to report certain information about its investments and liquidity management to its Member State regulator. With respect to each AIF, an AIFM must provide the following to the regulator:

- (1) the percentage of the AIF's assets that are subject to special arrangements arising from their illiquid nature,
- (2) any new arrangements for managing the liquidity of the AIF,
- (3) the current risk profile of the AIF and the risk management systems employed by the AIFM to manage the market risk, liquidity risk, counterparty risk and other risks including operational risk,
- (4) information on the main categories of assets in which the AIF invested, and
- (5) information on the results of the stress tests performed as specified above.<sup>33</sup>

AIFMD Delegated Regulation in Article 110 provides more detail on the information that must be provided to Member State regulators and the frequency of reporting, and includes the AIFM Reporting Template that specifies exactly the content and format of the disclosure.<sup>34</sup>

With respect to portfolio liquidity, for each AIF, the AIFM must specify the percentage of the portfolio capable of being liquidated within one of the following seven time periods:

- (1) 1 day or less,
- (2) 2-7 days,
- (3) 8-30 days,
- (4) 31-90 days,
- (5) 91-180 days,
- (6) 181-365 days, and
- (7) more than 365 days.<sup>35</sup>

Guidelines issued by the CESR on the reporting obligation clarify that, with respect to portfolio liquidity profile, each investment should be assigned to one period only and such assignment should be based on the shortest period during which such an investment could reasonably be liquidated at or near its carrying value, and that the total of all categories should equal 100%.<sup>36</sup>

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<sup>33</sup> Article 24(2) of AIFMD.

<sup>34</sup> The reporting template is available at [www.esma.europa.eu/content/Consolidated-AIFMD-reporting-template-revised](http://www.esma.europa.eu/content/Consolidated-AIFMD-reporting-template-revised).

<sup>35</sup> AIFMD Reporting Template items 178-185.

<sup>36</sup> ESMA Guidelines on reporting obligations under Articles (3)(3)(d) and 24(1), (2), and (4) of the AIFMD, paragraph 118, available at

[www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&cad=rja&uact=8&ved=0ahUKewjJof6H8KTKAhV](http://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&cad=rja&uact=8&ved=0ahUKewjJof6H8KTKAhV)

With respect to the investor liquidity profile, the AIFM must disclose, for each AIF, the percentage of investor equity that can be redeemed within (as a % of the AIF's NAV):

- (1) 1 day or less,
- (2) 2-7 days,
- (3) 8-30 days,
- (4) 31-90 days,
- (5) 91-180 days,
- (6) 181-365 days, and
- (7) more than 365 days.<sup>37</sup>

ESMA guidelines specify that AIFMs should divide the NAV of the AIF among the periods indicated depending on the shortest period within which the invested funds could be withdrawn or investors could receive redemption payments, as applicable, with the total equaling 100%. In making this calculation, AIFMs should assume that they would impose gates where they have the power to do so but that they would not suspend withdrawals/redemptions and that there are no redemption fees.<sup>38</sup> The Reporting Template further asks for information on whether the AIF provides investors with withdrawal/redemption rights in the ordinary course, and the frequency thereof, as well as the notice period required by investors for redemption and the length of any lock-up period.<sup>39</sup>

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[EKx4KHe6ICooQFggcMAA&url=https%3A%2F%2Fwww.esma.europa.eu%2Fsites%2Fdefault%2Ffiles%2Flibrary%2F2015%2F11%2F2014-869.pdf&usq=AFQjCNEaHhfKZ0-9EQ4qTfk9ix7qwcKM4A&sig2=DOMSSOxy--k1vVLRWk5uA&bvm=bv.111396085,d.dmo](https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-869.pdf&usq=AFQjCNEaHhfKZ0-9EQ4qTfk9ix7qwcKM4A&sig2=DOMSSOxy--k1vVLRWk5uA&bvm=bv.111396085,d.dmo). The ESMA Guidelines specify in paragraph 119 that if individual positions are important contingent parts of the same trade, AIFMs should group all of these positions under the liquidity period of the least liquid part.

<sup>37</sup> AIFMD Reporting Template items 186-192.

<sup>38</sup> ESMA Guidelines paragraph 120.

<sup>39</sup> AIFMD Reporting Template Items 193-196. The Reporting Template further requires information about any special arrangements and preferential treatment in Items 197-207.

## **Appendix D: Trade Flows and Operations in Europe As They Relate to Swing Pricing**

In Europe (especially for UK-, Ireland-, and Luxembourg-domiciled funds), funds successfully and widely use swing pricing in part because their operating models and distribution infrastructure permit them to obtain or derive accurate estimates or actual details on capital flows prior to the time they calculate their NAVs. The majority of shareholder trades in these locations are denominated in currencies (generally subscriptions), with a lesser percentage in share or unit amounts (generally redemptions). This commonality allows funds to estimate net capital flow activity for the day with a high level of accuracy.

The example below uses a Luxembourg-domiciled mutual fund and demonstrates how its model accommodates effective use of swing pricing.

1. 4:00 PM ET—10:00 PM CET is the fund's final cut-off for trading (subscription/redemption orders) through the electronic platform (SWIFT) instruction method. There are earlier cut-off times for other instruction methods such as manual and intermediary instructions.<sup>1</sup> This is in direct contrast to the U.S., where the 4:00 pm NYSE market closing time is typically the cut-off time for trading through all channels.<sup>2</sup>

There are instances where trades may arrive after the cut-off time, typically due to time zone differences for cross border trading or unexpected delays in system processing. These trades are an infrequent occurrence in Europe and represent a minor percentage of the overall capital flow. Funds have established procedures to address trades received after the cut-off time based on agreements with the fund intermediaries and business partners. For swing pricing purposes, trades received after the cut-off time are simply excluded from the calculation of net flow used to determine swing pricing. Over time, many funds have evaluated their procedures and capital flow activity and have determined that the capital flow information received by the fund's final cut-off is generally accurate.

2. Between 4:00 PM ET and 4:30 PM ET—10:00 PM and 10:30 PM CET, the fund gathers and reviews fund flow information (*e.g.*, flow reports, transfer agent files of actual and estimated transactions, intermediary trade flows) that provides a reliable estimate of the day's net capital flow and determines the fund's net capital activity for the day.

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<sup>1</sup> Depending on the fund and asset manager domicile, there are different practices across Europe regarding cut-off times for submitting orders. For example, some UK-domiciled funds will use the UK market closure as a cut-off for submitting orders.

