Secretary Brent J. Fields
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090
18 December 2015

Re: File No. S7-16-15
SEC Release 33-9922, "Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release"

To Secretary Fields:

Interactive Data Pricing and Reference Data LLC ("Interactive Data") appreciates the opportunity to comment on the recent release issued by the Securities and Exchange Commission ("Commission") entitled "Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release" (collectively, the "Proposal"). In general, Interactive Data supports regulatory initiatives aimed at improving transparency and encouraging best practices around liquidity risk management for the funds industry.

Background on Interactive Data Pricing and Reference Data

Interactive Data is a registered investment adviser with the Commission under the Investment Advisers Act of 1940 and has been in the evaluations business for more than 40 years. We provide global security evaluations, reference data, risk analytics and other information designed to support financial institutions' and investment funds' pricing activities, research, and portfolio management. We offer evaluations for approximately 2.7 million fixed income securities (including security-based swaps and loan products), and our Fair Value Information Services for international equities, options, and futures, and valuations for complex structured products and over-the-counter derivatives. These offerings are supplemented by a comprehensive range of reference data for more than 10 million global financial instruments, including descriptive data, corporate actions, and terms and conditions for current and historical fixed income securities.

Our company has built a strong presence within the U.S. mutual fund marketplace and currently counts as customers 50 of the top 50 U.S. mutual fund companies, 49 of the top 50 U.S. asset managers and 33 of the top 50 global hedge funds (rankings as of December 2015).

Interactive Data has developed a *Liquidity Indicators* service for quantifying liquidity at the security and portfolio level in the fixed income markets. The approach will be described in further detail below as appropriate to clarify our comments on the Proposal. Our service involves projecting a given security's future potential trading volume capacity along with its expected price uncertainty in order to support determinations on how long it would take to liquidate a position at or near the current value ascribed by a fund. We believe that this service, along with our extensive experience as a third party pricing and reference data provider serving more than 5,000 global organizations, gives us unique insight into the wide range of liquidity risk management practices and processes of various asset management companies.

Our comments focus on the following topics within the Proposal:

- The definition of standard assets, liquidity categories and factors impacting liquidity assessment
- Asset liquidity classification and the 15% standard asset rule
- Three-day liquid asset minimum
- Cross-trading under rule 17a-7
- Swing pricing
- Potential coordination among regulators
- Operational clarifications on Form N-PORT
- Burden and economic impact analysis

<u>Definition of Standard Assets, Liquidity Categories and Factors Impacting Liquidity Assessment</u>

Interactive Data recommendations:

- *Redefine "standard assets" (subject to the 15% ceiling) in terms of specific contractual provisions or transaction restrictions associated with particular asset types, rather than by reference to the number of days needed to sell or dispose of the asset.*
- *As a possible alternative to the preceding point, align the classification rules for "three-day liquid assets" and "standard assets" within a single uniform scale (this recommendation is discussed in detail in the next section).*
- *Provide additional guidance around the terms "materially affect" (as used in connection with the proposed liquidity classification requirements) and "at approximately the value" (as used in the proposed definition of "standard asset").*
- *Direct funds to consider position size in all asset liquidity classifications, subject to a materiality threshold for classifying any portion of a fund's holding of an asset in a bucket requiring more than seven days to liquidate.*
- *Include characteristics of comparable assets on the list of liquidity factors a fund should consider when assessing the liquidity of any portfolio asset, under all circumstances (i.e., even when pertinent information is available on the specific asset whose liquidity is being assessed).*
- *Consider the minimum set of factors as guidance instead of a codified dataset.*

For purposes of classifying the relative liquidity of a fund's position in a portfolio asset, the Commission proposes that the fund make an assessment as to the number of days in which it is determined "that the fund's position in an asset (or a portion of that asset) would be convertible to cash at a price that does not materially affect the value of the asset immediately prior to sale."[1] The Commission defines a standard asset (subject to the 15% ceiling) as "…any asset that may not be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund."[2] The proposed liquidity classification scheme thus depends on settlement date, while the definition of standard asset and the related 15% investment limit is based on trade date.

These two separately articulated approaches to liquidity management do not operationally align with one another, as shown in Figure 1A and Figure 1B on page 6 below. We also believe that dual schemes that

[1] SEC Release No. 33-9922, page 63-64.
[2] SEC Release No. 33-9922, page 152.

are both based on a prescribed number of days, one to convert to cash and the other to sell or dispose of the asset but not necessarily to receive the proceeds from such sale or disposition, could create investor confusion. Interactive Data believes that, as proposed, proposed rule 22e-4(b)(2)(iv)(D) may not advance the Commission's stated goals of serving as an "important limitation on certain relatively illiquid holdings in funds' portfolios, such as private equity investments, securities acquired in an initial public offering, and real estate assets"[3] and acting to "enhance disclosure regarding fund liquidity and redemption practices."[4]

We recommend modifying the definition of 15% standard assets to revolve around specific features of an asset or stated conditions under which an asset can be transacted. We believe that such a formulation is more likely to be applied uniformly across funds, leading to greater comparability of fund disclosures that would benefit both fund shareholders and the Commission. We further believe that building the 15% standard assets classification around explicit legal or other characteristics of an asset type rather than estimated days to enter into a trade to liquidate the asset would better serve the Commission's aim of limiting funds' exposure to instruments that have no public market.
Alternatively, as discussed more fully in the next section, we believe that a unified scale for delineating both "three-day liquid assets" and "standard assets" would be operationally easier for funds to implement and more straightforward for investors to interpret, and might better accomplish the Commission's goals.

