

July 20, 2017

The Honorable Jay Clayton
Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: *ICI's Recommendations Related to the Liquidity Risk Management and Fund Reporting Requirements*

Dear Chairman Clayton:

I am sending this letter to follow up on our June meeting at which we discussed issues of importance to the fund industry. As highlighted at our meeting, I respectfully request that you take action very soon to refine and phase in discrete yet impactful elements of two sets of recently adopted rules: the liquidity risk management program and the fund reporting rules.

The Commission adopted both sets of rules in October 2016, and the compliance dates for each are approaching. Based on our work with members in implementing these rules, we have deep concerns about the industry's ability to meet the compliance deadlines. More fundamentally, efforts to implement the rules have reinforced our belief that the Commission needs to re-examine the asset classification element of the liquidity rule and the required frequency of portfolio holdings reporting. We therefore request that the Commission take the actions summarized immediately below.

- Adjust the compliance schedule for the liquidity rule's asset classification and related requirements as soon as possible, providing the SEC with time to propose and finalize targeted rule amendments. Rule amendments should permit each fund to formulate its own policies and procedures to determine how to classify the liquidity of its investments.
- Even if the SEC determines not to pursue the recommended amendments, adjust the compliance schedule for the current liquidity rule and related reporting requirements by at least one year.
- Require quarterly (instead of monthly) reporting of portfolio holdings on Form N-PORT until the SEC can address information security concerns adequately.

- Even if the SEC determines to retain the monthly reporting requirement for portfolio holdings, delay the compliance dates for the Form N-PORT and Form N-CEN filing requirements for at least six months.

Each of these points is described in more detail below.

I. Recommendations Related to the Liquidity Risk Management Program Rule

The SEC should adjust the compliance schedule for the rule's asset classification and related requirements as soon as possible. Quick and decisive action—with respect to delaying the rule's asset classification requirements—is critical to avoid a repeat of the industry's difficult, costly, and confusing experience implementing the Department of Labor's fiduciary rule. Delay would provide the SEC time to propose and finalize targeted amendments, and would permit the industry to pause its work on implementing the most costly and challenging part of the rule (*i.e.*, asset classification) and focus on implementing the remaining elements.¹ The industry stands ready to assist the SEC in quickly developing and finalizing such targeted amendments.

In particular, the SEC should re-examine the rule's asset classification, or "bucketing," requirement via a request for additional comments that incorporates a delay in implementation commensurate with the Commission's re-examination. While the final rule improved the proposed asset classification methodology, in practice it still will overshadow the rest of the rule in ways the SEC likely did not contemplate or intend. This has proven to be—by far—the most costly and vexing piece of the rule to implement. The SEC's own economic analysis assumes that the costs of this classification requirement constitute approximately 75 percent of a fund's total cost to comply with the rule (industrywide, the SEC estimates the one-time implementation cost of the classification requirement alone to be more than \$640 million).² The rule would require funds to consider a number of complex

¹ This approach would stand in stark contrast to the tortured history of the DOL fiduciary rule. Despite the fact that DOL still is re-examining the fiduciary rule, the rule already has caused significant and widely reported dislocations and disruptions within the retirement services industry, including causing many investors to lose access to advice (due to both changes in intermediaries' service offerings and to intermediaries "orphaning" hundreds of thousands of investor accounts). DOL finalized the rule on April 8, 2016, with an effective date of June 7, 2016 and an applicability, or compliance, date of April 10, 2017. President Trump then issued a memorandum to the Secretary of Labor on February 3, 2017 directing DOL to prepare an updated analysis of the likely impact of the fiduciary rule on access to retirement information and financial advice and, depending on the outcome of that re-examination, to propose rescission or modification of the rule. On March 2, 2017, DOL proposed to delay the compliance date by 60 days, and finalized a partial delay of the compliance date on April 7, 2017—a mere 3 days before the scheduled compliance date—which allowed part of the rule to become applicable on June 9, 2017 and postponed required compliance with the rest of the rule until January 1, 2018. Consequently, significant portions of the rule became applicable on June 9 even though DOL has not yet completed its analysis. Most recently, on July 6, 2017, DOL issued a request for information on potential changes to the rule, including a request for comments on a potential delay in the January 1, 2018 secondary compliance date—further evidence that DOL should not have permitted the rule to become applicable before completing its re-examination and working out any necessary changes.

