



January 13, 2016

***By Electronic Submission***

Mr. Brent J. Fields  
Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549-1090

**RE: Open-End Fund Liquidity Risk Management Programs; Re-Opening of Comment Period for Investment Company Reporting Modernization Release (File Number S7-16-15)**

Dear Mr. Fields:

The Loan Syndications and Trading Association (the “LSTA”)<sup>1</sup> appreciates the opportunity to provide comments to the Securities and Exchange Commission (the “SEC”) regarding the potential impact on the loan markets of the SEC’s proposal regarding open-end fund liquidity risk management programs.<sup>2</sup> The LSTA membership is comprised of asset managers, banking entities and others who are involved with syndicated corporate loans and loan securitizations. Because the LSTA is focused on syndicated corporate loans and loan securitizations, in our letter, we will address only proposed Rule 22e-4 and related proposed reporting obligations; we

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<sup>1</sup> The LSTA is a not-for-profit trade association that is made up of a broad and diverse membership involved in the origination, syndication and trading of commercial loans. The 400 members of the LSTA include commercial banks, investment banks, broker-dealers, hedge funds, mutual funds, insurance companies, fund managers and other institutional lenders, as well as law firms, service providers and vendors. The LSTA undertakes a wide variety of activities to foster the development of policies and market practices designed to promote just and equitable marketplace principles and to encourage cooperation and coordination with firms facilitating transactions in loans. Since 1995, the LSTA has developed standardized practices, procedures and documentation to enhance market efficiency, transparency and certainty.

<sup>2</sup> Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, Investment Company Act Release No. 31835 (Sept. 22, 2015), 80 Fed. Reg. 62274 (Oct. 15, 2015).

will not address swing pricing. We refer to proposed Rule 22e-4 and the related proposed reporting obligations as the “proposal.”

To respond to the SEC’s request for comments, the LSTA first convened a roundtable with a large group of its members with an interest in the SEC proposal. Following that initial roundtable discussion, a working group of members was formed including representatives of over 15 open-end loan mutual fund managers whose responsibilities include, among other things, liquidity management. The LSTA also undertook a survey of open-end loan fund managers who manage over \$72 billion of open-end loan funds and ETFs to determine their holdings of cash, T+3 securities and lines of credit available to meet redemptions. The results of that survey are discussed in Section I (F).

The LSTA and its working group would like to propose a dialogue with the SEC staff as it considers liquidity risk management. The LSTA working group is also very interested in a continuing dialogue with the SEC staff after final rules are adopted to ensure an open line of communication regarding liquidity risk management.<sup>3</sup>

Because we believe it is critical that open-end funds and ETFs have adequate policies and procedures to address meeting investor redemption requests, we strongly support requiring open-end funds and ETFs to have formal liquidity risk management programs designed to address and manage liquidity risk, classify and monitor liquidity of investment portfolios, and maintain a minimum level of liquidity. We also support periodic reporting to the SEC and other regulators regarding portfolio liquidity. We have concerns, however, regarding several aspects of the SEC’s proposal, including the proposed liquidity classifications, the three-day liquid asset minimum, and public disclosure of liquidity determinations. We support the 15% standard asset test, as proposed, but oppose any change to the definition of 15% standard assets that would use a convert to cash concept.<sup>4</sup>

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<sup>3</sup> The LSTA would also be pleased to provide the SEC with data on the loan market generally and discuss market trends and developments.

<sup>4</sup> Although the LSTA believes that the SEC is right to focus on the liquidity of open-end funds, it also believes that the proposal should be considered in light of the extremely strong track record of the investment company industry, including open-end loan funds, in managing liquidity risk. Notwithstanding the recent suspension of redemptions by Third Avenue Focused Credit Fund, in reviewing the record of SEC actions under Section 22(e) for the 75 years that the Investment Company Act has been in existence, we have identified only seven occasions in which a registered open-end fund was unable to satisfy redemption requests in accordance with Section 22(e) due to portfolio liquidity issues. *See* Third Avenue Trust and Third Avenue Mgmt. LLC, Investment Company Act Release No. 31943 (Dec. 16, 2015) (notice and temporary order); Steadman Fin. Fund, Steadman Inv. Fund, Steadman Oceanographic, Tech. & Growth Fund, Steadman Am. Indus. Fund, & Steadman Associated Fund, Investment Company Act Release No. 16958 (May 16, 1989) (exemptive order) (following an investigation, SEC found that funds could not fairly determine the value of their net assets) (the Steadman order was amended to include an extension of the original suspension period, Steadman Fin. Fund, Steadman Inv. Fund, Steadman Oceanographic, Tech. & Growth Fund, Steadman Am. Indus. Fund, and Steadman Associated Fund, Investment Company Act Release No. 17010 (June 15, 1989)); OTC-100 Fund Inc., Investment Company Act Release No. 16846 (Mar. 3, 1989) (notice of application and temporary order) (order issued after two shareholder accounts representing 80% of the outstanding shares of the

This letter has two principal parts. Recognizing that the non-investment grade syndicated loan market (the “syndicated loan market”) has a number of unique characteristics, Part I begins by describing in detail syndicated non-investment-grade loans,<sup>5</sup> the issuers that rely on the syndicated loan market, the attributes of syndicated loans, the investors who find syndicated loans to be an attractive asset class, the mechanics of settlement of loan transactions and the significant efforts being undertaken by the LSTA and syndicated loan market participants to materially improve settlement times for syndicated loans. It then turns to the successful experience of open-end loan funds in dealing with investor redemptions during periods of financial stress and describes how loan fund managers address liquidity risk using stress tests. Part II of this letter comments on specific aspects of the SEC's proposal, including liquidity classifications, 15% standard assets, the three-day liquid asset minimum and classification factors. We also discuss the SEC's proposal as to reporting and public disclosure and the costs of the proposal.

## **I. The Syndicated Loan Market**

### **A. What are Syndicated Loans and Why Do Borrowers Rely On Them?**

Non-investment grade syndicated loans provide over \$1.2 trillion in financing for some of the most dynamic, job-creating companies in the United States.<sup>6</sup> These loans provide critical financing to the vast majority of American companies that are considered “non-investment

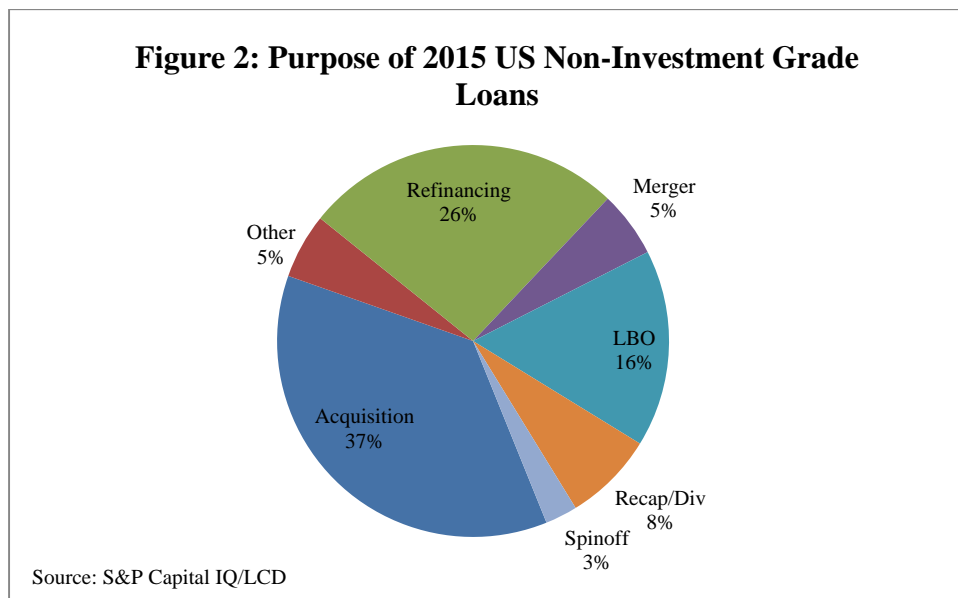
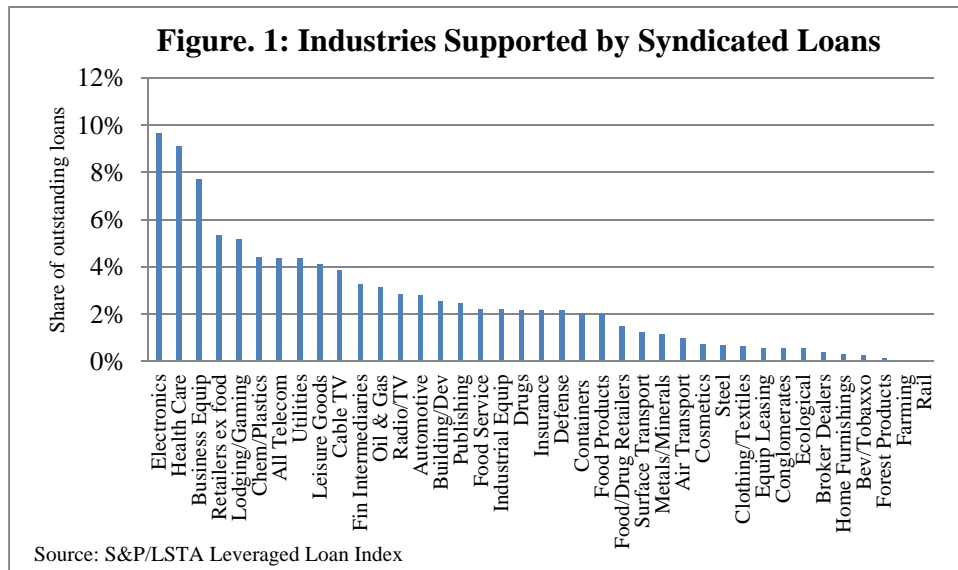
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fund submitted redemption requests); Shamrock Fund, Investment Company Act Release No. 7044 (Mar. 7, 1972) (exemptive order) (independent directors requested information regarding portfolio securities, which included a large amount of restricted securities, but were denied this information); Mates Financial Services, Advisers Act Release No. 247 (June 12, 1969) (finding that president of fund and investment adviser falsely represented that the fund would not acquire restricted securities). Two of those occasions concerned money market funds that were unable to meet redemptions during the 2008 financial crisis, Reserve Fund, Investment Company Act Release No. 28386 (Sept. 22, 2008) (order) and Reserve Mun. Money-Mkt. Trust, Investment Company Act Release No. 28466 (Oct. 24, 2008) (notice of application and temporary order), and the SEC, of course, has already addressed money market fund regulatory reform. Money Market Fund Reform; Amendments to Form PF, Investment Company Act Release No. 31166 (July 23, 2014). Although there have been other occasions where the SEC or its staff has issued exemptive orders or no-action letters to permit delayed redemptions, those have not been due to liquidity concerns, but instead have been caused by other factors, such as adverse weather or the closing of a stock exchange. Suspension of Redemption, Investment Company Act Release No. 10113 (Feb. 7, 1978) (order) (snowstorm); FT Int'l Trust, SEC No-Action Letter, 1987 WL 108732 (Nov. 19, 1987) (closing of the Hong Kong Stock exchange). The paucity of instances of portfolio liquidity issues should be seen in comparison to the number of mutual fund redemptions over the last 40 years. According to the Investment Company Institute, from 1975 through 2014, the mutual fund industry successfully processed \$296 trillion in redemptions. Investment Company Institute, 2015 Investment Company Fact Book 174 (2015). In short, the redemption record of the mutual fund industry shows that it has been quite successful in satisfying investor redemption requests. Accordingly, we believe that any SEC rule should largely codify existing practices, and avoid unnecessarily prescriptive standards.

