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**VIA E-MAIL RULE-COMMENTS@SEC.GOV**

Mr. Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

**Re: Investment Company Liquidity Disclosure (File No. S7-04-18).**

**We recommend that Rule 22e-4 be re-proposed to eliminate the current bucketing requirement and replace it with a simpler but more useful stress test regime.**

Dear Mr. Fields:

This letter presents the comments of Federated Investors, Inc. and its subsidiaries ("Federated") with respect to final rule 22e-4 (the "Rule") issued by Securities and Exchange Commission (the "Commission") requiring significant new reporting obligations for non-2a7 mutual funds.[1] Federated appreciates the recent decision by the Commission to propose changes in the public reporting requirements of rule 22e-4 (the "Proposal").[2] Federated strongly endorses the elimination of the public disclosure of the liquidity buckets as currently required under rule 22e-4 and has already provided extensive comments on February 6, 2018 to File No. s7-04-18 on this topic (the "Letter").[3] However, notwithstanding the absence from the Proposal of request for comment on the elimination of, or material changes in, the liquidity bucketing regime itself, the public comments of Commissioners Piwowar and Peirce [4] that challenge the current bucketing regime open the door to public comment on

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[1] Federated is one of the largest investment management firms in the United States (the "U.S."), managing $ 264.8 billion in mutual fund assets and $ 397.6 billion in total assets as of December 31, 2017, Federated provides comprehensive investment management to more than 8,400 institutions and intermediaries including corporations, government entities, insurance companies, foundations and endowments, banks and broker/dealers.

[2] https://www.sec.gov/rules/proposed/2018/ic-33046.pdf

[3] https://www.sec.gov/comments/s7-03-18/s70318-3129427-161937.pdf

[4] Comments by Commissioners Piwowar and Peirce during the SEC's public meeting on March 14, 2018.

a broader set of issues than those addressed in the Proposal itself. In particular, Federated believes that the bucketing regime in the adopted rule: (i) is highly burdensome and defective; (ii) will not provide the Commission or fund managers with meaningful insights into fund liquidity during times of market stress; (iii) will not provide the benefits to the Commission that were intended by this portion of rule 22e-4; and (iv) will therefore not meet the cost/benefit test associated with this very costly obligation on investment companies under the current Rule.

While not intending to repeat all the statements made in Federated's Letter, many of the facts and analysis provided in that comment relate directly to the question of whether the bucketing regime should be eliminated or materially altered. The Letter observed that:

> The bucketing regime required by Rule could inadvertently lead to potentially false and misleading information being reported to shareholders that may cause them to materially underestimate the liquidity risk in many funds. . . .
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> The reporting obligation . . . requires that the advisor of each fund assign each portfolio holding into one of four liquidity buckets. . . . [T]he advisor must: (i) project what reasonably foreseeable stressed market conditions might prevail; (ii) estimate what redemptions might foreseeably take place during such period; [and] (iii) determine what portion of each portfolio holding would be sold to meet such redemptions. . . . [T]he advisor is directed to use ***current market conditions*** for the expected transaction costs associated with each position to be sold. In particular, the advisor is not required to base liquidity assessments on the transaction costs that might reasonably be expected to prevail during the stress market conditions that are otherwise presumed.[5]
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> "[I]nvestors that rely on disclosures pursuant to current rule 22e-4 could be misled and potentially significantly harmed when large redemptions occur during periods of market stress.
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> Numerous commenters have observed that the current bucketing scheme provided in rule 22e-4 is onerous and may potentially result in false and misleading information being provided to shareholders. . . . [T]he recent U.S. Treasury report concurs in the determination that a principles-based regime is strongly preferred to the bucketing currently required in rule 22e-4.[6]

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[5] Rule at 104. "As discussed further below, in a modification to the proposed standard, each of the liquidity categories included in the classification requirement we are adopting requires a fund to determine the time period in which an investment would be reasonably expected to be converted to cash (or in some cases, sold or disposed of) in current market conditions without the conversion to cash (or in some cases, sale or disposition) significantly changing the market value of the investment. This modification highlights that the standard does not require a fund to actually re-value or re-price the investment for classification purposes, nor does the standard require the fund to incorporate general market movements in liquidity determinations or estimate market impact to a precise degree."

[6] U.S. Treasury Report at 34. "Treasury supports robust liquidity risk management programs and believes they are imperative to effective fund management and the health of the financial markets. For this reason, Treasury supports the 15% limitation on illiquid assets. However, Treasury rejects any highly prescriptive regulatory approach to liquidity risk management, such as the bucketing requirement. Instead, Treasury supports the SEC adopting a principles-based approach to liquidity risk management rulemaking and any associated bucketing requirements." https://www.treasury.gov/press-center/news/Pages/A-Financial-System-That-Creates-Economic-Opportunities---Asset-Management-and-Insurance.aspx

> Federated believes that investors are likely to assume that the Rule is intended to protect them precisely during the stress market conditions for which the Rule was envisioned, that is, when liquidity is impaired. It is therefore both ironic and contrary to public interest for a possible effect of rule 22e-4 under certain circumstances to be that investors may be misled regarding liquidity risk in exactly the circumstances that the Rule was designed to protect them.