Based on our ongoing discussions with fund professionals in connection with our *Liquidity Indicators* service, we believe the Commission could make it easier for entities to comply with these proposed requirements by providing additional guidance around the terms "materially affect" (used in the liquidity classification proposal) and "at approximately the value" (used in the proposed definition of standard asset). Although funds are familiar with these terms under the current 15% illiquidity guideline, market participants have voiced concerns to us about how they would structure their data for purposes of complying with the Proposal in the absence of concrete guidance from the Commission. It would also be helpful if the Commission could clarify whether it believes that the two terms "materially affect" (with regards to price) and "at approximately the value" should be interpreted differently, and if so, in what way. Based on our discussions with fund professionals, we believe much of the industry perceives these terms to be interchangeable.

Based on our ongoing discussions with fund professionals, we realize that certain firms may consider adopting multiple or different approaches to defining "materiality" or "at approximately the value". Below, we highlight three potential options that may result in different outcomes: 1) Net asset value ("NAV") impact based on a 1 penny movment, 2) Rule of thumb of 5% price impact, and 3) Use of volatility to determine security-specific materiality thresholds.

Some mutual funds have generally considered materiality through a holistic, fund-level analysis, typically considering whether a certain asset's price change would impact the fund's "NAV" by a penny or greater (e.g., for purposes of determining the impact of a pricing error on NAV). The weakness of such approach is that it may miss out on the granularity of individual instruments that is readily available. For example, in connection with extremely large portfolios, a small position of a single holding may need to move dramatically in order to move the NAV by a penny. Although the Commission's staff has stated that exclusive reliance on a quantitative threshold is insufficient in the context of assessing materiality in preparing financial statements and performing audits,[5] with lack of further guidance, we believe some funds will use a quantitative measure as the basis of their materiality threshold. The Commission staff's

[3] SEC Release No. 33-9922, page 153
[4] SEC Release No. 33-9922, page 1
[5] http://www.sec.gov/interps/account/sab99.htm

guidance has said that “the staff has no objection to such a ‘rule of thumb’ as an ***initial*** step in assessing materiality.” [6]

Even if overlaid with qualitative judgments, we believe the industry can benefit from more specific Commission guidance to assist in implementation of the Proposal if adopted. Funds could differ widely in how they assess liquidity of an identical position with the same size if the funds interpret “materially affect the value of the asset” to mean, for example, a 5% maximum price change, or some other price change threshold. For instance, consider Fund A and Fund B each holding a $10 million position in security X that is currently valued at par ($100.000). Assume Fund A implemented a materiality threshold of 5% while Fund B implemented a materiality threshold of 0.5%. Assume further that both Fund A and Fund B anticipate that the $10 million position in security X would reasonably take 2 days to liquidate (with $5 million sold on day 1 and $5 million sold on day 2), with an associated market price impact estimate of 2%, such that the average sale price of the instrument was $98.000 through liquidation. Although their liquidation forecasts are identical, the difference between the two funds’ interpretations of “materiality” would lead them to classify the security differently across the buckets. Fund A could reasonably account for the entire $10 million position in the 1-day bucket since its threshold for materiality is 5% (i.e., if it estimated liquidation over the course of 2 days with a 2% price impact, this could reasonably support an estimation of liquidation within a single day at a price impact of less than 5%). By contrast, with a lower materiality threshold, Fund B may have to exclude a significant portion of this asset from qualifying in the 1-day bucket (estimated at 25% of its holding), and rather extend out the anticipated liquidation of the position in security X. This varied interpretation of materiality can affect how funds represent portfolio liquidity across the buckets, and therefore can challenge investors’ ability to compare and contrast liquidity across different funds to inform investment decisions.

To overcome some of these concerns, one suggestion would be to consider guidance that incorporates a standard “rule of thumb.” In the above example, if “materiality” was designated at a standard threshold of 5%, both Fund A and Fund B may determine their 2% price impact assessment was immaterial which would make their disclosure of positions in security X within the liquidity buckets comparable. Alternatively, judgments of materiality could be pegged to the projected volatility of an asset’s price, while applying a “rule of thumb” threshold such as 5% to serve as an outer boundary. By incorporating a view on the security’s expected return variation, a material impact can be defined as a forecast price change from the sale of an asset that exceeds a certain statistical magnitude around the mean expected price change for that asset. Specifically, one might consider a magnitude threshold of, for example, 2 standard deviations away from the mean as qualifying as a substantial price movement, considering that a large portion of expected outcomes in price movements (95+%) would be expected to fall within these thresholds. Using security X as an example, assume a forecasted mean return of 0% with a volatility expectation of 1.00% around this mean. Two standard deviations from the mean could suggest that the price would have to move 2.00% (i.e., 2 standard deviations x 1.00%) in order to qualify as a substantial or “material” price movement. In this example, both Fund A and Fund B may determine that their 2% price impact assessment was immaterial, and therefore foster greater comparability of their disclosure of positions in security X within the liquidity buckets.