<sup>5</sup> For ease of use, we will refer to non-investment grade syndicated loans simply as syndicated loans in the remainder of the letter.

<sup>6</sup> There is no official figure for the outstanding amount of overall non-investment grade loans; outstanding institutional loans are estimated through the size of the S&P/LSTA Leveraged Loan Index.

grade.”<sup>7</sup> These borrowers, who rely on loans for the low-cost and flexible financing needed to operate, grow and create jobs, reflect a broad swath of American companies. As Figure 1 demonstrates, the loan market provides financing to companies in nearly 40 industries. Syndicated loans are used by companies for many different purposes. In the first nine months of 2015, 34% of non-investment grade syndicated loans were used for acquisitions, 28% were used to refinance existing loans, 18% were used for buyouts, and the remainder were used for other purposes (Figure 2).



<sup>7</sup> Of the more than 2,000 companies in the U.S. rated by Moody’s, 72% are non-investment grade, meaning they are rated below BBB-/Baa3.

Many of the companies that rely on the syndicated loan market are very familiar names. For instance, communications companies like Cablevision, Charter Communications and Univision, healthcare companies like Community Health and HCA, airlines like Delta and American, diverse food related companies such as Dole Foods, Albertsons and Aramark, many of America's fast food chains including Wendy's, Burger King and Dunkin' Donuts – as well as turnaround situations like Dell Corp. – use loans to grow or support their business. All told, it is estimated that such loans provide financing for more than 1,000 companies that employ over six million people.<sup>8</sup> Without such loans, these businesses would face limited or more expensive sources of financing.

Structurally, syndicated loans typically are divided into two components: a revolving credit facility, also known as a “revolver,” and a “term loan.” The revolver works like a credit card; a company can borrow, repay the borrowings, and then borrow again. In contrast, when using a term loan, the company borrows the full amount at or shortly after closing and repays it over time. In a typical transaction, banks provide the revolver, while both bank and non-bank lenders provide the funds for the term loan. The term loans that are sold to non-bank investors are called “institutional term loans.”<sup>9</sup>

An important aspect of syndicated loans – and one reason they are popular with U.S. companies – is that each loan is structured to meet each company's specific needs. For example, unlike high yield bonds, in a loan, the covenants, maturity and amortization requirements are customized to a borrower's profile. In addition, loans are freely prepayable, meaning that if a borrower's circumstances change, it can repay the loan without exorbitant prepayment fees – unlike bonds.<sup>10</sup> Syndicated loans also are typically the most senior liability in a company's capital structure and are usually secured by almost all of the company's assets. For these reasons, such loans are less risky than high yield bonds, and borrowers have to pay loan investors less than they would pay high yield bond investors.

While it is easy to understand why corporations find syndicated loans an attractive source of financing, the academic research also has substantiated their benefits. In a recent presentation,<sup>11</sup> Professor David Smith, Director of the University of Virginia McIntire Center for Financial

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<sup>8</sup> [www.loansmeanbusiness.com/positive-impact](http://www.loansmeanbusiness.com/positive-impact).

<sup>9</sup> The remainder of the letter will focus on institutional term loans.

<sup>10</sup> Borrowers' ability to prepay also means there is a continual stream of cash back into the hands of investors. As an example, in August 2011, which was the largest single month of open-end loan fund redemptions, borrowers prepaid \$15 billion of loans. This is money that was returned to managers and which also could be used to meet redemptions. Prepayments were excluded from the sample stress tests discussed below in Section I.F.

<sup>11</sup> Available at [http://www.lsta.org/uploads/DocumentModel/2009/file/2015-sidley-lsta-presentation\\_final.pdf](http://www.lsta.org/uploads/DocumentModel/2009/file/2015-sidley-lsta-presentation_final.pdf).

Innovation, showed that a sizeable body of academic evidence demonstrates that syndicated loans to non-investment grade companies have many positive attributes for borrowers. For example, research shows that (i) companies with high growth opportunities rely more on syndicated loans than public bonds,<sup>12</sup> (ii) investment-related loan covenants hinder bad investment and improve company performance,<sup>13</sup> (iii) loan agreements are renegotiated frequently to better manage borrower-lender relationships,<sup>14</sup> and (iv) even when borrowers underperform, financial covenant violations lead to more conservative behavior by borrowers and improved company performance.<sup>15</sup> In summary, the empirical academic research suggests that lending to non-investment grade borrowers plays a positive financing and governance role.

## **B. Why Investors Find Syndicated Loans to be an Attractive Investment**

Syndicated loans are attractive for investors because they combine a number of risk-mitigating factors with high income. In particular, loan characteristics i) reduce credit risk, ii) nearly eliminate interest rate risk, and iii) provide a significant flow of cash back to investors to be re-invested.

A key attribute of these loans is that, despite being non-investment grade, their overall credit risk is quantifiable and manageable. Syndicated loans are senior and secured, which means that even if a company defaults, the recovery given default on its loans will usually be very high and, thus, credit losses will be minimized. According to the S&P/LSTA Leveraged Loan Index, the average leveraged loan default rate since 1998 – the earliest data available – is 3.2%. According to S&P Capital IQ LCD, the weighted average historical loan recovery given default on senior secured loans has been 80.1 cents on the dollar, which means the weighted average loss given default is only 19.9 cents on the dollar.<sup>16</sup> By multiplying the average default rate (3.2%) by the typical loss given default (19.9%), one can roughly calculate the typical loss rate on such loans – just 0.64% per year.

High yield bonds have a much higher expected loss than syndicated loans. Since 1998, the average annual default rate on high yield bonds is 4.6%;<sup>17</sup> meanwhile, the weighted average

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<sup>12</sup> Houston, J., James, C., 1996, “Bank Information Monopolies and the Mix of Private and Public Debt Claims,” *Journal of Finance*, 51: 1863 – 1889.

<sup>13</sup> Nini, G., Smith D. and Sufi, A., 2009, “Creditor Control Rights and Firm Investment Policy,” *Journal of Financial Economics* 92: 400–420.

<sup>14</sup> Roberts, M., and Sufi, A., 2009, “Control Rights and Capital Structure: An Empirical Investigation.” *Journal of Finance* 64:1657–95.

<sup>15</sup> Nini, G., Smith, D., and Sufi, A., 2012, “Creditor Control Rights, Corporate Governance, and Firm Value,” *Review of Financial Studies*, 25: 1713 – 1761.

<sup>16</sup> This includes the 2008-2009 financial crisis.

<sup>17</sup> Moody’s Investors Service; Annual Default Study: Corporate Default and Recovery Rates, 1920-2014.

recovery given default on high yield bonds is significantly lower: it ranges from 26.8% (or loss given default of 73.2%) on junior subordinated notes to 41.1% (or loss given default of 58.9%) on senior unsecured bonds. By multiplying the average annual default rate (4.6%) by the typical loss given default (58.9%), one can roughly calculate the typical loss rate on senior unsecured bonds – a much higher 2.7% per year.