With this background in mind, Federated stated in our Letter that "a motivating factor for the Commission's rulemaking on liquidity risk was FSOC's particular concern regarding the redemption rights in open-end mutual funds, where "reaching for yield" in high yield portfolios was a specific concern." [7] In particular, in analyzing the various factors that can give rise to liquidity risk, the adopting release states: [8]

> There can be significant adverse consequences to remaining investors in a fund that does not adequately manage liquidity. . . . For example, during the pendency of our proposal, the Third Avenue Focused Credit Fund, a non-diversified open-end fund, adopted a plan of liquidation. . . . This event highlights the extent to which shareholders can be harmed when a fund holding portfolio assets that entail significant liquidity risk does not adequately anticipate the effects of market deterioration and increased shareholder redemptions. . . .
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> These factors in fund redemptions—either individually or in combination—can create incentives in times of liquidity stress in the markets for shareholders to redeem quickly to avoid further losses (or a "first-mover advantage"). If shareholder redemptions are motivated by this first-mover advantage, they can lead to increasing outflows, and as the level of outflows from a fund increases, the incentive for remaining shareholders to redeem may also increase. . . .

Motivated by these considerations, the adopting release proceeds to give explicit direction with regard to the manner that stress market conditions shall be incorporated in a fund's overall Liquidity Risk Management Program. For instance: [9]

> **Consideration of Investment Strategy and Portfolio Liquidity during Normal and Reasonably Foreseeable Stressed Conditions**
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> Finally, we also are modifying the proposed liquidity risk assessment requirement to clarify that certain liquidity risk factors must be considered during both normal and reasonably foreseeable stressed conditions. . . . In considering normal and reasonably foreseeable stressed conditions, funds should consider historical experience but should recognize that such experience may not necessarily be indicative of future outcomes, depending on changes in market conditions and the fund's particular circumstances.
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> We note that "stressed" conditions will likely entail different scenarios for different types of funds. . . . Assessment of stressed conditions also should take into account stresses originating outside of market stress. For example, certain funds could be significantly affected by geopolitical stresses, such as an emerging markets debt fund whose holdings' liquidity is

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[7] www.treasury.gov/initiatives/fsoc/rulemaking/Documents/Notice%20Seeking%20Comment%20on%20Asset%20Management%20Products%20and%20Activities.pdf.

[8] Rule at 31.

[9] Rule at 75.

> affected by factors such as economic uncertainty in the holdings' countries of issuance. The extent to which stressed conditions are reasonably foreseeable will vary depending on the fund's facts and circumstances.

It is therefore abundantly clear that a material intended benefit of rule 22e-4 is to improve fund liquidity risk management in stressed market conditions. However, our Letter points out that: (i) the reporting requirement of the rule directs fund advisers to use ***current market conditions*** in assessing the impact on remaining shareholders from liquidating fund holdings to meet redemptions in a future stressed market scenario; and (ii) that the use of current market conditions, rather than such market conditions that might exist in such future stressed market environment may, under certain conditions, lead to a false or misleading assessment of the liquidity in the fund in stressed conditions. It is therefore entirely appropriate for the Commission to eliminate the corresponding public disclosure requirement in current rule 22e-4; and Federated completely endorses this element of the Commission's Proposal.

However, if the data derived from the above-referenced process could be potentially false and misleading to shareholders with regard to fund liquidity in stressed market conditions, it would similarly be false and misleading for the Commission. Therefore, there is no cost/benefit justification for the Commission to collect such information regarding potential stressed market conditions using the bucketing regime prescribed by rule 22e-4 when there are alternative less burdensome and costly techniques available that are more likely to provide reasonable estimates of fund liquidity in potential stressed market environments. In particular, we draw the Commission's attention to the following:

- As part of its mandated Cost/Benefit Analysis, pages 332 – 340 of the adopting release discuss the benefits of rule 22e-4. There is no mention of any benefit to the Commission, for enforcement or other purpose, that is derived from the collection of fund liquidity bucketing data in normal or stressed market conditions.

- In the adopting release, the Commission estimates that the classification process (the bucketing regime) will represent approximately 75% of the cost of complying with rule 22e-4.[10]

- In the adopting release, the Commission estimates that: (i) the one-time costs for funds to range from approximately $0.8 million to $10.2 million (with an average cost of $1million for each fund complex); and (ii) the aggregate (industry-wide) cost will be approximately $855 million.[11] Using the Commission's above-referenced estimate, the average cost per fund complex for the bucketing regime alone will be approximately $0.75 million and the aggregate cost will be approximately $641 million.

