P.O. Box 2600
Valley Forge, PA 19482-2600

May 17, 2018

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

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

Dear Mr. Fields:

We appreciate the opportunity to provide our comments to the Securities and Exchange Commission (the "**Commission**") on its recent proposal to amend the liquidity disclosures required on its forms (the "**Proposed Amendments**").[1] Vanguard[2] is a Commission-registered investment adviser that offers more than 200 funds with aggregate assets of approximately $4.6 trillion. We commend the Commission for its engagement with market participants on liquidity risk management implementation and focus on continuous improvement. The Proposed Amendments represent a positive step forward by the Commission to provide all fund[3] investors with meaningful fund liquidity disclosure and avoid releasing misleading data into the public domain.

We continue to support the Commission's policy goals of promoting effective liquidity risk management practices, reducing redemption risk, mitigating dilution of shareholder interests, and enhancing investor understanding.[4] We further support the Commission's proactive approach to achieving these goals in its 2016 liquidity risk management final rule ("**Rule 22e-4**") to the extent that it formalizes existing best practices, improves transparency to both the Commission and investors, and holds funds accountable through board oversight. However, we have consistently cautioned against regulations that increase investors' expense without providing material offsetting protections and benefits.[5] We would

[1] Investment Company Liquidity Disclosure, Investment Company Act Rel. No. 33046, 83 Fed. Reg. 11905 (Mar. 19, 2018) ("**Proposing Release**").

[2] "Vanguard" refers to The Vanguard Group, Inc., a family of funds that began operations in 1975.

[3] As in the Proposing Release, the term "fund" means an open-end mutual fund, including an exchange-traded fund that is not a money market mutual fund.

[4] Investment Company Liquidity Risk Management Programs, Investment Company Act Rel. No. 32315, 81 Fed. Reg. 82142, 82143 (Nov. 18, 2016) ("**Rule 22e-4 Adopting Release**").

[5] *E.g.*, Vanguard Letter to the International Organization of Securities Commissions ("**IOSCO**") re: Response to IOSCO's Consultation on Collective Investment Scheme Liquidity Risk Management Recommendation, and Open-ended Fund Liquidity and Risk Management – Good Practices and Issues for Consideration Consultation Report, September 20, 2017 ("**Vanguard 2017 IOSCO Comment Letter**"); Vanguard Letter to the Department of the Treasury ("**Treasury**") re: The Department of Treasury's Report in Response to Executive Order 13772, "Core Principles for Regulating the United States Financial System," April 27, 2017 ("**Vanguard 2017 Treasury Comment**

therefore be remiss to comment on the Proposed Amendments without also providing the Commission with insights we have gathered during implementation of the liquidity classification requirements of Rule 22e-4.

In summary, we respectfully submit our views that: (i) the Commission should reassess the liquidity classification requirements of Rule 22e-4 because the holdings level assessment is misleading and expensive; (ii) the Commission avoids releasing misleading data to investors by eliminating the public disclosure of aggregate liquidity classification information; (iii) a proportionate liquidity risk narrative in the annual shareholder report promotes investor understanding of fund liquidity risks; and (iv) we appreciate the compliance date extension for certain rule requirements.

## I. The Commission should reassess the liquidity classification requirements of Rule 22e-4.

Vanguard appreciates the Commission's engagement with market participants as they gather insights during implementation of the Rule 22e-4 requirements,[6] particularly with respect to the Commission's willingness to consider a principles-based approach.[7] It is worth repeating that prior to the adoption of Rule 22e-4, asset managers have been effectively managing liquidity risk and satisfying shareholder redemptions for more than 75 years, including in periods of market stress,[8] and the Commission

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**Letter**"); Vanguard Letter to the Financial Stability Board ("**FSB**") re: Consultation Document—Public Consultation Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities, September 21, 2016 ("**Vanguard 2016 FSB Comment Letter**").

[6] *See* Proposing Release at 11911 (inviting comments from market participants as they gather insights as liquidity risk management programs are implemented); Statement at Open Meeting on Investment Company Liquidity Disclosure, Commissioner Michael S. Piwowar, March 14, 2018, *available at* https://www.sec.gov/news/public-statement/statement-piwowar-open-meeting-fund-liquidity-2018-03-14 ("**2018 Prepared Statement of Commissioner Piwowar**") (encouraging industry participants and service providers to continue providing feedback throughout implementation).