Second, syndicated loans have almost no interest rate risk because they are floating rate, which offers benefits for both borrowers and investors.<sup>18</sup> The borrowers choose interest rate contracts that best suits them, ranging from one-, two-, three- or six-month LIBOR. At the same time, investors benefit because their interest rates reset frequently, minimizing interest rate risk and reducing price volatility. For example, as Figure 3 indicates, syndicated loans are one of the few asset classes that are negatively correlated with 10-year U.S. Treasury bonds. This means that when interest rates rise – and U.S. Treasury bonds suffer negative returns – loans generally see positive returns. This reduces the risk for syndicated loans – and the likelihood of large mutual fund redemptions – as the U.S. shifts away from a zero interest rate policy. This stands in stark contrast to many other asset classes.

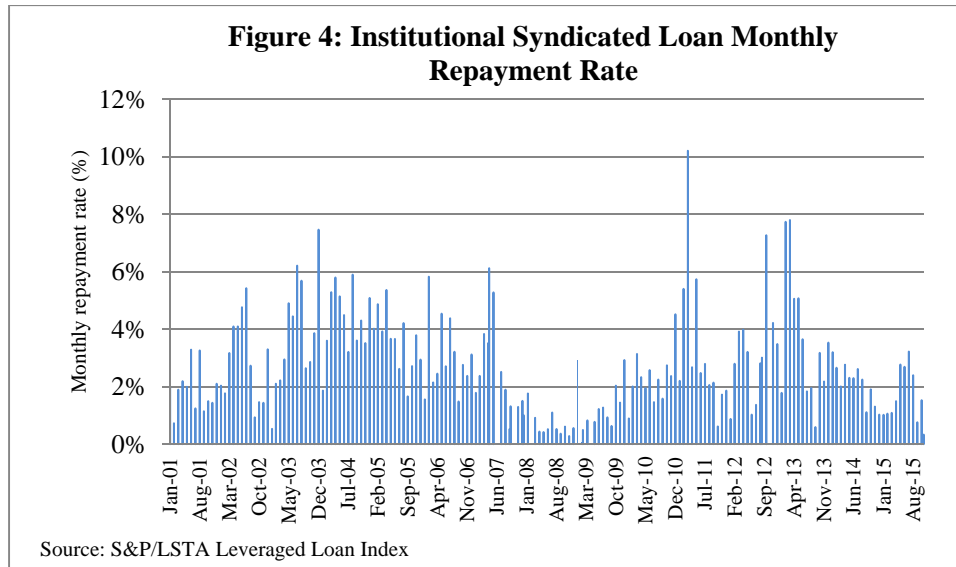
**Figure 3: Asset Correlation Matrix (Dec 2010-Nov 2015)**

Description	S&P/LSTA LLI	BofA Merrill Lynch US High Yield Constrained (USD Unhedged)	BofA Merrill Lynch Current US Treasury (10-Y) (USD Unhedged)	S&P 500	Barclays US Credit	Barclays US Aggregate Credit - Corporate -IG
S&P/LSTA Lev Loan Index	1.00	0.77	-0.36	0.61	0.24	0.27
BofA Merrill Lynch US High Yield Constrained (USD Unhedged)	0.77	1.00	-0.18	0.78	0.48	0.49
BofA Merrill Lynch Current US Treasury (10-Y) (USD Unhedged)	-0.36	-0.18	1.00	-0.48	0.68	0.65
Barclay US Credit Index	0.24	0.48	0.68	0.08	1.00	1.00
Barclays US Aggregate Credit - Corporate -IG	0.27	0.49	0.65	0.09	1.00	1.00

Source: Standard & Poor's, Bank of America Merrill Lynch, Barclays, FactSet

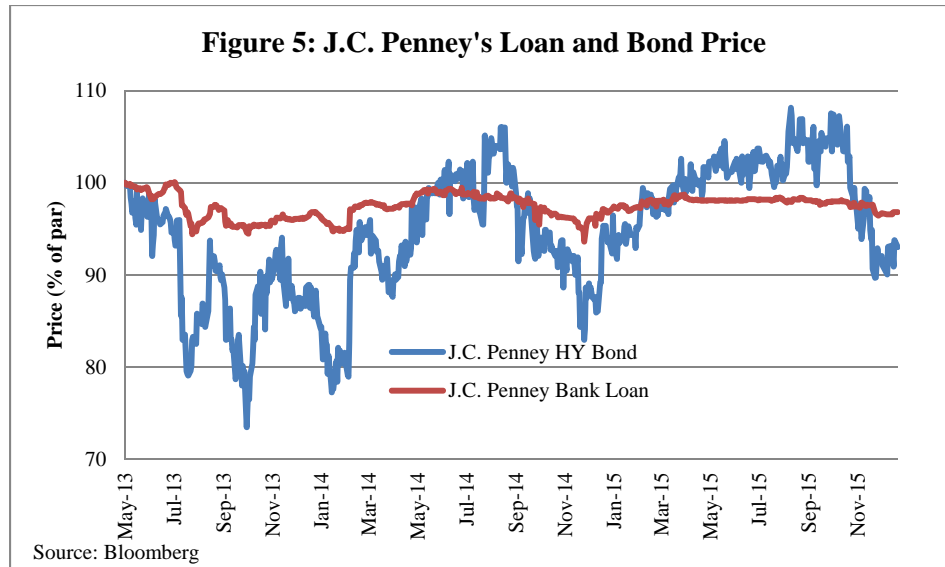
Third, syndicated loans amortize and prepay frequently, returning cash to investors' hands for reinvestment. Figure 4 illustrates the monthly repayment rate on the S&P/LSTA Leveraged Loan Index. While the repayment rate varies across time, the average monthly repayment rate since January 2001 is 2.72%. Notably, while repayments slowed during the financial crisis, they did not stop. The average monthly repayment rate between July 2008 and June 2009 was 0.81%. Importantly, while these repayments are generally reinvested, they also provide funds to meet redemptions (though most managers stress test their portfolios assuming no repayments).

<sup>18</sup> Borrowers access less expensive financing at the short end of the interest rate curve, while investors reduce interest rate sensitivity.



Syndicated loans, like high yield bonds, also trade in a robust secondary market. However, due to many of the risk mitigants noted above, secondary loan prices tend to be much more stable than high yield bond prices. First, because syndicated loans have a high recovery rate following a default, they tend not to trade down as far on negative news as high yield bonds. Second, because they are floating rate, changes in the interest rate environment impact their prices significantly less than they do for fixed-rate bonds. And, finally, because they are prepayable, syndicated loans are less likely to trade well above par. Due to all these factors, the price volatility of loans tends to be far lower than that of high yield bonds or equities. A familiar example may be J.C. Penney. As Figure 5 indicates, J.C. Penney has both high yield bonds and loans outstanding. In the past three years, the price of the high yield bond has fluctuated significantly, ranging from 73.5 in October 2013 to 108 in August 2015. In contrast, J.C. Penney’s institutional loan has been much more stable, with the high being 100 in June 2013, and the low being 93.6 in December 2014.





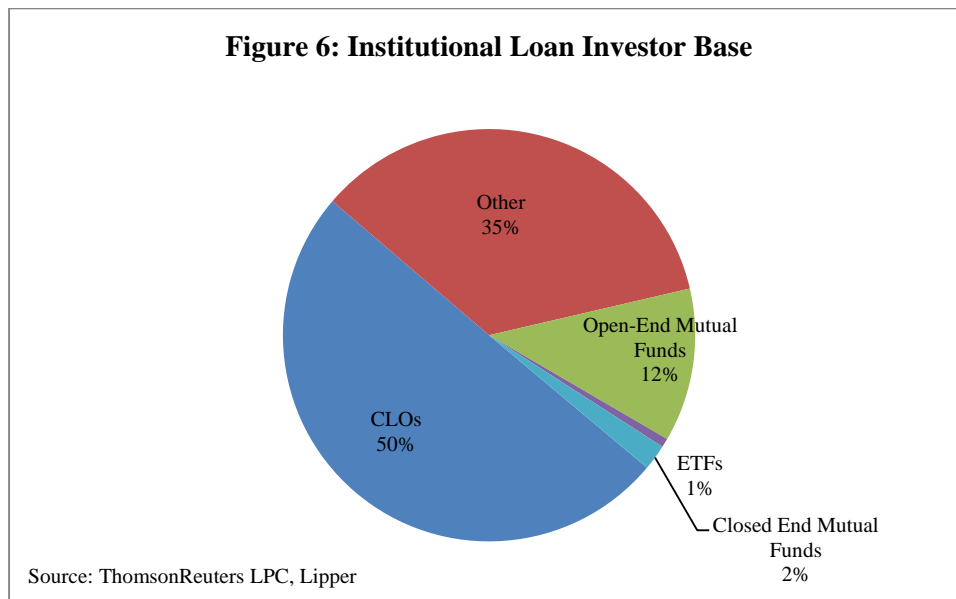
In addition to experiencing far lower price volatility than high yield bonds, syndicated loans also offer moderate to high income to their investors. As an example, in 2015, the income component of return in the S&P/LSTA Leveraged Loan Index was 4.62%. Because syndicated loans have both moderate to high income and low volatility, the volatility of their overall returns is much lower than it is for high yield bonds. Research from Barclays and Credit Suisse shows that, since 1998, the average trailing 12-month return volatility of syndicated loans is 0.99% - less than half that of high yield bonds (2.10%).