[10] Rule at 343. "In addition, because the process of classifying assets under the proposal would likely constitute a majority of a fund's costs, we assume the classification process constitutes approximately 75% of a fund's cost of complying with proposed rule 22e-4."

[11] Rule at 343. "This method results in one-time costs for funds under the proposed rule that range from approximately $0.8 million to $10.2 million, that the average cost per fund complex is $1 million, and the aggregate cost is approximately $855 million."

- In the adopting release, the Commission estimates that the ongoing costs for complying with the rule will range from 5% to up to 32.5% of the one-time costs.[12] Applying this range to the above referenced estimate of $641 million for the industry cost overall, this implies an industry-wide ongoing cost for the bucketing regime alone of between $32 million and $208 million.

In summary, the Commission has itself concluded that: (i) the majority of the cost of complying with rule 22e-4 results from the liquidity classification requirements (the bucketing regime); (ii) the associated costs are obviously material; (iii) by virtue of the Proposal, there is no net benefit (and probably an outright disadvantage or cost) to public disclosure of the results of the bucketing analysis because of the above-referenced defects and other shortcomings ; and (iv) the potential benefit to the Commission from receiving monthly reports of the liquidity classifications under rule 22e-4 were irrelevant for consideration in the mandated cost/benefit justification of rule, even under the Commission's prior belief that the liquidity classifications were sufficiently informative that they should be publicly disclosed. We conclude that the cost/benefit test of the liquidity bucketing regime required under current rule 22e-4 is not satisfied, particularly in light of the availability of less burdensome and costly alternatives, which we now address.

We begin with the premise that, under normal market conditions, fund liquidity and the ability of funds to meet redemptions without imposing significant harm on remaining shareholders has historically been appropriate to meet the regulatory and prudential requirements on advisers. In contrast, the financial crisis and specific events during stressed markets, such as the Third Avenue Focused Credit Fund closure, have raised new questions regarding fund liquidity in such stressed market conditions. In particular, FSOC's concern with the redemption rights in open-end funds[13] and the Commission's own consideration of "first mover advantage" referenced above has led the Commission to a sharper focus on liquidity risk management in stressed conditions. Even under such conditions, the Commission has not concluded that the existing liquidity management regime is necessarily inadequate. For instance, the adopting release states:[14]

> We agree with commenters that the empirical support for the existence of a first-mover advantage is not conclusive and that the mutual fund industry has been able to successfully navigate periods of historical market stress. While we understand that fund investors may not have historically been motivated to redeem on account of a perceived (or actual) first-mover advantage during previous periods of stress, we cannot predict how investors may behave in the future. To the extent that economic incentives exist to redeem fund shares prematurely, such redemptions could lead to investor dilution as discussed above, and the possibility of protecting against this potential dilution could be one benefit of rule 22e-4.

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[12] Rule at 345. "While our analysis in the proposal assumed ongoing costs ranged from 10% to 25% of the one-time costs resulting from the rule, we've reduced the low end of the range to 5% to reflect changes from the Proposing Release, discussed below, that should lower some funds' compliance burdens, and increased the high end of the range to 32.5% to reflect the commenter's estimate that ongoing costs for their fund under the proposed rule would be $0.65 million (compared to one-time costs of $2 million)."

[13] www.treasury.gov/initiatives/fsoc/rulemaking/Documents/Notice%20Seeking%20Comment%20on%20Asset%20Management%20Products%20and%20Activities.pdf.

[14] Rule at 336.

Furthermore, the Commission has already received ample evidence that, under normal market conditions, the new bucketing regime will demonstrate that even high yield funds would be deemed to be primarily highly liquid. For instance, the ICI November 3 2017 comment letter provides such conclusions for an array of equity, high yield and municipal funds.[15] We therefore conclude that, should the Commission consider new complex or costly reporting requirements for funds, it should focus primarily on liquidity conditions in stressed market environments. Moreover, it should not confuse or invalidate this exercise by asking advisers to conduct such studies under the bid-ask spread conditions that prevail in normal market conditions, as is done in current rule 22e-4.

In addressing the possible liquidity conditions of a fund in a future stress market scenario it must be understood that a highly quantitative approach, such as the approach employed by many vendors or advisers in responding to current rule 22e-4, will be unrealistic or impractical. Advisers should be informed by historical events, and the redemptions that ensued, but not unduly rely on such data as future stress events typically do not simply repeat prior patterns. Instead, we recommend that the Commission heed the advice provided in the ICI's May 17, 2016 comment letter and allow such estimates to employ judgment, be made on "top down" basis and be allowed to reflect the specific circumstances of each individual fund.[16] While a number of approaches may be available, Federated specifically recommends the following:

- The Commission require that fund advisers perform quarterly stress tests for each fund.

