May 18, 2018

Via Electronic Filing

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

Re: Investment Company Liquidity Disclosure (SEC Rel. No. IC-33046; File No. S7-04-18)

Dear Mr. Fields:

The Investment Adviser Association[1] (IAA) appreciates the opportunity to comment on the SEC's proposal to amend certain disclosure requirements for registered investment companies (funds) related to the new liquidity risk management rule (Rule 22e-4 or liquidity rule) under the Investment Company Act of 1940 (ICA).[2] Many of our members are SEC-registered advisers and/or sub-advisers to funds and are therefore significantly affected by the liquidity rule and the related requirements in Form N-PORT that funds disclose publicly the aggregate liquidity classifications, or "buckets,"[3] of fund portfolio investments and, non-publicly, the liquidity classifications for each portfolio holding.[4] While we support and commend the Commission's proposed initiative to modify the disclosure requirements, we urge the Commission to take this opportunity to reconsider the portfolio investment classification requirements of the liquidity

[1] The IAA is a not-for-profit association that represents the interests of investment adviser firms registered with the U.S. Securities and Exchange Commission (SEC or Commission). Founded in 1937, the IAA's membership consists of over 640 firms that collectively manage more than $20 trillion in assets for a wide variety of individual and institutional investors, including pension plans, trusts, registered investment companies, private funds, endowments, foundations, and corporations. For more information, please visit www.investmentadviser.org.

[2] *See Investment Company Liquidity Disclosure*, SEC Rel. IC-33046 (Mar. 14, 2018) (proposal), available at https://www.sec.gov/rules/proposed/2018/ic-33046.pdf.

[3] We use the terms "classification" and "buckets" or "bucketing" interchangeably in this letter.

[4] *See Investment Company Liquidity Risk Management Programs*, SEC Rel. IC-32315, 81 Fed. Reg. 82142 (Nov. 18, 2016) (adopted Oct. 13, 2016) (Adopting Release), available at https://www.sec.gov/rules/final/2016/33-10233.pdf (adopting Rule 22e-4, new Form N-LIQUID and Rule 30b-10, and Item B.8.a of Form N-PORT to require the public reporting of liquidity aggregate classification information, and Item C.7 of Form N-PORT to require the non-public reporting of one liquidity classification for each portfolio investment among four specifically defined categories of liquidity.)

rule, consistent with the recommendation of the U.S. Department of the Treasury (Treasury) in its November 2017 report on asset management.[5]

Introduction

The effective management of liquidity risk is critically important, and we strongly support efforts to maintain robust compliance with the liquidity requirements under the ICA. In fact, our members have been focused on the significant compliance implementation challenges presented by the liquidity rule, and therefore, we appreciate the recent compliance date delay adopted by the Commission.[6] We also appreciate that with regard to disclosure and reporting, the Commission acknowledged in the proposal that "public dissemination of the aggregate classification requirement, without an accompanying explanation to investors of the underlying subjectivity, methodological decisions, and assumptions that shape this information . . . may be potentially misleading to investors."[7] To address this stated concern, the Commission has proposed to rescind the requirement for funds to publicly report the "liquidity aggregate classification information" for portfolio investments in new Form N-PORT and would instead require funds to make public disclosure in their annual shareholder reports that would "briefly describe the operation and effectiveness" of the fund's liquidity risk management program.[8]

We support the Commission's efforts to address concerns about the potentially misleading nature of the public aggregate disclosure of the classifications and to recognize some of the implementation challenges present in the initial framework of the liquidity rule. However, we urge the Commission to reconsider the bucketing element of the liquidity rule itself before it acts on the proposed disclosure amendments. The Commission should reconsider whether requiring classification of a portfolio investment as highly liquid, moderately liquid, less liquid, or illiquid provides a meaningful regulatory tool to meet the stated objectives of the rule, given the other

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[5] *Asset Management and Insurance, Report to President Donald J. Trump from the U.S. Department of the Treasury* at 32-35 (Nov. 2017) (Treasury report), available at https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-That-Creates-Economic-Opportunities-Asset_Management-Insurance.pdf.

