asset management group

April 12, 2016

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

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 – Supplemental Comment Letter on Proposed Liquidity Risk Management Programs: Proposed Alternative Classification System

Dear Mr. Fields:

The Asset Management Group (the "**AMG**") of the Securities Industry and Financial Markets Association ("**SIFMA**")[1] appreciates the opportunity to supplement our January 13, 2016 comment letter (the "Original Letter")[2] to the United States Securities and Exchange Commission (the "**Commission**" or "**SEC**") on the Commission's proposal to require liquidity risk management programs for open-end funds and to permit swing pricing by open-end funds on an optional basis (the "**Proposal**").[3] This letter

1 The AMG is the voice for the buy side within the securities industry and broader financial markets, which serves millions of individual and institutional investors as they save for retirement, education, emergencies, and other investment needs and goals. The AMG's members represent U.S. asset management firms whose combined assets under management exceed $30 trillion. The clients of AMG member firms include, among others, registered investment companies, separate accounts, ERISA plans, and state and local government pension funds.

2 Letter from Timothy W. Cameron, Head, and Lindsey Weber Keljo, Vice President & Assistant General Counsel, SIFMA AMG, to Brent J. Fields, Secretary, SEC (Jan. 13, 2016), *available at* https://www.sec.gov/comments/s7-16-15/s71615-64.pdf. We also filed a separate comment letter on the swing pricing aspects of the Proposal, which are not addressed in this supplemental letter. Letter from Timothy W. Cameron, Head, and Lindsey Weber Keljo, Vice President & Assistant General Counsel, SIFMA AMG, to Brent J. Fields, Secretary, SEC (Jan. 13, 2016), *available at* https://www.sec.gov/comments/s7-16-15/s71615-65.pdf.

3 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), 80 Fed. Reg. 62274 (Oct. 15, 2015) (the **"Proposing Release"**).

addresses only the liquidity risk management program aspect of the Proposal and focuses specifically on the liquidity classification component of the proposed rule.

I. Introduction and Executive Summary

We continue to support, as we did in the Original Letter, the Commission's goal of strengthening liquidity risk management by open-end funds, particularly among funds that may to date have dedicated fewer resources to managing liquidity risk in a formalized way. In particular, we support what we view as the cornerstone of the Proposal, which is the requirement that all open-end funds adopt formal liquidity risk management programs that are reasonably designed to assess and manage the fund's liquidity risk.

We do not support the proposed classification system, for the reasons broadly shared across the spectrum of market participants, as expressed in the comment process. In the Original Letter, we proposed an alternative classification system based on four liquidity categories designed to achieve the Commission's classification and reporting goals in a simpler manner without the adverse consequences inherent in the six-category "days-to-cash" proposal.

The purpose of this letter is to propose a revised version of our alternative classification system designed with the same goals, but with the benefit of additional consideration based on review of other suggestions made in the comment process and further discussion with our members. The revised system has five liquidity categories and substantial additional detail about the liquidity characteristics of each category. The revisions are designed to further the Commission's goal of achieving, to the extent possible, a standardized and objective classification system for all funds. The revised alternative classification system is presented in the chart attached to this letter as Exhibit A, and is explained below.

We also address briefly our proposal for reporting and disclosure of liquidity classifications and propose several additional components for a final liquidity risk management program rule, including an early warning provision, a revised definition of liquidity risk, treatment of assets used as cover for derivatives transactions, and a safe harbor for good faith liquidity determinations.

With respect to all other aspects of the liquidity risk management proposal, including our concerns about the proposed three-day liquid asset minimum requirement, we continue to adhere to the views set forth in the Original Letter.

II. Explanation of the Proposed Alternative Classification System

A. Goals of a Classification System

We support the Commission's goal of receiving additional data about open-end fund liquidity to fulfill its regulatory mission. We understand that the Commission wishes to receive more nuanced, spectrum-based information about the liquidity of fund assets and, to the extent possible, to receive standardized and objective liquidity information across all funds. The proposed classification system is designed with these goals in mind.

