The Systemic Risk Council

Brent J. Fields
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Securities and Exchange Commission
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SUBMITTED VIA ELECTRONIC MAIL

January 13, 2016

Re: Proposed Rule, 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; File Nos. S7-16-15; S7-08-15)

Dear Secretary Fields:

The Systemic Risk Council (the "Council" or "we")[1] is grateful for the opportunity to respond to the request for comment recently issued by the Securities and Exchange Commission (the "Commission") in the above-referenced notice of proposed rulemaking (the "Proposed Rule")[2] relating to the Investment Company Act of 1940 (the "Investment Company Act"),[3] the Securities Act of 1933 (the "Securities Act")[4] and Regulation S-X under the Securities Act.[5]

We applaud the Commission for its efforts to promote prudent liquidity risk management and risk reduction throughout the open-end fund industry, particularly in light of the recent trend toward

[1] The independent, non-partisan Systemic Risk Council (www.systemicriskcouncil.org) was formed to monitor and encourage regulatory reform of U.S. and global capital markets, with a focus on systemic risk. The Council is funded by the CFA Institute, a global association of more than 125,000 investment professionals who put investors' interests first and set the standard for professional excellence in finance. The statements, documents and recommendations of the private sector, volunteer Council do not necessarily represent the views of the CFA Institute. The Council works collaboratively to seek agreement on each of its recommendations. This letter fairly reflects the consensus views of the Council but does not bind its individual members.

[2] Commission, *Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release*, 80 Fed. Reg. 62274 (Oct. 15, 2015) (henceforth, "Notice"). The Proposed Rule includes proposed amendments to Rules 22c-1 (17 C.F.R. § 270.22c-1) and 31a-2 (17 C.F.R. § 270.31a-2) and proposed new Rule 22e-4 (17 C.F.R. § 270.22-e4 (proposed)) under the Investment Company Act, amendments to Form N-1A (referenced in 17 C.F.R. § 274.11A) under the Investment Company Act and the Securities Act, amendments to Article 6 (17 C.F.R. § 210.6-01 *et seq.*) of Regulation S-X and amendments to proposed Form N-PORT (17 C.F.R. § 274.150 (proposed)) and proposed Form N-CEN (17 C.F.R. § 274.101 (proposed)) under the Investment Company Act.

[3] 15 U.S.C. § 80a-1 *et seq.*

[4] 15 U.S.C. § 77a *et seq.*

[5] 17 C.F.R. § 210.

increased investment by asset managers in potentially illiquid assets, which has made effective liquidity management all the more critical to maintaining financial stability.[6]

A. BACKGROUND: OPEN-END FUNDS, SYSTEMIC RISK AND FINANCIAL STABILITY

Last year we expressed our support for efforts by the Commission and the Financial Stability Oversight Council (the "FSOC") to examine potential systemic risks and to promote corresponding reforms in the asset management industry. We noted with approval the Commission's "continued commitment to improving our knowledge of the systemic risks posed by the asset management industry" while highlighting "a number of areas in which the Council believes that greater data collection efforts and, in some instances, additional regulatory measures would be beneficial, including . . . [e]xamining liquidity and redemption provisions, with an emphasis on measures to ensure sufficiency of liquid assets during times of financial distress."[7] We have also commended the FSOC for its "focus on identifying and understanding systemically risky products and activities in the asset management industry."[8]

These issues have grown in importance as the post-crisis regulation of banks and dealers has proceeded and has, unavoidably, created incentives for elements of financial intermediation to migrate to other parts of the financial system. Where investment vehicles are funded entirely or predominantly by irredeemable or long-term equity, which are able to absorb losses smoothly and so with less disruptive effect than other structures, increased market-based financing may make the financial system more resilient overall. Where, however, the financial structure of investment vehicles replicates or approximates those features of banks that contribute to their fragility—*i.e.*, on-demand liquidity and leverage—closer examination of those vehicles is warranted, because the costs to the economy as a whole arising from their failure could exceed the private costs of failure to their investors.

