J.P.Morgan
Asset Management

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May 18, 2018

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:

J.P. Morgan Asset Management ("JPMAM")[1] is pleased to respond to the Securities and Exchange Commission's (the "SEC" or the "Commission") request for comment on its proposal to amend its investment company liquidity disclosure requirements (the "proposal").[2] JPMAM offers 143 mutual funds and ETFs (together, "funds") in the US, excluding money market funds, with a total of approximately $372 billion in assets under management at the end of April 2018.

JPMAM supports the SEC's goal of promoting effective liquidity risk management throughout the fund industry. We are actively working towards implementation of the SEC's fund liquidity risk management and related reporting rules, which aim to improve oversight and governance of liquidity risks, and enhance disclosure and investor understanding of fund liquidity.[3] These efforts, particularly with respect to the liquidity classification process, have informed our view of the current proposal.

In particular, we support the proposal to remove public disclosure of funds' aggregate liquidity classifications. The liquidity classification process necessarily requires a range of judgments and inputs, with the result that similar funds could disclose materially different aggregate classifications simply by virtue of using different assumptions. We share the concerns, articulated in the Proposing Release, that this information will at best not be useful to investors, and at worst could be confusing or misleading.

[1] J.P. Morgan Asset Management is a marketing name for the investment management subsidiaries of JPMorgan.

[2] Investment Company Liquidity Disclosure, Release No. IC-33046 (Mar. 14, 2018), 83 Fed. Reg. 11905 (Mar. 19, 2018) ("Proposing Release").

[3] Investment Company Liquidity Risk Management Programs, Release Nos. 33-10233, IC-32315 (Oct. 13, 2016), 81 Fed. Reg. 82142 (Nov. 18, 2016) ("Liquidity Adopting Release").

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As an alternative, the proposal would require funds to provide a description of the operation and effectiveness of their liquidity risk management programs in the management's discussion of fund performance ("MDFP") contained in the funds' annual report. We agree that a narrative discussion of liquidity risk management would better satisfy the Commission's policy goal of promoting investor understanding of liquidity risk. We believe existing MDFP guidelines already effectively require a discussion of liquidity risk where it has had a material effect on performance, although this could be clarified. We recommend, however, that any discussion of a fund's liquidity risk management program that is not material to fund performance be included elsewhere in the annual report, so as not to distract from the MDFP's discussion of performance.

Separately, the SEC proposed to permit (but not require) funds to split positions across multiple liquidity classifications for purposes of reporting to the SEC on Form N-PORT, under three circumstances.[4] The Proposing Release explains that this optional approach would provide equally or even more accurate data, and could be less burdensome and costly for funds and thus their shareholders. We agree that a "proportional" allocation of a fund's entire portfolio, as the third circumstance would permit, may provide the SEC with a more accurate picture of a fund's liquidity. However, we do not believe the proposed option would be less burdensome or costly; in addition, we believe it has several insurmountable challenges, including incompatibility with the 15 percent illiquid asset restriction and insufficient time to modify our approach. As a result, we would not expect to utilize this option.

We believe that, if the Commission's goal is to improve the data it collects while reducing costs to funds and their shareholders, revisions to the liquidity risk management rule (rule 22e-4), and not just the reporting obligations on Form N-PORT, are necessary.

Our comments can be summarized as follows:[5]

- Public disclosure of aggregate liquidity classifications: JPMAM supports eliminating public reporting of funds' aggregate liquidity classifications. This information reflects funds' individual assessments, and classifications would not be comparable across funds. Public dissemination would not achieve the SEC's goal of enhancing disclosure, and may confuse or mislead investors.[6]

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[4] Currently, funds are required to select a single liquidity classification for each investment.

[5] The SEC also proposes to update Item B.2. of Form N-PORT (certain assets and liabilities) to require reporting of cash and cash equivalents not reported in Part C (schedule of portfolio investments) or Part D (miscellaneous securities). This disclosure would be made publicly available each quarter. We support this additional disclosure, which will allow the SEC to specifically monitor the amount of cash and cash equivalents held by the fund.

[6] We also support the proposal to keep Derivatives Classification Data nonpublic, for the reasons stated in the Proposing Release. *See* Proposing Release at 17.