### C. Who Invests in Syndicated Loans

Between attractive yields, low price volatility, minimal interest rate risk and low expected losses, investors recognize that syndicated loans are an attractive asset class.<sup>19</sup> In turn, a diverse loan buyer base, which comprises investors with different investment horizons and different liquidity needs, has developed. The single largest investor class in syndicated loans – CLOs – are match funded. That is, they have long term, non-mark-to-market liabilities, which support investments in long-term assets. Two other investor types, which are captured in the “other” category of Figure 6, are separately managed accounts (“SMAs”) and commingled accounts. In an SMA, a large investor like a pension fund will mandate a manager to run a large separate account, often \$100 million or more. Smaller mandates may be combined in a commingled account. While the terms vary, many of these funds have a lock-up period of one year or more, removing the need to sell based on market movement. Open-end loan funds, which account for 12% of the syndicated loan investor base, have shorter investment horizons and redemption periods, and manage liquidity proactively. The existence of different types of investors with different strategies

<sup>19</sup> The institutional loan market – as measured by the S&P/LSTA Leveraged Loan Index, an index of syndicated loans that are purchased by non-bank lenders – totaled \$866 billion in face value and \$802 billion in market value as of November 2015.

stabilizes the market, as some funds will be actively buying when others are selling – and vice versa.



#### D. Syndicated Loan Settlement

One question that has been raised is how open-end loan funds are able to invest in an asset class that has an unconventional settlement regime and settlement times that are typically longer than other asset classes that are traded on an exchange or cleared through a clearinghouse.<sup>20</sup> In the first three quarters of 2015, the median settlement time for buy-side sales<sup>21</sup> – in other words, how long it typically takes an asset manager’s loan sale to settle – was 12 days.<sup>22</sup> However, it is

<sup>20</sup> Some of the features of loans that benefit borrowers can lengthen settlement times. One example is “agent freezes.” As discussed previously, one of the reasons that borrowers find loans to be a good source of credit is that they can pick their interest rate and period, ranging from one-, two-, three- or six-month or even one-year LIBOR. While this provides considerable flexibility for the borrower, it does have an impact on settlement times, because of the agent freeze. Agent banks often freeze settlement for two to three business days when interest rates are reset in order to pay interest to the appropriate parties. Thus, if interest were due on March 31<sup>st</sup>, the last day for a trade to settle would typically be March 27<sup>th</sup>. On the 28<sup>th</sup>, a notice of intent would be sent to the current lenders of record notifying them that interest will be paid and what the borrower has elected for the next interest period. On the 29<sup>th</sup>, the interest rate for the new period would be locked. Interest will be paid on the 31<sup>st</sup>, the day the new contract begins. After that, trades would begin to settle again.

<sup>21</sup> In considering redemption liquidity, the appropriate measurement is the median buy-side sale settlement time. First, buy-side purchases are not relevant to redemption liquidity. Second, sell-side purchases or sales are not relevant to redemption liquidity. Loan trading settlement times demonstrate a non-normal distribution, with a mode at seven days. With a non-normal distribution, the median is a more appropriate measurement than the average. While a 12 day median settlement time is still not optimal, it is significantly lower than the settlement numbers that have been discussed and written about in recent press accounts. All settlement times cited come from extensive data collected by the LSTA.

<sup>22</sup> This time frame tightens in periods of outflows. In August 2011, loan funds saw \$8 billion of outflows. The median buy-side settlement time reduced to six days in this period.

important to note that loan investors have developed techniques to manage the liquidity of their portfolios in light of extended loan settlement. In addition, loan market participants are also keenly focused on loan settlement and have developed – and continue to improve – standardization, procedures and best practices to speed up settlement.

Indeed, the LSTA’s Board of Directors<sup>23</sup> has put improving loan settlement times at the very top of its agenda. In 2014 it formed a board-level liquidity committee charged with addressing these challenges. In that time, the median settlement time for buy-side sales decreased two days. In early 2016, the LSTA is introducing a major initiative to further reduce settlement times by better aligning the economic incentives of loan market participants to settle loans as quickly as possible. Ultimately, the goal is to transform syndicated loan settlement, within the next three years, to more closely adhere to conventional standards applicable to most other asset classes.<sup>24</sup>

Among the concrete steps loan market participants have already undertaken are the development and use of standard trading documents, adoption of best practices and technology improvements. The LSTA has published a suite of standard trading documents: forms of “trade confirmations” are used to evidence loan trades and a full suite of form agreements are used to document the terms and conditions upon which the parties can settle those trades. The LSTA continuously updates and refines these documents to adjust to changing market dynamics. The adoption by the market of the LSTA’s standard trading documents and best practices has greatly reduced the time spent on the legal and documentation side of syndicated loan settlement.

On the operational and technology front, market participants have numerous ongoing projects to shorten settlement times. In February 2015, the LSTA published operational best practices for trade settlements. In July 2015, FpML Version 5.8 was published establishing a standard for syndicated loan notifications.<sup>25</sup> The LSTA works to ensure that CUSIP Numbers<sup>26</sup> are assigned to all credit agreements and facilities, and loan market participants are uniquely identified by

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<sup>23</sup> The LSTA’s Board of Directors is comprised of 23 buy-side and sell-side institutions: Ares Management LLC, Bank of America Merrill Lynch, Barclays, Blackrock, Citigroup, Credit Suisse, Deutsche Bank AG, Eaton Vance, Fidelity, Goldman Sachs, Golub Capital, GSO Capital Partners LP, Guggenheim Partners, Highbridge, Invesco, JPMorgan Chase, Kohlberg Kravis Roberts & Co., Morgan Stanley, Octagon Credit Investors LLC, RBC Capital Markets LLC, Sankaty, Voya Investment Management and Wells Fargo.

<sup>24</sup> A group of syndicated loan market participants, in conjunction with the LSTA, would be pleased to discuss these efforts with the SEC staff and report periodically on the progress of our continuing efforts.

<sup>25</sup> FpML is Financial Products Mark-Up Language. The Syndicated Loan FpML is an industry standard which is an XML-based data format to model servicing and inventory messages in FpML Version 5.8. Trade and settlement messages are expected to be published in 2016. The benefits attributed to electronic messaging (rather than standard faxes) is that it (i) provides for cleaner and more transparent referential data, (ii) standardizes notices across agent banks requiring certain fields to always be populated, (iii) allows for quicker/easier automatic processing and an electronic audit trail of events and (iv) facilitates technology innovation.

<sup>26</sup> A CUSIP Number is an identification number for financial institutions. The CUSIP system is overseen by the Committee on Uniform Securities Identification Procedure.

Markit Entity Identifiers. The identifiers improve trade data accuracy, assist with reconciliations, allow for electronic messaging for servicing, inventory and trade, and permit faster trade matching, enabling faster settlement times. Many of these initiatives are important prerequisites to achieving the ultimate goal of a more conventional electronic settlement regime.

While the loan market continues to work to improve settlement, the reality is that loan fund managers have developed strategies to manage liquidity in light of extended settlement periods. As we demonstrate below, loan funds did meet redemptions in three periods of stress – 2008, 2011 and 2014. We also show how loan funds’ liquidity management programs position them to meet any future redemption needs even in periods of great stress.

### **E. Open-End Loan Fund Redemptions: Experiences of 2008, 2011 and 2014**

Open-end loan funds have weathered significant periods of stress and have always met investor redemptions. Indeed, in the past ten years there have been three periods of significant stress driven by external events. First, during the financial crisis, open-end loan funds saw considerable outflows. In particular, between July 2007 and December 2008, such funds experienced more than \$15 billion in outflows.<sup>27</sup> While this was a very substantial proportion of open-end loan fund assets at the time, open-end loan funds met investor redemptions.

Following the financial crisis, investors believed that interest rates were likely to rise and, in 2011, put a significant amount of money into loan funds, which are protected from interest rate increases.<sup>28</sup> As a result, the assets in open-end loan funds increased from \$48 billion in January 2011 to \$66 billion in July 2011.<sup>29</sup> But early 2011 also witnessed considerable global instability, including the Fukushima nuclear crisis, the Arab Spring and the continuing crisis in Greece. Closer to home, the federal government narrowly averted a shutdown, which eventually led to a ratings downgrade from AAA by Standard & Poor’s. These stresses percolated through financial markets, and ultimately led to material redemptions for funds in many asset classes. The pressures were exacerbated for open-end loan funds when, in early August, the Board of Governors of the Federal Reserve System promised to hold short-term interest rates near zero for two years.<sup>30</sup>

The resulting impact on open-end loan funds was striking. In August 2011 alone, open-end loan funds experienced redemptions totaling more than 13% of their assets. This was a very

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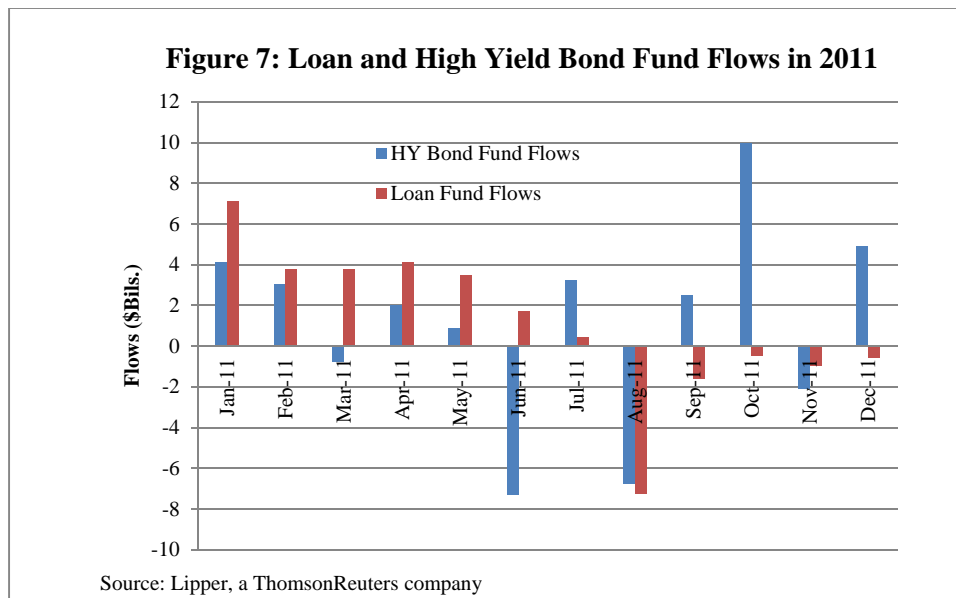
<sup>27</sup> Lipper, a ThomsonReuters company.