B. Concept and Overview

The proposed revised classification system builds on SIFMA AMG's original proposal, with additional specifications designed to provide substantially greater detail on the liquidity characteristics and the types of assets that would normally be classified in each category. As a consequence, there should be substantially increased standardization, objectivity, and comparability across fund groups. The revised system would provide the Commission with more extensive and detailed information about fund liquidity than it currently receives.

The approach we propose can be described generally as "asset-type mapping with exceptions."

Each category has a generic description or "definition" of the liquidity characteristics of instruments that would fall into the category, plus a list of asset types that would normally match these characteristics. The definitions would reflect a common set of variables used in determining the liquidity categorization of the asset types appropriate for each category. These common variables would be:

- Market conditions (normal v. stressed);
- Market structure (size, breadth, and depth of the market); and
- Transaction costs (bid-ask spreads).

Positions would generally be placed in categories based on the asset types identified under the category descriptions. Classification by asset type would thus be the "default" method.

Positions that have liquidity characteristics that a fund believes are different from those that are typical for the asset type and that are deemed to make the position substantially more or less liquid would be addressed on an exception basis and, if the fund deemed appropriate, placed in a different category, which could be either higher or lower.

The proposed alternative represents, in a certain sense, an asset-by-asset or "bottom-up" classification of assets, because each asset must be identified by asset type, and the exception processing will need to be done on a bottom-up basis. However, classification in this manner is also "top-down," because identification of the asset type will generally determine the classification, and is therefore much more objective than the "days-to-cash" approach in the Proposal. We believe that the alternative would address concerns of commenters regarding the subjectivity of the "days-to-cash" approach by creating an objective baseline of the general liquidity classification of each asset type, while also providing the flexibility for advisers to make any necessary adjustments with respect to any specific asset, which we anticipate will be done through the exception process, and will result in a more granular and thoughtful approach to classifications.

Under the proposed alternative, the classification considerations and factors identified in the Commission's Proposal (trading data, position size, and price impact, as well as other components of the nine factors stated in the Proposal) would be embedded in the determination of which asset types fall into the five categories. Thus, these considerations would not ordinarily be individually re-vetted in connection with ongoing classifications. The exception process, however, would involve consideration of some or all of the nine factors, price impact, and other relevant factors, as appropriate, as part of the methodology for determining whether to override classification by asset type for specific positions. This would be addressed in each firm's liquidity risk management policies and procedures.

C. Market Impact

The Commission's Proposal uses the phrase "at a price that does not materially affect the value of the asset prior to sale" in order to address potential market impact of trading as a liquidity classification consideration.[4] As explained in the Proposing Release, "the term 'immediately prior to sale' is meant to reflect that the fund must determine whether the sales price the fund would receive for the asset is reasonably expected to move the price of the asset in the market, independent of other market forces affecting the asset's value. The term 'immediately prior to sale' is not meant to require a fund to anticipate and determine in advance the precise current market price or fair value of an asset at the moment before the fund would sell the asset."[5]

In our revised proposal, we address market impact and relationship of price to liquidity in two ways. First, the proposed categories are differentiated from one another with reference to, among other things, the degree of divergence between bid-ask spreads. Second, as mentioned above, factors related to market impact are embedded in the process of identifying the asset types that are appropriate to each category, as well as in the exception process. For example, the size of a market is an important factor in assessing market impact. The larger the market, all else being equal, the less impact any one given trade will have on that market. The reverse is also true: the smaller the market, the more likely any one trade may impact that market.

D. Settlement Times

We do not believe that the concepts of liquidity and transaction costs should be confused with settlement timing associated with certain asset types, such as bank loans. The issue of investments with extended settlement times creating a potential mismatch between a fund's cash needs and its available cash could more properly be dealt with in the context of a fund's overall liquidity risk management program, rather than intertwining settlement times with the construction of the asset classification system. The requirement for funds to have a more formal process in place for evaluating liquidity risk will put fund boards in a better position to oversee any concerns regarding potential liquidity mismatches within a fund and ensure that the adviser has taken steps to mitigate this risk. In addition to the existing risk mitigation techniques in this area, including securing committed lines of credit and interfund lending arrangements, requiring funds to consider the risks associated with extended settlement times as part of their overall liquidity risk management programs will enable the industry to innovate and create new ways to deal with potential cash shortfalls resulting from extended settlements.