- Liquidity risk management program disclosure: We support providing investors with a narrative discussion of liquidity risk management. To the effect liquidity risk management had a material effect on performance, we agree that this discussion should be included in the MDFP; however, we recommend that the additional narrative contemplated by the proposal, which may not be material to the fund's performance, be disclosed elsewhere in the annual report, so as not to distract from the intent of the MDFP.

- Liquidity reporting amendments on Form N-PORT: While we appreciate the SEC's intent to improve data quality and reduce cost burdens, we do not expect to utilize the proposed reporting amendments. In particular, the proportional approach for a fund's entire portfolio would not be less burdensome or costly, and is inconsistent with rule 22e-4.

- Reconsideration of rule 22e-4: If the SEC's objective is to improve data quality and enhance efficiency and cost-effectiveness, we believe it must reconsider the liquidity risk management program requirements, including asset classification and the limit on illiquid assets set forth in rule 22e-4.

I. Public Reporting of Aggregate Liquidity Classifications

JPMAM supports the proposal to remove public disclosure of funds' aggregate liquidity classifications. Varying methods of analyzing data inputs could reasonably lead similar funds to arrive at materially different classification results. If made public, the data would not be useful for investors, and indeed could be confusing or misleading. As discussed in Section II below, we agree with the SEC that effective disclosure of liquidity risks may be better achieved through another approach.

A. Variations in assessing liquidity can lead to materially different classification results

Rule 22e-4 requires funds to classify the liquidity of each of the fund's portfolio investments into one of four defined liquidity categories: highly liquid investments, moderately liquid investments, less liquid investments, and illiquid investments. In doing so, funds must consider relevant market, trading and investment specific factors for each position. Importantly, the rule does not articulate how such considerations must be undertaken. As a result, the analysis of these factors will vary by fund, as well as by the vendors on which many funds will rely for data.

Indeed, the SEC recognized the possibility for variability across funds' liquidity assessments. In its explanation of these requirements, the Liquidity Adopting Release set forth certain factors that a fund may consider in assessing liquidity, including: the existence of an active market, historical trading volume, price volatility, bid-ask spreads, market depth, and other asset class-specific characteristics. It then observed that even if funds were to consider every enumerated metric, "a

fund may decide that it is appropriate to focus more heavily on certain factors and less on others in evaluating its portfolio investments' liquidity."[7]

In addition to these factors, rule 22e-4 overlays two additional determinations. When bucketing assets, funds must consider how long it would take to convert a position into cash in current market conditions, 1) *without significant impact to its market price*,[8] 2) *taking into account a position size that the fund would reasonably anticipate trading* (the "RATS" determination).[9] As to the first, the SEC did not define "significant impact." To date we have not observed consensus in the industry. More importantly, price impact is challenging to project without knowing the market conditions for any given trade, particularly for assets with lower shares or notional outstanding and smaller trading volume. Similarly, the RATS determination requires consideration of a range of factors, including historic fund flows, projection of consecutive days of outflows, and stress scenarios. Taken together, we believe these decisions and variables create the opportunity for disparate results across similar funds.

In consideration of the proposal, we conducted a scenario analysis to observe the impact of input assumptions on classification results. Using a preliminary model from a third-party vendor, and a portfolio of high yield assets from one of our bond funds[10], we classified assets using two different values of market price impact while holding all other factors constant. In both scenarios we applied a conservative RATS threshold (*i.e.*, a large projected outflow relative to historical redemptions and anticipated flows in times of stress).