[7] *See* Proposing Release at 11912 (specifically requesting comment on any advantages to the principles-based approach that Treasury recommends and next steps to consider a shift toward one); Statement on Proposed Amendments to Public Reporting of Fund Liquidity Information, Commissioner Hester M. Peirce, March 14, 2018, *available at* https://www.sec.gov/news/public-statement/statement-peirce-open-meeting-fund-liquidity-2018-03-14a ("**2018 Prepared Statement of Commissioner Peirce**") ("At a minimum, we should propose that funds be allowed to take a principles-based approach to classifying the liquidity of their securities.").

[8] *See, e.g.*, Vanguard Letter to the FSB re: Consultative Document (2nd) – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions, May 29, 2015, ("**Vanguard 2015 FSB Comment Letter**"); Vanguard Letter to the Financial Stability Oversight Council re: Notice Seeking Comment on Asset Management Products and Activities, (FSOC – 2014-0001), 14-15 (Mar. 25, 2015). Each letter cites examples of fund redemption activity during periods of market stress. Other regulators have been prudent to take into account this strong track record when considering how to address liquidity risk. *See, e.g.*, A Financial System That Creates Economic Opportunities; Asset Management and Insurance, Treasury, October 2017, at 21–24 and accompanying Figures, *available at* https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-That-Creates-Economic-Opportunities-Asset_Management-Insurance.pdf ("**2017 Treasury Report**") (acknowledging that "the types of industry-wide 'runs' that occur in the banking industry during a systemic crisis have not materialized in the asset management industry"); Open-ended Fund Liquidity and Risk Management – Good Practices and Issues for Consideration Consultation Report, IOSCO, July 2017, at 20, *available at* https://www.iosco.org/library/pubdocs/pdf/IOSCOPD574.pdf (acknowledging that "open-ended funds have historically been able to manage their day-to-day liquidity requirements even during periods of high redemption demand in an orderly manner").

has presented no empirical data to support theoretical concerns to the contrary.[9] Limited isolated occurrences where funds have encountered liquidity concerns exist; however, these occurrences also represent anomalies to existing best practices within the industry.[10] As stated in our initial comment letter, evidence suggests that portfolio holding liquidity classification would not have indicated there were significant issues in the most recent instance.[11] Given the subjective multi-dimensional dynamic nature of liquidity, it is not surprising that a prescriptive classification scheme fails to simultaneously achieve precision and accuracy.

We believe it is of paramount importance that the Commission assess how investors are affected by its rules, including whether they achieve their stated objectives, and whether they give rise to any unintended adverse consequences.[12] We submit that the prescriptive classification framework has indeed given rise to unintended adverse consequences,[13] particularly in the way of imposing significant additional costs on investors without providing any commensurate benefits. As discussed in many of our prior comment letters to the Commission as well as to other regulators, we strongly believe that a top-down, portfolio-based approach is the most effective way to manage liquidity risk,[14] and, indeed, we intend to continue using this approach to manage the liquidity risk of our funds.

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[9] *See* Rule 22e-4 Adopting Release at 82143–44 (summarizing funds' obligations to meet redemptions since the origin of the Investment Company Act of 1940).

[10] Indeed, we are aware of only two such occurrences this century in which the Commission deemed it necessary to permit a fund to suspend the timely payment of redemptions in order to serve the best interests of investors. *See* Third Avenue Trust and Third Avenue Management LLC; Notice of Application and Temporary Order, Release No. IC-31943 (Dec. 16, 2015), 80 Fed. Reg. 79638 (Dec. 22, 2015); Reserve Municipal Money-Market Trust, et al.; Notice of Application and Temporary Order, Release No. IC-28466 (Oct. 24, 2008), 73 Fed. Reg. 64993 (Oct. 31, 2008).

[11] Vanguard Letter to the Commission re: Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release – File No. S7-16-15, January 6, 2016 ("**Vanguard 2016 SEC Comment Letter**") at 9–10, n.33.

[12] *See* Statement on Proposed Amendments to Public Reporting of Fund Liquidity Information, Chairman Jay Clayton, March 14, 2018, *available at* https://www.sec.gov/news/public-statement/statement-clayton-open-meeting-fund-liquidity-2018-03-14 ("**2018 Prepared Statement of Chairman Clayton**") ("It is good government to engage with stakeholders and examine how investors are affected by our rules, including whether our rules are achieving their objectives, and whether there are unintended adverse consequences.").