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4 Proposed Rule 22e-4(b)(2)(i).

5 Proposing Release, *supra* note 3, at 62292.

E. Status of Asset Type Designations – Updating Designations

The identification of asset types for each category is critical for achieving the goals of objectivity and comparability. Absent a common understanding of the asset type mapping, these goals cannot be achieved.

To maximize these goals, a list of the asset types for each category could be included in the adopting release or in frequently asked questions ("FAQs") promulgated by the Commission or the staff in conjunction with adoption of a final rule. Our proposal on Exhibit A includes a list of asset types for each category, although the list does not include all asset types and thus is not intended to be exhaustive.

This approach would allow the staff to provide guidance on the classification of particular asset classes based on current market conditions and structures. This guidance would facilitate objective application of the liquidity classification definitions contained in the rule and provide the staff with more comparable data. By providing further clarity regarding the staff's understanding of the classification definitions, market participants would be better positioned to objectively classify the liquidity of novel or innovative asset types as markets evolve.

We understand that as markets, technology, and other factors affecting liquidity evolve, the asset types for each category may change. To some extent, this can be part of the exception process. However, in order for the classification system to retain the benefits of standardization and objectivity, it would be preferable to develop a process for monitoring and updating the current asset types periodically on an ongoing basis (for example, once a year). SIFMA AMG and its members are willing to work with the Commission or its staff to develop an industry-led process and methodology for monitoring and updating the asset types in each category, including considering new asset types that emerge over time. One such model might be the forum that SIFMA created for the TBA market, where market participants come together on a periodic basis through a SIFMA forum to set the schedule for TBA trade settlements, determine trading practices, and develop other market standards and practices. This industry-driven process has endured from the early 1980s through today, and has created a robust framework through which a multi-trillion dollar market operates and remains liquid, in a safe and sound manner.

F. Relationship to Highly Liquid Target Component

For the reasons set forth in the Original Letter, SIFMA AMG does not support the Proposal's three-day liquid asset minimum component requirement.[6] Others in the comment process also seemed to share this position for similar reasons. We believe that the undesirability of building T+3 settlement into the rule is also shown by the current industry and regulatory initiative to move to T+2 settlement, which is recommended to occur on September 5, 2017.[7]

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6 We believe that the proposed three-day liquid asset minimum may prevent funds from fulfilling their investment mandate and may have a pro-cyclical effect during periods of market stress. *See* Original Letter, *supra* note 2, at 27 – 28.

7 U.S. T+2 Industry Steering Committee, Media Alert, US T+2 ISC Recommends Move to Shorter Settlement Cycle on September 5, 2017 (Mar. 7, 2016), *available at* http://www.ust2.com/pdfs/T2-ISC-recommends-shorter-settlement-030716.pdf.

G. Liquid Assets Held as Cover for Derivatives

We do not support the view, expressed in the Proposing Release, that instruments held as cover for derivatives and other transactions that implicate section 18 of the Investment Company Act of 1940 should be classified based on the liquidity characteristics of the related derivative or other transaction.[8] Under our proposed alternative, liquidity characteristics would be determined solely by the instrument itself, not the related derivative or financial commitment transaction. This ensures that each asset is appropriately classified. To do otherwise would be misleading as to the true liquidity profile of a fund's portfolio. For example, to the extent that liquid assets were used for asset segregation purposes to cover less liquid derivatives and other transactions, this could artificially increase the percentage of a fund's assets listed in less liquid categories, while artificially decreasing its assets in more liquid categories. We also do not believe that liquid assets used for asset segregation should count as 15% Standard Assets (as this could reduce the 15% threshold, in effect, to as little as 7.5%). Thus, these assets should not be classified in category 5 or be considered for purposes of the restriction on further purchases of 15% Standard Assets.