Under proposed rule 22e-4(b)(2)(ii), the Commission sets out a list of market and asset-specific factors that must be evaluated when assigning a portfolio position to a liquidity category. Moreover, the Proposal goes on to suggest that a fund that lacks the pertinent information about these assets will then be required to consider factors associated with “comparable assets.”

Interactive Data believes that when assessing the liquidity of any portfolio asset, in addition to considering factors associated with the asset itself, it is appropriate to consider relevant liquidity factors

[6] http://www.sec.gov/interps/account/sab99.htm

associated with comparable assets. We believe this to be true for all asset types, although our discussion on this topic is focused on Fixed Income assets. Consequently, we believe the Commission should consider explicitly stating that a fund's process for assigning individual assets to liquidity categories should consider factors that bear on liquidity of both that particular asset and comparable assets in relation to the overall market, even when pertinent information is available on the asset being analyzed for liquidity classification. Our view is informed by research we have conducted toward assessing the liquidity of a portfolio position in the development of our *Liquidity Indicators* service.

Our *Liquidity Indicators* service distinguishes the projected trade volume capacity between the directly observable trading activity and the overall potential trade volume capacity. The portion of the projected trade volume capacity which incorporates directly observable trading activity for the security is represented as the "active trading estimate", whereas the remaining portion of the projected trade volume capacity is represented as the "surplus potential estimate." Here, the surplus potential estimate is critical to establishing a view on overall projected trade volume capacity of the security, quantifying the contributions of factors associated with the security and comparable assets in the context of the overall market. This projected trade volume capacity is a key input in determining the projected days to liquidate.

We chose to consider the overall market and not focus solely on the specific asset because we believe the probability of misclassifying an asset into a liquidity bucket is reduced when the factors are put into the context of the overall market. Considering the factors and trading activity on comparable assets addresses both situations where there is a highly desirable asset that is widely held but with little or no transaction data, as well as the "liquidity mirage" (where an asset has a short-term period of high transaction activity due to a period of stress that would give the false appearance of ongoing liquidity).

When developing our *Liquidity Indicators* service, our focus was to design an approach for measuring liquidity in the fixed income markets. This research and development effort included analyzing a number of variables to determine suitability and statistical relevance in explaining future observations in trading patterns. These factors can vary from asset class to asset class and the dynamics can change over time. Thus, a factor that is statistically relevant today may not be so tomorrow, and vice versa. We therefore suggest considering the non-exhaustive list of factors as guidance instead of mandatory. By not mandating a review of inconsequential factors, funds will be able to focus their consideration on the then relevant factors, creating efficiencies in allocation of time and resources.

In addition, we suggest that the Commission consider including the following modifications to the factors stated in the Proposal. These modified factors are intended to offer a more complete picture of a security's ability to trade at a certain size at or near the current price, which is particularly relevant when there are no directly observable recent trades of that security:

- Consider replacing ***average*** daily trading volume of the asset with ***potential*** daily trading volume of the asset
- Consider replacing position size relative to ***average*** daily trade volume with position size relative to ***potential*** daily trading volume
- Consider replacing volatility of ***trading price*** with volatility of ***traded or evaluated pricing information***

We believe it is important to use the concept of potential volumes instead of looking solely at historical levels in order to appropriately measure those instruments that are widely held and less active but would be met with liquidity if brought to the market. Similarly, volatility of prices should be measured based on the value assigned to the asset by the fund because typically less than 2% of the fixed income market has observable trading at a given time.

Asset Liquidity Classification and the 15% Standard Asset Rule

Interactive Data recommendation:

- *If the final rule does not update the definition of 15% Standard Asset to refer to specific asset types or restrictions, then we suggest replacing the two proposed classification schedules (outlined in Figures 1A and 1B) with a single unified schedule such as outlined in Figure 2.*

Under proposed rule 22e-4, the Commission is proposing a separate system for position liquidity classification that differs from how the Commission has proposed codification of the 15% standard asset calculation, with the former classifications pegged to the number of days to settle the transaction, and the latter classification pegged to the number of days to enter into a trade to dispose of the position. Figures 1A and 1B below outline the respective definitions as stated in the proposal.

Figure 1A: Proposed Liquidity Classification Schedule

Classifications	**1 Day**	**2-3 Days**	**4-7 days**	**8-15 days**	**16-30 Days**	**>30 Days**
Convention	Business Days		Calendar Days			
Type	Three-Day Liquid Asset		"Less Liquid Asset"			
Definition	*"Any cash held by a fund and any position of a fund in an asset (or portion of the fund's position in an asset) that the fund believes is convertible into cash within three business days at a price that does not materially affect the value of that asset immediately prior to sale."*		Not a Three-Day Liquid Asset as defined to the left.			
Compliance	*"Under proposed rule 22e-4(b)(2)(iv)(C), a fund would not be permitted to acquire any less liquid asset if, immediately after the acquisition, the fund would have invested less than its three-day liquid asset minimum in three-day liquid assets."*					
Notes	(1) Based on <u>Settlement</u> Date, not Trade Date (2) Factors in the fund's position size into classification (3) Bucketing asset between multiple classifications is permissible.					