[13] Indeed, the Commission has acknowledged as much. *See* Investment Company Liquidity Risk Management Programs; Commission Guidance for In-Kind ETFs, Investment Company Act Rel. No. 33010, 83 Fed. Reg. 8342, 8348 (Feb. 27, 2018) ("**Interim Final Rule Release**") (acknowledging that "there are issues with the classification requirement"); 2018 Prepared Statement of Commissioner Peirce (noting "the increasingly real complexities and unanticipated burdens associated with the liquidity classification requirement").

[14] *See* Vanguard 2017 IOSCO Comment Letter; Vanguard 2017 Treasury Comment Letter; Vanguard 2016 FSB Comment Letter; Vanguard 2016 SEC Comment Letter; Vanguard 2015 FSB Comment Letter.

**A. Advantages of a Principles-Based Regulatory Approach to Monitor Portfolio-Level Liquidity**

Liquidity is dynamic and cannot be simplified into a single metric.[15] Rather, it requires both quantifiable data and qualitative judgement to assess. Shifting to a principles-based regulatory approach that relies on board oversight rather than the current prescriptive classification requirements would create a more effective regulatory regime to safeguard the ability of investors in a pooled investment vehicle to redeem shares. Such an approach would also be consistent with the Commission's prior principles-based rulemaking in other critical areas,[16] as well as the approach to the liquidity disclosure requirement contained in these very Proposed Amendments.[17]

Vanguard employs its own robust principles-based liquidity risk management practices,[18] which have benefited fund investors for more than four decades. Our principles-based approach evaluates the liquidity characteristics of a portfolio holistically, rather than at an individual holding level. The advantages of this approach include the necessary flexibility to take into account changing market liquidity conditions and the unique circumstances of each fund; the ability to consider differences in equity and fixed income

[15] The Division of Economic and Risk Analysis of the SEC assessed access to capital and market liquidity in August 2017 and noted in relevant part that, "[C]omposite measures typically rely on weighted averages or principal component analysis of several liquidity measures that quantify different dimensions of liquidity. However, such index measures may be difficult to interpret." Access to Capital and Market Liquidity, Staff of the Division of Economic and Risk Analysis of the SEC, at 73, August 2017, *available at* https://www.sec.gov/files/access-to-capital-and-market-liquidity-study-dera-2017.pdf.

[16] *See* 17 C.F.R. § 270.38a-1 (requiring a fund's board to adopt written policies and procedures reasonably designed to prevent the fund from violating the federal securities laws); 17 C.F.R. § 270.2a-7(a)(25) (requiring a "retail money market fund" to adopt and implement policies and procedures reasonably designed to limit beneficial ownership of the fund to natural persons; 17 C.F.R. § 270.2a-41 (requiring a fund's board to determine in good faith a fair value for securities without readily available market quotations); 17 C.F.R. § 12b-1(h) (permitting a fund to use a selling broker to execute portfolio securities transactions if the fund or its adviser adopts and implements policies and procedures reasonably designed to ensure that the selection of a selling broker for portfolio securities transactions is not influenced by considerations about the sale of the fund's shares); 17 C.F.R. § 270.17e-1 (requiring a fund's board to adopt procedures reasonably designed to ensure that any remuneration paid by a fund to an affiliated broker is reasonable and fair compared to remuneration received by other brokers in connection with comparable transactions).

[17] Proposing Release at 11910, n.38 (reasoning that the proposed principles-based approach to disclosure would best achieve the Commission's goals without risking investor confusion, while also permitting flexibility for a fund to customize its disclosure in a manner most appropriate for the particular fund). See *infra* Section III for a discussion of Vanguard's views supporting this element of the Proposed Amendments.

[18] See Appendix A to Vanguard 2016 SEC Comment Letter for an overview of Vanguard's Liquidity Risk Management Practices. In assessing liquidity risk, we evaluate a number of factors including: (1) the construction of the portfolio; (2) the liquidity of the underlying market; (3) historical levels of peak redemption under market stress; (4) composition of the fund's investor base; and (5) the percentage of a fund's assets held in ETF shares. Based on this comprehensive analysis, a liquidity management approach is established for each fund and its portfolio is constructed and managed to align with the approach, which can be further tailored to address changing market conditions.

market structures, portfolio composition, and investment objectives;[19] and the capacity to adjust to the dynamic, multi-dimensional nature of liquidity.