<sup>28</sup> Unlike fixed rate bonds, loan funds often see inflows when interest rates are expected to rise. This is because loans are floating rate instruments, and their yields typically increase when interest rates increase.

<sup>29</sup> In contrast, high yield bond funds totaled more than \$200 billion in assets in 2011. Thomson Reuters LPC.

<sup>30</sup> Because loans are floating rate, investors are particularly inclined to purchase fund shares when they expect interest rates to climb. However, if this expectation is shattered, they also can leave the asset class quickly.

substantial real-world test of open-end loan funds' ability to meet redemptions – which they did. Figure 7 illustrates inflows and outflows from open-end loan and high yield bond funds in 2011. In August 2011, open-end loan funds experienced more than \$7 billion of redemptions, while high yield bond funds saw outflows of more than \$6 billion.

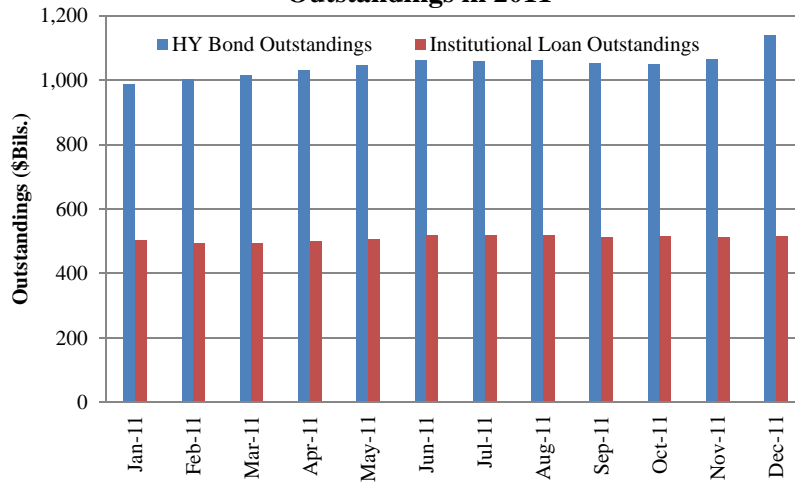


Though similar in size, the outflows were far more material for the loan market than for the high yield bond market. At that time, as measured by representative indices, institutional loan outstandings totaled \$517 billion,<sup>31</sup> while high yield bond outstandings were more than \$1.06 trillion (Figure 8).<sup>32</sup> Meanwhile, open-end loan funds had \$66 billion of assets, while open-end bond funds had more than \$200 billion of assets (Figure 9). Thus, August redemptions accounted for roughly 13% of open-end loan fund assets, and 1.4% of all loan outstandings. In contrast, redemptions accounted for 3% of high yield bond fund assets and 0.63% of all high yield bond outstandings (Figure 10).

<sup>31</sup> S&P/LSTA Leveraged Loan Index.

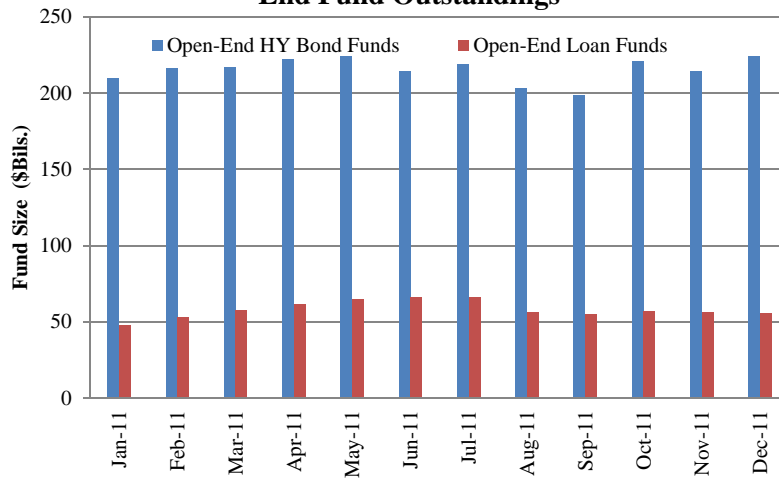
<sup>32</sup> Bank of America Merrill Lynch High Yield Index.

**Figure 8: Institutional Loan and High Yield Bond Outstandings in 2011**

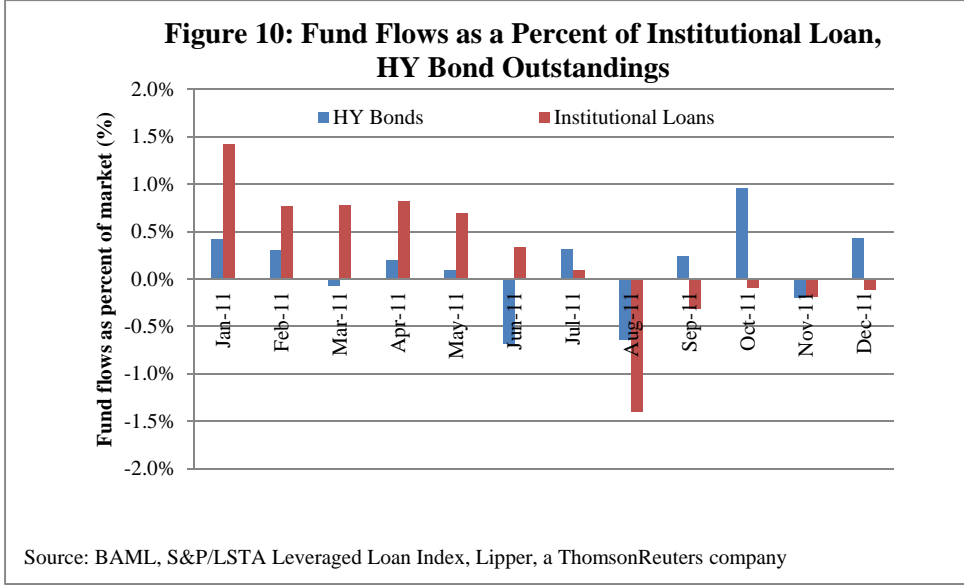


Source: Bank of America Merrill Lynch, S&P/LSTA Leveraged Loan Index

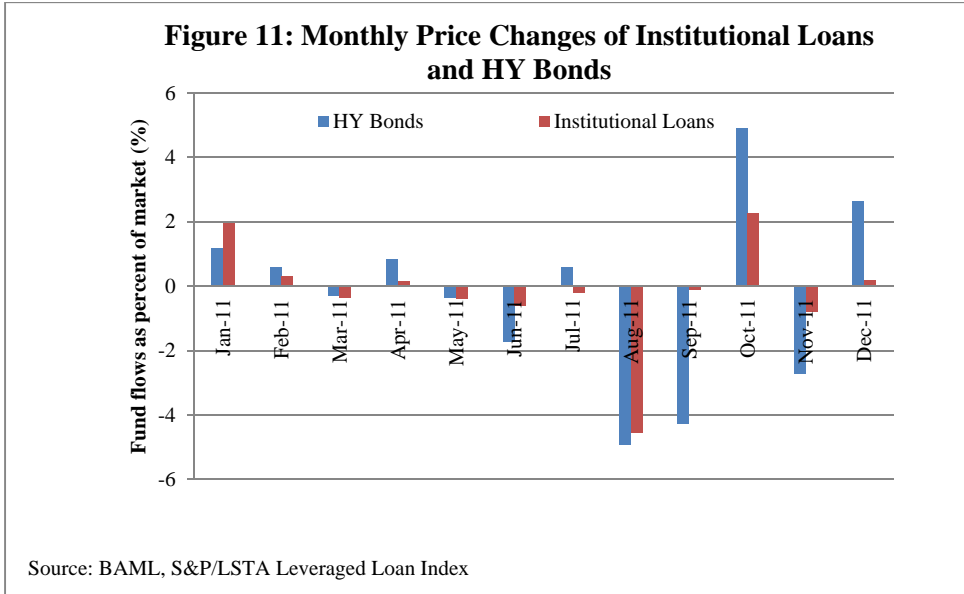
**Figure 9: Institutional Loan and High Yield Bond Open End Fund Outstandings**



Source: Lipper, a ThomsonReuters company, ThomsonReuters LPC



Between general market volatility and selling to meet redemptions, loan prices declined by 4.5 percentage points, while high yield bond prices declined by 4.9 percentage points (Figure 11). Critically, despite enduring more than twice the market-weighted volume of outflows and four times the fund-weighted volume of outflows, loan prices declined *less* than high yield bond prices. Notably, the ability to transact held up better in the loan market than it did in the high yield bond market, despite a much larger share of the loan market changing hands.<sup>33</sup> This demonstrates loan managers’ ability to transact even in a stressed market environment.



