

COMMENT LETTER

July 20, 2012

ICI Comment Letter on IOSCO Liquidity Risk Management for CIS Consultation (pdf)

July 20, 2012 Via Electronic Mail (cisliquidity@iosco.org) Mr. Mohamed Ben Salem International Organization of Securities Commissions (IOSCO) Calle Oquendo 12 28006 Madrid Spain Re: Principles of Liquidity Risk Management for Collective Investment Schemes Dear Mr. Ben Salem: The Investment Company Institute¹ (the "Institute") welcomes the opportunity to comment on the IOSCO Technical Committee's consultation report, Principles of Liquidity Risk Management for Collective Investment Schemes ("CIS"), which proposes principles against which both the industry and regulators can assess the quality of regulation and industry practices concerning liquidity risk management for CIS (the "Report").² We appreciate IOSCO's recognition that the implementation of the principles may vary from jurisdiction to jurisdiction depending on local circumstances and laws.³ In the case of open-end investment companies registered under the Investment Company Act of 1940 ("U.S. mutual funds"), the requirements of the Investment Company Act of 1940 ("1940 Act") provide the legal framework for the activities and operations of U.S. mutual funds and therefore will inform the application of the

¹ The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$12.9 trillion and serve over 90 million shareholders. ² The Report is available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD378.pdf>. ³ See, e.g., Report at 3 and 5. Text under Principle 1 states, "When considering creating a new CIS, the responsible entity must be able to (demonstrate that they can) comply with the relevant explicit or principle-based local liquidity requirements that will apply to the CIS." The footnote accompanying this sentence states "[t]he remainder of the principles in this document should be interpreted in that context. For example, in the case where a certain percentage of the CIS's assets must be kept in a certain type of liquid instruments, the responsible entity's systems should be appropriate to ensure that percentage is adhered to at all times." Mr. Mohamed Ben Salem July 20, 2012 Page 2 of 4 liquidity principles to U.S. mutual funds. The U.S. Securities and Exchange Commission ("SEC") also has provided additional detail regarding liquidity. We explain below the key provisions of U.S. law that will inform the application of these principles to U.S. mutual funds. Liquidity and the 1940 Act In the Introduction and under Principle 1, the Report acknowledges that some jurisdictions set out in their law quantitative limits on investments by CIS for liquidity

purposes. Under the 1940 Act, U.S. mutual funds must stand ready to redeem shares daily and pay redeeming shareholders within seven days of receiving a redemption request.⁴ The ability of a U.S. mutual fund to suspend redemptions is extremely limited.⁵ To ensure its ability to meet these legal requirements, a U.S. mutual fund must maintain a high degree of portfolio liquidity. To ensure that U.S. mutual funds can satisfy all redemption requests within the seven day period, the SEC has taken the position that mutual funds should not invest in illiquid securities if doing so would cause the fund to have less than 85% of its assets in liquid securities.⁶ In determining this limit, the SEC stated that it believes that a 15% standard should satisfactorily assure that U.S. mutual funds will