Figure 1B: Proposed 15% Standard Asset Classification Schedule

Classifications	**<=7 Days**	**>7 Days**
Convention	Calendar Days	Calendar Days
Type	Liquid Asset	Standard Asset
Definition	*Not applicable*	*"…any asset which may not be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund."*
Notes	(1) Based on <u>Trade</u> Date (2) Does not require a fund to consider any specific factors such as the fund's position size ("*standard size lot for its holding in that position.")* (3) Bucketing asset between multiple classifications is not necessary (since based on 'standard' size).	

If the 15% standard assets classification continues to be based on number of days to enter into a trade to liquidate, then we recommend that the Commission adopt a unified approach for delineating both "three-day liquid assets" and "standard assets," in which both determinations would be based on a trade date concept, except as discussed below. We believe that a unified scheme would be operationally easier for funds to implement and more straightforward for investors to interpret, and might better accomplish the Commission's goals. The modified approach outlined in Figure 2 shows one possible way in which this could be done. Our suggested alternative removes potential reporting discrepancies between the percentage totals that funds would report among the three buckets that lie within the right-hand portion of Figure 1A (8-15 Days, 16-30 Days, and > 30 Days), and the same funds' reported percentages of standard assets, defined as those requiring more than seven days to liquidate (right-hand portion of Figure 1B).

Figure 2: Alternate, Unified Liquidity Classification Schedule Suggested By Interactive Data

Classifications	**1 Day**	**2-3 Days**	**4-7 days**	**8-15 days**	**16-30 Days**	**>30 Days**
Convention	Business Days		Business Days	Business Days		
Type	Three-Day Liquid Asset		Less Liquid Asset	Standard Asset		
Notes	(1) Based on Trade Date – however, see next paragraph (2) Prohibit longer than T+3 settlement assets from being placed into the 1 Day or 2-3 Day buckets. (3) Bucketing asset between multiple classifications is permissible. (4) Paired or hedge positions map to the longer of the 4-7 day bucket or its mapping as an unpaired instrument.					

We suggest that all liquidity buckets be based on trade date, with an important provision. To achieve the Commission's goal of requiring funds to maintain a certain board-approved minimum amount of assets convertible into cash to meet potential shareholder redemptions, we suggest prohibiting positions that require longer than three days to settle from being included in either the 1-Day or 2-3 Day liquidity buckets, regardless of how quickly a fund could exit the position on a trade date basis.

We also suggest changing the Proposal so that all liquidity assessments would be based on business days instead of calendar days. We believe this is preferable from a consistency standpoint, and reasonable given the lack of expectations around receiving cashflows on non-business days.

Our suggested alternative also removes the distinction between classification procedures that consider the size of a fund's holding of a particular asset (for liquidity classification) and separate procedures premised solely on a "normal trading lot for that asset" (for "standard asset" classification purposes). We believe that distinction could confuse investors, and further supports defining the standard asset based on characteristics other than the time it would take to sell or dispose of the instrument. Under our single classification scheme recommendation, a fund's position size would be considered in all asset classifications.

To address a potential unintended consequence of our recommendation to consider position size in all asset classifications, we believe that if the Commission adopts our suggested classification scheme, it would be appropriate to adopt a materiality threshold for classifying any portion of a fund's holding of an asset into one of the three least-liquid buckets (i.e., greater than seven days to enter into a trade to liquidate). Under this approach, if a portion of the asset that would require longer than seven days to liquidate fell below that materiality threshold, the fund would be permitted to classify its entire holding of that asset in the 4-7 Day classification. A materiality threshold for designating 15% standard assets could help avert situations in which a fund would be forced to rebalance its portfolio as a result of holding highly liquid instruments in such large amounts that some portion of those assets could take longer than seven days to liquidate. We further recommend that the Commission consider guidance on setting the materiality threshold that is a function of fundamental characteristics of the asset, such as duration or maturity for fixed income assets.

The Commission's proposal suggests that paired hedge trades would map to the longer classification of either instrument. However, the hedge itself would not count towards the cap on standard assets. For example, if a fund owns a $10 million position in a private equity investment that would map to the >30 day bucket and hedged with a $10 million position in a U.S. Treasury, then for liquidity classification purposes, $20 million of assets would map to the >30 day bucket (since the Treasury is tied to the private equity investment), but only $10 million would be attributable towards the 15% cap on standard assets. Under our unified scale proposal, we believe that one potential way to address the issue of paired hedge trade, in this example, the U.S. Treasury position would map to the longer of the 4-7 day classification or its classification as a standalone instrument (i.e. 1 day bucket). This recommendation achieves the goal of not allowing a paired hedge asset from counting toward the fund's three-day liquid asset minimum, while not penalizing the fund toward their 15% cap for hedging a standard asset. As an alternative, the Commission could consider increasing the cap on standard assets to 20% or 25% to achieve the same goal of reducing these unintended consequences.