<sup>2</sup> The consistent cutoff across all distribution channels in the U.S. is foundational to support the predominant intermediary-based fund distribution model and ensures equal treatment of all fund shareholders regardless of their choice of service model.

Unlike the U.S. market, European distributor systems and processes are typically not dependent upon receipt of the fund's current-day NAV to provide daily estimated capital flows to the funds. For example, unit-based orders trading in Europe are converted to monetary value, generally by the intermediary, based on the prior day's NAV; this is possible because of the time window between trading cutoff and the start of the fund valuation process, and the availability of systems that support such processes.

The determination of swing pricing applicability occurs once sufficient capital flow information is received. The fund's valuation process (*i.e.*, calculation of the fund's NAV) is completed concurrently or soon thereafter.

3. By 7:00 PM ET—11:00 AM CET,<sup>3</sup> the fund valuation process is completed, and an indicative NAV is provided to the fund manager by the fund accounting agent, including application of a swing factor, if necessary. Once the fund manager has completed its review of and approved the NAV calculation, the final NAV is published, typically by 9:00 pm ET (3:00 am CET). In contrast, U.S. mutual funds attempt to complete their valuation process and publish their final NAVs by 6:00 pm ET to allow intermediaries to determine NAVs for any intermediary-created unitized products that may hold mutual funds as securities, price and create exchanges, convert share- and percentage-based orders, and begin processing of retirement (*e.g.*, defined contribution) instructions.

This example demonstrates that the operating model for determining fund flow information in Europe benefits from extended time between trading cut off and initiation of the fund's NAV valuation process. This timing, as well as the systems environment, permits those funds who use swing pricing to incorporate estimates of most shareholder activity into a daily net capital flow calculation. The result is a more fully informed determination of swing thresholds and, if warranted, swing pricing application.

The following table compares the key points in trading, valuation, NAV dissemination, and intermediary interaction between the European and U.S. mutual fund markets:

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<sup>3</sup> The timing of the valuation process may vary depending on product types, fund company practices, and the fund's domicile.

**U.S. vs. European fund trading and valuation models**

<i>Key Attributes</i>	<i>Europe</i>	<i>U.S.</i>
Trading cut off time(s)	Different cut off times <sup>4</sup> , with final cut off at US market close (i.e., 4:00 PM ET). <sup>5</sup>	Single cut off typically at market close (i.e., 4:00 PM ET)
<i>Determination of net capital flow</i>	4:00 PM ET – 6:00 PM ET using estimated and actual flow data from transfer agent and intermediaries	N/A
<i>NAV calculation begins</i>	4:00 PM ET - 6:00 PM ET, includes applying swing factor (if applicable)	4:00 PM ET
<i>Time between trading cut off and NAV calculation</i>	Varies between 0-2 hours	N/A
<i>Final NAV review and dissemination</i>	By 9:00 PM ET <sup>6</sup>	6:00 PM ET target; most NAVs are disseminated by 8:00 PM ET
<i>Role of Intermediaries</i>	<p>2:00 PM ET – 4:00 PM ET Provide estimated net capital flow information to funds</p> <p>By 2:00 AM ET (T+1) Complete processing of orders, transmit final trades to funds.</p>	<p>8:00 PM ET – By 6:00 AM ET (T+1)<sup>7</sup> Intermediaries with unitized products (Collective Investment Trusts;<sup>8</sup> Funds of Funds) create NAVs</p> <p>Retirement intermediaries convert instructions to orders and process orders; create aggregate subscriptions and/or redemptions; transmit final trades to funds.</p> <p>Omnibus intermediaries process individual orders; create aggregate subscriptions and/or redemptions; transmit final trades to funds.</p>

<sup>4</sup> Depending on the fund, asset manager domicile, asset manager’s product ranges, and trade delivery methods, there are different practices across Europe regarding cut-off times for submitting trades.

<sup>5</sup> Due to time zone differences between local domiciles and U.S. ET, most trading activity is usually known to the fund well before the final trading cut off time.

<sup>6</sup> An indicative NAV is typically provided to the fund manager by the fund accountant by 7:00 pm ET. Once reviewed and approved by the fund manager it is released to intermediaries and other parties by 9:00 pm ET.

<sup>7</sup> Intermediary systems currently do not provide estimated net capital flow information to funds. Systems typically require a current-day NAV to value and process today’s transaction activity.

<sup>8</sup> An A2 fund (i.e., Collective Investment Trust) is established under 12 CFR 9.18(a)(2) and may consist only of assets of retirement, pension, profit sharing, stock bonus, or other trusts that are exempt from federal income tax. (Source: Office of the Comptroller of the Currency Asset Management Handbook: Collective Investment Funds, May 2014, Page 39.)

## **Appendix E: Swing Pricing – Rules and Guidelines Outside the United States**

In this Appendix, we broadly describe swing pricing approaches permitted in certain countries around the world, including Member States in the European Union (“EU”). According to a recent IOSCO survey of twenty-six countries, there are eleven countries that permit swing pricing, the majority of which are in Europe.<sup>1</sup>

The Financial Services Authority (“FSA”) in the United Kingdom, in 2002, appears to have been the first authority to publicly consult on swing pricing and adopt rules to allow it. The authorities in the other three largest EU domiciles for funds authorized under the UCITS Directive (“UCITS”) – France, Ireland and Luxembourg – allow swing pricing, either implicitly or explicitly, and these funds may be distributed in countries outside the EU. In some Member States, industry associations have produced standards or best practices for swing pricing. At the same time, we understand that some Member States do not permit this practice *e.g.*, Germany.<sup>2</sup> Switzerland allows only full swing pricing, meaning an adjustment is made to the fund’s price each day there is net capital flow irrespective of the size of that flow. Within Asia, swing pricing may be used in Hong Kong and Singapore, although there are no specific regulations governing the practice. According to the IOSCO Survey, swing pricing is not available in Australia, China or Japan. Swing pricing also is unavailable in India and Canada.<sup>3</sup>

### **EU – Fund Pricing and Valuation**

In the EU, some UCITS and retail investment funds available under national rules and the Alternative Investment Fund Managers Directive (“AIFMD”) utilize swing pricing. While there are pricing and valuation provisions in the UCITS Directive, there is no explicit provision on swing pricing. The following UCITS Directive articles address pricing and valuation.

