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COMMENT LETTER

May 17, 2016

ICI Submits Supplemental Comment Letter on SEC Liquidity Risk Management Proposal (pdf)

May 17, 2016 Mr. Brent J. Fields Secretary Securities and Exchange Commission 100 F Street, NE Washington, D.C. 20549 Re: Supplemental Comments on Open-End Fund Liquidity Risk Management Programs (File No. S7-16-15) Dear Mr. Fields: The Investment Company Institute ("ICI")1 is pleased to provide additional comments on the Securities and Exchange Commission ("SEC" or "Commission") proposal to promote effective liquidity risk management throughout the open-end fund industry.2 Since submitting our initial comment letters,3 we have continued to analyze the proposal, reviewed other comment letters 1 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 $17.6 trillion and serve more than 90 million U.S. shareholders. 2 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. 3 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 www.sec.gov/comments/s7-16- 15/s71615-59.pdf; Letter from David W. Blass, General Counsel, Investment Company Institute, to Brent J. Fields, Secretary, Securities and Exchange Commission, dated January 13, 2016 ("ICI Comment Letter"), available at www.sec.gov/comments/s7-16-15/s71615-54.pdf; and 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 www.sec.gov/comments/s7-16-15/s71615-56.pdf. Mr. Brent J. Fields May 17, 2016 Page 2 submitted, and engaged in further dialogue with our members and Commission staff.4 We now offer for your consideration additional recommendations to: • Enhance the proposed 15% limitation on illiquid assets; • Encourage the SEC to follow enumerated principles as it further considers any asset classification requirement; and • Revise the proposed definition of "liquidity risk." We also reiterate our recommendation that the SEC not incorporate a three-day liquid asset minimum in any final rule. There is a clear path for the SEC to advance a final package of reforms that would enhance the existing legal framework and

current liquidity risk management practices, and ICI stands ready to assist in these efforts.5 I. Enhancement to 15% Limitation on Illiquid Assets The ICI Comment Letter strongly supported the SEC's proposed codification of the 15% limit on illiquid assets and recommended certain enhancements to that limit.6 After further dialogue with our members and Commission staff, we have concluded that the Commission should make an additional enhancement to this 15% limit. Specifically, a fund should notify the SEC when its percentage of illiquid assets exceeds 15%.7 The SEC has a legitimate interest in receiving notice of an increase in a fund's percentage of illiquid holdings beyond 15%. We recommend that the SEC require a fund to report such circumstances to the SEC after five business days if its illiquid holdings continue to 4 ICI representatives met with SEC staff (information available at www.sec.gov/comments/s7-16-15/s71615-98.pdf), Chair Mary Jo White (information available at www.sec.gov/comments/s7-16-15/s71615-99.pdf), and Commissioner Kara Stein (information available at www.sec.gov/comments/s7-16-15/s71615-97.pdf) on February 23, 2016. 5 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. See, e.g., Appendix A to the ICI Comment Letter. 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. 6 ICI Comment Letter at 16-17. The proposed rule would codify current SEC guidance by prohibiting 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. 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." For clarity, and consistent with our recommendation, we refer to these as "illiquid assets" throughout this letter. 7 We also recommend subjecting these notifications to the proposed rule's recordkeeping requirements. Mr. Brent J. Fields May 17, 2016 Page 3 exceed 15%. The five business days would allow the fund to consult with its board regarding how to proceed in response.8 Enhancing the rule in this way should instill even greater discipline in the oversight of fund holdings of illiquid assets and provide the SEC with early warning of potentially problematic circumstances. In the attached Appendix, we offer proposed rule text for implementing this recommendation. II. Recommendations Regarding Asset Classification ICI and most other commenters opposed the SEC's proposed asset classification scheme for a number of reasons. ICI recognized the value of assessing liquidity at the asset level as one component of sound liquidity risk management, however, and we offered a constructive alternative that would accomplish the