Interactive Data believes that this unified liquidity scale is preferable to the current proposal regardless of the number of liquidity classification buckets settled upon in the final rule.

Three-Day Liquid Asset Minimum

Under proposed rule 22e-4, fund boards would be required to set a minimum level of three-day liquid assets (instruments the fund believes are convertible to cash within three business days without materially affecting the value of the asset) as a percentage of the fund's NAV. When a fund's three-day liquid asset level is below the minimum, the fund would be prohibited from purchasing new assets that are not three-day liquid assets until the proportion is back above the threshold.

Interactive Data generally supports this measure but we believe the rules for classifying three-day liquid assets and "standard assets" subject to the 15% ceiling should be mutually consistent, as outlined above.

We also note that requiring a three-day liquid asset minimum could have the unintended consequence of creating or exacerbating imbalances between supply and demand for highly liquid assets. In the United States, Basel III Liquidity Coverage Ratio (LCR) reporting requirements are currently in effect for approximately 24 bank entities and will take effect for an additional 60 to 70 banks effective January 2016. If the mutual fund sector simultaneously sees a need to boost allocations to the most liquid assets to meet three-day liquid asset minimums, there is the potential for market disruption caused by significantly increased demand for a finite supply of these assets.

Recent research by Interactive Data suggests that banks have been accumulating high-quality liquid assets (HQLA) as defined for LCR purposes during the period since U.S. banking regulators finalized the LCR rules for the U.S.[7] We found that HQLA-eligible and non-eligible sovereign bonds began to diverge in price near the September 2014 implementation date and have continued to diverge since then. We believe the U.S. LCR regulation is causing the observed price tiering by straining the demand side of the equation

[7] "Liquidity Rules Make Liquid Assets Less Liquid," Wall Street Journal MoneyBeat blog, October 20, 2015. http://blogs.wsj.com/moneybeat/2015/10/20/liquidity-rules-make-liquid-assets-less-liquid/

for a finite pool of high-quality liquid assets.[8] This effect could be magnified if the Commission's proposed rule causes mutual funds to bid for the same finite asset pool as the banks need to meet their LCR requirements.

Cross-Trading under Rule 17a-7

Interactive Data recommendations:

- *Clarify and modernize past Commission staff guidance to explicitly permit cross-trading for additional fixed income asset classes at the price used to determine the funds' NAV per share (i.e., using a third-party pricing vendor price rather than the average of independent bids and offers to determine the "current market price") under conditions similar to those set out in the existing no-action letters [9] applicable to municipal securities ("United/Federated No-Action Letters").*

In general, the Investment Company Act of 1940 (the "Act") prohibits affiliated persons from transacting with registered funds on a principal basis ("cross trading"). Rule 17a-7 under the Act exempts certain purchase or sale transaction between an investment company and certain affiliated persons thereof. [10] The current rule "requires, among other things, that: (i) the transaction at issue is a purchase or sale, for no consideration other than cash, for a security for which market quotations are readily available; (ii) the transaction be effected at the independent current market price for the security at issue; (iii) the transaction must be consistent with the policy of each fund participating in the transaction…"[11] For non-exchange traded instruments, the independent current market price is defined as "the average of the highest current independent bid and the lowest current independent offer determined on the basis of reasonable inquiry." [12]

Interactive Data believes that cross trading plays an appropriate and important role in liquidity risk management. Our experience indicates that although funds view cross-trading as a means of transacting that could simultaneously benefit both buyer and seller, they do not take full advantage of the exemptive rule with respect to transactions in fixed income securities because of the challenges in obtaining dealer quotes and the potential impact on participating funds from transacting at the price determined through compliance with the explicit requirements of the rule. Consequently, Interactive Data believes that this is an opportune time for the Commission to remove this impediment and modernize rule 17a-7 as it applies to fixed income securities.

Our fund outreach indicates that for certain fixed income asset classes, many funds view the current practice of soliciting two-sided broker quotes and executing at the average of the highest bid and lowest offer of these quotes suboptimal and operationally inefficient as it creates a gain or loss that is economically artificial but has adverse tax and accounting effects on the funds. Our fund outreach also indicates that most funds believe that the United/Federated No-Action letters guidance with respect to the use of a third-party pricing vendor price for cross-trades covers municipal debt but may not extend to other fixed income asset classes. We believe the

[8] For further discussion of the impact that regulation is having on collateral management, see [http://www.thetradenews.com/news/Asset_Classes/Derivatives/Standards_primed_to_tackle_collateral_challenge.aspx]
[9] https://www.sec.gov/divisions/investment/noaction/1995/unitedmunicipal012795.pdf; https://www.sec.gov/divisions/investment/noaction/2006/fmf112006.htm
[10] 17 CFR 270.17a-7
[11] SEC Release No. 33-9922, page 171, footnote 391
[12] 17 CFR 270.17a-7

Commission should amend (or provide interpretive guidance with respect to) rule 17a-7 to allow funds to engage in cross-trades of both municipal securities and other fixed income asset classes for which market quotations are not readily available by using a price provided by the third-party pricing vendor the fund uses to value such securities for purposes of section 2(a)(41) of the Act and rule 2a-4 thereunder, under the same or similar conditions to those set out in the United/Federated No-Action letters. Such conditions may include, for example, a requirement that the funds apply the same diligence and discretion used in connection with their activities pursuant to section 2(a)(41) and rule 2a-4 to the use of evaluated pricing provided by an independent pricing service for Rule 17a-7 purposes.