III. Reporting and Disclosure

With respect to reporting and disclosure, we propose that asset level liquidity classifications in the five categories be reported to the Commission monthly on Form N-PORT, but that the classifications not be made public. As discussed in the Original Letter, we have serious concerns about the public availability of this information, and these concerns were broadly shared by commenters across the industry.[9] If the Commission believes that making some information about fund liquidity classifications available to the public is in the public interest and in the interests of investors, we believe that any such public reporting should be limited to portfolio level information only, indicating the percentage of portfolio assets in each of the five categories. We also believe that in advance of requiring such information to be publicly available, the Commission should study the information received for at least one year, to make a full and reasoned determination whether or not the potential benefits of public availability outweigh the harms, including the dangers of misleading investors and creating adverse incentives for fund liquidity determinations.

IV. Additional Recommendations

1. Early Warning Notification

To respond to concerns raised by the Third Avenue Fund liquidation,[10] we support the addition to the Proposal of an early warning notification provision, under which funds would be required to notify the

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[8] Proposing Release, *supra* note 3, at 62301 – 02; *see also* Use of Derivatives by Registered Investment Companies and Business Development Companies, Release No. IC–31933 (Dec. 11, 2015), 80 Fed. Reg. 80884, 80926 n.328 (Dec. 28, 2015).

[9] *See, e.g.,* the comment letter from Morningstar, Inc. (Jan. 13, 2016), *available at* https://www.sec.gov/comments/s7-16-15/s71615-63.pdf.

[10] *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), *available at* https://federalregister.gov/a/2015-32079.

Commission when 15% Standard Assets held at the end of a business day exceed 15% of net assets. In order to avoid unnecessary warnings, we believe the notification requirement should apply only if 15% Standard Assets continue to exceed 15% of net assets three business days after the threshold was first exceeded.

2. Safe Harbor

As we stated in the Original Letter, we continue to believe that funds and their affiliates need a safe harbor to protect them against undue risk with respect to liquidity risk management programs and liquidity classification determinations made in good faith. These concerns were also broadly expressed during the comment process. Although the changes we recommend to the Proposal would increase the objectivity in the classifications, the residual subjectivity from the exception process would still leave funds open to second guessing based on later developments. Without a safe harbor, funds would have incentives either to be overly conservative in their liquidity classifications or to avoid exception classifications, either of which would reduce the value of the reported classifications to the Commission.

3. Definition of Liquidity Risk

In connection with the proposed alternative, we believe the definition of "liquidity risk" should be revised to eliminate the phrase "without materially affecting the fund's net asset value." The definition would thus be: Liquidity risk means the risk that the fund could not meet requests to redeem shares issued by the fund that are expected under normal conditions, or are reasonably foreseeable under stressed conditions.

IV. Summary of Benefits of the Revised Alternative Classification System and Additional Components

We believe that our revised proposed alternative, together with the additional components, will provide the following benefits, designed to achieve the Commission's goals underlying the Proposal:

1. Overall, the requirement that all funds adopt liquidity risk management programs will bring discipline and attention to liquidity risk management.

2. Data reported to the Commission for monitoring fund liquidity across the industry will be provided on a more consistent basis than under the Commission's Proposal.

3. The alternative will provide more extensive and detailed liquidity information to the Commission than it is currently receiving.

4. The proposed alternative classification system avoids the features of the Proposal's classification system that have raised the greatest concern among commenters. It removes the vast majority of the subjectivity in the Proposal, since placement in categories will be based primarily on objective

identification of asset type. The proposed alternative also provides a greatly simplified process and reduces burdens that lack corresponding benefits.[11]

5. Similar funds will appear similar, and outliers will be apparent.

6. The proposed alternative addresses the lessons learned from the Third Avenue liquidation. Unlike the Commission's situation in the past, the Commission will receive early warning notification if a fund's 15% Standard Assets exceed 15% of its net assets.