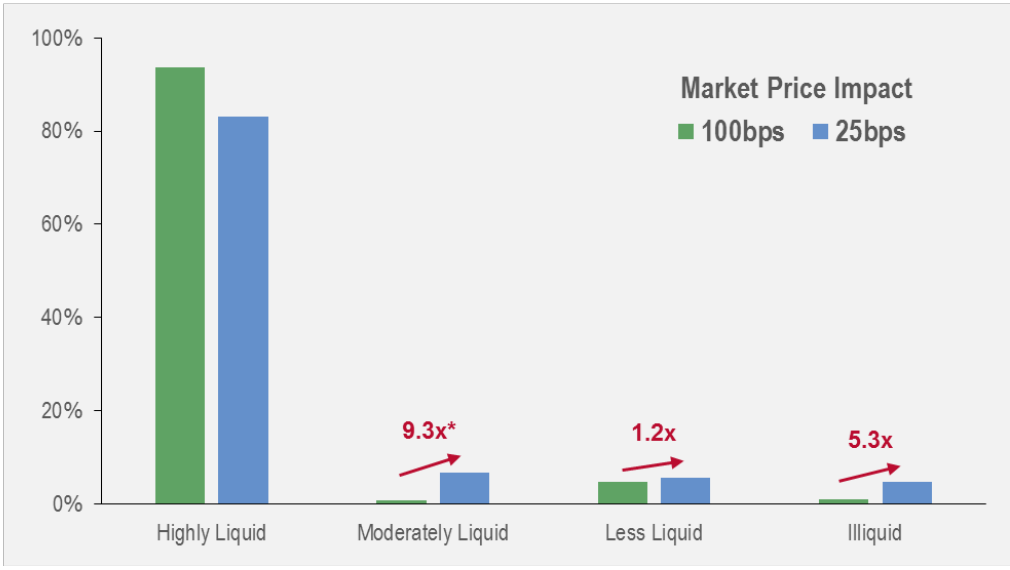
[7] Liquidity Adopting Release at 159.

[8] Funds must determine the time period in which an investment would reasonably be expected to be converted to cash (or in some cases, sold or disposed of) in current market conditions without the disposition significantly changing the market value of the investment.

[9] *See* rule 22e-4 (b)(1)(ii)(B).

[10] The sample portfolio represents approximately 95 percent of high yield assets contained in a JPMAM bond fund. Omitted high yield assets were due to vendor data limitations; we would not expect inclusion of these assets to dramatically skew the results.

Percent of assets allocated to each liquidity classification based on reasonably anticipated trade sizes, considering two estimates of market price impact



*Estimated change factor.

The results above demonstrate how changing one input can result in different liquidity classifications.[11] We adjusted the estimated market price impact threshold from 100bps to 25bps, both of which could be considered an appropriate limit on "significant market impact." This change alone resulted in the value of *moderately liquid* assets to increase by more than a factor of nine, and *illiquid* assets to grow by more than a factor of five.

Additionally, we are not confident that the combined impact of various assumptions and methodologies would result in convergence into a single liquidity measure, *i.e.*, that such differences would average out, and similar funds would produce comparable results. On the contrary, the impact of each variable and subjective decision could be additive, and thus magnified by aggregation.

Finally, we are concerned that vendor models will provide another source of disparate results. We expect vendors to treat input factors differently, and take distinct but reasonable approaches to estimating price impacts and forecasting market conditions. Indeed, an industry implementation working group observed widely different outputs across vendors' preliminary results.[12] The vendor model itself could potentially be the largest source of classification disparities across funds.

[11] The vendor data used for this analysis is extremely preliminary; we are still evaluating and conducting due diligence on the data. As discussed below in Section III, the next year of implementation will be devoted to testing and verification that fund investments are appropriately evaluated.

[12] ICI facilitated an exercise in which two vendors bucketed the same high yield bond portfolio and assumed the same RATS. Investments assigned to the *highly liquid* bucket ranged from 7 to 95 percent. *See* Letter from Dorothy Donohue,

B. Public disclosure would not provide useful information, and could be misleading to investors

The SEC appropriately expects a certain level of variability in how funds classify investments.[13] In FAQs to the rule, staff acknowledged that funds may arrive at different classifications for the same instrument using differing market, trading, and investment-specific assumptions.[14] However, the SEC will have access to the underlying data, and could inquire into a fund's assessment methodology if necessary to understand such variability in classification results.

Investors, on the other hand, could be provided different results for nearly identical funds, without an understanding of these differences. We agree with the SEC that providing the detailed disclosure and nuanced explanation necessary to inform investors about the subjectivity and limitations of aggregate liquidity classifications "may not be the most accessible and useful way to accomplish the Commission's goals."[15] It would not be practical to provide an investor-friendly explanation of each input, and associated effect on the classification output. Absent this information, however, investors may reasonably believe they are looking at an objective assessment of a fund's liquidity profile. As we observed in our comment letter to the SEC when it proposed rule 22e-4[16], we are concerned that this may "disadvantage funds with a more conservative approach to classification, and provide false assurances to investors regarding funds that are more aggressive in their approach to classifications."[17]

Finally, we agree with the SEC that in theory, public disclosure of the liquidity classifications could encourage funds to classify investments as more liquid, such as by adjusting the relative weight of

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Acting General Counsel, ICI, to Brent J. Fields, Secretary, SEC (Nov. 3, 2017), *available at* www.sec.gov/comments/s7-03-18/s70318-3129402-161936.pdf.