We believe allowing additional fixed income asset classes to benefit from cross trading based on a price provided by the pricing services that the fund uses to value the securities for section 2(a)(41) and rule 2a-4 purposes is supported by broader changes in market structure and technological evolution in the industry. Public trade reporting systems, such as those operated by the MSRB and FINRA, today cover multiple asset classes with new sectors and detail (i.e. distinction of trades between dealers and "non-member affiliates") being added to these reporting systems. Public sources of transaction data include FINRA ® TRACE ® for U.S. Corporate bonds, EMMA ® for U.S. Municipal bonds, and FINRA Securitized Products Dissemination Service™ (SPDS ™) for U.S. Agency Pass-Throughs, Mortgage-Backed Securities Traded To Be Announced (TBA), and recently added U.S. Asset-Backed Securities. For other U.S. structured products, FINRA-Interactive Data Structured Products Aggregated Reports (STAR) aggregates market data on these assets. Moreover, additional regulations such as MiFID II will bring trade reporting transparency to the public once implemented in the European Union. The Staff's decision, in the United No-Action Letter, to allow cross trading pursuant to rule 17a-7 using a price provided by the third-party pricing vendor that supplies the prices the fund uses to value the securities for purposes of section 2(a)(41) and rule 2a-4 took into account the then new establishment of the MSRB trade reporting system. In footnote 1 to the United No-Action Letter the staff indicated that it expected that "such information will be utilized by pricing services and persons charged with evaluating the performance of pricing services as it becomes available". The expansion of public trade reporting systems to additional asset classes which brought with it increased transparancy relative to such asset classes, provides another factor in support of expanding to all fixed income asset classes the permission to use, under the conditions described above, evaluated prices provided by third-party pricing vendors for cross- trading purposes.

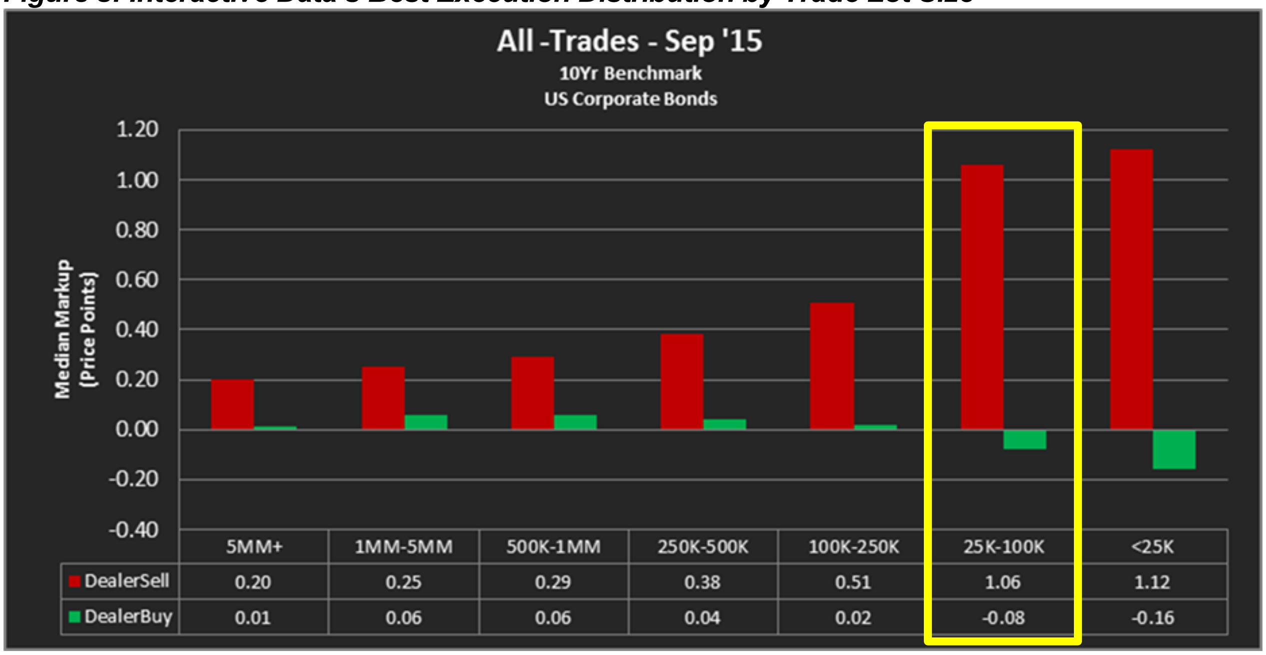
With increased transparency and better access to market information, Interactive Data has been able to provide its clients with both end-of-day evaluated prices and intra-day evaluated prices. In addition, evaluated prices are now available for many instruments as bid, ask and mid evaluations. We believe that such developments should also be taken into account by the Commission and that it would be appropriate for the Commission to explicitly allow, under the conditions set forth above, for cross-trading transactions at the such evaluated prices selected by the fund in accordance with its pricing policy which may not necessarily be limited to end-of-day evaluated bid price but may also include the intra-day evaluated price provided by a third-party pricing vendor and the potential use of available mid evaluated prices.