We are fully supportive of retaining the codified limitation on illiquid investments if the Commission adopts a more principles-based approach.[20] We believe this is an important investor protection measure and appropriate guardrail to ensure that funds stand ready to redeem shares and pay redemption proceeds daily. We agree with the Commission that funds' extensive experience in accurately identifying and monitoring illiquid investments enables them to comply with such a limit without engaging in full portfolio classification, [21] and that they may otherwise employ a principles-based program to assess, manage, and review their liquidity risk using elements they view as reasonable to achieve such goals.[22] We therefore recommend that the Commission consider making such an approach, which it clearly deems appropriate during the interim compliance period, permanently permissible and eliminate the prescriptive classification framework. Adopting such an approach would also achieve a more appropriate cost-benefit balance for investors.

**B. The Prescriptive Classification Framework is Misleading and Expensive**

In our experience implementing the classification requirement, we have found (and believe the Commission will also find upon beginning its review in June 2019) the data to be imprecise and ultimately useless in helping to assess portfolio liquidity risk as it implies a level of precision in predicting liquidity at an individual holding level that simply does not exist. The prescriptive classification scheme incorporates the flawed logic of viewing portfolio-level liquidity as a simplistic sum of the liquidity of the funds' holdings.

As a result of vetting various vendor solutions designed to achieve compliance with the classification requirement, we have found (1) a wide divergence in liquidity assessments depending on the vendor used and (2) a general tendency to *overstate* the liquidity of the overall portfolios under current market conditions relative to a principles-based classification. For example:

1. When testing a sample portfolio of a short-term investment-grade bond fund, results ranged from a 77% to a 93% highly liquid classification by different vendors based on the same assumptions.[23]

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[19] *See, e.g.*, 2017 Treasury Report at 34 ("Even within an asset class, such as fixed-income, the liquidity of issues can differ considerably depending on factors such as credit quality and industry. Internal policies and procedures require a certain amount of flexibility to account for market and issuer-specific dynamics.").

[20] We are also supportive of the SEC retaining the corresponding new Form N-Liquid reporting requirements. We further support maintaining the highly liquid investment minimum requirements under a principles-based approach.

[21] *See* Interim Final Rule Release at 8348–49 (noting that funds have extensive experience in evaluating and identifying illiquid assets pursuant to prior guidance and should therefore be able to comply with the Rule 22e-4 15% limit during the period of the compliance date extension without engaging in the otherwise delayed classification requirement).

[22] *See* Interim Final Rule Release at 8348 (noting that funds already have in place systems and processes to assess and manage liquidity risk that can be incorporated into the Rule 22e-4 required program during the period of the compliance date extension without engaging in the otherwise delayed classification requirement).

[23] We highlight that this result is not an anomaly, but rather has been experienced across the industry over the course of classification implementation as acknowledged by the Commission in its Interim Final Rule Release. Interim Final Rule Release at 8345, n.32 and accompanying text (citing the Investment Company Institute's finding that outputs

2. When testing a sample portfolio of an international bond fund, results showed a greater-than 98% highly liquid classification by multiple vendors despite assuming an extreme 10% redemption scenario.

Our intention is not to suggest that these liquidity assessment examples are substantially inaccurate as compared to our own existing liquidity risk management practices, which are designed to ensure that the funds we manage remain highly liquid in order to meet day-to-day redemptions. Rather, we highlight our findings in vetting various methodologies to evidence the lack of precision and utility of classifying each individual holding in the manner prescribed by Rule 22e-4 to determine portfolio liquidity profiles. Moreover, we restate our concerns that the heavy reliance on third-party vendors created by the classification requirement[24] could give rise to the same types of concerns that Congress found to be unacceptable with regard to credit rating agencies[25] by overstating liquidity within the industry. When testing vendor solutions yielding a wide variation in results depending on the vendor used, funds may be more likely to select the vendor whose methodology shows the highest liquidity in their portfolios.[26] This could incentivize a race to the bottom among vendors, who may develop more aggressive methodologies to reflect higher liquidity in order to attract more business and increase their revenue streams.