SEC's objectives in a more effective and less burdensome way.9 We continue to believe that the SEC should require each fund, as part of its written liquidity risk management program, to determine how best to classify and monitor the liquidity of its portfolio assets. Simply put, funds employ many different yet sound practices for this purpose.10 At the same time, we appreciate the SEC staff's desire to have a methodology that generates industry-wide liquidity classification information to allow the staff to monitor liquidity across the fund industry. If the SEC remains committed to requiring a uniform asset classification scheme, we strongly recommend that it incorporate the following principles as it moves forward with this rulemaking: 8 We are aware that another commenter recommended reporting to the SEC after three business days. We believe five business days gives a fund greater ability to assess its liquidity risk considering all relevant factors, consult with its board, and formulate a plan in response. This assessment would not necessarily result in sales or purchases of

portfolio assets—the fund manager, in consultation with the board, may very well conclude that continued monitoring is the best short-term course of action. We also are aware that a fund's filing on Form N-PORT (Item C.7) would provide the SEC with a monthly alert regarding the percentage of the fund's holdings in illiquid assets. We believe it will be useful to the SEC in conducting its oversight function to receive an alert on a much more expedited basis if a fund's illiquid assets exceed 15%. 9 ICI Comment Letter at 18-36. 10 The SEC would do well to align itself with the approach described by the United Kingdom's Financial Conduct Authority ("FCA"). In a recent paper on good liquidity management practices, the FCA avoided putting forward any mandatory asset classification methodology, noting that investment managers use a variety of sound techniques to classify the liquidity of assets in the funds they manage. Liquidity management for investment firms: good practice, Financial Conduct Authority (29 Feb. 2016), available at www.fca.org.uk/news/firms/liquidity-management-for-investment-firms- good-practice. We agree with the FCA that asset classification is a good practice that can contribute to strong liquidity risk management, and we support the SEC including a related requirement in its final liquidity risk management program rule. It does not follow, however, that the SEC must prescribe any particular methodology. Mr. Brent J. Fields May 17, 2016 Page 4 • Employ a "top-down" approach. Currently, fund managers 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, duration, credit quality, and currency) and use CUSIP-specific quantitative metrics in a much more limited way. This approach is appropriate and effective because instruments with certain similar characteristics are often highly comparable and substitutable from a liquidity perspective. Accordingly, the SEC should permit this type of top-down approach as part of any final asset classification requirement. Additionally, the SEC should permit funds to use some judgment in evaluating asset liquidity. For instance, even within a particular asset class (e.g., high yield bonds), the liquidity of issues can differ considerably depending on factors such as credit quality and industry (e.g., energy bonds), and funds could determine to reflect these differences in their methodologies. Fund policies and procedures could provide for asset-specific exceptions, both at the time of purchase and on an ongoing basis. Thus, a fund's top-down methodology, and its application, could have a certain amount of fluidity and change over time, to account for market and issuer-specific events. Consistent with this approach, we do not believe that consideration of position size is essential to an effective asset classification requirement. The SEC's operative assumption in its proposal is that a fund should classify its assets assuming complete liquidation of the entire portfolio. By contrast, assessing the liquidity of an asset by examining that of a trading lot—current practice for many funds—aligns the classification with typical fund experiences that do not require forced sales of large positions, quickly and unexpectedly, to meet redemptions. Funds generally do not experience large and sudden outflows, and therefore generally are not forced to sell large or entire portfolio positions in response to redemption requests. In light of this experience, and the relatively diversified nature of fund portfolios, the liquidity of an