Since much of the financial activity that is liable to migrate or grow as a result of regulatory arbitrage or other forces is likely to fall under the jurisdiction of securities regulators, the Commission and its international peers carry a special responsibility to encourage the establishment of sound structures and practices. As Section 2 of the Securities Exchange Act of 1934 states, "securities transactions . . . involve the use of credit, . . . and [there can be] excessive speculation, resulting in sudden and unreasonable fluctuations in the price of securities which (a) cause alternately unreasonable expansion

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[6] *See* Division of Economic and Risk Analysis, *Liquidity and Flows of U.S. Mutual Funds* (Sept. 2015), *available at* https://www.sec.gov/dera/staff-papers/white-papers/liquidity-white-paper-09-2015.pdf ("Potentially less liquid mutual fund categories have grown substantially over the same period [2000-2014]."); Fitch Ratings, *Fitch: Funds Face Shrinking Market Liquidity, Capacity Issues* (Oct. 6, 2015), *available at* https://www.fitchratings.com/site/fitch-home/pressrelease?id=991839 ("Fitch Ratings says funds face growing capacity issues due to the combined effect of reduced overall market liquidity, growth of a fund's AUM relative to supply, fund flow concentration and search for return reaching into less liquid asset classes."); Financial Stability Board, *Implementation and effects of the G20 financial regulatory reforms: Report of the Financial Stability Board to G20 Leaders* (Nov. 9, 2015), *available at* http://www.financialstabilityboard.org/wp-content/uploads/Report-on-implementation-and-effects-of-reforms-final.pdf ("There have been some concerns that the depth of liquidity in fixed income markets has declined in recent years. . . . The FSB is examining structural and conjunctural risks from market liquidity and asset management activities, such as the extent to which open-end funds offering on-demand liquidity could suffer mass redemptions that might amplify a severe market sell-off.").

[7] *See* Comment Letter of the Council to the Commission (Aug. 7, 2015), *available at* http://www.sec.gov/comments/s7-09-15/s70915-19.pdf.

[8] *See* Comment Letter of the Council to the FSOC (Mar. 25, 2015), *available at* http://www.systemicriskcouncil.org/wp-content/uploads/2015/03/SRC-Letter-to-FSOC-Re-Asset-Management-Products.pdf (henceforth, "FSOC Comment Letter").

and unreasonable contraction of the volume of credit available for trade, transportation and industry . . . and (c) prevent the fair valuation of collateral for bank loans and/or obstruct the effective operation of the national banking system."[9] Those words, written and passed by Congress over 80 years ago, capture much of the thinking that guides this century's policies on financial stability in the wake of the latest crisis and the economic and social harm that it wrought.

The Council is pleased, therefore, that the Commission continues to search for, examine and, where it judges appropriate, address potential threats to financial stability arising from risks in the asset management industry,[10] and we are encouraged by the Commission's efforts in the Proposed Rule to reduce potential risks to stability from open-end investment management companies ("open-end funds"), such as mutual funds and open-end exchange-traded funds.

Open-end funds are an appropriate focus of these efforts because they permit daily redemption of their shares. Particularly where an open-end fund is leveraged or invested in assets that are illiquid, opaque or otherwise hard to value, the ability of its investors to redeem their shares on a daily basis creates a vulnerability to liquidity risk. The prospect and, even more, signs of the crystallization of those liquidity risks could give rise, potentially, to investor runs that could choke off the supply of credit or other valuable financial services to the general economy. In particular, as the Commission has stated in the preamble of the Proposed Rule, funds that offer "[d]aily redeemability as a defining feature" but "pursue more complex investment strategies . . . focused on less liquid asset classes,"[11] especially investments in credit instruments that are difficult to value, require the Commission's attention.