- The stress test would specify: (A) three market scenarios: a base case, an adverse market environment and an extreme adverse environment; and (B) for each such market scenario, advisers should specify three redemption scenarios: a base case, an adverse and an extreme adverse level of (net) redemptions realized over a span of time, such as one week. This creates nine (9) outcomes (three market scenarios x three redemption scenarios).

- For each of the nine market/redemption scenarios, the adviser should provide an estimate of the average transaction cost that might be realized in meeting the corresponding redemptions.

- The Commission should provide guidance for the development of the market or redemptions scenarios. For instance, the Commission may suggest specific redemption magnitudes (perhaps informed by each fund's historical experience) and/or specific market shocks, again informed by historical experience.

- Funds should be required to maintain liquidity risk practices, policies and procedures that are reasonably designed to meet redemptions without significant harm to remaining shareholders in the base case and adverse market/redemption scenarios; and maintain additional facilities such as redemption in kind, delayed redemptions or (for certain asset classes) redemption fees, which funds already have an obligation to consider, to prevent significant harm to shareholders in extreme adverse scenarios where markets may not function normally.

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[15] ICI November 3rd, 2017 comment letter: Supplemental Comments on Investment Company Liquidity Risk Management Programs; Request for Delay (File No. S7-16-15)
[16] ICI Comment letter May 17, 2016 https://www.sec.gov/comments/s7-16-15/s71615-141.pdf

- The stress test program and related policies and procedures should be a required element in the written liquidity risk management program required under rule 22e-4. Stress test results should be reviewed with fund trustees at least annually.

- The Commission could require that advisers maintain books and records to be available for examination to demonstrate the methodology and rigor with which the stress tests were conducted.

- The stress test results would be reported to the Commission, but not be made public.

Federated believes that the program outlined above would have significant advantages over the liquidity bucketing regime that is now required under rule 22-e-4. In particular, this program:

- Would eliminate the most costly and onerous element of current rule 22e-4 and replace it with a far less costly and flexible approach that would eliminate the defects in the current rule and allow a more direct and accurate assessment of liquidity in potential stressed market environments.[17]

- It would enable the Commission to provide guidance on the market or redemption scenarios that funds should consider, thus eliminating the many ambiguities that are evident in the current rule. In the current rule, advisers are led to believe that they should be considering one fund at a time, and not to be considering stress events that may be driving redemptions across multiple funds in the same complex or across the entire industry. Improved guidance from the SEC regarding what specific assumptions should be made on simultaneous redemptions in other funds the adviser may manage, or regarding industry-wide redemptions, will provide better-defined stress event scenarios and enable far better comparability of results across funds and fund complexes. Such guidance could evolve in the future to reflect developments in the markets or new forms of liquidity risk that may emerge.

- In addition to improving the applicability and usefulness of the stress test results for both advisers and the SEC, the approach we are proposing will better enable the SEC to perform its duties in both investor protection and as a systemic risk regulator.

- This approach could be designed to satisfy any potential obligations on the Commission under section 165(i) of the Dodd Frank Act, thus eliminating the need for additional rulemaking under that Act, while improving the effectiveness and reducing the cost of compliance with rule 22e-4.

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We strongly recommend that rule 22e-4 be re-proposed to eliminate the current bucketing and resulting portfolio-level liquidity disclosures that are now required. We instead propose that the

[17] The stress test methodology adopted by advisers would not require costly vendor systems that aggregate individual security analyses, but could instead evaluate portfolio level liquidity risks and employ the expert judgments of portfolio managers and traders that may be informed by portfolio-level quantitative analysis.

Commission adopt a more principles-based regime, such as that suggested above, and has been repeatedly advised in numerous industry comment letters. [18,19] In particular, we recommend that the bucketing regime be replaced by simpler methods that would enable advisors to provide portfolio level estimates of liquidity risks in both normal and stressed market conditions based on practical but realistic liquidity assessments.

Federated hopes that the Commission finds these comments helpful and constructive and is happy to provide additional information relating to our comments or discuss any questions you may have.

Yours very truly,

Michael R. Granito
Chief Risk Officer

cc: The Honorable Jay Clayton
The Honorable Michael S. Piwowar
The Honorable Hester M. Peirce
The Honorable Kara M. Stein
The Honorable Robert J. Jackson Jr.

[18] Federated comment letter, January 13, 2016. https://www.sec.gov/comments/s7-16-15/s71615-50.pdf
[19] ICI comment letters, January 13, 2016. https://www.sec.gov/comments/s7-16-15/s71615-59.pdf and May 17, 2016 https://www.sec.gov/comments/s7-16-15/s71615-141.pdf