Interactive Data understands that allowing cross-trading may create the potential for abuses that would disadvantage one of the transacting parties. However, cross-trading could potentially benefit both parties to a transaction (and thus both funds' shareholders), especially for fixed income instruments which are generally less observable than equities, and can play an important role in liquidity risk management.

Interactive Data, utilizing all of the transparency that has been brought to the market thanks to previous Commission requirements, has created a continuous evaluated pricing product and best execution offering for the fixed income market, that among other things, provides a trade-by-trade measure of relative execution quality in relation to our current evaluated price. Our best execution score is a percentile rank of a trade versus comparable transaction in the marketplace, aggregated by maturity and trade lot size to derive expected transaction costs across these cohorts. This product has allowed us to detect consistent patterns in the market, as demonstrated below in Figure 3. This same analysis has been conducted for 13 consecutive months and data continues to plot a similar distribution by size.

By means of a specific example, assume Fund A owns a 50 thousand dollar position in a U.S. Corporate bond benchmarked to the current 10-Year U.S. Treasury note (as represented in Figure 3) that it would like to sell to Fund B (same fund family) to align with the investment strategy of both funds. Let's assume that the previous end of day evaluation for this bond was $101.750 and due to market movements on the trade date, the current continuous evaluated bid price at the time of the cross trade is $102.000. Figure 3 highlights that Fund A would be expected to receive a price of $101.920 for selling that instrument in the open market and Fund B would be expected to pay a price of $103.060 to purchase that bond in the open market given a lot size of only 50 thousand. A transaction price of $102.570 for the cross-trade would economically benefit both funds based on this example in Figure 3.

Figure 3: Interactive Data's Best Execution Distribution by Trade Lot Size



	5MM+	1MM-5MM	500K-1MM	250K-500K	100K-250K	25K-100K	<25K
DealerSell	0.20	0.25	0.29	0.38	0.51	1.06	1.12
DealerBuy	0.01	0.06	0.06	0.04	0.02	-0.08	-0.16

Swing Pricing

Interactive Data supports the Commission's proposal to permit funds to apply swing pricing

Under proposed rule 22c-1(a)(3), funds (other than money market funds and exchange-traded funds) will be permitted, although not required, to introduce swing pricing. Swing pricing is defined as "the process of adjusting a fund's current net asset value per share to mitigate dilution of the value of its outstanding redeemable securities as a result of shareholder purchase and redemption activity..."[13] The workflow for a fund that opts to use swing pricing will be to establish a swing factor ("the amount, expressed as a percentage of the fund's net asset value and determined pursuant to the fund's swing pricing procedures, by which a fund adjusts its net asset value per share…") [14] once the swing threshold ("the amount of net purchases into or net redemptions from a

[13] SEC Release No. 33-9922, page 191, footnote 427
[14] SEC Release No. 33-9922, page 192, footnote 431

fund, expressed as a percentage of the fund's net asset value, that triggers the initiation of swing pricing.")[15] is breached.

Interactive Data supports proposed rule 22c-1(a)(3) and any efforts by the Commission to protect the investment of non-transacting shareholders.

However, fund industry participants have voiced concern to us that swing pricing may encounter implementation challenges in the United States due to the prevalence of omnibus accounts and the timing of receiving daily flow information relative to the NAV determination process. Thus, we question how readily adopted swing pricing will be in the United States.

Commercially available software can assist funds in estimating transaction costs for fixed income instruments as well as equities for modeling the swing factor. For example, as described above, Interactive Data has developed a Best Execution platform, that among other things, models the expected execution adjustment for a given volume bucket and sector.

Potential coordination among regulators

Interactive Data recommendations:

- *Adopt uniform criteria for liquidity classifications under Commission regulations and those promulgated by banking regulators*

The Commission is not alone in reviewing and updating policies and regulations governing liquidity assessment and risk management among financial institutions. Public authorities both in the United States and elsewhere are implementing new mandates intended to promote more effective management of liquidity risk. Recently adopted regulations related to liquidity risk management include but are not limited to: Basel III (Liquidity Coverage Ratio and Net Stable Funding Ratio) for banks; MiFID II (Liquid Markets Indicator for pre-trade transparency reporting requirements) for EU investment firms; AIFMD's minimum liquidity risk management procedures for EU alternative funds; Solvency II for EU insurance companies; and several provisions within the Dodd-Frank Act.