We are pleased that the Commission has recognized "a potential for adverse effects on the markets when open-end funds fail to adequately manage liquidity," and the potential that "the sale of less liquid portfolio assets at discounted or even fire sale prices can produce significant negative price pressure on those assets and correlated assets, which can impact other investors holding these assets and may transmit stress to other funds or portions of the markets."[12] The Proposed Rule is an important initiative in part because of its requirement that open-end funds carry a certain amount of liquid assets and its introduction of a mechanism through which individual investors may be required to bear more of the cost of their own choices to redeem. By requiring funds to carry some liquid assets, the risk of redemptions severely depleting asset values should be reduced. By requiring individual investors to bear some of the costs of liquidity transformation themselves, the potential for one investor's redemptions to trigger others to redeem should also be reduced. These measures taken together, the systemic risks potentially arising from open-end funds would in degree be mitigated.

The inevitable uncertainties in this area underline, in our view, the need for a richer understanding of the financial practices employed by open-end funds and the ways in which those practices might, plausibly, exacerbate their liquidity requirements. For example, if an open-end fund were to depend on borrowing arrangements to meet its cash requirements to fund shareholder redemptions,[13] it could find its funding impaired by any reduction in liquidity across markets or the financial system more

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[9] 15 U.S.C. § 78b.

[10] Mary Jo White, "Statement on Open-End Fund Liquidity Risk Management Programs and Swing Pricing," remarks in open meeting of the Commission under the Government in the Sunshine Act (Sept. 22, 2015), *available at* http://www.sec.gov/news/statement/open-end-fund-liquidity-risk-management-programs--sept-22-2015.html.

[11] *See* Notice, *supra* n. 2, at 62275.

[12] *See* Notice, *supra* n. 2, at 62351.

[13] *See generally* Notice, *supra* n. 2, at 62320-21.

broadly.[14] Even when an open-end fund maintains leverage within applicable limits under the Investment Company Act,[15] it could face materially greater funding requirements during stressed financial market conditions than during normal conditions. This danger is hard for fund managers to judge on the basis of past experience, given that widely supported public policy now precludes—correctly, in our view—the taxpayer bailouts that kept credit flowing during previous market disruptions. In other words, a greater burden might well fall on asset managers that experience heavier shareholder redemptions during future stressed or crisis conditions than has been the case during similar situations in the past. The Commission needs actively to seek to understand these changes in the dynamics of markets and the financial system as a whole and, accordingly, to direct or provide guidance to asset managers to make appropriate adjustments. We see the Proposed Rule in that light.

B. SUMMARY OF PROPOSED RULE

The Commission has noted the scale of use of open-end funds by U.S. investors.[16] Liquidity is essential to the operation of open-end funds, based on their legal obligation to redeem securities upon shareholder demand at the price of the shareholder's proportionate share of the relevant fund's net asset value.[17] The Commission has advocated liquidity management that "reduc[es] the risk that a fund will be unable to meet its obligations to redeeming shareholders while also minimizing the impact of those redemptions on the fund."[18] If adopted, the Proposed Rule would mandate liquidity risk management standards, permit so-called "swing pricing" standards and require enhanced disclosure.[19]

1. Liquidity Risk Management

Under the proposed new Rule 22e-4, registered open-end funds (including exchange-traded funds but excluding money market funds) would be required to implement a liquidity risk management program.[20] The covered funds would be required to classify and monitor the liquidity of their portfolio assets, as well as identify a minimum amount of assets to hold in (i) cash and (ii) assets that the covered fund believes can be converted to cash within three business days without a material loss of value.[21] The Commission contends that this proposed new rule "could decrease the chance that a fund could meet its redemption obligations only with material effects on the fund's net asset value per share or changes to the fund's risk profile."[22]

2. "Swing Pricing" Standards

Under the proposed amendment to Rule 22c-1, registered open-end funds (excluding exchange-traded funds and money market funds) would be permitted to engage in "swing pricing," which entails adjusting a fund's net asset value per share in order to pass on the costs of purchasing or redeeming

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[14] *See* Notice, *supra* n. 2, at 62321 n. 374 (citing Comment Letter of Nuveen Investments on the FSOC Notice (Mar. 25, 2015) at 9-10 ("To the extent that a fund draws on a credit line to meet net redemptions (and thus temporarily leverages itself), it increases its market risk at a time when markets are stressed. While this can be potentially beneficial to long-term performance if the asset class recovers, it increases the risk of loss to remaining shareholders if markets continue to weaken.").