- Calculation of Value and Price (Articles 85 and 87). The rules for the valuation of assets and for calculating the subscription or redemption price of UCITS units shall be laid down in the

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<sup>1</sup> See IOSCO, Liquidity Management Tools in Collective Investment Schemes: Results from an IOSCO Committee 5 survey to members, FR 28/2015, December 2015, available at [www.iosco.org/library/pubdocs/pdf/IOSCOPD517.pdf](http://www.iosco.org/library/pubdocs/pdf/IOSCOPD517.pdf), at 4 (“IOSCO Survey”) (Countries allowing swing pricing: France, Hong Kong, Ireland, Italy, Jersey, Luxembourg, Mexico, Netherlands, Singapore, Switzerland and the United Kingdom). In the United States, the Office of the Comptroller of the Currency (“OCC”) has permitted collective investment trusts to charge individual participants with the cost of entering or exiting a fund with express approval from the OCC. Such approvals with conditions have been granted to national banks administering index and model-driven funds. The OCC has addressed permitted costs in interpretive letters, but not calculation methodologies. See OCC, Trust Interpretive Letter 228 (Aug. 8, 1989); OCC, Interpretive Letter 919 (Nov. 9, 2001); OCC, Interpretive Letter 1120 (Feb. 20, 2009). See also Comptroller’s Handbook, Fiduciary Activities, Fiduciary Precedent 9.5980 (Sept. 1990).

<sup>2</sup> See IOSCO Survey. In addition, swing pricing raises questions under German tax rules and may need to be excluded from German tax reporting. See ALFI 2015 Paper at 31-32. The ALFI 2015 Paper is available at [www.alfi.lu/sites/alfi.lu/files/Swing-Pricing-guidelines-final.pdf](http://www.alfi.lu/sites/alfi.lu/files/Swing-Pricing-guidelines-final.pdf).

<sup>3</sup> IOSCO Survey at 4.



applicable Member State law, in the fund rules or in the articles of incorporation of the fund. A UCITS cannot issue a share unless the equivalent of the net issue price is paid to the fund on a timely basis.

- Frequency of Pricing (Article 76). A UCITS must make public the price by which it redeems or sells units at least twice a month. Member State authorities may permit a reduction in frequency to once a month as long as the change does not prejudice the interests of unitholders.
- Depository Obligations (Article 22). The depository must ensure that the value of the UCITS' units are calculated in accordance with applicable Member State law and the fund rules or instrument of incorporation.
- Prospectus Disclosure (Article 71 and Annex 1, Schedule A). Various information must be set forth in the prospectus including procedures and conditions for the issuance of shares and rules for valuation and pricing (*e.g.*, method and frequency of pricing, purchase and redemption charges).

Similarly, the AIFMD includes provisions on valuation, the responsibilities of the depository with regard to valuation and requirements related to investor disclosure on valuation and pricing, but it does not explicitly address swing pricing.<sup>4</sup> Like the UCITS Directive, under Article 19 of the AIFMD, the rules applicable to the valuation of assets of an alternative investment fund (“AIF”) and the calculation of the NAV of a unit or share of an AIF are determined by the law of the country where the AIF is established and/or in the AIF’s rules or instruments of incorporation. Member State rules on valuation can, and do, differ.

Accordingly, for UCITS and AIF, the permissibility of, and any details for, swing pricing are addressed at the Member State level.

## **Summaries For European Jurisdictions**

Below, we provide background on swing pricing as well as general descriptions of the current rules or approaches in France, the United Kingdom, Luxembourg, Ireland and Switzerland. In these country summaries, we seek to highlight areas of common approach and areas where one country has a rule or approach that is distinguishable from the others. The required disclosure in the United Kingdom is notably different from the disclosure approaches in France and Luxembourg. In France and Luxembourg, as compared to the United Kingdom, there has been more focus on governance and the calculation of the swing pricing adjustment. In France, while the industry association authored the code of conduct, we understand the code can be a basis for regulatory sanction. In Luxembourg, there has been significant ongoing work since 2006 by industry to identify practices related to the swing

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<sup>4</sup> See generally Directive 2011/61/EU, June 8, 2011 (“AIFM Directive” or “AIFMD”), Articles 19 (valuation), 21 (depository) and 23 (disclosure to investors) available at [eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32011L0061&from=EN](http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32011L0061&from=EN).

factor and threshold, governance and operational topics as well as the consideration of issues arising from fund structures, reporting and transparency. In Switzerland, only full swing pricing is allowed.

As additional background on the UCITS market and how it compares with the US mutual fund market, it is important to appreciate that UCITS are sold across the EU as well as globally, including in Asia and Latin America.<sup>5</sup> Generally, we understand that UCITS have a higher institutional investor presence than do US mutual funds.<sup>6</sup> UCITS also tend to be smaller and are more likely to be invested in fixed income securities. The average US mutual fund has assets of \$1.83 billion and the median fund has \$281 million in assets. In comparison, the average UCITS has \$392 million in assets and the median fund holds \$86 million.<sup>7</sup> At the end of 2014, 52 percent of US mutual fund assets were in equity funds, while in the EU, 36 percent of UCITS assets were in equity funds and approximately 46 percent of UCITS assets were in bond or balanced funds.<sup>8</sup> UCITS and US mutual funds have similar average and median numbers of share classes but UCITS are offered with different currency denominated classes which better accommodate cross border sales.<sup>9</sup> We understand that some of these characteristics, such as the smaller UCITS size alongside the higher institutional investor presence, have influenced the attractiveness of, or the need for, swing pricing and other anti-dilution tools. Operational differences in the receipt and processing of fund orders between the United States and the EU also have influenced the use of swing pricing and are described in the comment letter and in an appendix.

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<sup>5</sup> Lipper, Thompson Reuters, Symbiosis in the Evolution of UCITS 1988-2018: Three Decades of Funds Industry Transformation, available at [www.alfi.lu/sites/alfi.lu/files/Lipper-FMI-report-Symbiosis-in-the-evolution-of-UCITS.pdf](http://www.alfi.lu/sites/alfi.lu/files/Lipper-FMI-report-Symbiosis-in-the-evolution-of-UCITS.pdf) at 28-29. Total UCITS assets as of the end of September 2015 were \$8.7 trillion compared with total US open-end registered investment company (or mutual fund and ETF) assets of \$17.2 trillion for the same period. Data from the European Fund and Asset Management Association (EFAMA) and the International Investment Funds Association (IIFA) available at [www.efama.org/Publications/Statistics/Monthly/Monthly%20Fact%20Sheets/EFAMAFactSheet\\_Sept2015.pdf](http://www.efama.org/Publications/Statistics/Monthly/Monthly%20Fact%20Sheets/EFAMAFactSheet_Sept2015.pdf) and [Table 2.1 at www.ici.org/info/ww\\_report\\_q3\\_15.xls](http://www.ici.org/info/ww_report_q3_15.xls).