With so many global regulatory bodies simultaneously active in this area, we believe that both the public and the financial industry could benefit from increased coordination among regulatory authorities when formulating rules and policies for measuring liquidity of financial instruments.

For example, the Commission's current proposed rule cites Basel III's Liquidity Coverage Ratio (LCR).[16] We note that the list of factors the Commission proposes that funds be required to consider when classifying the liquidity of portfolio assets is similar but not equivalent to the criteria proposed by U.S. banking regulators (the OCC, FDIC and Federal Reserve) to implement the "liquid and readily marketable" standard within Basel III's Liquidity Coverage Ratio. [17] We believe that if the Commission and banking regulators adopted uniform criteria for liquidity classifications, the resulting standardization of measurement practices among a broad range of entities could bring operational efficiencies.

[15] SEC Release No. 33-9922, page 192, footnote 431

[16] Page 83, Footnotes 206 and 207

[17] The "liquid and readily marketable" criteria for the LCR allows for an asset to be considered liquid if "*it is traded in an active secondary market with more than two committed market makers, a large number of committed non-market maker participants on both the buying and selling side of the transactions, timely and observable market prices, and high trading volumes*." Federal Register, Volume 79 # 197, Friday October 10, 2014 "Liquidity Coverage Ratio: Liquidity Risk Measurement Standards"

We believe that various regulatory bodies share our viewpoint. For example, Federal Reserve Governor Dan Tarullo stated in a September 28, 2015 speech: "Conceptually, the cleanest approach might be to integrate capital and liquidity requirements in a single regulatory framework, which would establish minimum levels of capital and liquidity and then increase the capital requirement for intermediaries with more vulnerable funding structures. … (T)he risk of loss associated with a particular corporate loan or mortgage-backed security or, indeed, any other asset does not vary just because its legal owner is an insurance company or mutual fund, rather than a bank." [18]

Operational clarifications on Form N-PORT

Interactive Data recommendation:

- *Clarify the form to make it easier for a fund to report multiple dollar balances of a position in one asset within multiple liquidity buckets*

The liquidity classification portion of this proposal will permit funds to assign a particular asset to multiple categories. "For example, a fund could determine that it could convert half of a portfolio position to cash in 2-3 business days and the other half of the position in 4-7 calendar days in order to dispose of the position without creating a market impact…"[19] In this case, proposed Item C.13 in Form N-PORT would require funds to indicate the dollar amount attributable to each liquidity classification.

We suggest that the Commission clarify how funds should operationally break out their holdings by instrument and liquidity classification on Form N-PORT. We believe the proposed liquidity classification disclosures are operationally easier to implement by itemizing holdings and dollar balances within each liquidity classification bucket (i.e., a list of 1 Day assets, 2-3 Day assets, etc.), rather than instrument-by-instrument disclosure. If many funds classify each of their instruments among multiple liquidity buckets, we believe the functional utility of proposed Form N-PORT would be less valuable without additional clarification.

Burden and Economic Impact Analysis

Interactive Data recommendation:

- *Include the estimated cost to purchase third-party liquidity assessment data within the total estimated costs to comply with this proposed rule*

The Commission states that "based on staff outreach, the annual costs to subscribe to the liquidity classification services provided by third-party data and analytics providers currently range from $50,000 - $500,000."[20] Although the Commission acknowledges the role that data vendors will play in providing information to support funds' liquidity classification workflows, these fees are otherwise omitted from the Commission's economic impact analysis. We believe that clarifying that the estimated costs funds will pay for third party data services are included in the economic impact analysis, and if necessary, revising

[18] "Financial Regulation Stability versus Uniformity; A Focus on Non-bank Actors". Speech at Banque de France Conference, Paris: http://www.federalreserve.gov/newsevents/speech/tarullo20150928a.pdf
[19] SEC Release No. 33-9922, page 258
[20] SEC Release No. 33-9922, page 311, footnote 705

the analysis accordingly, would more accurately reflect the economic burden of this proposal, given the likelihood that many funds will subscribe to such services.

Conclusion

Interactive Data appreciates the opportunity to present our views on the implementation of liquidity risk management programs for registered investment companies. We strongly support the Commission's goals of increasing transparency into fund portfolios and investment practices.

With regard to specified provisions of this proposal:

- Either redefine the term "standard asset" or unify the measurement scale between liquidity classification and standard asset calculations.
- Adjust the set of factors for liquidity classification to include comparable assets and the context of the overall market.
- Define the list of factors for liquidity classification as guidance instead of a codified minimum set of standards.
- Clarify and modernize Rule 17a-7 guidance through the expansion of eligible assets, and allow for the use of various types of vendor pricing to demonstrate independent current market prices.
- Recognize the market impact of this proposal within the context of other regulatory liquidity initiatives.
- Change Item C.13 on proposed Form N-PORT to better match the requirements in this proposal.
- Update the estimated cost to expressly include the use of third-party liquidity assessment services.

We look forward to working with the Commission and the fund management community toward upgrading both the content and format of fund liquidity disclosures.

Sincerely,

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