[6] The SEC voted unanimously to adopt an interim final rule delaying the compliance date for portions of the liquidity rule and the reporting of portfolio investment liquidity classification information in Form N-PORT and Form N-LIQUID. *See Investment Company Liquidity Risk Management Programs; Commission Guidance for In-Kind ETFs*, SEC Rel. IC-33010, 83 Fed. Reg. 8342 (Feb. 27, 2028) (adopted Feb. 22, 2018) (interim final rule; interpretation), available at https://www.sec.gov/rules/interim/2018/ic-33010.pdf. The SEC delayed the compliance date by six months to June 1, 2019 (for larger entities) and December 1, 2019 (for smaller entities) for the following elements of the liquidity rule and related disclosures: (i) for Rule 22e-4: the portfolio holding classification requirements; the highly liquid investment minimum (HLIM); the board initial approval of the liquidity risk management program and annual board reporting; (ii) for Form N-LIQUID Part D: assets that are highly liquid investments below the HLIM; and (iii) for Form N-PORT: Item B.7 – HLIM and Item C.7 – liquidity classification information (the content of which is the subject of the proposal).

[7] Proposal at 13-14.

[8] *See* proposed amendments to Item 27 of Form N-1A.

significant elements of the rule and related disclosure requirements. We believe that it does not and that the Commission should at this time consider replacing the liquidity rule's classification requirements with a more principles-based approach, as recommended by the Treasury, that would rely on other protections that strengthen funds' liquidity risk management. In the alternative, if the Commission determines to retain the bucketing element, we support the Commission's proposal to eliminate potentially misleading disclosure of the aggregate liquidity classifications and to permit funds flexibility in the liquidity classification disclosure. Our comments are discussed below.

I. The SEC Should Embrace a Principles-Based Approach to the Liquidity Rule and Eliminate the Bucketing Requirement, as Recommended in the Treasury Report

We appreciate that the Commission is seeking comments in the proposal about whether there are advantages to Treasury's recommendation and what additional steps the Commission should consider to shift toward a principles-based approach.[9] Noting the costly and difficult implementation that firms have experienced thus far, Treasury specifically recommended that the Commission reject a highly prescriptive approach. Indeed, the Treasury report echoed the experience of our members – that since the liquidity rule was adopted, funds and fund advisers have struggled with implementing the rule's "overly prescriptive asset classification or bucketing methodology despite the fluid, and sometimes subjective, nature of liquidity."[10] We agree that the Commission should amend the rule to shift to a principles-based approach, rather than relying on and imposing a uniform classification scheme.[11]

We recognize and appreciate that the Commission and its staff have spent many months engaging with stakeholders since the liquidity rule was adopted in October 2016, including through the issuance of frequently asked questions.[12] However, based on our members' experience as advisers and sub-advisers working with funds to implement the liquidity rule, we do not believe that the bucketing requirement will contribute to the Commission's goals of "promoting consistency in funds' processes for assessing portfolio investments' liquidity and enhancing the data quality of funds' liquidity-related reporting and disclosure."[13]

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[9] Proposal at 23.

[10] Treasury report at 34.

[11] Treasury report. *See also, ICI Recommendations Related to the Liquidity Risk Management and Fund Reporting Requirements*, Letter from ICI President Paul Schott Stevens (July 20, 2017) at 3 ("maintaining a uniform asset classification requirement is not essential to a strong liquidity risk management program rule.")

[12] *See Investment Company Liquidity Risk Management Programs Frequently Asked Questions* (FAQs) by staff of the Division of Investment Management, SEC (updated Feb. 22, 2018), available at https://www.sec.gov/investment/investment-company-liquidity-risk-management-programs-faq.

[13] *See* Adopting Release at 82174.