<sup>6</sup> In addition, as reported by EFAMA, EU households invest less of their wealth in investment funds compared with US households. As of the end of 2013, EU households invested less than 10% of their wealth in investment funds and held more than 40% of their assets in bank deposits and currency. EFAMA, Asset Management in Europe, 8<sup>th</sup> Annual Review, April 2015, at 11, available at [www.efama.org/Publications/Statistics/Asset%20Management%20Report/150427\\_Asset%20Management%20Report%202015.pdf](http://www.efama.org/Publications/Statistics/Asset%20Management%20Report/150427_Asset%20Management%20Report%202015.pdf). This contrasts with US households which held, as of the end of 2014, 24% of their assets in investment companies. ICI, Fact Book 2015, available at [www.icifactbook.org/](http://www.icifactbook.org/) at 11, Figure 1.3.

<sup>7</sup> ICI and ICI tabulation of Strategic Insight Global database.

<sup>8</sup> ICI, Fact Book 2015, available at [www.icifactbook.org/](http://www.icifactbook.org/) at 175 (Table 3 Total Net Assets of the Mutual Fund Industry); EFAMA, Monthly Fact Sheet, available at [www.efama.org/Publications/Statistics/Monthly/Monthly%20Fact%20Sheets/150219\\_EFAMA%20Monthly%20Fact%20Sheet%20December%202014.pdf](http://www.efama.org/Publications/Statistics/Monthly/Monthly%20Fact%20Sheets/150219_EFAMA%20Monthly%20Fact%20Sheet%20December%202014.pdf).

<sup>9</sup> For share classes, US mutual funds and UCITS have similar average and median numbers of share classes – 3 is approximately the average and 2 the median – but the maximum in the United States is 17 and in the EU it is 110. The average number of currency share classes is 3 for funds with 2 or more classes, with a maximum of 16. ICI tabulation of Strategic Insight Global database.

## France

Background. In 2013, the Autorité des marchés financiers (“AMF”) authorized the use of swing pricing and dilution levies for UCITS and AIF.<sup>10</sup> The authorization was part of the Guide des mesures de modernisation apportées aux placements collectifs français published in July 2013 (“AMF 2013 Measures”).<sup>11</sup> The authorization did not require amendments to French law or to the AMF General Regulation. Instead, the AMF 2013 Measures directed fund managers to comply with good practices to be published by the Association Française de la Gestion (“AFG”). The use of swing pricing or levies does not require AMF approval. Nevertheless, where the level of subscription or redemption fees change, such as with a levy, notice of the fee change and an offer to exit without costs or fees must be given to all investors. For swing pricing, only notice to investors is expected. Although the adjustment costs are identified in the same way for a levy or a swing adjustment,<sup>12</sup> no offer to exit for the introduction of swing pricing would be expected under AMF rules because a swing adjustment is part of valuation, not a change in the fund’s subscription or redemption fees.<sup>13</sup> The AMF can impose sanctions for breaches or deviations from the AFG’s good practices.

AFG Code of Conduct. In 2014, the AFG published a Code of Conduct for Fund Swing Pricing and Anti-Dilution Levies (“AFG Code”).<sup>14</sup> Notable AFG Code provisions for swing pricing include:

- *Full or partial swing pricing.*
  - Full or partial swing adjustments are permitted.

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<sup>10</sup> In 2013 when announcing the transposition of the AIFM Directive, the AMF stated that it had undertaken measures to improve the attractiveness of Paris as a marketplace and to improve AIF liquidity including measures to implement an anti-dilution levy and swing pricing ([www.amf-france.org/en\\_US/Reglementation/Dossiers-thematiques/Epargne-et-prestataires/Gestion-alternative/La-directive-AIFM-est-en-vigueur-en-France.html](http://www.amf-france.org/en_US/Reglementation/Dossiers-thematiques/Epargne-et-prestataires/Gestion-alternative/La-directive-AIFM-est-en-vigueur-en-France.html) and [www.amf-france.org/Publications/Guides/Professionnels.html?docId=workspace%3A%2F%2FSpacesStore%2F923b0a56-73bd-428e-9ed7-ec2ee814148b](http://www.amf-france.org/Publications/Guides/Professionnels.html?docId=workspace%3A%2F%2FSpacesStore%2F923b0a56-73bd-428e-9ed7-ec2ee814148b)).

<sup>11</sup> The AIFMD was transposed into French law in 2013 and effective in 2014.

<sup>12</sup> See AFG Code at paragraphs 1 and 1.1 (total estimated costs related to subscriptions and redemptions is identical for swing pricing and dilution levies).

<sup>13</sup> See AMF, Directive AIFM, *Guide des mesures de modernization apportees aux placements collectifs francais*, July 2013 available at [www.amf-france.org/Publications/Guides/Professionnels.html?docId=workspace%3A%2F%2FSpacesStore%2F923b0a56-73bd-428e-9ed7-ec2ee814148b](http://www.amf-france.org/Publications/Guides/Professionnels.html?docId=workspace%3A%2F%2FSpacesStore%2F923b0a56-73bd-428e-9ed7-ec2ee814148b) (only in French).

<sup>14</sup> The AFG Code is available in French only at [www.afg.asso.fr/index.php?option=com\\_content&view=article&id=5550%3Acharte-de-bonne-conduite-pour-le-swing-pricing-et-les-droits-dentree-et-de-sortie-ajustables-acquis-aux-fonds-&catid=58%3Azoom&lang=en](http://www.afg.asso.fr/index.php?option=com_content&view=article&id=5550%3Acharte-de-bonne-conduite-pour-le-swing-pricing-et-les-droits-dentree-et-de-sortie-ajustables-acquis-aux-fonds-&catid=58%3Azoom&lang=en).

