

**MEMO# 29586**

December 22, 2015

# **ICI Draft Comment Letter on SEC's Liquidity Risk Management Proposal; Your Feedback Requested by January 6**

[29586]

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TO: ACCOUNTING/TREASURERS COMMITTEE No. 32-15  
BANK, TRUST AND RETIREMENT ADVISORY COMMITTEE No. 41-15  
BROKER/DEALER ADVISORY COMMITTEE No. 56-15  
CHIEF COMPLIANCE OFFICER COMMITTEE No. 21-15  
COMPLIANCE ADVISORY COMMITTEE No. 11-15  
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 90-15  
END OF DAY PRICING FORUM No. 12-15  
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 34-15  
ETF ADVISORY COMMITTEE No. 33-15  
FIXED-INCOME ADVISORY COMMITTEE No. 40-15  
INVESTMENT ADVISERS COMMITTEE No. 16-15  
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 24-15  
OPERATIONS COMMITTEE No. 30-15  
SEC RULES COMMITTEE No. 42-15  
SMALL FUNDS COMMITTEE No. 35-15  
TRANSFER AGENT ADVISORY COMMITTEE No. 67-15  
UNIT INVESTMENT TRUST COMMITTEE No. 12-15  
VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 23-15 RE: ICI DRAFT COMMENT LETTER ON SEC'S LIQUIDITY RISK MANAGEMENT PROPOSAL; YOUR FEEDBACK REQUESTED BY JANUARY 6

As previously reported, the Securities and Exchange Commission ("SEC") issued its proposed liquidity risk management rules for mutual funds and open-end ETFs ("funds") in late September. [\[1\]](#) SEC Chair White first discussed this liquidity initiative as part of a broader package of reforms intended to enhance and strengthen the SEC's regulation of the asset management industry in December 2014. [\[2\]](#)

Broadly speaking, the Proposal aims to promote effective liquidity risk management among funds, and reduce the risk that funds will be unable to meet redemptions, or else will meet redemptions in ways that dilute interests of fund shareholders. The Proposal would:

- Require each fund to establish a formal liquidity risk management program that would require the fund to, among other things: (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;
- Permit, but not require, mutual funds to use swing pricing in pricing their shares; and
- Require each fund to make public its liquidity classifications and information about redemptions and swing pricing (if applicable) through disclosure on proposed Form N-PORT, Form N-1A, and proposed Form N-CEN.

ICI's draft comment letter (the "Letter") is attached and briefly summarized below. Please provide comments as soon as possible, but no later than January 6, as follows:

- On proposed Rule 22e-4 (the program rule) generally and swing pricing generally – to Matt Thornton ([matt.thornton@ici.org](mailto:matt.thornton@ici.org))
- On disclosure changes, interfund lending, suspension of redemptions, cross-trades, and compliance and effective dates – to Ken Fang ([kenneth.fang@ici.org](mailto:kenneth.fang@ici.org))
- On swing pricing financial statement and performance reporting – to Greg Smith ([smith@ici.org](mailto:smith@ici.org))
- On ETF matters – to Jane Heinrichs ([jane.heinrichs@ici.org](mailto:jane.heinrichs@ici.org)) or Ken Fang ([kenneth.fang@ici.org](mailto:kenneth.fang@ici.org))

Comments are due to the SEC by January 13, 2016.

#### I. Proposed Liquidity Risk Management Program Rule

Proposed Rule 22e-4 would require each fund to establish a written liquidity risk management program, tailored to its own liquidity risk. The rule and the required liquidity risk management program would include the following elements:

- Classification and ongoing review of the liquidity of portfolio assets: Each fund would classify and engage in an ongoing review of the relative liquidity of each portfolio position (or portion thereof). The classification and ongoing review would be based on the number of days in which the fund's position (or portion thereof) would be convertible to cash at a price that does not materially affect the value of that asset immediately prior to sale.
- Assessment and management of a fund's liquidity risk, including "three-day liquid asset minimum" requirement: A fund would be required to assess and manage its liquidity risk, and management would include determination, periodic review, and investment in accordance with the fund's "three-day liquid asset minimum." Management also would require limiting investments in illiquid assets (referred to as "15% standard assets" in the Proposal) and adopting redemption in-kind policies and procedures for funds wishing to reserve that right.
- Board review and approval: A fund's board, including a majority of the fund's independent directors, would be required to approve the fund's liquidity risk management program. The board also would be required to review a written report that reviews the program's adequacy, provided at least annually from the fund's investment adviser or officer administering the program.

The Letter:

- 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 the fund's liquidity risk;

- opposes the Proposal's very specific and prescriptive elements, i.e., the six-category asset classification scheme (and related disclosure on Form N-PORT) and the "three-day liquid asset minimum," and advances reasonable alternatives in their place;
- supports the definition of "liquidity risk," with certain key modifications;
- supports codification of the 15% limitation on illiquid assets;
- supports the requirement that funds reserving the right to redeem shares in-kind establish policies and procedures;
- strongly recommends the SEC implement measures to shield from liability funds that make good faith assessments of liquidity;
- opposes the requirement that funds determine liquidity classifications based on related assets;
- requests codification of an exemptive rule permitting interfund lending;
- supports the SEC's decision not to propose rules permitting funds to temporarily suspend redemptions or impose redemption gates;
- objects to certain proposed guidance on cross-trades suggesting a link between an instrument's liquidity and its ability to be cross-traded; and
- requests additional flexibility for ETFs to: (a) customize creation and redemption baskets under certain conditions; and (b) permit ETFs to charge Authorized Participants more than two percent (2%) on redemptions.