Given the ineffectiveness of classifying individual holdings to determine portfolio-level liquidity profiles, the devotion of a substantial amount of time, money, and resources in this pursuit is not justified. Notwithstanding that Vanguard intends to continue using our in-house principles-based practices to actually manage liquidity risk in our funds, we have undertaken a multi-year analysis, expended an enormous amount of labor, and initiated investment in multi-million dollar technology solutions to develop, test, and implement the various liquidity classification, monitoring, and reporting systems required by Rule 22e-4. As we believe this classification requirement will neither contribute meaningfully to our liquidity risk management, nor provide useful insight into liquidity risk to the Commission or investors,[27] we view it as

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from different service providers' liquidity assessments varied widely); *id.* at 8345 (noting that the service providers themselves had observed significant disparities amongst themselves in assessing the liquidity of the same security as a result of different models, market data, or assumptions used).

[24] *See* Interim Final Rule Release at 4–11 (acknowledging that virtually all fund groups will rely on third-party vendors to implement the classification requirement to a significant degree, which is far more extensive than the Commission had anticipated).

[25] Vanguard 2016 SEC Comment Letter at 10, n. 35.

[26] This would be especially true if the requirement to publicly disclose aggregate liquidity classification information were not eliminated. See *infra* Section II for a discussion of Vanguard's views supporting this element of the Proposed Amendments.

[27] *See* Vanguard 2016 SEC Comment Letter at 5 (submitting that the Commission's proposed liquidity classification framework would "not provide meaningful tools for the Commission and could mislead investors by implying a degree of precision in liquidity classification that does not exist"); *id.* at 13 (raising concerns that a prescriptive classification framework "would materially increase the costs of a fund's compliance without providing a corresponding benefit in terms of materially enhancing a fund's liquidity risk management practices or strengthening the Commission's oversight capabilities"); Vanguard Letter to the SEC re: Investment Company Liquidity Risk Management Programs; Request for Delay – File No. S7-16-15, November 8, 2017, at 2 ("**Vanguard 2017 SEC Comment Letter**") ("Vanguard continues to question whether such costs are warranted given the limited utility of the information being collected."). We further note that Vanguard is not alone in this view. *See, e.g.*, Liquidity Rule's Buckets Could Still Get Dumped: Sources, IGNITES.COM, April 11, 2018, *available at* http://ignites.com/c/1933804/225394/liquidity_rule_buckets_could_still_dumped_sources?referrer_module=emailM

an unwarranted material cost that will ultimately be borne by fund shareholders—and a very expensive and burdensome one at that.[28]

We have long been concerned that the Commission significantly underestimated the regulatory compliance costs associated with implementation of the liquidity classification requirements within Rule 22e-4,[29] and our experience confirms that is the case. We recognize that, as an industry, we can assist the Commission in improving its analysis by providing more concrete data regarding our implementation efforts. We estimate that—at a minimum—our implementation costs include:[30]

1. More than 7,000 hours spent thus far on implementation, primarily on the classification framework.[31]
2. More than 10,000 additional hours projected to complete implementation, primarily on the classification framework.
3. More than 3,000 hours projected per year post-implementation to maintain, monitor, and report classifications.
4. Approximately $2.8 million on technology solutions to support the classification process. We anticipate additional ongoing expenses associated with data licensing and software maintenance.

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[28] *See, e.g.*, 2017 Treasury Report at 34 (noting the added cost to funds of having to implement the mandated bucketing methodology alongside their existing liquidity risk management methodologies); 2018 Prepared Statement of Commissioner Piwowar (calling out the "costly make-work" created by the current rule and noting that it does "not improv[e] funds' management of their liquidity risk"); 2018 Prepared Statement of Commissioner Peirce (observing that "the liquidity classification requirement is proving to be much more burdensome than the Commission thought at the time it was adopted").

[29] Vanguard 2017 SEC Comment Letter at 18, n.53 (raising concerns that the Commission's cost analysis overestimated the economies of scale that could be achieved in establishing the systems and resources required to implement a prescriptive classification framework). We note, however, that the Commission has begun to question the cost-benefit balance of the classification framework, and we strongly encourage that it undertake to do so more thoroughly. *See, e.g.*, 2018 Prepared Statement of Commissioner Peirce ("We ought to seriously consider whether the benefit the Commission will derive from the classification schema—a benefit beyond the potential to obtain some interesting information has not yet been identified to me—is warranted."); 2018 Prepared Statement of Commissioner Piwowar ("[S]ince we adopted these rules, it has become clear that they do not benefit investors as we had intended.").