- For partial swing pricing, a fund’s policy must specify the rules defining the thresholds, which can vary to reflect market conditions and must limit the ability of investors to take undue advantage of movements due to knowledge of the technique.<sup>15</sup>
- *Adjustment Calculation.*
  - The adjustment is based on net purchases or redemptions, reflecting actual or estimated transactions in proportion to the fund’s assets or in proportion to the benchmark of the fund.
  - The methodology for allocating and calculating costs can distinguish between transactions in-kind versus cash and take into account “net” balances for investors acting in opposite directions.<sup>16</sup>
  - Eligible costs include transaction costs, bid-ask prices, tax, by asset class, market segment (*e.g.*, country, sector, maturity) or by security.
  - The calculation must be documented and supported with data.
  - Any calculation of the liquidity cost must take into account the fund valuation policy, *e.g.*, valuation by “mid” or “bid.”<sup>17</sup>
- *Governance.* A fund’s policy must specify the costs taken into account, the calculation methodology and rules regarding the allocation of costs among incoming, outgoing and remaining investors. The metrics must be based on data and at a minimum, reviewed twice a year.<sup>18</sup>
- *Conflicts.* The manager must have a policy to identify and manage conflicts of interest, and ensure that no one can exploit information about purchases and redemptions to their benefit.<sup>19</sup>
- *Disclosure.* Funds must indicate that they use swing pricing and the general principles underlying it. The detail provided, including recent metrics, should not allow investors to benefit inappropriately by adjusting their orders.<sup>20</sup> When swing pricing is used, only the swung NAV can be communicated to investors and consequently performance figures and risk indicators also must be calculated on the swung NAV.<sup>21</sup>

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<sup>15</sup> AFG Code, Section III, paragraph 1.3.

<sup>16</sup> AFG Code, Section III, paragraph 1.4.

<sup>17</sup> AFG Code, Section III, paragraph 1.1.

<sup>18</sup> AFG Code, Section III, paragraph 2.

<sup>19</sup> AFG Code, Section III, paragraph 3. The AFG Code also identifies the possible conflict of interest where there is purchase and redemption activity that may be used to increase or decrease the fund’s NAV to influence performance, for example in relation to the fund’s benchmark or in comparison with other funds. *Id.*

<sup>20</sup> AFG Code, Section III, paragraph 4.2.

<sup>21</sup> AFG Code, Section IV, paragraph 1. Performance fees should be calculated using the unswung NAV. *Id.*

## United Kingdom (UK)

Background. In October 2001, the FSA issued a paper on possible changes to the single pricing regime for funds. At the time, UK open-end investment companies were using a single pricing methodology based on a mid-market valuation and managers were able, but not required, to recover dilution costs with a separate levy on purchases or sales payable to the fund.<sup>22</sup> The FSA had concerns that the regime did not provide sufficient transparency on dealing costs. On dilution levies, the FSA raised questions because the levies were not automatically imposed on all transacting investors and typically were imposed only on large investors.

In practice, dilution was reported to be quite small. The FSA noted dilution could be more significant on small, growing or shrinking funds or those investing in markets with high dealing costs.<sup>23</sup> On swing pricing, the FSA put forth the following:

- Swing pricing provides in a simple and transparent way the same price for all investors, buying or selling.
- Swing pricing eliminates manager discretion because it applies to all transacting investors on a given day.
- To the extent managers find it easier and make fuller use of it, swing pricing better protects continuing investors.
- While the current regime separates charges and duties from the price and is transparent, a swing pricing adjustment would not be separately identified and investors could be confused by large inexplicable NAV swings.
- When swing pricing is permitted, steps would be necessary to ensure investors that swings are reasonable, *e.g.*, a requirement that the adjustment to the mid-market price should be no more than the dealing price and associated costs of shrinking or growing the fund for the valuation period. This could be supported by “information about boundaries,” together with a reasonable description of the fund’s pricing policy.
- The monetary value of adjustments made to mid-market should be disclosed in a fund’s report and accounts (like the accounting requirement for dilution levies).
- A full swing approach could be required but given that dilution cannot be calculated precisely until after the event, estimates must be used. So since the scale of dilution tends to be small, the manager should have the discretion to make a swing adjustment.<sup>24</sup>

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<sup>22</sup> FSA Discussion Paper 08, Single Pricing of Collective Investment Schemes: A Review (October 2001), available at [www.fsa.gov.uk/pubs/discussion/dp8.pdf](http://www.fsa.gov.uk/pubs/discussion/dp8.pdf) (“DP 08”) at 3.

<sup>23</sup> DP 08 at 18.

<sup>24</sup> DP 08 at 24-25.

Other options under evaluation included prohibiting dilution levies,<sup>25</sup> requiring dilution levies,<sup>26</sup> and a “minimalist” approach – single price but leave the manner of compensation for dilution to disclosure.<sup>27</sup> The FSA’s preliminary view was that swing pricing had advantages – confusion over the levy would be eliminated, continuing investors would be better protected and the UK industry’s competitiveness would be improved. While transparency would be lost, the FSA believed current transparency did not help investor understanding and that limiting the adjustment to the mid-market price could be reassuring.<sup>28</sup>

In 2002, the FSA proposed amendments to give fund managers the option to use levies, swing pricing or neither technique.<sup>29</sup> The FSA stated that, while dilution is typically small,<sup>30</sup> there are a variety of funds and investor dealing patterns as well as a variety of manager attitudes as to whether dilution costs should be recovered, so it proposed a choice. Overall, neither option had significant advantages over the other and providing a choice, with safeguards, was better.<sup>31</sup> To address transparency, the FSA proposed disclosure, including related to the frequency of a levy or adjustment, the maximum and a usual rate.<sup>32</sup> Later that year, the FSA formally introduced the option to use swing pricing, adopting the rules as proposed with minor changes.<sup>33</sup> On disclosure, the FSA allowed estimates and disclosure on the likelihood of dilution being collected to be made on a historic basis or estimated.<sup>34</sup>

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<sup>25</sup> See DP 08 at 24 (The FSA noted that prohibiting levies would remove confusion and be less complex for managers but would remove a tool for mitigating dilution, which seemed unfair to continuing investors.).

<sup>26</sup> See DP 08 at 24-25 (On requiring a levy, the FSA believed such an approach could be more equitable but because they are hard to calculate and cannot be quantified in advance such an approach would increase costs and not solve investor confusion.).

<sup>27</sup> See DP 08 at 25 (This “free for all” approach concerned the FSA in part because it could make comparability among investment products harder and, further, the FSA was reluctant to rely on disclosure alone.).

<sup>28</sup> DP 08 at 27.