[15] 15 U.S.C. § 80a-18(f)(1) (permitting open-end funds to borrow from banks subject to an asset coverage requirement).

[16] Notice, *supra* n. 2, at 62276.

[17] *Id*., at 62275, n. 2.

[18] *Id*., at 62275.

[19] *Id*.

[20] *Id*., at 62286.

[21] *Id*.

[22] *Id*.

shares exclusively to investors engaged in such transactions. This approach is intended to "protect existing shareholders from dilution associated with such purchase and redemption activity and could be another tool to manage liquidity risks."[23]

3. Enhanced Disclosures

With respect to disclosure and reporting, the Commission's proposals would bring about "greater transparency with respect to funds' liquidity risks and risk management."[24] The proposed amendment to Form N-1A would require enhanced disclosure relating to how open-end funds meet redemption requests and to the effects of swing pricing, if applicable.[25] The proposed amendments to Form N-PORT and Form N-CEN would require open-end funds to disclose information regarding their liquidity-related holdings and liquidity risk management practices.[26]

C. RECOMMENDATIONS OF THE COUNCIL

We believe that the Proposed Rule represents a material contribution to mitigating the evolving systemic risks associated with the open-end funds industry and the way it has developed over recent years. We agree that the Commission's proposal "is appropriate and that it is in the interest of funds and fund investors to create a regulatory framework that would reduce the risk that a fund will be unable to meet its redemption obligations and minimize dilution of shareholder interests by promoting stronger and more effective liquidity risk management across open-end funds."[27]

More broadly, as open-end funds become a more important part of credit intermediation, the regulatory regime needs to address the potential for socially costly systemic disturbances resulting from investor runs. In that connection, we believe that the Proposed Rule is in the interests of the wider public too.

1. The Proposed Rule properly focuses on regulating products and activities.

As we have previously advocated,[28] in addressing the potential systemic risks posed by asset management, regulators should, wherever appropriate, deploy measures that focus on systemically significant "products and activities" under their respective jurisdictions, rather than rely upon the designation of "entities." The Proposed Rule is consistent with this position because it focuses on how redemption rights as a general feature of open-end funds could combine with investment in illiquid or hard-to-value assets to create hazards for investors and to create vulnerabilities in the system as a whole.

Earlier this year we encouraged regulatory standards "when it has been demonstrated that certain products, activities, and structures employed by the asset management industry create, amplify, and transmit the risk of loss in ways that could be destabilizing to the financial system."[29] Designation of systemically important financial institutions ("SIFIs") is not necessarily always the best tool for mitigating systemic risk. Simply put, "[i]t isn't enough to focus on large systemic institutions, or on

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[23] *Id.*
[24] *Id.*
[25] *Id.*
[26] *Id.*
[27] *Id.* at 62275.
[28] FSOC Comment Letter, *supra* n. 8.
[29] *Id.*

banks more generally," as "[a]ctivities and markets matter for stability too."[30] The Proposed Rule represents that kind of approach and, subject to the comments below, we recommend that it be adopted.