[13] Liquidity Adopting Release Page at 182 ("We recognize that there is still likely to be variation between funds in how they classify certain asset classes and investments, and believe that despite any variations, this liquidity information will be useful and valuable to us. We will be able to identify different fund liquidity classification practices, and use that information to gain insight into how different funds view liquidity in the market, and whether there are any identifiable liquidity concerns.").

[14] *See* Investment Company Liquidity Risk Management Programs Frequently Asked Questions (Feb. 21, 2018), *available at* https://www.sec.gov/investment/investment-company-liquidity-risk-management-programs-faq ("The Commission recognizes that different funds may classify the liquidity of similar investments differently based on the facts and circumstances informing their analysis. This could result in classifications of the same investment that vary from fund to fund.").

[15] Proposing Release at 14.

[16] Open-End Fund Liquidity Risk Management Programs; Swing Pricing; re-Opening of Comment Period for Investment Company Reporting Modernization Release, Release Nos. 33-9922, IC-31835 (Sept. 22, 2015), 90 Fed. Reg. 62274 (Oct. 15, 2015) ("Liquidity Proposing Release").

[17] *See* Letter from George C.W. Gatch, CEO – Global Funds Management & Institutional, J.P. Morgan Asset Management to Brent Fields, Secretary, Securities and Exchange Commission, dated Jan. 13, 2016, at 10, *available at* https://www.sec.gov/comments/s7-16-15/s71615-67.pdf.

input factors, or using different trading assumptions.[18] However, given that the liquidity classifications are based on an estimate of the time to sell a small portion of each position the fund holds (*e.g.,* 10 percent), our experience suggests that many funds will report a large proportion of *highly liquid* assets, reducing the perverse incentive.[19] Either way, this information will likely be confusing for investors, who may not understand the inherent subjectivity, or realize the assessment is based on a liquidity analysis of only a small pro-rata slice of the fund. As described in Section III below, consideration of the entire portfolio, with other modifications to rule 22e-4, could provide the SEC with a comprehensive and more accurate view of funds' liquidity.

II. Liquidity Risk Management Program Disclosure

JPMAM supports the SEC's goal of ensuring investors understand the liquidity risks that a fund may face and how those risks are managed. The SEC proposed to amend Form N-1A to require funds to "*briefly discuss the operation and effectiveness of the Fund's liquidity risk management program during the most recently completed fiscal year*," as part of the MDFP in funds' annual report to shareholders.[20] The SEC believes this approach would be more useful in improving investor understanding of fund liquidity than the currently required aggregate classification disclosure.

While we support the Commission's approach to enhancing the narrative disclosure around liquidity risk management, we believe the discussion in the MDFP should be limited to circumstances in which there was a material impact to the performance of the fund. Investors rely on the MDFP to explain the market conditions and investment strategies that materially affected performance.[21] In fact, given that liquidity can affect performance in certain market conditions and investment strategies, we believe the existing MDFP instructions already require consideration of liquidity risk. Nonetheless, to ensure material liquidity issues are discussed, the Commission may find it beneficial to clarify the MDFP instructions to also cover liquidity-related factors that affected fund performance.

However, we believe that the proposed discussion of the operation and effectiveness of a fund's liquidity program does not belong in the MDFP. The MDFP is not intended to describe fund operations in the normal course. Discussion of a fund's liquidity program, absent an impact on performance, could distract investors' attention from performance-related topics. Instead, we

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[18] Proposing Release at 14.

[19] See chart on page 5. Our analysis of a high yield bond portfolio, which used a conservative RATS threshold, resulted in over 80 percent of assets allocated to the *highly liquid* classification under both market price impact scenarios; *but see supra* note 12 and accompanying text.