<sup>33</sup> Many market participants note that loans often have superior trading liquidity than high yield bonds.

Despite redemptions totaling more than 13% of assets, all open-end loan funds met their investors' needs. Part of this was due to loan market liquidity holding up in a stressed environment, and part was due to open-end loan funds managing their liquidity risk. Finally, it may be worth commenting on loan repayment rates. Although the syndicated loan repayment rate dropped below its historical monthly average of 2.7% during a period of macro volatility in August 2011, corporate borrowers still repaid 2% of the overall loan outstandings in that month. Assuming that open-end loan funds experienced a similar asset repayment rate, this also provided a source of cash to meet redemptions.

Having come through a material dislocation in the fixed income markets in 2011, the markets shifted again in 2012. Open-end loan fund redemptions slowed through year-end, and then flows turned positive in March 2012. Between March 2012 and March 2014, open-end loan funds once again saw strong inflows, as investors looked to put money to work in anticipation of rising rates. By March 2014, loan fund assets (including closed end funds) totaled \$174 billion.<sup>34</sup> However, as it became clear that no rate increases were on the horizon by spring 2014, investors again began to pull back from loan funds. This shift in sentiment led to large and sustained open-end loan fund outflows – totaling more than \$38 billion, or 20% of open-end loan fund assets – between April 2014 and January 2015. Again, open-end loan funds met all investor redemptions.

#### **F. The Syndicated Loan Market and Liquidity Risk**

Open-end loan funds were able to meet redemptions in the stress periods of 2008, 2011 and 2014 because they proactively manage their liquidity profile. Specifically, they can – and generally do – i) hold cash positions, ii) invest a portion of their portfolio in securities that settle in three days (“T+3 securities”), and iii) secure a line of credit from banks to ensure access to liquidity.<sup>35</sup>

To better quantify loan mutual fund managers' liquidity management practices, in August 2015, the LSTA surveyed open-end loan fund managers. We collected information from open-end funds and ETFs with a total of \$72 billion in assets; this is over half the open-end loan fund and ETF universe. The combination of funds' cash and T+3 securities, representing their share of

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<sup>34</sup> ThomsonReuters LPC.

<sup>35</sup> Market participants say that syndicated loans typically have better trading liquidity than comparable asset classes such as high yield bonds, but their settlement period often is longer. In this context, loan funds' lines of credit are used to bridge the gap between when a loan trade occurs (and the price has been set) and when the trade settles. Unlike the financing of an investment whose ultimate value is not yet demonstrated by the market, the financing of confirmed but unsettled trades is in our view a prudent and appropriate source of liquidity on which mutual funds can rely. It is a tool to manage this specific aspect of the cash-conversion liquidity timing particular to the loan asset class.



readily accessible liquid assets, ranged from 2% of the fund to 26% of the fund.<sup>36</sup> The median fund had 3.5% of assets in cash and another 6.1% in T+3 securities.

In addition to the cash and T+3 securities, all fund complexes surveyed also had access to substantial lines of credit that could be used to cover open-end loan fund redemptions. The size of the lines of credit ranged from \$50 million to \$2.5 billion (for the entire complex). In some cases, the lines of credit were dedicated to the open-end loan fund and were a substantial percentage of the assets of the fund. In other cases, the lines of credit actually exceeded the size of the open-end loan fund assets, but were shared with other funds in the complex. Most funds had access to lines of credit of more than 10% of their fund assets.

The significant holdings of cash and T+3 securities, in tandem with access to large lines of credit, demonstrate open-end loan fund managers' long-term commitment to actively managing the liquidity needs of their funds – and to meet redemptions in all environments.

However, loan mutual fund managers do not simply presume that they will have sufficient liquidity to meet redemptions. Instead, managers have told us that they stress test their portfolios by assuming that a certain percentage of assets will be redeemed in a short period of time. They then model how quickly they can raise cash by i) using cash on hand, ii) selling and settling T+3 securities, iii) selling and settling loans, and iv) using their lines of credit if necessary. Managers have described several types of stress tests they undergo. On one end of the spectrum, a stress test can assume a short fast shock (such as a sizeable one-day redemption from a large investor). At the other end of the spectrum, a stress test could assume an extended period of large outflows (such as two consecutive months of record redemptions). Based on these stress tests, managers have indicated that they can meet redemptions in both normal and stressed environments.

Because open-end loan fund managers have different investor profiles, different investment strategies and different portfolios, they employ different liquidity management strategies; this is an important reason to implement a principles-based approach. On one end of the spectrum, some managers have large T+3 and cash holdings, but smaller lines of credit; on the other end of the spectrum, some managers have smaller holdings of highly liquid assets, but larger lines of credit. In our stress tests below, we test two types of liquidity management strategies. Based on feedback from our manager survey, a fund managed by one manager (“Manager A”) may hold 2% cash and T+3 securities, while having a line of credit equivalent to 20% of fund assets. A fund managed by another manager (“Manager B”) may have 15% in cash and T+3 securities, but a line of credit of 10% of fund assets. As illustrated below, both funds can demonstrate the ability to meet redemptions in stress scenarios.

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<sup>36</sup> Funds with a larger proportion of liquid assets often have a smaller liquidity line, and vice versa.

### *Stress Test One: Short, fast shock*

The first type of stress test assumes a sudden, intense shock, such as a large redemption request from a large investor. In this scenario, a fund sees outflows of 10% in one day (“Day Zero”); this approaches the worst *one-month* industry outflow of 13% of open-end loan funds.

Manager A’s fund would have 2% cash and T+3 securities, coupled with a line of credit equivalent to 20% of assets. If such a fund had a one-day outflow of 10%, it would use its cash and sell its T+3 securities. Combined, this quickly provides 2% for redemptions. It could also draw 40% of its credit facility, which provides another 8% for redemptions. Between the cash, T+3 securities and 40% of its line of credit, it would meet the T+3 redemptions.

Simultaneously, on Day Zero, the fund would sell loan assets. Based on the stability of loan assets and the volume of loan trading,<sup>37</sup> it is reasonable to assume that the fund could sell 5% of its original loan position on Day Zero, 5% of its original loan position on Day One, 5% of its original loan position on Day Two, and 5% of its original loan position on Day Three.

Over the following days, the loans that were sold would begin to settle. These loan sale proceeds would replenish the credit facility and further raise cash in preparation for any additional redemptions. Based on a median buy-side sale settlement of 12 days,<sup>38</sup> by Day Six, the fund should have received settlement payment on one-fourth of the loans it sold on Day Zero (e.g., 1.25% of assets). The fund would receive another 1.25% on each of Day Seven, Eight and Nine. Thus, by Day Nine, the fund would have received 5%. At this point, the fund would either hold cash or begin to pay down its credit line. The fund would continue to receive settlement cash in the coming days, which would permit it to either fully pay down its credit line or continue to build its cash position. In this manner, the fund would fully meet a one-day redemption that approaches the largest one-month industry redemption.

Conversely, Manager B’s fund would have a larger proportion of cash and T+3 assets (15%) but a smaller line of credit (10%). Again on Day Zero, Manager B’s fund sees outflows of 10% in one day. Manager B immediately uses the fund’s cash and sells its T+3 assets. Together, this more than covers the 10% redemptions that have to be met in T+3. In this way, the fund would meet a short, sharp redemption.

### *Stress Test Two: Extended period of significant outflows*

The second test would assume two consecutive months of outflows, each matching the largest monthly outflow on record. August 2011 saw investor redemptions totaling 13% of total open-

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<sup>37</sup> Discussed in the August 2011 case study.

<sup>38</sup> While the stress test is based on a median 12 day settlement period, the median buy-side sale settlement time was T+7 in 2011-12, and T+6 in August 2011. Thus, cash from loan settlements would likely be available more quickly than the stress test assumes.

end loan fund assets. Thus, the second stress test assumes two consecutive months of 13% outflows; this totals 26% of the fund in two months and is equivalent to daily redemptions of 0.65% of the fund.

Again, Manager A's fund would have 2% in cash and T+3 securities, with a 20% line of credit. On Day Zero, Manager A's fund would sell its T+3 securities. In addition, the fund would sell loans equivalent to 1% of its original assets, a process it would continue for every business day for the next two months. These sales would start to settle on T+6, bringing in 0.25% of fund assets on each of days 6-11, 0.5% of fund assets in each of days 12-17, 0.75% of fund assets in each of days 18-23, and 1% of fund assets in each of days 24-39. However, the cash from loan settlements would not be available on Day 3, when the first redemptions have to be paid. Thus, the manager would rely on the fund's cash position and cash raised from the sale of T+3 securities, a total of 2% to meet 0.65% redemptions. Having paid out 0.65%, at the end of Day 3, the fund would have 1.35% in cash. On Day 4, the fund would have to meet 0.65% redemptions, leaving it with 0.7% cash on hand. At this point, the fund would likely have drawn on its line of credit. Usage on the line would climb from 0.35% of assets on Day 6 to 3.25% of assets on Day 17 because the settlement of 1% daily loan sales would lag redemption requests. Starting on Day 18, cash from loan settlements begin to exceed daily redemptions and the usage of the line begins to decrease. By Day 20, line usage falls below 3%. By Day 25, line usage falls below 2%. By Day 28, line usage falls below 1% and by Day 31, the fund has stopped using its line of credit. Beginning on Day 31, Manager A begins to build the fund's cash position, which tops out at 2.95% on Day 39. Thus, by using cash, sale of T+3 securities and drawing on its considerable line of credit, the fund meets redemptions in a stress test that doubles the worst month of outflows on record.