² In April 2017, ICI surveyed its members to better understand their progress in implementing the liquidity rule (the "Liquidity Survey"). Fifty ICI member firms responded, representing 78 percent of US registered open-end fund assets as

and interrelated fund-, market-, trading-, and investment-specific factors and make judgment calls. Presently, systems that will allow funds to synthesize this disparate information and generate outputs in accordance with the rule are far from complete. Although funds and vendors are working on solutions, these solutions will be costly for funds to implement and use on an ongoing basis, and likely will require several more months before they are mature enough for meaningful evaluation and testing. These costs simply cannot be justified, because maintaining a uniform asset classification requirement is not essential to a strong liquidity risk management program rule.

Moreover, when these systems are finalized, the liquidity classifications these systems generate for a given security either will differ (in which case the classifications will be subject to second-guessing, and potentially confuse regulators and the public) or be largely identical (creating the potential for crowded trades and herding). ICI submitted a comment letter on the proposal, which among other things discussed how the proposal risked creating more correlated portfolios and trades across funds if funds gravitate toward investments perceived (by third parties, regulators, or the public) as “more liquid.” This herding in turn could increase dislocations and volatility in financial markets by contributing to cliff events in liquidity (similar to those arising from credit rating agencies downgrading certain investments during the financial crisis).³

These concerns remain even though the final rule and reporting requirements were not as draconian as the proposed requirements. We understand the SEC’s desire for uniformity and consistency in liquidity classification of portfolio assets and the reporting that will follow from it (which the public would see in aggregated form periodically), and the surface appeal of such uniformity. But the more a regulator insists upon uniformity and consistency in this area, the greater the likelihood of correlation, herding, and cliff events.

In addition to these potentially adverse market-wide effects, there is substantial risk that the SEC and other regulators will overemphasize and be misled by this limited, subjective, and forward-looking classification information. In theory, regulators may acknowledge these limitations, but in practice, they will be hard-pressed to resist latching on to these conclusory measures in monitoring market and fund activity and making policy. In time the associated caveats and need for cautious reliance (at most) will be forgotten. Our concerns surrounding public reporting are even greater, because the public is even more likely to be misled by (or fail to fully understand the inherent limitations of) this information.

Nor are the potential benefits to uniform classification and reporting requirements clear and substantial. The SEC will receive a wealth of objective information from funds through Form N-

of March 31, 2017. The Liquidity Survey indicated that 75 percent of respondents with a view believed that the SEC’s 75 percent estimate was either “about right” or “too low.” More generally, one member preliminarily estimates that its one-time costs to comply with the liquidity rule will range from \$5 to 10 million, with annual ongoing costs in the low millions. Another member estimates that its one-time costs to comply with the rule will be approximately \$7 million.

³ See Letter from Brian K. Reid, Chief Economist, ICI, to Brent J. Fields, Secretary, SEC, dated January 13, 2016, available at www.sec.gov/comments/s7-16-15/s71615-56.pdf.

PORT filings, which will require funds to report portfolio holdings and other information (*e.g.*, information about fund flows and return information). With this information, the SEC will be well-positioned to monitor developments at the macro level (*e.g.*, deterioration of the performance or liquidity of a particular asset class such as high yield debt, and its effect on funds) or micro level (*e.g.*, whether a particular fund is under liquidity pressure, based on its monthly flows, performance, and/or the composition of its portfolio). This would greatly elevate the SEC's ability to effectively monitor the fund industry and share information with other interested regulators. Subjective and limited classification information would add little to this picture, and as outlined above, could very well detract from it.

Instead, the rule's real benefits in enhancing liquidity risk management practices and investor protection will be derived from its requirements related to assessing, managing, and reviewing (with periodic board reporting) liquidity risk. Liquidity risk is a very broad concept, and it encompasses much more than classifying every portfolio asset using a uniform "days to cash" framework. At most, a reasonable approach to asset classification contributes to a fund's overall understanding of its liquidity risk. And the contributions from a uniform methodology implemented solely for regulatory purposes—especially if it is run parallel to the fund's preferred methodologies—will be more modest still.

Instead of the rule's current complex, costly, and uniform approach to asset classification, the SEC should require each fund, as part of its liquidity risk management program, to formulate its own policies and procedures to determine how to classify the liquidity of its investments. Asset classification, while not an end in itself, is a useful internal discipline that helps funds assess and manage liquidity risk, and it has a place in any comprehensive liquidity risk management program. Approaching asset classification in this way would respect the diversity of practices that have emerged in the industry and their validity; focus funds' attention on comprehensive liquidity risk assessment, management, and review; and greatly reduce the cost and complexity of implementing and administering the rule.