[20] Proposing Release, Item 27(b)(7)(iii) of Form N-1A.

[21] Item 27(a)(7)(i) of Form N-1A states that the MDFP should discuss "factors that materially affected the fund's performance during the year, including market conditions, investment strategies, and techniques used by the adviser."

recommend the SEC consider requiring such disclosures in a new section in the annual report. We believe the annual report, which is both backward-looking and delivered to investors (unlike the statutory prospectus or Statement of Additional Information), is the best place for this type of narrative disclosure. Creating a separate section would allow space for this important information without diluting the MDFP.

III. Liquidity Reporting Amendments on Form N-PORT

JPMAM appreciates the SEC's willingness to reconsider its approach to reporting to improve data quality, and potentially reduce the costs and burdens associated with the current approach, by permitting (but not requiring) funds to classify a single position across multiple buckets on Form N-PORT in three specific circumstances. The first two circumstances – (1) where a fund has multiple sub-advisers with differing liquidity views, and (2) where portions of a position have differing liquidity features that justify treating the portions separately – may be of use to some firms, particularly to avoid burdensome reconciliation processes.

The third circumstance, where a fund currently uses a "proportionality" approach for internal risk management purposes and may wish to report this way for efficiency and cost reduction, is well intentioned but, in our view, unworkable, for three reasons. First, proportionality is separate from the requirements of rule 22e-4, which by its terms still requires that each investment be assigned to one bucket based on a RATS assessment. Second, assignment of the entire position, rather than a RATS subset, may cause funds to exceed the 15 percent limit on illiquid assets.[22] Finally, given the time pressure to meet the current compliance dates, we are not able to pause our implementation efforts until any optional approaches may be adopted.

As a preliminary matter, we agree that allocation across multiple buckets could provide the SEC with better data and potentially reduce cost burdens. Particularly for funds that have large positions in individual securities, it is rarely the case that the entire position could be sold at once. Indeed, JPMAM maintains an internal risk program that estimates the ability to sell a fund's entire position in each asset (*i.e.*, not just a reasonably expected trade size) over various periods of time (*e.g.*, percent in 1 day, percent in 1 week) including consideration of price impacts. We believe this is a better approach to monitoring and reviewing the liquidity of fund assets. After consideration of rule 22e-4, our risk and portfolio management teams determined that our existing system was preferable, so we elected to develop a parallel system to comply with rule 22e-4. We would be grateful for the ability to better align our 22e-4 obligations with our existing internal risk program, and reduce this redundancy.

[22] Rule 22e-4 prohibits funds from acquiring an illiquid investment if, immediately after the acquisition, the fund would have invested more than 15 percent of its net assets in illiquid investments, which are defined as investments that cannot be sold or disposed of in current market conditions in seven calendar days or less without significantly changing the market value, in sizes that a fund reasonably anticipates trading.

However, our understanding is that the proposal applies only to how funds *report* their liquidity classifications to the SEC. It does not purport to revise the requirements of the classification program under rule 22e-4, which by its terms requires each asset to be assigned to a single bucket based on a reasonably expected trade size.[23] Unless 22e-4 itself is amended, we believe we would still need to maintain the liquidity classification approach required by the rule, precluding any cost savings. In fact, utilizing the optional reporting approach could necessitate a third, hybrid approach, creating additional costs.

Additionally, because as proposed the proportionality approach would require an assessment of the liquidity of entire positions, rather than only a RATS subset[24], we believe it is likely to be unworkable under the existing 15 percent illiquid asset limit. Since most funds have relatively modest flows even in times of market stress, the RATS approach enables funds to consider only the time to liquidate a small portion of each position (*e.g.,*10 percent), and then classify the entire position into that basket. By definition, smaller positions are easier to sell without market impact, and will therefore appear more liquid.[25] To the extent funds were instead classifying their entire portfolios, many of them, particularly those of substantial size, would likely have more than 15 percent of their assets in the "illiquid" bucket.[26]

Consider the scenario in footnote 61 of the Proposing Release. A fund has a $100 million position in a security with a reasonably anticipated trade size of $10 million, and determines that $4 million can be converted to cash in 1-3 days, and $6 million in 4-7 days. Under the final rule, the fund would put the entire position into the *moderately liquid* bucket. Using the optional proportionality approach as proposed, *i.e.,* allocating the entire portfolio across buckets, it is likely that a substantial portion of the remaining $90 million would belong in the "illiquid" classification. A fund would violate the 15 percent illiquid asset if this example played out across its investments.