<sup>29</sup> FSA Consultation Paper 131, Single Pricing of Collective Investment Schemes: Proposed Amendments, Feedback on DP 08 (March 2002), available at [www.fsa.gov.uk/pubs/cp/cp131.pdf](http://www.fsa.gov.uk/pubs/cp/cp131.pdf) (“CP 131”).

<sup>30</sup> On calculating dilution, commenters agreed dilution was difficult to calculate. In response to a survey, firms representing 26% of total UK investment company variable capital funds under management (a type of open-end fund) responded that average dilution was approximately 0.19% annually, ranging from 0.127% for funds with small dilution to 0.384% for funds with large dilution. CP 131 at 13-14. Using the dilution estimates, the FSA estimated that the cost of switching to swing pricing and losing the “windfall benefit” of the current system over 7 years amounted to approximately 0.06% per annum of their investment. CP 131 at 28.

<sup>31</sup> CP 131 at 4, 17-18.

<sup>32</sup> CP 131 at 3-4, 18-19.

<sup>33</sup> FSA Policy Statement, Single Pricing of Collective Investment Schemes, Feedback on CP 131 and made text (July 2002) available at [www.fsa.gov.uk/pubs/cp/cp131.pdf](http://www.fsa.gov.uk/pubs/cp/cp131.pdf).

<sup>34</sup> CP 131 at 11.

UK Rules – FCA Handbook, COLL Collective Investment Schemes<sup>35</sup> The UK rules for fund valuation and pricing permit managers to mitigate the effects of dilution. Each class of shares and sub-fund must have the same method of pricing.<sup>36</sup> The price of a share must be calculated by reference to the fund's net value and in accordance with its constituting documents and its prospectus and be expressed in a form that is accurate to at least four significant figures.<sup>37</sup> The value of a single priced fund should reflect the mid-market value of investments.<sup>38</sup> The UK rules explicitly permit managers to impose dilution levies, swing pricing adjustments or neither of the two.<sup>39</sup>

- *Full or partial swing pricing.* A dilution adjustment may be made as part of the calculation of the unit price to reduce dilution or recover any amount paid or expected to be paid to issue or cancel units.<sup>40</sup>
- *Adjustment Calculation.* Dilution adjustments can reflect amounts paid or estimates of the costs to issue or cancel units.<sup>41</sup>
- *Governance/Conflicts.* The manager must operate the technique in a fair manner and solely to reduce dilution. The decision to make an adjustment cannot be used to create a profit or loss for an account. The manager must provide the adjustment to the depositary as soon as possible after valuation.<sup>42</sup>
- *Disclosure.* Specific information must be included in the prospectus including a statement on the likelihood that the fund will make an adjustment and the basis, historical or projected, for the statement as well as the estimated rate or amount of the adjustment based on historical data or future projections.<sup>43</sup> Also the prospectus should

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<sup>35</sup> We generally refer to the FCA Handbook, Sourcebook, COLL Collective Investment Schemes, available at [www.handbook.fca.org.uk/handbook/COLL/](http://www.handbook.fca.org.uk/handbook/COLL/), as "UK Rules."

<sup>36</sup> COLL 6.3.2 G.

<sup>37</sup> COLL 6.3.5 R. *See also* COLL 6.3.5A R (single priced funds cannot sell for more than the price plus preliminary charges or redeem for less than the price less any redemption charge or deductions); COLL 6.3.6 G (a single priced fund should reflect mid market value of investments and guidance on fair value).

<sup>38</sup> COLL 6.3.6 G.

<sup>39</sup> COLL 6.3.8 R.

<sup>40</sup> COLL 6.3.8 R.

<sup>41</sup> *Id.*

<sup>42</sup> COLL 6.3.8 R The FCA's rules also expressly permit higher sales or lower redemption prices for large deals (as defined in a prospectus) provided they do not exceed relevant parameters. COLL 6.3.5C G and FCA Glossary Handbook.

<sup>43</sup> *See also* Investment Association, Position Paper: Meaningful Disclosure of Costs and Charges (February 2015) (transaction costs shall be presented on a basis that makes a clear distinction between what can be known with certainty (historical figures) and what only can be estimated and charges and transaction costs shall be separately identifiable) available at <file:///C:/Users/solson/Downloads/20150210-iacostsandchargesreport.pdf>; IMA Enhanced Disclosure of Fund Charges and Costs (September 2012) (to enhance comparability among funds which can have dual pricing, swinging single pricing or single pricing with levies, a dilution levy should not be disclosed as an entry or exit charge; rather, amounts

include a description of the manager’s policy for when a dilution adjustment may be made.<sup>44</sup>

## **Luxembourg**

In 2004, the CSSF published Circular 04/146 on the protection of funds and their investors against market timing and late trading.<sup>45</sup> While the use of subscription and redemption charges, along with increased transaction monitoring and “fair value” pricing, were mentioned as possible solutions, swing pricing was not explicitly addressed. The Association of the Luxembourg Fund Industry (“ALFI”), however, through a working group, went on to develop guidelines on swing pricing in 2006 (“ALFI 2006 Paper”),<sup>46</sup> an update in 2011, along with results of a survey (“ALFI 2011 Paper”) and, most recently another update in December 2015 (“ALFI 2015 Paper”). The ALFI 2015 Paper is based on meetings with practitioners operating swing pricing and there was also a survey of Luxembourg asset managers.<sup>47</sup> For managers deciding to use swing pricing, the ALFI 2015 Paper is intended to provide guidance on key elements to be considered and recommended standards of best practice.<sup>48</sup>

For the ALFI work in 2015, a survey was distributed to 65 Luxembourg asset managers and 45 responses were received, accounting for 69% of Luxembourg assets under management. Of the 45, there were 30 that used swing pricing. Some of the relevant findings included:

- Of the 45 respondents, there is a strong bias by asset managers of US, UK, French and Swiss origin to apply swing pricing, while Belgian, German, and Italian asset managers tend not to apply swing pricing. Of the 15 managers that do not currently apply swing pricing, seven are considering implementing it, and four have included permission for it in their prospectus but currently don’t operate it.
- All respondents that use swing pricing apply it on UCITS fund ranges, while only 37% apply it to AIF. It is applied to various asset classes. The main driver for determining which fund ranges or asset classes to apply it to is the practicality of applying swing pricing to certain asset classes and product types, as well as the costs and benefits of doing so.
- 97% of respondents who apply swing pricing use the partial swing pricing method either exclusively or in addition to the full swing pricing method, primarily to prevent the NAV volatility created by full swing.