## II. Swing Pricing Proposal

The SEC's Proposal would permit, but not require, mutual funds to engage in swing pricing pursuant to the terms specified in amended Rule 22c-1. The SEC believes that swing pricing could be a useful tool in mitigating potential dilution of fund shareholders. The key provisions would include the following:

- **Policies and Procedures:** A fund that chooses to use swing pricing would be required to adjust its NAV by a specified swing factor once the level of net purchases into or net redemptions from the fund exceeds a specified swing threshold. The proposed rule amendments include factors that a fund would consider to determine its particular swing threshold and swing factor.
- **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.
- **Reporting:** For purposes of performance reporting, calculations of NAV-based performance fees, and financial statements, the SEC indicates that a fund should use NAVs as adjusted pursuant to its swing pricing policies and procedures.

In the letter, we urge the SEC to carefully explore swing pricing's associated benefits and operational challenges. In addition, the Letter describes (or provides, as applicable):

- ICI members' varying views on swing pricing; [\[3\]](#)
- operational impediments to swing pricing in the U.S.;
- a comparison of U.S. and European mutual fund operations;
- legal impediments to implementing swing pricing;
- general considerations regarding swing pricing; and
- specific comments on the swing pricing proposal.

### III. Proposed Disclosure Changes

The Proposal features revisions to a number of fund reporting forms, including the following:

- Proposed Form N-PORT would be amended to require funds to: (i) identify liquidity classifications for each portfolio position (or portion thereof), and (ii) disclose their “three-day liquid asset minimums.”
- Form N-1A would be amended to require funds to provide disclosure about: (i) circumstances and effects of swing pricing (if applicable); (ii) number of days in which redemption proceeds are paid; and (iii) methods and funding sources to meet redemptions. Funds also would be required file to any agreements related to lines of credit for their benefit as exhibits to their registration statements.
- Proposed Form N-CEN would be amended to require funds to disclose certain information about lines of credit, interfund lending, borrowing, and swing pricing.

The Letter:

- opposes the proposed requirement that a fund publicly disclose on Form N-PORT its asset-level liquidity classifications;
- opposes the proposed requirement that a fund file as an exhibit to its registration statement any line of credit agreements for the benefit of the fund; and
- generally supports the other proposed disclosure requirements.

### IV. Compliance Dates

Proposed compliance dates for key parts of the Proposal are as follows:

- Larger entities [\[4\]](#) would have a compliance date of 18 months after the effective date to comply with the new liquidity risk management program rule; smaller entities would have a compliance date of 30 months after the effective date.
- The proposed swing pricing amendments would not have a compliance period, because use of swing pricing would be voluntary. Eligible funds wishing to use swing pricing could do so after the effective date.

The letter recommends that:

- all funds be given at least a 30-month 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 comply with the program rule and related Form N-PORT disclosure requirements; and
- if the SEC adopts swing pricing, it delay effectiveness for at least one year.

Kenneth C. Fang  
Assistant General Counsel

Matthew Thornton  
Assistant General Counsel

## [Attachment](#)

### endnotes

[1] 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 (the “Proposal”), available at [www.sec.gov/rules/proposed/2015/33-9922.pdf](http://www.sec.gov/rules/proposed/2015/33-9922.pdf). See Institute [Memorandum](#) No. 29370, dated September 28, 2015, for a more complete summary of the Proposal. Unless otherwise indicated, references to “funds,” “mutual funds,” and “open-end funds” do not include money market funds.

[2] 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#.VloGhTHF884](http://www.sec.gov/News/Speech/Detail/Speech/1370543677722#.VloGhTHF884). In addition to this Proposal, the SEC has issued two proposals that would modernize reporting requirements for registered investment companies and registered investment advisers. (See Institute [Memorandum](#) No. 29036, dated May 28, 2015, for a summary of these proposed reporting requirements.) The SEC also issued a proposal that would limit funds’ use of leverage and ensure that funds engaging in derivatives have adequate assets to meet their obligations under those transactions. (See Institute [Memorandum](#) No. 29566, dated December 17, 2015, for a summary of these proposed requirements.) In addition to enhanced reporting, liquidity risk management, and funds’ use of derivatives, Chair White also discussed initiatives that would address: (i) transition planning; and (ii) stress testing for large funds and advisers.

[3] The Letter states: “Our members do not share a singular view on 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. Still 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. All members expressing their views to us recognize the operational challenges to implementing swing pricing in the U.S., and such challenges may be more daunting for our smaller members.”

[4] Namely, funds that together with other investment companies in the same “group of related investment companies” have net assets of \$1 billion or more as of the end of the most recent fiscal year.