asset's ordinary trading lot is a reasonably reliable proxy for the position's overall liquidity for purposes of asset classification. We note, however, that a fund might take a relatively concentrated position as part of its investment strategy. In this case, we would expect the fund to consider this concentration as part of its overall assessment of its liquidity. • Encourage tailoring in applying factors. The SEC's proposed rule would require funds to take into account, to the extent applicable, nine quantitative and qualitative factors in classifying their assets.11 We understand from conversations with the Commission staff that the SEC did not intend to require a fund to apply each factor to each asset. 11 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 Mr. Brent J. Fields May 17, 2016 Page 5 We remain concerned, however, that the inclusion of these nine factors in the rule text creates a presumption that each factor should be considered, and will lead SEC examiners to second-guess funds that give little or no weight to certain factors (particularly the quantitative factors, when assessing instruments that trade over-the-counter). We therefore recommend that the SEC provide guidance about factors to consider, and permit funds to address in their policies and procedures those that they typically would consider for each asset class. This would offer much more transparency and predictability to the SEC with respect to how a fund would apply the factors, and encourage the tailoring that is critical for fund complexes holding a wide variety of investments. • Avoid an overly-prescriptive methodology. The SEC's proposed asset classification scheme would require a fund to classify assets based on "days to liquidate" the fund's entire portfolio, taking into account (i) position size, and (ii) whether sales of assets would have a material price impact. To a considerable extent, this aspect of the proposal suffers from trying to achieve too much, given the multifaceted, fluid, and subjective nature of liquidity and related data limitations. This is not a test that funds could apply with much confidence or precision. The more complicated an asset classification scheme becomes to design and administer, the greater the likelihood that fund managers will be distracted from the broader assessments of portfolio liquidity risk that should be the heart of their liquidity risk management programs. Therefore, we recommend that any final asset classification scheme be greatly simplified. • Recognize the tension in the objectives underlying a uniform asset classification requirement. The SEC's proposed asset classification scheme seems designed to (i) serve as an integral part of a fund's internal liquidity risk management program, and (ii) provide comparable industry-wide data to the SEC. These two objectives are in tension with one another. Permitting funds to adopt their own asset classification methodologies, as we have recommended, would be an effective means of 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. Mr. Brent J. Fields May 17, 2016 Page 6 achieving the first objective, but clearly would not result in uniform reporting across funds through proposed Form N-PORT.12 By contrast, a uniform asset classification scheme would effectively provide (considerably more) uniform data about fund liquidity to the SEC, but many funds may find other internal asset classification methodologies more beneficial. The SEC should acknowledge these trade-offs, and remain open to achieving these objectives through different means. • Make the classifications non-public and provide a safe harbor. The SEC's proposal would require each fund to report monthly on proposed Form N-PORT each asset's liquidity classification, and the SEC would make public the information contained in the filings for the third month of each fiscal quarter. It is critical that the SEC make reporting of liquidity classifications non-public. As explained in the ICI Comment Letter, publicly-disclosed asset level liquidity classifications would expose funds to continued second-guessing about determinations and judgments that are subjective in nature; may harm shareholders by adversely impacting portfolio management or revealing proprietary investment strategies and techniques; and would be unnecessary for regulatory purposes and not in the public interest.13 Furthermore, if a fund manager's subjective judgments reflect a deterioration of a fund's overall liquidity profile, these public disclosures could themselves encourage redemption activity and exacerbate liquidity stress within the fund.