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recovered from transacting investors should be disclosed in a comparable way in the pricing policy notes) available at [file:///C:/Users/solson/Downloads/20120920-enhanceddisclosureoffundchargesandcosts%20\(4\).pdf](file:///C:/Users/solson/Downloads/20120920-enhanceddisclosureoffundchargesandcosts%20(4).pdf).

<sup>44</sup> COLL 4.2.5 18 R.

<sup>45</sup> CSSF Circular 04/146, Protection of undertakings for collective investment and their investors against late trading and market timing practices, June 17, 2004, available at [www.cssf.lu/en/documentation/regulations/circulars/info/article/592/](http://www.cssf.lu/en/documentation/regulations/circulars/info/article/592/)

<sup>46</sup> ALFI 2006 Paper, page 4. This paper is no longer available on ALFI’s website but a copy is attached to this public comment letter, [www.sec.gov/comments/s7-11-09/s71109-37.pdf](http://www.sec.gov/comments/s7-11-09/s71109-37.pdf).

<sup>47</sup> The ALFI 2015 Paper is available at [www.alfi.lu/sites/alfi.lu/files/Swing-Pricing-guidelines-final.pdf](http://www.alfi.lu/sites/alfi.lu/files/Swing-Pricing-guidelines-final.pdf) and the ALFI 2015 Survey is available at [www.alfi.lu/sites/alfi.lu/files/ALFI-Swing-Pricing-Survey-2015-FINAL.pdf](http://www.alfi.lu/sites/alfi.lu/files/ALFI-Swing-Pricing-Survey-2015-FINAL.pdf) (“ALFI 2015 Survey”).

<sup>48</sup> ALFI 2015 Paper at 6.



- 80% of asset managers that apply swing pricing use a pre-determined swing factor to apply the swing adjustment; 7% use a method that values the portfolio at bid or offer prices and add actual transaction costs incurred; and 13% differentiate which method they use by product type.
- When considering the constituent components of swing factors, all asset managers calculate these based on a combination of bid-offer spread impacts, transaction costs and transaction taxes associated with purchasing or selling portfolio investments. 80% of the respondents that apply swing pricing use all three components in their factors.
- Approximately half of respondents that use swing pricing cap the level of the swing factor applied on certain asset classes, with equity, fixed income and multi-asset funds most commonly capped at 2%.
- With respect to a swing threshold, the most commonly applied threshold is 1% or less, with over half of all respondents applying a threshold interval of 3% or less. The majority do not disclose thresholds to avoid attempted arbitrage by investors.
- Almost 50% of respondents that use swing pricing disclose swing factor information upon client request, but most do not disclose this in formal fund documentation because it quickly becomes stale.
- Regarding NAV publication, only one NAV is published (whether or not swing pricing was applied) almost unanimously; only a few asset managers disclose whether the NAV was swung on the day of publication; and 30% have a process to tell investors whether the NAV had been swung after the fact.
- Almost half of asset managers review swing factors on a quarterly basis and 80% have the ability to update swing factors when required depending on market conditions.
- The majority of respondents that use swing pricing have set up a standalone valuation and swing pricing committee to oversee how the swing pricing policy is applied and monitored. Of these, 70% operate a single committee responsible for the governance of swing pricing for multiple fund ranges. Such committees often have participation of board members and senior management from within the organization.
- 43% of respondents that use swing pricing rely on the fund administrator to determine whether or not a fund should swing on a day-to-day basis, in 27% of the cases the management company decides, and the remainder rely on a mixture of the administrator, the management company and the transfer agent.
- 43% of asset managers that use swing pricing responded that there is potential to apply swing pricing as part of a range of measures to assist with fund liquidity issues, but several stated that this would be the remedy of last resort, after fair valuation and redemption gates.

The ALFI 2011 and ALFI 2015 Papers include descriptions of many aspects of swing pricing and a wide range of considerations for fund managers. For example, swing pricing considerations are identified related to fund mergers, the handling of contributions and redemptions in-kind, launches of

new funds and share classes as well as the liquidation of a fund, single class and multi-class funds, master-feeder structures and fund of funds. Descriptions of issues to consider with respect to performance calculations and performance reporting as well as financial reporting also are included in the 2015 ALFI Paper.

At a high level, the 2015 ALFI Paper provides the following guidance on certain key swing pricing areas:

- *Swing Threshold.* Relevant considerations in determining a swing threshold include understanding investor flows, the approaches within a fund complex or umbrella (*e.g.*, consistency), the portfolio assets (*e.g.*, liquidity, types), fund size, investor base and concentration and costs of markets in which the fund invests.<sup>49</sup>
- *Adjustment Calculation.* The bid offer spread is a key component. If bid and offer prices are unavailable, estimates may be reasonable. Other items that may be considered include brokerage commissions – actual or estimated, custody – actual or historical, fiscal charges, share class characteristics (*e.g.*, costs), market impact, any swing factors or dilution amounts applied to underlying funds or derivative instruments. Other points to consider include whether the fund is actively managed or passive and the possibility of tiering the swing adjustment to reflect the size of capital activity to take account of sliding scale brokerage costs based on trade size.<sup>50</sup>
- *Governance.*
  - *Committee.* A governing body with final responsibility to the board of directors should be established with approved terms of reference defining powers, membership, frequency of meetings and nature and frequency of reporting responsibilities. Meetings and decisions should be documented.<sup>51</sup>
  - *Documented Policy.* There should be a documented swing pricing policy. The policy should include key principles relating to swing pricing, identification of entities responsible for swing pricing, policies for periodic reviews, policies for corporate actions and details regarding reporting to governing bodies. The swing pricing policy should be imbedded in the NAV calculation policy. The swing threshold and factor should be regularly reviewed and backtested (*e.g.*, reasonable in relation to investment costs incurred, threshold consistent with objectives of policy).<sup>52</sup>

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<sup>49</sup> ALFI 2015 Paper at 11.

<sup>50</sup> ALFI Paper 2015 at 12. The ALFI 2015 Paper also provides commentary on how to estimate market impact, including the need for work with traders executing portfolio management decisions and the use of third party vendors. *Id.* at 12-13. Methods for determining the amount are also described. *Id.* at 17.

<sup>51</sup> ALFI 2015 Paper at 14.