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[11] Our concerns about the proposed classification system are described in detail in the Original Letter, and echoed in many other comment letters from a range of industry participants. To summarize briefly these concerns, the proposed classification system is too complex, granular, and subjective, would create a false sense of precision, and would impose unnecessary burdens. *See, e.g.,* the comment letters filed by Federal Regulation of Securities Committee, Section of Business Law, American Bar Association (Feb. 11, 2016), *available at* https://www.sec.gov/comments/s7-16-15/s71615-96.pdf; Financial Services Institute (Feb. 4, 2016), *available at* https://www.sec.gov/comments/s7-16-15/s71615-94.pdf; Better Markets, Inc. (Jan. 13, 2016), *available at* https://www.sec.gov/comments/s7-16-15/s71615-84.pdf; Americans for Financial Reform (Jan. 13, 2016), *available at* https://www.sec.gov/comments/s7-16-15/s71615-76.pdf; Mutual Fund Directors Forum (Jan. 13, 2016), *available at* https://www.sec.gov/comments/s7-16-15/s71615-66.pdf; Morningstar, Inc. (Jan. 13, 2016), *available at* https://www.sec.gov/comments/s7-16-15/s71615-63.pdf; Investment Company Institute (Jan. 13, 2016), *available at* https://www.sec.gov/comments/s7-16-15/s71615-54.pdf.

SIFMA AMG sincerely appreciates the opportunity to supplement our comments and your consideration of these views. We stand ready to provide any additional information or assistance that the Commission might find useful. Please do not hesitate to contact either Timothy Cameron at [redacted] or [redacted] or Lindsey Keljo at [redacted] or [redacted] with any questions.

Sincerely,

Timothy W. Cameron, Esq.
Asset Management Group – Head
Securities Industry and Financial Markets Association

Lindsey Weber Keljo, Esq.
Asset Management Group - Vice President and Assistant General Counsel
Securities Industry and Financial Markets Association

Exhibit A

	Category 1	Category 2	Category 3	Category 4	Category 5
Definition	Assets that can be readily converted to cash in normal and even during stressed markets. Minimal volatility in bid-ask spreads, although spreads may widen during stressed markets. Assets generally trade in the largest, deepest markets with the largest and most diverse group of market participants.	Assets that can be readily converted to cash in normal and during reasonably foreseeable stressed markets. Modest volatility in bid-ask spreads, and spreads are expected to widen during stressed markets. Assets generally trade in markets considered broad and deep, but with fewer participants than Category 1.	Assets that can be readily converted to cash in normal markets but become more difficult to transact during reasonably foreseeable stressed markets. Greater volatility in bid-ask spreads, and spreads are expected to be much wider during stressed markets. Assets generally trade in markets that are moderate in size and depth, with fewer participants than Category 2.	Assets that are difficult to trade in normal and stressed markets. Bid-ask spreads are wide during normal markets. Assets generally trade in markets that are smaller in size and/or have few participants.	Assets that require heavy negotiations. Bid-ask spreads are wide during normal markets or may not be readily available. Assets trade in the smallest sized markets with the fewest, most concentrated group of participants.
Asset Types	CASH and CASH EQUIVALENTS • Cash • Cash equivalents (corresponding to money market instruments permitted under rule 2a-7) EQUITIES • Developed markets listed equities FIXED INCOME / OTHER • Investment grade government/sovereign bonds • Agency MBS (including TBAs) • Futures and centrally cleared swaps • Spot FX • FX forwards and swaps (deliverable and NDFs)	EQUITIES • Emerging and frontier markets listed equities • Preferred securities FIXED INCOME / OTHER • High yield government/sovereign bonds • Investment grade municipal securities • Investment grade corporate bonds (developed markets only) • Senior ABS • Senior CMBS • Bilateral and non-centrally cleared swaps	FIXED INCOME / OTHER • High yield municipal securities • High yield corporate bonds (developed markets only) • Emerging markets investment grade corporate bonds • Syndicated bank loans (issue size greater than $250M) • Senior non-agency RMBS • GSE risk-sharing securities • Subordinate ABS • Subordinate CMBS • Senior CLO debt tranches	FIXED INCOME / OTHER • Emerging markets high yield corporate bonds • Syndicated middle market loans (issue size less than $250M) • Subordinate non-agency RMBS • Mezzanine CLO debt tranches • Securitized asset residuals / equity tranches • Defaulted securities with public pricing	15% STANDARD ASSETS • Assets that may not be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to them by the fund