While Manager A relied on its line of credit, Manager B – whose fund has 15% in cash and T+3 securities, as well as a 10% line of credit – focuses on asset sales. On Day 1, the fund managed by Manager B will start selling 1% of its loan assets every day for the next two months. It also sells its T+3 securities. Thus, by Day 3, the fund has redemptions of 0.65% of its assets, while the fund has 15% cash on hand. At the end of Day 3, the fund has 14.35% of its assets in cash. In Days 4 through 23, the fund sees cash outflows exceeding inflows as loan sale settlements do not keep up with redemptions. In turn, the fund's cash position declines from 13.7% of assets on Day 4 to 9.75% on Day 17. Thereafter, cash from loan sale settlements accrue faster than redemptions are paid out, increasing the fund's cash position. By Day 39, the fund has 15.95% in cash. Thus, by relying on its large cash and T+3 securities position, the fund meets record redemptions.

Critically, even though they employ very different strategies to manage liquidity risk, funds managed by Manager A and Manager B each are able to meet redemption requests. Notably, these examples do not take into account important mitigating factors. First, they do not assume that loan settlements could be expedited, even though in August 2011, the median buy-side sale settlement time was reduced to six days, rather than 12 days. Second, there is no reliance on loan

repayments, even though 2.8% of loan outstandings were repaid in August 2011. In a real stress environment, both of these factors would make meeting redemption requests easier.

As both the stress tests and the events of 2008, 2011 and 2014 illustrate, open-end loan funds have shown the ability to meet redemptions in normal and stressed environments. Part of the reason for this is that most open-end loan fund managers have managed loans in some form for at least a decade, and often longer. They are well aware of the time it can take for loan trades to settle, and have developed techniques that do not rely on short loan settlement times to meet investor redemptions. The industry agrees with the SEC that it is important to test portfolios and ensure that redemptions can be met in stressed scenarios. However, doing so in an overly prescriptive manner, and requiring techniques that are not applicable to all asset classes, will not make investors safer – and will likely reduce their investment options (and increase their investment costs) materially. Below, we respectfully propose several options that we believe are as effective as the SEC proposal but would cause less disruption to many markets.

## **II. Comments on Specific Aspects of the Proposal**

The LSTA generally agrees with the comments of the Investment Company Institute on the SEC's proposal. Beyond that, the LSTA appreciates the opportunity to comment on specific aspects of the SEC's proposal as they would affect open-end loan funds. In particular, we wish to address (1) the need for the proposal to be less prescriptive and more principles-based, (2) the costs of the proposal, and (3) public disclosure of liquidity classifications.

### **A. The Need for Principles-Based Regulation**

The LSTA appreciates and supports the efforts of the SEC to strengthen liquidity management by open-end funds using a principles-based approach. We strongly endorse the SEC's proposal to require each open-end fund to adopt a formal, written liquidity risk management program designed to assess and manage an open-end fund's liquidity risk. We also agree that given the differing characteristics of each open-end fund, it is not possible for the SEC to prescribe a regulatory approach that will fit all, or even a majority, of open-end funds. First, every open-end fund has its own unique set of distribution arrangements and shareholders; accordingly, redemption requests will vary for every open-end fund. Second, each open-end fund will have its own portfolio and other sources of liquidity, such as committed lines of credit, access to interfund transactions using Rule 17a-7, interfund lending facilities and cash inflows from new sales of fund shares.

For these reasons, it is simply not possible (or necessary) to prescribe specific, detailed and prescriptive liquidity risk management requirements. Accordingly, at bottom, a principles-based approach is the only appropriate approach. Nevertheless, as detailed below, the LSTA is concerned that many aspects of the SEC's proposal stray from a true principles-based approach

and accordingly will be unworkable for many, if not most, open-end funds. We now turn to specific prescriptive requirements of the proposal.

### Liquidity Classifications

The proposal requires open-end funds to classify, and conduct an ongoing review of, each portfolio position using nine mandatory factors and a prescribed six category classification scheme in which the open-end fund's position would be convertible to cash at a price that does not materially affect the value of the asset immediately prior to sale.

As many have noted over the years, determining whether an instrument is liquid or not necessarily involves employing a variety of factors to make a subjective determination.<sup>39</sup> In fact, several commenters noted this in their letters on the SEC's investment company reporting modernization proposal, which required only that instruments be designated as liquid or illiquid and did not require six classifications of liquidity.<sup>40</sup> Moreover, that determination necessarily depends on factors that may vary depending on a fund's particular situation and use historical information that may or may not reflect future circumstances. In addition, it may not be possible to determine with any degree of certainty whether a particular instrument may be sold and converted into cash in a particular time period, particularly when using six different liquidity classifications. We also note that the six classifications of liquidity may work well for some types of instruments, particularly equity securities, but are not well-suited for other types of instruments, including most fixed income securities and loans. Instead, it would be far more practical for a fund to determine the liquidity of its portfolio using a top down approach, or evaluating each type of instrument in the portfolio, rather than each specific instrument. In short, the SEC's proposal to put each instrument into one of six liquidity classifications assumes a degree of certainty and precision that simply does not exist.

Accordingly, we recommend that the SEC replace the six classifications of liquidity with a truly principles-based approach. Under this approach, a fund would determine broadly its liquidity needs, based on factors it deems appropriate, such as the redemption characteristics of its investors, the liquidity characteristics of its portfolio, in terms of the likely timing of any conversion of assets to cash, and the availability of alternative sources of liquidity. As contemplated by the proposal, each fund would have a written liquidity risk management

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<sup>39</sup> See, e.g., Investment Company Institute, *Valuation and Liquidity Issues for Mutual Funds* (1997) at 44 (“the process of determining the liquidity of a portfolio security is often a subjective one, reflecting judgments as to the practical ability of a fund to sell a security in less active and in some cases specialized markets”).

<sup>40</sup> See, e.g., Independent Directors Council, *Comment Letter on Investment Company Reporting Modernization*; File No. S7-0815 (Aug. 11, 2015) (“process for making liquidity determinations and the factors forming the basis of those determinations involve subjective judgments regarding the market and the specific fund in question, including investment professionals’ projections of future potential trading volume and price volatility, and the fund’s ability to exit its position at or near its current value.”).

program that would be overseen by the fund's board of directors. Thus, this approach would be similar to the approach taken to compliance generally under Rule 38a-1.

If the SEC is unwilling to embrace fully a principles-based approach, and instead decides to adopt a prescriptive rule requiring that funds classify individual instruments, we suggest that the SEC require funds to use their own categorization system as part of their written liquidity risk management program. This is a preferable alternative because it would recognize the diversity of portfolio assets and risk management approaches that exist today in the fund industry.

For example, a fund could decide that its assets should be divided into three categories: (1) most liquid assets, consisting of cash and any instrument that the fund believes is convertible into cash within three business days under normal conditions; (2) illiquid assets, consisting of 15% standard assets; and (3) intermediate liquidity assets, consisting of assets that are not most liquid assets or illiquid assets.

Another fund might decide that its assets should be divided into six categories: (1) three-day liquid assets, as defined in the proposal; (2) instruments traded on a securities exchange or similar marketplace; (3) instruments that are easily sold within three days and settled within seven days during almost all market conditions; (4) instruments that generally may be sold within three days during normal market conditions, but that typically do not settle within seven days, such as loans; (5) instruments that often may be sold within three days, but at other times may take up to a week to sell and (6) 15% standard assets, as defined in the proposal.<sup>41</sup>

Funds could be required to document their categories as part of their written plan and also to record their specific classifications of portfolio assets. They also should conduct back testing to evaluate the effectiveness of their liquidity determinations. We expect that the SEC, as a part of its examination program for open-end funds, would review this documentation as a matter of course.

We also recommend that if the SEC adopts a rule requiring liquidity determinations as to specific assets, it should expressly acknowledge that funds and their advisers may make reasonable judgments and assumptions in making liquidity determinations and that those determinations, if made in good faith, will not be second-guessed.

#### 15% Standard Assets

In the proposal, the SEC uses its long-standing definition of an illiquid asset: “any asset that may not be sold or disposed of in the ordinary course of business within seven calendar days at

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<sup>41</sup> The final rule should make clear that if a particular instrument can be shown to differ from others in its asset class, it may be classified differently.

approximately the value ascribed to it by the fund.” As the SEC notes, this definition does not look to whether a fund may receive the proceeds of sale or disposition within seven days.<sup>42</sup>

The LSTA strongly supports the 15% standard assets limit as proposed by the SEC. We believe that it has served open-end fund investors well by limiting the degree to which open-end funds may invest in assets that may not be freely or easily traded.