Finally, we cannot pause our implementation efforts to wait for any possible changes. We already face a very tight timeline to meet the December 2018 and June 2019 deadlines. We are currently undertaking due diligence on potential service providers and their data. If we select a vendor, we will then need to negotiate required agreements and obtain Board approval. Only after the service provider model has been decided can we progress on key aspects including verification that fund

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[23] Rule 22e-4(b)(1)(ii).

[24] Proposing Release footnote 56. A fund using the proportionality approach would split entire position sizes among the four classification categories as appropriate. Such a fund would not use a RATS approach, but would instead assume liquidation of the whole position.

[25] See chart on page 5. Our analysis of a high yield bond portfolio shows that most assets are classified as *highly liquid* when considering only the time to liquidate a small portion of each position.

[26] Importantly, we do not believe that a fund presents liquidity risk solely by virtue of having more than 15 percent of its assets classified as illiquid; it is important to consider the fund's redemptions, much as the RATS determination requires, before making this assessment.

investments are appropriately evaluated, and identification of illiquid investments. Thereafter, we will modify and test internal systems to ensure proper integration and functionality. Finally, we must confirm that the supervisory model and compliance procedures accurately reflect both the final operational structure, and program and reporting requirements. If we paused this process, we might be unable to meet the deadlines. On the other hand, once we have decided on a service provider model and begun integration with our systems, we will have reached a "point of no return," after which we would be unlikely to change our approach to take advantage of the voluntary approaches.

IV. Reconsideration of the liquidity classification requirements under rule 22e-4

If the SEC seeks to improve data quality and enhance efficiency and cost-effectiveness, we believe it must reconsider the liquidity program requirements under rule 22e-4, including asset classification and the 15 percent limit on illiquid assets. As we articulated in our comment letter on the Liquidity Proposing Release, we support a requirement that funds classify portfolio holdings across a spectrum of liquidity, *i.e.,* bucketing.[27] This approach is reflected in our own internal risk program, which predates rule 22e-4. However, several requirements of rule 22e-4, such as the definitions applied to bucketing and market price impact, have made it impractical to overlay that framework with our internal program, which uses different inputs and parameters. We believe a better approach would be for the SEC to offer funds flexibility to design a liquidity risk management program, while setting parameters around essential components, such as liquidity classifications. [28]

Should the SEC take this approach, we note that it would be necessary to reconsider the 15 percent illiquid asset limit, for the reasons described above. We believe this could be accomplished in at least two ways. The SEC could consider a limit on illiquid assets that takes into account potential outflows in times of stress, so that large funds are not disadvantaged purely by holding larger positions. Alternatively, the SEC could permit funds to establish their own illiquid asset limits, similar to the Highly Liquid Investment Minimum approach under rule 22e-4, where funds consider various liquidity risk factors.[29] While we acknowledge that the Proposing Release does not contemplate amendments to rule 22e-4, we believe that changes to the rule would best achieve the SEC's goal of improving oversight and governance of liquidity risks.

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[27] *See* Letter from George C.W. Gatch, *supra* note 17.

[28] The U.S. Department of the Treasury similarly observed that the classification requirements reflect a "highly prescriptive regulatory approach to liquidity risk management," and recommended that the Commission embrace a "principles-based approach to liquidity risk management rulemaking and any associated bucketing requirements." *See* A Financial System That Creates Economic Opportunities; Asset Management And Insurance, U.S. Department Of The Treasury (Oct. 2017), *available at* https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-That-Creates-Economic-Opportunities-Asset_Management-Insurance.pdf.

[29] *See* Rule 22e-4(b)(1)(iii).

JPMAM appreciates the opportunity to comment on the Commission's proposal to amend the investment company liquidity disclosure requirements. We would be pleased to provide any further information or respond to any questions that the Commission or the staff may have.

Very truly yours,

/s/ George C.W. Gatch

George C.W. Gatch

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
Dalia Blass, Director, Division of Investment Management