The bucketing requirement is not needed and not likely to achieve Commission's goals for several reasons. First, reliance on buckets is misplaced. Liquidity risk is not a fixed concept. Rather, it is determined based on the investment strategy of the fund, and the liquidity of a fund depends on the ability to dispose of portfolio investments at the time and market price desired by the portfolio manager and in accordance with the fund mandate. It is not at all clear that the classification requirement under the liquidity rule will correlate to a fund's ability to meet redemption requests or that it will otherwise benefit funds, shareholders, or the Commission.

Second, by requiring funds to uniformly classify holdings by the number of days to liquidate, the classification element imposes a uniform one-size-fits-all formula on dynamic portfolio management and risk management techniques. The classifications are not useful to portfolio managers in their day-to-day risk management. Funds holding the same amount of the same position can legitimately come to different conclusions about how long it would take to liquidate the position. Further, we understand that this requirement has had, and continues to have, significant operational and technological effects on fund advisers and sub-advisers. Given the complexity of managing the classification process among many funds and within many relationships, funds have not surprisingly turned to third-party vendors to provide solutions for compliance with the classification requirements. This has potential negative consequences for portfolio management by placing unnecessary demands on firms' human resources as well as third-party vendor resources. These demands are outpacing any perceived benefit of the bucketing, which for many funds and fund advisers is strictly an exercise in compliance, rather than being truly reflective of their dynamic liquidity management programs.

Third, other requirements are in place. As noted by Commissioner Peirce, the framework of the new provisions of the liquidity rule–even without the bucketing requirement–likely provides sufficient information for an evaluation of fund liquidity.[14] In particular, the following important elements of the regulatory framework around managing liquidity risk already require (or would require by the proposal) a fund to: (i) have a liquidity risk management program (LRMP) to regularly assess and manage liquidity risk; (ii) comply with a codified limit on illiquid investments of 15 percent of net assets; (iii) disclose holdings considered illiquid under Form N-PORT; (iv) disclose cash and cash equivalents; and (v) provide qualitative liquidity disclosure.

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[14] *See Looking at Funds through the Right Glasses*, SEC Commissioner Hester Peirce, Remarks at the 2018 Mutual Funds and Investment Management Conference (Mar. 19, 2018), available at https://www.sec.gov/news/speech/peirce-looking-funds-through-right-glasses. *See also*, *ICI Supplemental Comments on Investment Company Liquidity Risk Management Programs; Request for Delay* (File No. S7-16-15) (Nov. 3, 2017) at 7 (noting that the bucketing has "limited utility" due to the high compliance costs exceeding any meaningful benefits and the fact that multiple vendor models produce various classifications for the same investments.) As investment advisers and sub-advisers, our members have a fiduciary duty to manage each client's assets in accordance with the client's investment objectives and guidelines. In addition, advisers to funds are required to comply with the ICA Section 22(e) to redeem shareholders' fund interests no more than seven days after the request, with some limited exceptions.

Given these substantial provisions and the substantial negative impacts of the classification requirement, we urge the Commission to take an incremental approach and consider the effects of these enhancements before imposing the classification requirement on top of them.

For these reasons, we urge the Commission to take this opportunity to move toward a more flexible approach to monitoring, managing, and measuring liquidity risk by eliminating the classification requirement.

II. Additional Comments

1. Proposal to Eliminate Public Aggregate Liquidity Classification Information

While we hope the Commission reconsiders its bucketing approach, we recognize and appreciate that the proposal would rescind the requirement to disclose publicly the aggregate percentage of the fund's liquidity classification holdings in each of the four liquidity buckets.[15] We agree that the SEC should eliminate this public disclosure of funds' aggregate liquidity profiles. First, we do not believe investors would have relied on a fund's aggregate liquidity profile in making investment decisions. Second, we agree that the aggregate liquidity profiles could be confusing and even misleading for investors.[16] At a minimum, classifications produced and published by vendors to comply with the specific terms and prescriptive methodology of the rule may not have any direct relation to the actual day-to-day portfolio management and risk management processes in use for management of the fund. This could give investors a misimpression about the source and quality of disclosure information. The degree of subjectivity in making classifications and the multiple inputs inherently makes the data unreliable and not comparable. Accordingly, we support this proposal.