The rule has a number of sound elements that we recommend preserving, and that could proceed without delay. Most notably, the Commission should keep the rule's definition of "liquidity risk" and its broad and practical set of related factors and guidance. The rule's framework for assessing, managing, and reviewing liquidity risk—which appropriately appears as the rule's first required program element—should be the heart of the rule. Adoption of liquidity risk-centered programs will enhance the formality, discipline, and rigor of the industry's current liquidity risk management practices. Additionally, the Commission should maintain other elements of the rule, such as its 15 percent limit on illiquid investments and related reporting requirements to fund boards and the SEC when a fund exceeds this limit; general board oversight of the program, including annual reporting to the board; establishment of redemption in-kind policies and procedures; and the recordkeeping requirements. Finally, we support retaining the new prospectus disclosure requirements that have taken effect and the liquidity-related disclosure items on Form N-CEN.

Even if the SEC ultimately determines not to propose rule amendments, it must act quickly to delay the compliance dates of the current rule and related requirements for at least one year. Given the complexity of the asset classification function, we anticipate that most fund complexes will engage third parties to assist with it, and those third parties will not have mature products to evaluate for several more months. Moreover, firms effectively must complete their liquidity programs prior to obtaining requisite board approvals, and we anticipate many fund complexes educating their boards about their programs over multiple board meetings and obtaining final approvals by fall 2018. Consequently, many fund complexes will be left with a relatively short period of time to conduct all of the work that is necessary to ensure a smooth and successful implementation.

II. Recommendations Related to New Fund Reporting Requirements

The SEC should require quarterly, instead of monthly, reporting of portfolio holdings until it addresses information security concerns. In addition, the SEC should provide adequate time to implement the Form N-PORT and Form N-CEN filing requirements. For reasons similar to those we outline above with respect to the liquidity rule, we urge the SEC to address these issues quickly and decisively. Each of these points is explained in more detail below.

We are extremely concerned about the SEC's ability to protect the valuable and sensitive portfolio holdings information that funds will be required to report monthly under the SEC's fund reporting rules. As detailed in our earlier letter, a breach of the Commission's data security would cause irreparable harm to funds.⁴ The SEC's collection of immense volumes of fund data will create a vast, unique, trove of structured data—data that reflects the intellectual capital and very lifeblood of the fund business—and a potential single point of failure that undoubtedly will attract the attention of cybercriminals. A hack of Form N-PORT data could expose the entire universe of funds to predatory trading practices, including front-running of fund trades, “free riding” of fund investment research, and reverse engineering or “copycatting” of fund investment strategies—all at the expense of fund shareholders.

Under the SEC's fund reporting rules, the Commission will make public only the holdings reported for the third month of each fiscal quarter after a 60-day lag. However, regardless of the length of the time lag between when the data is transmitted to the SEC and posted publicly, reporting of data on a monthly basis to the Commission increases the challenge of securing the information and heightens the risks of hacking. Recent reports by the Commission's own inspector general, as well as the Government Accountability Office (GAO) raise serious concerns about the SEC's current ability to maintain the security of monthly portfolio holdings information.⁵ The GAO Report, for example,

⁴ See Letter from David W. Blass, General Counsel, ICI, to Brent J. Fields, Secretary, SEC, dated August 11, 2015, *available at* www.sec.gov/comments/s7-08-15/s70815-315.pdf.

⁵ See US Securities and Exchange Commission, Office of Inspector General, *Audit of the SEC's Compliance with the Federal Information Security Modernization Act for Fiscal Year 2015* (Jun. 2, 2016), summary available at www.sec.gov/oig/reportspubs/Audit-of-the-SECs-Compliance-with-the-Federal-Information-Security-Modernization-Act-for-Fiscal-Year-2015.pdf (Inspector General Report); United States Government Accountability Office, *Information*

noted that the SEC “did not consistently protect its network from possible intrusions” or “restrict physical access to sensitive assets.”⁶ This Report recommended that the Commission take six steps to improve its information security program. The Inspector General Report found numerous weaknesses in the SEC’s information security program, including outdated policies and procedures, and recommended that the SEC address these areas of potential risk.

In addition to thoroughly addressing these weaknesses, we recommend that the SEC implement aggressive measures to protect Form N-PORT data, including independent third-party testing and verification of its information security programs, prior to requiring firms to commence monthly filing of portfolio holdings. Other entities have delayed reporting of sensitive industry information until data security concerns could be adequately addressed. For example, FINRA’s Comprehensive Automated Risk Data System (“CARDS”) proposal, which would have required certain firms to periodically submit in an automated, standardized format specific information relating to their securities accounts, recently was put on hold so that FINRA could first conduct additional analyses and engage third-party experts to analyze potential threats to the security of the information being collected.⁷ We strongly urge the SEC to take responsible steps similar to those that FINRA outlined.