The SEC requests comment as to whether it should modify this definition to require funds to take into account the time period associated with the receipt of proceeds of sale or disposition. The LSTA strongly believes that it would be inappropriate to so modify the definition. The existing definition serves to identify those assets that cannot be sold within a short enough time period to allow an investment adviser and its funds to manage cash flows to meet redemptions. As we demonstrate above in our section regarding the syndicated loan market and liquidity risk, despite the fact that syndicated loans have longer settlement times than most conventional asset classes,<sup>43</sup> open-end loan funds have always been able to meet redemption requests, even during periods of market stress. Indeed, most syndicated loans are quite liquid and may be sold promptly. Accordingly, they are appropriate assets for open-end funds, despite settlement periods that frequently exceed seven days, because open-end loan funds are able to use sources of short-term liquidity that enable them to bridge the short gap between redemption periods and settlement periods. Thus, revising the definition of an illiquid asset to take into account settlement periods is unnecessary and inconsistent with the SEC's long-standing position.

### Three-Day Liquid Asset Minimum

The proposal would require each open-end fund to determine its “three-day liquid asset minimum,” defined as the percentage of the fund’s net assets to be invested in three-day liquid assets, based on a fund’s consideration of the factors it would be required to consider in assessing its liquidity risk. An open-end fund’s board would be required to approve this minimum. Although an open-end fund would not be required to dispose of less liquid assets if it fell below the minimum, it would be precluded from purchasing less liquid assets.

We believe this requirement has several flaws. First, it is not tied to the language of the statute, which requires only that funds make payments to investors within seven days of a redemption request. We recommend that the Commission, if it continues to prescribe a liquid asset

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<sup>42</sup> This definition is consistent with the SEC’s long-standing definition of an illiquid asset. *See* Revisions of Guidelines to Form N-1A, Investment Company Act Release No. 18612 (Mar. 20, 1992).

<sup>43</sup> Although, as discussed above, the LSTA and syndicated loan market participants are actively engaged in many important initiatives designed to materially improve syndicated loan settlement times and transform loan settlement to a more conventional regime.

minimum, do so in a way that is tied to the specific requirements of the Investment Company Act.<sup>44</sup>

Second, we believe that by constraining a fund's actions if it fell below the three-day liquid asset minimum, the requirement could interfere with legitimate portfolio management decisions and reduce investment opportunities, to the detriment of fund investors.

Third, we also are concerned that the three-day liquid asset minimum runs the risk of actually increasing systemic risk, because, in times of market stress, it might lead to "herding" behavior and actually reduce market liquidity. We believe that the ICI's recommendations for an alternative to the three-day liquid asset minimum is a sensible approach and we urge the SEC to adopt that recommendation.

### Classification Factors

The proposal would mandate that a fund take nine factors into account when classifying the liquidity of each portfolio position: (1) existence of an active market for the asset, including whether the asset is listed on an exchange, as well as the number, diversity, and quality of market participants; (2) frequency of trades or quotes for the asset and average daily trading volume of the asset (regardless of whether the asset is a security traded on an exchange); (3) volatility of trading prices for the asset; (4) bid-ask spreads for the asset; (5) whether the asset has a relatively standardized and simple structure; (6) for fixed income securities, maturity and date of issue; (7) restrictions on trading of the asset and limitations on transfer of the asset; (8) the size of the fund's position in the asset relative to the asset's average daily trading volume and, as applicable, the number of units of the asset outstanding; and (9) relationship of the asset to another portfolio asset.

We believe that mandating these factors is a departure from a principles-based approach and may result in unnecessary costs and application of resources. In particular, we note that while these factors are generally well-suited for equity securities, many will not be applicable for other types of instruments, particularly for fixed income instruments that trade in the over-the-counter market, including loans and bonds. The proposal does indicate that these factors would only need to be taken into account to the extent they were applicable. We recommend that the SEC reiterate that approach if it decides to codify the nine factors and acknowledge that funds may decide that many of the factors do not apply to a particular asset or category of assets.

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<sup>44</sup> See Commissioner Michael S. Piowar, Statement at Open Meeting on Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release (Sept. 22, 2015).



## Materially Affecting the Fund's NAV

The proposal in several places refers to the ability of a fund to sell an asset “without materially affecting the fund’s net asset value.”

This terminology does not reflect the reality of most markets in financial instruments. It is often difficult or impossible to determine whether a fund’s sale of an asset has affected the price of that asset, or whether instead other factors, such as general market movements or sales by other investors, have been responsible for any price movement, *even after a transaction in the asset*. It is even more difficult to determine beforehand whether the sale of an asset will affect the valuation of that asset. Accordingly, we believe that the definition should be revised to allow funds to assume a reasonable amount of price movement. The SEC’s traditional definition of liquidity defines an “illiquid security” as “any security that cannot be disposed of within seven days in the ordinary course of business at approximately the amount at which the company has valued the instrument.”<sup>45</sup> We recommend that similar language be incorporated in Rule 22e-4.

### **B. Reporting and Public Disclosure of Liquidity**

Although the LSTA supports requiring reporting the liquidity of portfolio holdings by open-end funds to the SEC, it strongly believes that reporting of the liquidity of portfolio holdings should not be publicly disclosed, for at least three reasons.

First, we do not believe that reporting the liquidity of fund holdings will help investors to understand the liquidity risks in the open-end funds. As noted above, liquidity determinations are inherently subjective, so that different funds may reach different conclusions as to the liquidity of the same instrument, as the SEC acknowledges in its proposal. Moreover, even open-end funds within the same family of investment companies may reach different conclusions due to the facts and circumstances related to each fund. Simply reporting the liquidity of fund portfolio holdings will not capture these nuances and accordingly will not result in meaningful information being provided to open-end fund investors. Instead, the reporting has the potential to cause investor confusion, particularly at times of market stress. Also, because the information being disclosed will be at least 60 days old at the time the public receives it, it will be stale, both because it necessarily will not reflect the current portfolio holdings of a particular open-end fund, and also because liquidity conditions applicable to a particular instrument may have changed.

Second, reporting the liquidity of open-end fund holdings may actually alter fund behavior and cause open-end funds to invest in similar instruments, to avoid appearing to be outliers. Such herding behavior could actually result in increased liquidity risks, if a large number of funds in a particular asset class had similar investments at a time of large-scale redemptions. This concern

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<sup>45</sup> Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities under Rules 144 and 145, Investment Company Act Release No. 17452 (Apr. 23, 1990)

could be addressed by providing public disclosure at a portfolio level, rather than at instrument level.

Third, it is not obvious why public disclosure supports the most important aspect of the SEC's proposal: to require that funds adequately manage their liquidity risks to be able to meet redemptions. Public disclosure of the liquidity of portfolio holdings has nothing to do with how funds manage their liquidity risks.

We emphasize that we have no concerns with the SEC sharing the disclosure of liquidity risk with other regulators. Indeed, we encourage reporting to a system that all the regulators can access. Rather, our concern relates solely to public, nongovernmental disclosure.

If the SEC adopts our approach regarding the proposed categorization of instruments, or a similar approach, our concerns about public disclosure would be greatly reduced.

### **C. Costs of the Proposal**

We agree with the comments of others that the costs of the proposal are very significant and likely far greater than estimated by the SEC. In particular, we believe the instrument by instrument approach to liquidity determinations, the mandate to classify each instrument in one of six liquidity categories, the designation of the specific factors that a fund must consider in making liquidity determinations, and the requirement that funds consider whether it is appropriate to determine the liquidity classifications of its portfolio holdings as frequently as daily or even hourly all will result in the application of significant resources by investment companies and their advisers. We believe these costs could be materially reduced by replacing these specific requirements with a truly top-down, principles-based approach.

We also believe that it is likely that the proposal, if adopted, would create an incentive for open-end funds to needlessly invest in more liquid assets that provide lower returns, to avoid regulatory second-guessing. Accordingly, investors would receive lower investment returns, resulting in an indirect cost of the proposal. It also may encourage "herding" by open-end funds, leading many open-end funds to invest in the same categories of instruments, thereby contributing to systemic risk.

### **III. Conclusion**

For the foregoing reasons, the LSTA respectfully urges the SEC to revise the proposal by adhering to a truly top-down, principles-based approach. To the extent that the SEC imposes prescriptive requirements, we urge the SEC to: (1) allow funds to determine their own liquidity classifications, (2) drop the three-day liquid asset minimum, (3) adopt the definition of 15% standard assets as proposed, (4) make clear that the liquidity classification factors need not apply to instruments that do not have the characteristics listed, (5) revise the language concerning

materially affecting a fund's NAV, and (6) not require public disclosure of liquidity of individual portfolio holdings.

We believe that the alternative suggestions we have made above would greatly reduce the costs of the proposal, while at the same time still accomplishing the SEC's fundamental goal of promoting effective liquidity risk management throughout the open-end fund industry, and reducing the risk that funds will be unable to meet redemption obligations or that fund shareholders will experience dilution of their interests. Furthermore, our suggestions would reduce the herding behavior – and unintended systemic risk – that the original proposal might engender. Importantly, funds would still be required to have written liquidity risk management plans, approved by their boards, and would be required to file reports with the SEC that would enable the SEC and other regulators to assess liquidity risk.

We appreciate the importance of the SEC addressing open-end fund liquidity and appreciate the efforts the SEC has made to create a workable proposal. We appreciate your consideration of our comments and concerns, stand ready to provide any additional information you believe might be useful, and encourage a continuing dialogue between the SEC staff and the LSTA working group.

Please feel free to contact my colleagues Meredith Coffey at [REDACTED] or Elliot Ganz at [REDACTED] if you have any questions regarding our comments.

Sincerely,

A handwritten signature in black ink, appearing to read "R. Bram Smith". The signature is written in a cursive style with a horizontal line extending from the end.

R. Bram Smith  
Executive Director