2. The Proposed Rule, while flexible, should not allow too much subjectivity as to which assets are deemed "liquid."

As noted above, under the proposed new Rule 22e-4, registered open-end funds (including exchange-traded funds but excluding money market funds) must identify a minimum amount of assets to hold in (i) cash and (ii) assets that the fund *believes* can be exchanged for cash within three business days without a material loss of value. Notably, proposed new Rule 22e-4(b)(2)(iii)(D) would require a fund's liquidity risk management program to "[a]ssess and periodically review the fund's liquidity risk, considering the fund's . . . borrowing arrangements and other funding sources."[31]

We think that it is important that the Commission, drawing on research and, as appropriate, market comment should reach a view and make a determination as to those asset classes that may *reasonably* be deemed capable of being liquidated within three business days without being likely to cause or materially to exacerbate market dislocations during reasonably foreseeable stressed conditions, *i.e.*, in circumstances in which redemptions might spike. The need for a reasonable standard, instead of individual decision-making, arises because of the risk of market confusion arising from a proliferation of idiosyncratic liquidity assessments and because, by definition, individual asset managers cannot be expected to internalize the wider economic costs of a liquidity breakdown.

We encourage the Commission to elaborate upon its guidance beyond the factors in proposed new Rule 22e-4(b)(2)(ii).[32]

3. The Proposed Rule should allow the balance of methods adopted to mitigate liquidity risk to take into account meaningful differences in the liquidity of underlying asset portfolios.

Some funds may be able to enhance liquidity more easily than other funds. As the Commission acknowledges, certain funds "may be unable to fully offset decreases in market liquidity because of their investment mandate."[33]

On the one hand, in some instances a shift in mandate may be appropriate. For example, if a fund that is heavily invested in illiquid high-yield securities has produced a high *ex post* return largely because liquidity risk in its asset class has not crystalized, it may be appropriate to amend its remit to permit the fund to hold some lower-yielding but more liquid assets. Without such an adjustment, the fund's remit might be socially suboptimal for the financial system as a whole even when highly desired by some investors.

On the other hand, funds that are unleveraged and invested in resiliently liquid assets might have less need for a material portfolio of unquestionably liquid assets. It might be appropriate for such funds to rely to a greater extent on swing pricing and other non-asset-based liquidity enhancements.

We therefore recommend that the Commission consider whether it could lay down parameters that would apply the new asset-based liquidity requirements with varying intensity according to a fund's

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[30] Paul Tucker, *Regulatory Reform, Stability, and Central Banking* (Jan. 16, 2014), *available at* http://www.brookings.edu/research/papers/2014/01/16-regulatory-reform-stability-central-banking-tucker.

[31] *See* Notice, *supra* n. 2, at 62385.

[32] 17 C.F.R. § 270.22e-4(b)(2)(ii) (proposed).

[33] *See* Notice, *supra* n. 2, at 62354 n. 640.

liquidity and leverage-based risk, while providing reasonable assurance that every fund can withstand liquidity risk. Such flexibility, with appropriate disclosures, would leave investors to make decisions based on their investment goals, risk tolerance and understanding of those disclosures.

4. Disclosures mandated by the Proposed Rule will be more helpful to the extent that they allow for comparisons among funds.

Clear, meaningful public disclosure of risk management practices should help to provide the basis for market forces to discipline asset managers. To this end, we strongly encourage the Commission to promulgate standardized forms or to issue guidance to ensure that risk management disclosures by open-end funds are comparable at a glance so that investors and others can easily comprehend the liquidity risks associated with investment alternatives, including the role of leverage if used. Otherwise, under the Proposed Rule, it might be hard for investors and analysts to identify where different fund managers within the same asset category operate with disparate minimum cash buffer sizes for their respective funds. That would complicate the tracking, assessment and comparison of such funds by investors and by the Commission itself.

Earlier this year, in the context of SIFI living wills, we emphasized that "disclosures are more informative if they facilitate comparison" and that comparability "generally requires the use of common definitions and reporting practices."[34] This approach applies equally in the present context. Clear disclosures are helpful, but complexity arising from vague standards or no standard at all would make obfuscation tempting even while the letter of a rule was ostensibly being satisfied.

5. The Commission should continue to research and exchange views in this area.

We believe that the Commission should finalize rules in this area as soon as practicable. We believe that this will be good for investors, the industry and the financial system as a whole. We are fortified in this view by the pace of innovation and the incentives created by the significant re-regulation of banks and dealers since the financial crisis, as noted earlier in this comment.