[30] Note that this is by no means an exhaustive list of the costs associated with implementation of Rule 22e-4. As Treasury correctly observed, "regulatory compliance costs come in the form of legal expenses, preparation of new policies and procedures, creation of internal controls, technology expenditures, increased use of third-party service providers, rising vendor charges, increased oversight costs, and higher overall requirements for staffing and training. Moreover, these costs do not capture the opportunity costs associated with these efforts, including diversion of resources . . . ." 2017 Treasury Report at 25.

[31] It would not be appropriate to simply divide these expenses by fund to generate a per fund expense as much of the work to date (e.g., assessing and developing classification methodologies, vetting vendors, and coordinating related information technology projects) is more appropriately viewed as a fixed not variable cost of implementation.

5. Unquantifiable opportunity costs associated with these efforts, including diversion of staffing and resources from efforts to boost portfolio return, manage risk, and improve client service.[32]

While we are progressing with the implementation process and appreciate that many of the upfront costs already expended cannot be recouped, we highlight the substantial remaining implementation and ongoing costs and burden associated with performing classifications and caution the Commission against falling victim to the sunk cost fallacy.[33] Moreover, as described above, there is no corresponding benefit to the costly classification framework, and it would be very short-sighted to conclude that it should remain simply because so much progress has been made toward implementation.[34]

Finally, the Commission will be receiving monthly portfolio holdings on Form N-PORT to which it may apply its own consistent methodology and assumptions to independently assess a fund's liquidity, as well as to make apples-to-apples comparisons across funds if it so wishes. This would enable the Commission to focus on areas of the industry where liquidity presents the most concern whereas, in its current form, the costly classification requirement is the responsibility of each and every fund regardless of whether liquidity is a material risk for its investment mandate. Thus, the costs are passed on to millions of fund investors saving for college, retirement, and other long-term investing goals.

While we remain supportive of the Commission's efforts to strengthen resiliency of mutual funds and the markets in which they participate, we believe it is appropriate to reassess and seek to improve the cost-benefit balance of Rule 22e-4 to ensure that investors are not unduly burdened with ineffective regulation. For the reasons set out above, we believe the Commission should consider eliminating Rule 22e-4's prescriptive classification framework and shifting to a principles-based approach while retaining the 15% illiquid investment limit, which we believe serves as an important investor protection.

## II. The Commission avoids releasing misleading data to investors by eliminating the public disclosure of aggregate liquidity classification information.

We commend the Commission for proposing to rescind the current requirement that funds publicly disclose aggregate liquidity classification information about their portfolios in light of concerns about the usefulness of that information for investors.[35] We share these concerns—and continue to question the usefulness of that information to the Commission—particularly given the fundamentally flawed framework underlying the classifications.

[32] For example, at times during implementation up to five key members of our Risk Management Group spent significant time on the classification requirements with one to two members consistently spending on average more than 50% of their time per week on the project rather than on their traditional focus of mitigating risks within portfolio management activities.

[33] "Sunk cost fallacy" refers to continuing a behavior or endeavor simply as a result of previously invested resources such as time, money, or effort.

[34] We whole-heartedly agree with Commissioner Peirce that: "[A] lot of time and money has been spent on implementation already, but it is worth taking a moment to ask whether this is a project that warrants the expenditure of even more time and resources. Throwing good money after bad is not wise." 2018 Prepared Statement of Commissioner Peirce.

[35] Proposing Release at 11906.

Our support for the elimination of the aggregate liquidity classification data mirrors our concerns with the overall limited benefit of implementing the prescribed liquidity classifications. As highlighted in Section I above, there is no general market consensus on assessing liquidity, and the methodologies that funds have been designing to implement the prescribed liquidity classifications are highly dependent on subjective judgments. The Commission anticipates classification conclusions to vary from fund to fund,[36] and its proposal to permit funds to split a single portfolio holding into multiple buckets[37] will result in further variability in the classifications.

