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ICI and IDC Submit Comment Letters on SEC's Liquidity Risk Management Proposal

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VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 2-16 RE: ICI AND IDC SUBMIT COMMENT LETTERS ON SEC’S LIQUIDITY RISK MANAGEMENT PROPOSAL

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; reduce the risk that funds will be unable to meet redemptions, or else will meet redemptions in ways that dilute interests of fund shareholders; and enhance disclosure regarding fund liquidity and redemption practices.; 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.

On the same day that the SEC issued the Proposal, the SEC's Division of Economic and Risk Analysis ("DERA") released an accompanying study titled "Liquidity and Flows of U.S. Mutual Funds," [3] which is intended to provide economic support for the Proposal. The DERA study focuses on three key areas, including the recent growth of mutual funds with potentially less liquid strategies, the variability of fund flows across investment strategies, and the liquidity of U.S. equity fund portfolios. In particular, the study analyzes how equity fund portfolio liquidity is related to a fund's redemptions. Due to data limitations, with the exception of a very limited analysis of municipal funds, the DERA study provides no analysis of the underlying liquidity of bond fund portfolios.

ICI and IDC submitted four separate comment letters in response to the Proposal and the DERA study:

- ICI's comment letter on the Proposal generally (the "ICI Letter"); [4]
- ICI Research's comment letter that addresses specifically the DERA study and the economic analysis that the Proposal cites ("ICI Research Letter"); [5]
- IDC's comment letter that focuses on the role of the fund board under the Proposal (the "IDC Letter") [6]; and
- ICI's letter to SEC Chair White, which summarizes the prior three letters. [7]

Below, we summarize the Proposal and the key points we make in the ICI Letter, the ICI Research Letter, and the IDC Letter.

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 ICI 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 six-category asset classification scheme (and public disclosure of related information on proposed Form N-PORT);
- recommends that, instead of the proposed asset classification scheme, the SEC require each fund to formulate policies and procedures to determine how best to classify and monitor the liquidity of its portfolio assets; [8]
- opposes the proposed "three-day liquid asset minimum;"
- recommends instead 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; [9]
- evaluates the Proposal's economic analysis of the asset classification scheme and three-day liquid asset minimum, challenging its assessment of costs and reasonable alternatives;
- evaluates the proposed definition of "liquidity risk" and recommends 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;
- supports generally how the Proposal has framed the role of the fund board (*i.e.*, as one of oversight), but cautions against requiring a fund board to oversee elements of the Proposal that would be fundamentally unworkable or assuming responsibilities that start to become more hands-on;
- supports the SEC's decision not to propose rules permitting funds to suspend redemptions;

- objects to certain proposed guidance on cross-trades suggesting a link between an instrument's liquidity and its ability to be cross-traded traded and requests confirmation of the validity of the SEC staff's no-action and interpretive positions that the proposed guidance seemingly calls into question; and
- requests additional flexibility for ETFs to: (a) customize creation and redemption baskets; 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.

The ICI Letter urges the SEC to explore carefully swing pricing's potential benefits, disadvantages, and operational challenges. The ICI Letter describes (or provides, as applicable):

- ICI members' varying views on swing pricing; [10]
- 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 ICI Letter:

- opposes the proposed requirement that a fund publicly disclose on proposed Form N-PORT its asset-level liquidity classifications; [11]
- opposes the proposed requirement that a fund file as an exhibit to its registration statements 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 [12] 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 two years.

V. ICI Research Letter

The Proposal interprets the DERA study's findings as indicating that the average U.S. equity fund sells relatively more liquid assets to meet large redemptions, to the potential detriment of non-redeeming shareholders. The DERA study analyzes only a single "bottom up" measure of fund liquidity (the so-called "Amihud" measure) and does not provide any analysis of the Proposal's three-day liquid asset minimum requirement or its six liquidity buckets classification scheme.

The ICI Research Letter discusses the lack of support in the DERA study for the Proposal's three-day liquid asset minimum requirement and the six-bucket asset classification scheme.. The Letter indicates that funds have been highly successful in meeting redemptions. Consequently, the Letter cautions against the possibility of introducing problems where none now exist..

The ICI Research Letter also discusses how the three-day liquid asset minimum and asset classification scheme could create problems. The Proposal could create the potential misimpression that certain funds (*e.g.*, larger funds) are highly illiquid and thus unlikely to be able to meet redemptions. Significantly, the Proposal risks creating more correlated portfolios and trades across funds if funds gravitate toward securities designated by thirdparties as “more liquid.”. This in turn risks precipitating liquidity “cliff events” during periods of market stress—similar to those created by credit rating downgrades during the financial crisis—if third-party vendors “downgrade” the liquidity of a security or group of securities, causing a rush to sell the downgraded securities.

VI. IDC Letter

Like ICI, IDC advocates a more flexible, principles-based approach and strongly opposes the prescriptive elements of the Proposal, which would be challenging for boards to oversee. Given the industry’s 75-year history of successfully managing liquidity risk, IDC asserts that wide-ranging reforms are not warranted. IDC suggests a less prescriptive approach that would satisfy the SEC’s goal of promoting effective liquidity risk management across the industry. Regarding the swing pricing proposal, IDC notes the significant operational obstacles to implementing swing pricing in the U.S., and urges the SEC to study and address these issues more thoroughly and present a more comprehensive discussion of them in a re-proposal before considering whether to adopt a swing pricing rule.

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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. *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#.VIoGhTHF884. 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 transition planning and stress testing for large funds and advisers.

[3] Available at www.sec.gov/dera/staff-papers/white-papers/liquidity-white-paper-09-2015.pdf (the "DERA study").

[4] Letter from David W. Blass, General Counsel, Investment Company Institute, to Brent J. Fields, Secretary, Securities and Exchange Commission, dated January 13, 2016, available at https://www.ici.org/pdf/16_ici_sec_lrm_rule_comment.pdf.

[5] Letter from Brian K. Reid, Chief Economist, Investment Company Institute, to Brent J. Fields, Secretary, Securities and Exchange Commission, dated January 13, 2016, available at https://www.ici.org/pdf/16_ici_sec_lrm_dera_comment.pdf.

[6] Letter from Amy B.R. Lancellotta, Managing Director, Independent Directors Council, to Brent J. Fields, Secretary, Securities and Exchange Commission, dated January 13, 2016, available at https://www.ici.org/pdf/16_idc_sec_lrm_comment.pdf.

[7] Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, to The Honorable Mary Jo White, Chair, Securities and Exchange Commission, dated January 13, 2016, available at https://www.ici.org/pdf/16_ici_sec_lrm_overview_comment.pdf.

[8] The ICI Letter provides non-exclusive examples of how a fund may comply with this alternative requirement.

[9] The ICI Letter provides examples of how a fund might comply with this alternative requirement.

[10] The Letter states: "[O]ur 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."

[11] Instead, the ICI Letter proposes that a fund provide *aggregated* (rather than asset-by-asset) monthly reporting of these classifications 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. In place of the proposed reporting related to the three-day liquid asset requirement, the ICI Letter proposes that a fund provide related monthly reporting to the SEC (on a *non-public* basis) on proposed Form N-PORT (*e.g.*, if a fund adopts a liquidity target, it would report its target and where the fund stood in relation to the target at month-end) and enhanced public disclosure regarding how it seeks to ensure that it has sufficient liquidity to meet redemptions under normal and

reasonably foreseeable stressed conditions on Form N-1A.

[12] 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.

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