We urge the Commission to distinguish between information needed to regulate, which need not be made public (e.g., reporting in response to a uniform asset classification requirement), and information that would be useful for investors, which should be publicly available. The Financial Stability Oversight Council ("FSOC") recently addressed steps to consider for mitigating liquidity and redemption risk,14 and made this important distinction.15 We certainly share the SEC's and FSOC's interest in ensuring that the 12 On balance, we still prefer this course, because (i) it recognizes the benefits of having diverse approaches to asset classification, and (ii) the SEC and the public would have access to valuable and voluminous information through Form N- PORT as originally proposed, from which they could formulate their own views about a fund's, or the industry's, liquidity profile. See ICI Comment Letter at 31-32. 13 ICI Comment Letter at 26-29. 14 Update on Review of Asset Management Products and Activities, Financial Stability Oversight Council (April 18, 2016) ("FSOC Update"), available at www.treasury.gov/initiatives/fsoc/news/Documents/FSOC%20Update%20on%20Review%20of%20Asset%20Manageme nt%20Products%20and%20Activities.pdf. 15 FSOC distinguished between (i) "[a]dditional reporting requirements" that would "allow regulators to better understand how funds are assessing liquidity" and (ii) "public disclosure of funds' liquidity and their liquidity risk management Mr. Brent J. Fields May 17, 2016 Page 7 public has sufficient information about a fund's management of its liquidity. This can best be accomplished through narrative in fund disclosure documents, and objective data related to liquidity (such as quarterly portfolio holdings) can complement that narrative.16 Additionally, because liquidity classifications disclosed on Form N-PORT likely would have fundamentally forward-looking elements, we strongly recommend that the SEC implement measures to shield from liability funds that in good faith make such future assessments of liquidity that subsequently turn out to differ materially from actual liquidity.17 III. Revisions Related to "Liquidity Risk" The ICI Comment Letter objected to part of the SEC's proposed definition of "liquidity risk"18 and recommended that it eliminate the consideration of material impact to a fund's NAV. Among other things, we pointed out that fund investors knowingly and willingly accept investment risk, as manifested in large part through a fluctuating NAV.19 The SEC clearly views liquidity risk as encompassing more than a failure to meet redemptions under normal and reasonably stressed conditions, and states in the Release that mitigating shareholder dilution is one of the proposal's objectives.20 Fund managers already take that goal seriously, as practices" that could "help improve liquidity risk management standards across the industry and enhance market discipline with respect to how funds manage and measure liquidity risk." FSOC Update at 12. 16 In this regard, the ICI Comment Letter supported most of the proposed disclosure changes on Form N-1A, proposed Form N-PORT, and proposed Form N-CEN, with the most notable exception being asset level liquidity classifications on proposed Form N-PORT. ICI Comment Letter at 69-72. As part of our alternative to the SEC's asset classification scheme, we recommended that a fund (i) report to the SEC only on Form N-PORT, on an aggregated basis, the percentages in each of the asset categories that the fund establishes, and provide a description of those categories, and (ii) provide additional disclosure in its prospectus about how it assesses, classifies, and monitors fund liquidity. ICI Comment Letter at 31. 17 See ICI Comment Letter at 32-33 for a more detailed treatment of forward-looking statements and safe harbors. 18 The proposed rule would define liquidity risk 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." 19 ICI Comment Letter at 4, 13-16. 20 The SEC appears to define dilution as the impact of fund share redemptions on the fund. Release at 62275. In our view, mutualized transaction costs that may accompany redemptions are not problematic per se—they are an aspect of investing in any pooled vehicle. Rather, fund managers

should be sensitive to the magnitude of these costs, minimize them to the extent practicable, and seek to treat all shareholders fairly, so that these costs are not borne disproportionately by any one group of shareholders (e.g., long-term shareholders). Finally, when thinking about dilution we would sharply distinguish between transaction costs (included) and losses that may result from market factors (not included). Mr. Brent J. Fields May 17, 2016 Page 8 exemplified by the care with which they seek to minimize transaction costs and manage portfolio assets in a way that accomplishes long-term objectives and is fair for all shareholders.21 If the SEC wishes to adopt a comprehensive definition of liquidity risk that avoids the inherent difficulties associated with examining price fluctuation, then it should instead incorporate language relating directly to dilution. As one of the liquidity risk factors for funds to consider, the SEC also could include the transaction costs22 associated with meeting redemptions. At any rate, the SEC should emphasize that the goal of a successful liquidity risk management program is to enable a fund to satisfy redemption requests in normal and reasonably foreseeable stressed market conditions in a manner that is consistent with the interests