We further agree with the Commission that reporting the aggregate classification data in a standard format with no context could mislead investors by implying a degree of precision and objectivity in liquidity classifications that does not exist and would not form an appropriate basis for comparing funds or making investment decisions.[38] Moreover, the subjectivity and lack of precision in liquidity data assessments, especially those prescribed by the Commission, have the potential to result in an overstatement of fund portfolio-level liquidity,[39] the public disclosure of which could compound the problem by creating perverse incentives to classify investments as more liquid.[40] We therefore agree with the Commission that a brief, narrative discussion of a fund's liquidity risk management program in its annual shareholder report is a more appropriate approach to promoting investor understanding of fund liquidity risks subject to the below recommended enhancements.

Finally, we support the Commission's proposal to add holdings of cash and otherwise unreported cash equivalents to Part B of Form N-PORT. We acknowledge that cash and cash equivalents are among the data points that may be relevant for determining a fund's compliance with the highly liquid investment minimum ("**HLIM**") requirement.[41] While registrants may already plan to disclose securities considered to be cash equivalents in Parts C and D on Form N-PORT under the previously adopted Rule,[42] we believe the proposed requirement to disclose cash and cash equivalents not reported elsewhere on Form N-PORT

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[36] Proposing Release at 11909, n.33 (acknowledging the variability and subjectivity required to engage in Rule 22e-4 classifications); 2018 Prepared Statement of Chairman Clayton ("[T]he assumptions, methodologies, and outputs of the analysis are significantly subjective and fund-specific, and the staff expects that they will vary from fund to fund.").

[37] Proposing Release at 11912.

[38] Proposing Release at 11909; *see also* Vanguard 2016 SEC Comment Letter at 18 ("[W]e believe the proposed disclosure would confuse investors by encouraging investors to: (i) place undue emphasis on a fund's subjective liquidity classifications; and (ii) misinterpret differences in liquidity classifications for similar portfolio positions across various funds."); Vanguard 2017 IOSCO Comment Letter at 13 ("A liquidity assessment conducted at the asset level rather than the portfolio level may mislead investors into believing that there is some objective measure of liquidity and impair the integrity of the multi-dimensional nature of liquidity risk management by distorting the substitutability of assets in liquidity risk management decisions and the consideration of appropriate redemption management tools.").

[39] See *supra* Section I.B for a discussion of this potential pitfall.

[40] Proposing Release at 11908 ("As a result, the public disclosure of liquidity profiles may provide funds an incentive to classify their securities as more liquid in order to make their funds appear more attractive to investors, further increasing the risk of investor confusion.").

[41] Proposing Release at 11913.

[42] Investment Company Reporting Modernization, Investment Company Act 34-79095; IC-32314, 81 Fed Red. 81870 (Oct. 13 2016).

will provide the Commission with additional information to perform an independent analysis of a fund's HLIM. In addition to cash and cash equivalents, the Commission should consider other data points in monitoring a fund's compliance with its HLIM. Additional information about a fund's HLIM, if applicable, is required to be reported in Item B.7 on Form N-PORT and in Item D.1 on Form N-LIQUID.

## III. A proportionate liquidity risk narrative in the annual shareholder report promotes investor understanding of fund liquidity risks.

Vanguard is fully supportive of proportionate and appropriate liquidity risk disclosure in annual reports to accomplish the policy goal of promoting investor understanding while minimizing risks of investor confusion. We agree that a narrative description in the annual shareholder report is the appropriate vehicle for delivery of such information to strike that balance.[43] As opposed to Form N-PORT, shareholder report disclosure is equally accessible to all investors and not solely to those sophisticated enough to navigate the Commission's filing system.

We commend the Commission for proposing a "principles-based approach" to liquidity risk disclosure that would not require a fund to disclose any specific classification information in order to "give a fund the flexibility to disclose its approach to liquidity risk management in a manner most appropriate for the fund."[44] We believe that such an approach to the underlying liquidity risk management program would likewise be more effective, and, as such, that a narrative discussion focused on the liquidity characteristics of a fund's portfolio holistically rather than at an individual holding level provides investors with a more accurate, proportionate description of fund-level liquidity risk.[45] Additionally, the narrative format provides an opportunity to inform investors on how liquidity risk is mitigated within a fund.