To adequately protect sensitive portfolio holdings data, we recommend that the SEC require that funds report this Form N-PORT information to the Commission quarterly, 30 days after the end of the reporting period, until the Commission has implemented the recommendations of a third-party expert.⁸ Meanwhile, the SEC could, as currently required, continue to collect other Form N-PORT data on a monthly basis. Staging reporting in this manner would enhance significantly the Commission’s ability to oversee the fund industry while ensuring that the Commission is appropriately prepared to protect confidential fund information.

We recognize that the Commission ultimately might determine to require reporting of portfolio holdings information on a monthly basis. Separate and apart from this determination, however, we request that the Commission provide at least an additional six months—until December 2018—for funds to comply with the Form N-PORT and Form N-CEN filing requirements.⁹ While

Security: Opportunities Exist for SEC to Improve Its Controls over Financial Systems and Data (Apr. 2016), available at www.gao.gov/assets/680/676876.pdf (GAO Report).

⁶ GAO Report at 5-6.

⁷ See Testimony of Richard G. Ketchum, Chairman and CEO, FINRA, Before the Committee on Financial Services, US House of Representatives (May 1, 2015), available at financialservices.house.gov/uploadedfiles/hhrg-114-ba16-wstate-rketchum-20150501.pdf.

⁸ The Commission would make this portfolio holdings information (Part C of Form N-PORT) public 60 days after the end of the reporting period.

⁹ We similarly ask that the Commission provide at least an additional six months—until December 2019—for funds that are part of a group of related investment companies that has net assets of less than \$1 billion as of the end of the most recent fiscal year to comply with the Form N-PORT filing requirements.

ICI members have been working diligently to prepare for the new reporting requirements since the rules were adopted, our members face significant challenges in meeting the regulatory deadlines.

The vast amount of new data required for Forms N-PORT and N-CEN are not easily accessed, compiled, and reported. Funds will have to create new systems to source the data, assemble it in one place, and transform it into a form acceptable to the Commission. Once these significant undertakings are accomplished, funds will have to test their systems to ensure that the information is accurate and reliable.

Funds increasingly are concerned that they will not have adequate time under the current compliance dates to complete these requirements, as the timing is dependent on multiple third parties. We understand that most fund complexes will engage third parties to assist with the extrapolation, compilation, and reporting of the immense amounts of required data, and these third parties have not yet fully developed products for funds to evaluate—and likely will not have these products fully developed—for at least several more months. Many members have told us that they cannot even begin some of the most time-consuming endeavors associated with implementing the rule until these products are available.

Anecdotally, our members have expressed concern that third-party vendors may not have products ready even by the end of the third quarter of 2017, despite optimistic forecasts for product availability. In addition, we have heard that there are specific item requirements that funds are having trouble preparing for, even with third-party assistance. For example, many funds currently do not compute the portfolio-level risk metrics that the new rules require, and tell us that many third-party vendors they have consulted do not anticipate calculating those metrics as part of their product offerings. Even if a fund finds a third party to provide the information, it will need time to fully vet the calculations, to ensure that the information can be determined on a monthly basis, and to ensure that the information is reported accurately.

We, therefore, recommend delaying for at least six months the compliance dates for the initial Form N-PORT and Form N-CEN filings to provide funds with sufficient time to appropriately implement and address the sheer amount of data that must be collected and reported under the new fund reporting rules. The six-month delay for the Form N-PORT and N-CEN filing requirements should provide funds with sufficient time to:

- develop new technologies to compile vast amounts of data on a monthly basis;
- assess the sources for the data elements from several different systems;
- determine whether to build or enhance their own systems or use third-party vendors to assist in the process;
- if they use third-party vendors, upload their data to vendor platforms;
- test their systems to ensure that the data is of sufficient quality; and

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- design processes and controls to ensure the accuracy of the data.

In connection with this recommendation, we also recommend that the Commission maintain as non-public all reports filed on Form N-PORT for the first six months following the compliance dates. This would allow funds sufficient time to work out any issues they have with filing the forms in the required XML format and is consistent with the Commission's approach under the current compliance schedule.

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We appreciate the opportunity to provide these additional recommendations to you. If you have any questions regarding this letter or would like additional information, please feel free to contact me at [REDACTED] or Dorothy Donohue, Acting General Counsel, at [REDACTED].

Sincerely,

/s/ Paul Schott Stevens

President and CEO
Investment Company Institute

cc: The Honorable Kara M. Stein
The Honorable Michael S. Piwowar

David Grim, Director
Division of Investment Management