The suspension of the redemption rights of investors in the Third Avenue Focused Credit Fund ("FCF") in December 2015 is a reminder of the magnitude of the liquidity problems that can engulf an open-end fund holding illiquid assets.[35] According to the managers of FCF, "[i]investor requests for redemption . . . in addition to the general reduction of liquidity in the fixed income markets, have made it impracticable for FCF going forward to create sufficient cash to pay anticipated redemptions without resorting to sales at prices that would unfairly disadvantage the remaining shareholders."[36] This event should be carefully examined to determine what measures the fund might have followed to avoid a total suspension of redemptions and whether those measures might be applied to other open-end funds.

We expect that all parties, regulators included, will learn more about liquidity risk and liquidity risk management in the asset-management industry as the years pass. That prospect is not grounds for delay, but it underlines the need for continuing research and learning from as wide a body of experience as possible. For this reason, we urge the Commission to continue working with the Office of

[34] *See* Letter from Sheila Bair, Chair, Council, to Chairman Janet Yellen (Sept. 8, 2015), *available at* http://www.systemicriskcouncil.org/wp-content/uploads/2015/09/SRC-Letter-to-Fed-and-FDIC-re-Living-Wills-09-08-15.pdf.

[35] Third Avenue Management, Letter to Shareholders from David Barse, CEO of Third Avenue Management (Dec. 9, 2015), *available at* http://thirdave.com/wp-content/uploads/2015/12/FCF-Shareholder-Letter-12-2015.pdf.

[36] *Id.*

Financial Research ("OFR") as the Commission develops industry-wide standards addressed to any serious systemic risks posed by asset management industry activities, practices and structures. We continue to advocate "a fully functioning OFR data-collection and analytics system, including the integration of data amassed by the various agencies represented on the FSOC."[37]

The Commission should also communicate with its European counterparts, which permit the use of swing-pricing and similar features with respect to UCITS funds.[38] Such efforts may help the Commission to identify the strengths and weaknesses in the pricing mechanism used in U.S. markets and to benefit from any lessons (good or bad) to be learned from overseas market mechanisms such as those used in Europe.

In short, liquidity risk management issues are unlikely to recede in the coming years and, therefore, we recommend that the Commission continue to play an active role in identifying and mitigating systemic risks within the capital markets, where the Commission has the primary jurisdiction over and, thus, longstanding experience with relevant products and activities.

We commend the Commission's proposal of a pragmatic approach oriented toward products and activities to promote liquidity risk management and risk reduction in the open-end fund industry. We urge the Commission to continue examining areas for reform in the asset management industry more broadly, while working thoughtfully with its sister agencies in the United States and its regulatory counterparts abroad.

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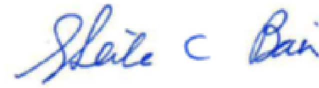
[37] *See* FSOC Comment Letter, *supra* n. 8; *see also* Council, Office of Financial Research (Feb. 2, 2015, 10:41 AM), http://www.systemicriskcouncil.org/issues/office-of-financial-research-ofr/.

[38] *See* Notice, *supra* n. 2, at 62333 ("We note that some foreign jurisdictions have a similar conception of liquidity fees as a distinct tool separate from swing pricing. For example, in Europe, UCITS may use swing pricing and apply 'dilution levies.' While many UCITS use swing pricing as a matter of normal course, dilution levies may be considered a liquidity risk management tool that is used in connection with stressed conditions.") (citing BlackRock, Viewpoint, *Fund Structures as Systemic Risk Mitigants* (Sept. 2014), *available at* http://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-fund-structures-as-systemic-risk-mitigants-september-2014.pdf).

Thank you very much for your consideration.

Respectfully submitted,



Sir Paul Tucker, Chair

Sheila Bair, Chair Emeritus

On behalf of the Systemic Risk Council
www.systemicriskcouncil.org

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