However, we share certain Commissioner concerns that the disclosure could become boilerplate and focused more on process than substance.[46] Therefore, we recommend that the Commission provide additional guidance emphasizing that the disclosure include a description of the material liquidity risks, if any, actually faced by a particular fund during the fiscal period. The requirement that a fund discuss only its "program" may result in disclosures that do little to inform investors about the actual liquidity risks experienced by the fund in which they are investing and focus instead on the board oversight process for that particular fund complex. This would undermine the Commission's intention.[47] Instead, guidance that clarifies that the narrative disclosure should discuss material liquidity risks faced during the relevant period would help ensure that the disclosure does not become boilerplate for those funds where the disclosure matters the most. Though this approach may impose an increased administrative and compliance burden on funds that face material liquidity risks, it may be eased by relevant disclosure that may already be included

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[43] Proposing Release at 11909.

[44] Proposing Release at 11910, n.38.

[45] Indeed, we do not believe that the mandated classification process contributes meaningfully to our liquidity risk management process, *see supra* Section I, and would therefore likely have great difficulty in trying to explain how it fit into its "operation and effectiveness."

[46] *See* Statement on Proposed Amendments to Public Reporting of Fund Liquidity Information, Commissioner Robert J. Jackson, Jr., March 14, 2018, *available at* https://www.sec.gov/news/public-statement/statement-johnson-open-meeting-fund-liquidity-2018-03-14.

[47] Proposing Release at 11910, n.38.

in the management discussion as a material factor that impacts fund performance. In order to ensure that investors receive proportionate liquidity risk disclosure relative to the risks within a particular fund, we believe the modest additional expense would be warranted.

In addition, the Commission should consider excluding funds that were primarily highly liquid during the reporting period from the requirement. To the extent that no material liquidity risks were faced, an affirmative statement to this effect may seem out of place relative to other material factors that impacted fund performance during the period. Disclosure should not over-emphasize liquidity risk, which has the potential to confuse investors rather than promote decision-making.[48] We therefore recommend enhancing the liquidity risk management disclosure requirement by limiting it to funds for which the disclosure would be proportionate to their actual liquidity risk profiles.

Vanguard believes that the proposed narrative description in the annual report is a significant step in the right direction to ensure all investors are provided with comprehensive and relevant liquidity disclosures to help them better understand their investments and recommends the minor enhancements noted above only to further improve the disclosure requirement.

## IV. Vanguard appreciates the compliance date extension.

Finally, Vanguard appreciates the extension in compliance date for certain rule requirements[49] as implementation has thus far been a significantly expensive, resource- and time-intensive, enterprise-wide effort, and the additional time will allow us to continue working through operational complexities and educate our board on its new oversight responsibilities.

Specifically, we appreciate the extension in the reporting compliance date for the classification requirement. This facet of the rule is particularly costly and time-consuming to implement,[50] giving rise to many technical issues that require significant time to develop and test, particularly for those asset managers that are largely building their own systems and testing capabilities in-house. Although we continue to believe that no amount of additional time or guidance will completely alleviate our concerns with this fundamentally flawed framework,[51] we nonetheless appreciate the opportunity to ensure operational readiness.

We further support the extension in compliance date for board oversight requirements. The process of educating our board on its new oversight responsibilities, in addition to reviewing with the trustees how the liquidity of fund assets will be classified, monitored, and reported, under the novel classification regime of Rule 22e-4 will take time. This process will be made easier by the delay in board oversight requirements in that we plan to proceed with implementation on the original timeline and can then go to the board armed with data.

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[48] *See* Vanguard 2017 IOSCO Comment Letter at 10 ("Excessive disclosure can overload, and thus confuse, investors and impede rather than promote decision-making. Liquidity risk is one of many risks that investors should understand regarding [an] investment and any such disclosure should place these risks in proportionate context and not overemphasize liquidity risk.").

[49] Interim Final Rule Release.

[50] *See supra* Section 1.B for further discussion of cost.

[51] *See supra* Section 1 for a discussion of our views on the classification framework.

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We appreciate the opportunity to comment on the Commission's Proposed Amendments. If you have any questions about Vanguard's comments or would like any additional information, please contact Christyn Rossman, Senior Counsel – Office of the General Counsel, at [redacted].

Sincerely,

/s/ Gregory Davis

Gregory Davis
Chief Investment Officer
Vanguard

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

John Cook, Senior Advisor to the Chairman

Dalia Blass, Director
Division of Investment Management