4 See Section 22(e) of the 1940 Act. 5 Under Section

22(e) of the 1940 Act, a U.S. mutual fund cannot suspend the right of redemption or postpone the date of payment more than seven days after the tender of the security, except: (1) during any period during which the New York Stock Exchange (the “NYSE”) is closed (except for customary week-end and holiday closings) or during which trading on the NYSE is restricted; (2) any period during which an emergency exists, as defined by the rules issued by the SEC, as a result of which disposal by a fund of portfolio securities is not reasonably practicable or it is not reasonably practicable for the fund to determine fairly the value of its assets; and (3) such other periods as the SEC may by order permit to protect a mutual fund’s investors. In order to facilitate the orderly liquidation of a money market fund, a recently adopted SEC rule permits money market funds to suspend redemptions and postpone payment of redemption proceeds if: (1) the fund’s board, including a majority of disinterested directors, determines that the deviation between the fund’s amortized cost price per share and the market-based net asset value per share may result in material dilution or other unfair results; (2) the board, including a majority of disinterested directors, irrevocably has approved the liquidation of the fund; and (3) the fund, prior to suspending redemptions, notifies the SEC of its decision to liquidate and suspend redemptions. See Rule 22e-3 under the 1940 Act. 6 See Investment Company Act Release No. 18612 (March 12, 1992) (“1992 Release”). Although as a technical matter the SEC has rescinded the Guidelines to Form N-1A, see Investment Company Act Release No. 23064 (March 13, 1998), the position taken in the Guidelines relating to liquidity continues to represent the staff’s position. See, e.g., Valuation of Portfolio Securities and other Assets Held by Registered Investment Companies – Select Bibliography of the Division of Investment Management, available at <http://www.sec.gov/divisions/investment/icvaluation.htm>. The SEC further restricts the ability of U.S. mutual funds that are money market funds complying with Rule 2a-7 to purchase illiquid securities. Under Rule 2a-7, money market funds may not purchase illiquid securities if, after the purchase, more than 5 percent of the fund’s portfolio will be illiquid securities. See Rule 2a-7(c)(5) under the 1940 Act. Mr. Mohamed Ben Salem July 20, 2012 Page 3 of 4 is able to make timely payment for redeemed shares.⁷ The SEC also expects funds to monitor portfolio liquidity on an ongoing basis to determine whether, in light of current circumstances, an adequate level of liquidity is being maintained.⁸ For purposes of applying the 15% limit on illiquid securities, the SEC has defined an illiquid security as a security 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 on its books.⁹ U.S. Mutual Fund Compliance Policies and Procedures The Report includes in Chapter 4 a number of principles regarding “day-to-day liquidity risk management,” which address performance, maintenance and ongoing review of a CIS’s liquidity requirement. Rule 38a-1 under the 1940 Act requires mutual funds to establish policies and procedures reasonably designed to prevent violations of the federal securities laws, including the 1940 Act. This rule was adopted to help facilitate the development of strong systems of controls to prevent violations and to protect the interests of shareholders. This rule also requires U.S. mutual funds to have a chief compliance officer

(“CCO”) and adopt a written compliance program reasonably designed to prevent, detect, and correct violations of the federal securities laws.¹⁰ Compliance programs must be reviewed at least annually for their adequacy and effectiveness, and mutual fund CCOs are required to report directly to the independent directors. The SEC specified that, among other items, a U.S. mutual fund’s compliance program must address portfolio management processes. Disclosure Principles for U.S. Mutual Funds The Report includes as Principle 7 that “[t]he responsible entity should ensure that liquidity risk and its liquidity risk management process are effectively disclosed to prospective investors.” U.S. mutual funds provide key information about the fund, including its investment objectives and strategies, risks, costs and performance, in the mutual fund’s prospectus, which is required to be delivered to all investors. When enacting substantial revisions to the registration statement for U.S. mutual funds in 1998, including revisions to require “plain English” disclosure, the SEC emphasized that one of the

7 See 1992 Release.
8 See 1992 Release. 9 Investment Company Act Release No. 14983 (March 21, 1986) and 1992 Release. See also Rule 2a-7(a)(19) (defining the term “illiquid security”). 10 See Compliance Programs of Investment Companies and Investment Advisers (Rel. No. IC-26299), available at <http://www.sec.gov/rules/final/ia-2204.htm>. See Board Oversight of Fund Compliance, Independent Directors Council, Task Force Report, September 2009 (discussing, among other things, that the compliance program must be adopted by the fund’s directors, including a majority of the fund’s independent directors), available at http://www.ici.org/pdf/idc_09_compliance.pdf. Mr. Mohamed Ben Salem July 20, 2012 Page 4 of 4 fundamental disclosure principles for a fund’s registration statement is to avoid simply restating legal or regulatory requirements to which funds generally are subject.¹¹ The SEC confirmed this principle in 2009 when it substantially revised U.S. mutual fund registration statement requirements. In particular, the instructions to the U.S. mutual fund disclosure form continue to state that “the prospectus should avoid . . . simply restating legal or regulatory requirements to which Funds generally are subject.”¹² U.S. mutual fund disclosure will therefore be informed by this disclosure principle. * * * * * We appreciate the opportunity to express our views and invite you to contact me (202-326-5813 or solson@ici.org) or Eva Mykolenko (202-326-5837 or emykolenko@ici.org) if you have any questions about our comments. Sincerely, /s/ Susan M. Olson Susan M. Olson Senior Counsel – International Affairs

11 See Registration Form Used by Open-End Management Investment Companies (Rel. No. 33-7512), available at <http://www.sec.gov/rules/final/33-7512r.htm>. 12 See Form N-1A General Instructions at 6, available at <http://www.sec.gov/about/forms/formn-1a.pdf>.