of the fund and its shareholders. In the following Appendix, we provide specific rule text to incorporate the changes we recommend in this section. IV. Assessment of the Three-Day Liquid Asset Minimum The SEC proposed that each fund establish, periodically review, and manage in accordance with a "three-day liquid asset minimum." This minimum would be the percentage of the fund's net assets to be invested in "three-day liquid assets," and these 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." ICI and most other commenters addressing the matter opposed the SEC's proposed three-day liquid asset minimum for a number of reasons. Having reviewed all comment letters and discussed the three-day liquid asset minimum further with members, our views on it are unchanged. As explained in the ICI Comment Letter, the three-day liquid asset minimum: relies on an asset classification scheme to which we objected; could adversely affect funds' ability to adhere to their investment objectives, policies, and strategies; could deprive funds of investment opportunities; could depress demand for "less liquid assets," making them less liquid still; and could reduce market liquidity generally (funds near or below their respective minimums would be precluded from making countercyclical investments in less liquid assets).23 For these reasons, we continue to recommend that the SEC not incorporate the three-day liquid asset minimum into any final rule. In the ICI Comment Letter, we recommended instead that 21 See ICI Comment Letter at 9-10 (explaining that fund managers' fiduciary duties and economic incentives are in accord with minimizing dilution, and that they have tools and techniques to minimize it). 22 These would consist of costs associated with selling portfolio assets, including commissions and spreads. 23 ICI Comment Letter at 37-40. Mr. Brent J. Fields May 17, 2016 Page 9 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).24 * * * We appreciate the opportunity to provide these additional comments 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; Dorothy Donohue, Deputy General Counsel, at (202) 218-3563; or Matthew Thornton, Assistant General Counsel, at (202) 371-5406. 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 24 ICI

Comment Letter at 41. 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). A-1 Appendix: ICI Recommended Potential Modifications to Proposed Rule 22e-4 Relevant existing provisions of proposed Rule 22e-4 are provided below for context, and new text is marked. Proposed Changes Related to the 15% Limitation on Illiquid Assets (a) Definitions. For purposes of this section: * * * (4) 15% standard Illiquid asset means 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. 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. * * * (b) Adoption and implementation of liquidity risk management program. (1) Program requirement. Each fund shall adopt and implement a written liquidity risk management program (“program”) that is reasonably designed to assess and manage the fund's liquidity risk. The program shall include policies and procedures incorporating the elements of paragraphs (b)(2)(i) through (iv) of this section. The program shall be administered by the fund’s investment adviser, or an officer or officers of the fund, but may not be administered solely by portfolio managers of the fund. (2) Required program elements. Each fund must: * * * (iv) Manage the fund's liquidity risk, including that the fund will: * * * (D) Not acquire any 15% standard illiquid asset if, immediately after the acquisition, the fund would have invested more than 15% of its total net assets in 15% standard illiquid assets; and (E) Promptly notify the Commission by electronic mail directed to the Director of Investment Management, or the Director’s designee, if the fund’s percentage of illiquid assets exceeds, for five consecutive business days, 15% of its net assets as of any time that the fund calculates its current net asset value; * * * (c) Recordkeeping. The fund must maintain: A-2 * * * (2) Copies of any materials provided to the board of directors in connection with its approval under paragraph (b)(3)(i) of this section, copies of notices provided to the Commission under paragraph (b)(2)(iv)(E) of this section, and written reports provided to the board of directors under paragraph (b)(3)(ii) of this section, for at least five years after the end of the fiscal year in which the documents were provided, the first two years in an easily accessible place; and Proposed Changes Related to “Liquidity Risk” (a) Definitions. For purposes of this section: * * * (7) Liquidity risk means 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 unreasonably diluting the interests of remaining fund shareholders. * * * (b) Adoption and implementation of liquidity risk management program. (1) Program requirement. Each fund shall adopt and implement a written liquidity risk management program (“program”) that is reasonably designed to assess and manage the fund's liquidity risk. The program shall include policies and procedures incorporating the elements of paragraphs (b)(2)(i) through (iv) of this section. The program shall be administered by the fund’s investment adviser, or an officer or officers of the fund, but may not be administered solely by portfolio managers of the fund. (2) Required program elements. Each fund must: * * * (iii) Assess and periodically review the fund's liquidity risk, considering the fund’s: * * * (E) Transaction costs associated with meeting redemptions.