2. Proposal to Permit Multiple Liquidity Classifications for a Portfolio Investment Holding ("Splitting")

Under the proposal, the Commission would allow a fund the option to change the way in which it classifies and reports a portfolio investment holding to attribute multiple—instead of just one—classification categories to the holding under three circumstances: if a fund has multiple sub-advisers with differing liquidity views; if portions of the position have differing liquidity features that justify treating portions separately; or if the fund chooses to classify the position through

[15] The proposal would also re-designate from public to non-public the reporting about derivatives transactions that includes the percentage of the fund's highly liquid investment minimum that the fund has segregated to cover or pledged to satisfy certain margin requirements, *i.e.*, those in connection with derivatives transactions that are classified among the categories of moderately liquid investments, less liquid investments, and illiquid investments. The SEC stated that the public disclosure of this information would be of limited utility to investors without broader context and therefore may be confusing.

[16] Accordingly, we would not support simply making the aggregate profile non-public for some additional period of time (*e.g.*, 2 to 3 years).

evaluation of how long it would take to liquidate the entire position, rather than basing it on the sizes it would "reasonably anticipate trading." We support and appreciate the proposal's flexible approach. We agree the options should be permissible to permit funds to take the approach they determine to be most appropriate.

3. <u>Considerations Related to an Additional Proposed Narrative Summary of the Operation of a Fund's Liquidity Risk Management Program</u>

The Commission proposes to eliminate the aggregate liquidity profile public disclosure requirement of Form N-PORT and to replace it with a requirement that funds discuss the operation and effectiveness of their LRMP as part of their annual reports to shareholders. The amendments would add disclosure to Item 27, Financial Statements, Management's Discussion of Fund Performance, to "[b]riefly describe the operation and effectiveness of the Fund's liquidity risk management program during the most recently completed fiscal year."

While we appreciate the Commission's effort to replace the current Form N-PORT disclosure of aggregate liquidity classifications with additional disclosure about managing liquidity and redemptions, we respectfully request that the Commission consider avoiding duplicative disclosure. In particular, relevant items in Form N-1A already require funds to disclose share redemption provisions and, if relevant, liquidity risk as a principal risk of investing in the fund.[17] Further, we suggest that a discussion of the operation and effectiveness of a liquidity risk management program is more appropriately within a fund board's purview. As such, it should be subject to board review rather than being included in a management discussion and analysis about fund performance in an annual report. Alternatively, if the Commission chooses the approach in the proposal, it should recognize the fund board's governance function and consider requiring that any narrative be included in disclosure regarding the process of fund operations or factors considered by the board in approving the advisory agreement, rather than in relation to fund performance.

4. <u>Continued Assessment of the Effectiveness and Costs of the Rule</u>

Given the importance of the liquidity rule on fund advisers and sub-advisers, we recommend that the Commission continue to assess the effectiveness of the rule and related disclosure on a regular basis. A timely retrospective review of the rule would be warranted as a means to ensure that the rule's operation and effects—intended and unintended—are consistent with and supportive of the Commission's regulatory objectives.

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[17] Item 11(c) of Form N-1A, which was updated in connection with the liquidity rule adoption, requires funds to disclose information about redemption of fund shares, including the methods that the fund typically expects to use to meet redemption requests, and whether those methods are used regularly, or only in stressed market conditions (*e.g.*, sales of portfolio assets, holdings of cash or cash equivalents, lines of credit, interfund lending, and/or ability to redeem in kind). *See* Adopting Release at 82267. Items 4(b) and 9(c) of Form N-1A require funds to disclose principal risks of investing in the fund.

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We appreciate the Commission's consideration of our comments and would welcome the opportunity to meet with you to discuss our recommendations. In the meantime, please do not hesitate to contact the undersigned at ([redacted] if we may provide any additional information.

Respectfully Submitted,

/s/

Monique Botkin
Associate General Counsel

cc: The Honorable Walter J. 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