<sup>52</sup> *Id.*

- *Disclosure.* Summary details of swing pricing should be outlined in the prospectus. Certain details, such as the threshold, may remain confidential to ensure information cannot be used to the detriment of the fund. Where increased transparency is being provided to some investors (e.g. UK pension defined contribution schemes – disclosure of swing events and factors), it is important to consider fair and equal treatment of all shareholders. In addition, it is becoming more common to provide the swing pricing adjustment to impacted or potential investors upon request. Funds with multiple thresholds and swing factors may have other challenges to consider. Reporting of the swung NAV is generally market practice; however, the unswung NAV may serve certain purposes (e.g., performance calculations, investor or regulator requests, internal purposes).<sup>53</sup>

## **Ireland**

While there are no specific Irish rules on swing pricing, there are references to permitted changes in unit prices or valuation for dealing costs, so the practice seems to be permitted.<sup>54</sup> For example, a guidance note by the Central Bank of Ireland (“CBoI”) provides, subject to prospectus disclosure, that the price of fund units can be increased or decreased by charges relating to the redemption or purchase of units.<sup>55</sup> Other guidance from the CBoI permits valuation “adjustments” to be made where the adjustment is necessary to reflect the fair value in the context of currency, marketability, dealing costs and any other relevant considerations.<sup>56</sup>

## **Switzerland**

The Swiss Federal Act on Collective Investment Schemes (“CISA”) requires that a fund’s NAV represent “the market value of the fund’s assets, less all the fund’s liabilities, divided by the number of units in circulation.”<sup>57</sup> Under CISA, the Swiss Financial Market Supervisory Authority (“FINMA”) may allow alternative calculations of a fund’s NAV “provided that such method meets international standards and the protective purpose of [CISA] is not impaired as a result.”<sup>58</sup>

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<sup>53</sup> ALFI 2015 Paper at 14-15.

<sup>54</sup> See also IOSCO Survey at 4 (swing pricing permitted in Ireland).

<sup>55</sup> Central Bank of Ireland Conditions imposed in relation to Collective Investment Schemes Other than UCITS, at 29-30, available at [www.centralbank.ie/regulation/industry-sectors/funds/Documents/NU%20Series%20of%20Notices.pdf](http://www.centralbank.ie/regulation/industry-sectors/funds/Documents/NU%20Series%20of%20Notices.pdf).

<sup>56</sup> Central Bank of Ireland Guidance Note 1/00, Valuation of the Assets of Collective Investment Schemes, July 2011, available at [www.centralbank.ie/regulation/industry-sectors/funds/documents/guidance%20note%20100%20valuation%20of%20assets.pdf](http://www.centralbank.ie/regulation/industry-sectors/funds/documents/guidance%20note%20100%20valuation%20of%20assets.pdf).

<sup>57</sup> Article 83(2), Federal Act on Collective Investment Schemes (CISA), available from [www.admin.ch/opc/en/classified-compilation/20052154/201507010000/951.31.pdf](http://www.admin.ch/opc/en/classified-compilation/20052154/201507010000/951.31.pdf).

<sup>58</sup> Article 83(3), CISA.

In 2007, the Swiss Federal Banking Commission (the predecessor of FINMA) approved only full swing pricing as an alternative method for calculation of a fund's NAV.<sup>59</sup> The rationale of the Swiss regulator for only allowing full swing pricing was not published. The 2006, 2011 and 2015 ALFI Papers identify the following advantages to full swing pricing: transparent, easy to understand, consistent treatment of shareholder transactions on all dealing days; and "always benefits the fund."<sup>60</sup>

Article 20(1)(c) of CISA requires a fund to disclose all charges and fees incurred directly or indirectly by an investor. A description of swing pricing generally would be included in a fund's prospectus, too.<sup>61</sup> Article 89 of CISA requires a description of the principles used for the calculation of the net asset value in the annual report. The annual and semi-annual reports also must include the swung and unswung price along with a description of the difference.<sup>62</sup>

## **Selected Jurisdictions in the Asia Region**

### **Singapore**

Swing pricing is available to fund managers in Singapore, as noted in the IOSCO Survey.<sup>63</sup> There does not appear to be regulation that specifically permits the use of swing pricing and prior regulatory approval is not required to employ swing pricing. We understand that a fund must, however, demonstrate ex post that swing pricing was used in the best interest of investors.

We understand that swing pricing is not commonly used by Singapore-domiciled funds. Where swing pricing is used, it appears to be primarily for feeder funds to EU-domiciled master funds or sub-funds in an EU-domiciled umbrella fund.

### **Hong Kong**

Swing pricing is available to fund managers in Hong Kong, as noted in the IOSCO Survey.<sup>64</sup> As in Singapore, there does not appear to be regulation that specifically permits the use of swing pricing.

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<sup>59</sup> The approval was granted through a Board resolution and communicated privately to the Swiss Funds Association ("SFA"). The SFA announced the approval. See Circular 29/07, "Admission of Swinging Single Price, 5 November 2007 (German version only) and website publication at [www.sfama.ch/de/publikationen/sfama-news/sfama-news-winter-2007/@@download/file](http://www.sfama.ch/de/publikationen/sfama-news/sfama-news-winter-2007/@@download/file).

<sup>60</sup> ALFI 2015 Paper at 9; ALFI 2011 Paper at 17; ALFI 2006 Paper at 7.

<sup>61</sup> SFAMA News Circular 4/07 (German language version only), available from [www.sfama.ch/de/publikationen/sfama-news/sfama-news-winter-2007/@@download/file](http://www.sfama.ch/de/publikationen/sfama-news/sfama-news-winter-2007/@@download/file) at 28.

<sup>62</sup> SFAMA Guidance Note, March 14, 2007 (German language version only), available from [www.sfama.ch/de/selbstregulierung-musterdokumente/fondsverwaltung/zusaetzliche-dokumente/sfama-fi\\_d\\_kostenkompensation\\_070314.pdf/@@download/file](http://www.sfama.ch/de/selbstregulierung-musterdokumente/fondsverwaltung/zusaetzliche-dokumente/sfama-fi_d_kostenkompensation_070314.pdf/@@download/file) at 1.

<sup>63</sup> IOSCO Survey at 4, 13 and 15.

<sup>64</sup> IOSCO Survey at 4, 13 and 15.

We understand that there is no requirement for prior regulatory approval if swing pricing has been clearly disclosed in the fund's offering documents.