MFDF

MUTUAL FUND DIRECTORS FORUM

The FORUM *for* FUND INDEPENDENT DIRECTORS

January 13, 2016

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

Re: Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release (File Nos. S7-16-15 and S7-08-15)

Dear Mr. Fields:

The Mutual Fund Directors Forum ("the Forum")[1] welcomes the opportunity to comment on the Commission's recent rule proposals regarding the management of liquidity risk by open-end mutual funds.[2]

The Forum is an independent, non-profit organization for investment company independent directors and is dedicated to improving mutual fund governance by promoting the development of concerned and well-informed independent directors. Through education and other services, the Forum provides its members with opportunities to share ideas, experiences and information concerning critical issues facing investment company independent directors and also serves as an independent vehicle through which Forum members can express their views on matters of concern.

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1 The Forum's current membership includes over 887 independent directors, representing 122 mutual fund groups. Each member group selects a representative to serve on the Forum's Steering Committee. This comment letter has been reviewed by the Steering Committee and approved by the Forum's Board of Directors, although it does not necessarily represent the views of all members in every respect.

2 *See* Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, Release Nos. 33-9922 and IC-31835 (File Nos. S7-16-15 and S7-08-15), 80 Fed. Reg. 62274 (Oct. 15, 2015).

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I. Introduction

We commend the Commission for choosing to address the issue of liquidity risk. Although the issue has been indirectly addressed at various times since the Investment Company Act was adopted, this release represents the Commission's first comprehensive attempt to address a fundamentally important issue for funds. Liquidity serves many purposes at an open-end fund, ranging from the ongoing implementation of the fund's investment strategy to the satisfaction of the expenses the fund incurs in its daily operations. But most importantly, as the Commission recognizes, a fund needs to have adequate liquidity to satisfy its obligation to meet any and all redemption requests it receives while at the same time executing its core investment strategy on behalf of non-redeeming shareholders. On the one hand, a fund that maintains insufficient liquidity may not be able to meet redemption requests in a timely fashion; on the other, a fund that consistently has too much liquidity may reduce its shareholders' returns through underinvestment of its assets. Neither is a satisfactory result.

As we outline below, we broadly support the Commission's proposal to require that funds adopt policies and procedures governing the liquidity risk management process. We also support the role that the Commission assigns to fund boards (and independent directors) in overseeing the management of liquidity risk. However, we have a number of concerns regarding the rigidity of the Commission's approach, including the proposed requirement that funds classify all portfolio securities into one of six liquidity buckets and the limits that the Commission proposes to place on the investment activities of funds that breach their internally-developed three-day minimum liquidity requirements.

II. Liquidity Risk Management Policies and Procedures and the Role of Board Oversight

Given the importance of the redemption obligation, we agree that funds should have a written liquidity risk management plan and associated policies and procedures to guide the management of liquidity risk. In our view, the vast majority of fund complexes seek to manage their liquidity risk and the vast majority of fund boards oversee those efforts, just as they oversee advisers' and other service providers' efforts to mitigate other aspects of operational risk. That said, we recognize that the need to have appropriate policies addressing fund liquidity has only grown as funds have adopted an increasing number of fixed income and other alternative strategies and as markets have grown more complex and, in some cases, themselves become less liquid.

We also agree with the Commission that directors have a fundamental role to play in the oversight of the liquidity of the funds they oversee. A fund's liquidity directly affects its shareholders, and as the representatives of shareholders, it is fully appropriate for directors to be involved in approving fund policies related to liquidity, overseeing the manner in which those policies are implemented and assessing the success of those policies. We thus believe it is appropriate for the fund board to approve the liquidity risk management plan and to both review that plan on an annual basis and approve any material changes to it. Finally, given the complexity inherent in managing liquidity risk, we believe that it is appropriate for a fund to designate a specific individual (or individuals) in fund management to have overall responsibility for the program, and have the designation be subject to board approval.

While we have reservations about the substance of the Commission's approach, discussed more fully below, we believe that the Commission has outlined an appropriate role for directors in overseeing the management of a funds liquidity risk. In our 2010 white paper on directors' role in risk management, we specifically stated that:

> Fund directors are not . . . responsible for designing and implementing the systems and procedures that are used to identify, analyze and track [risk]. Instead, boards typically oversee risk management by reviewing and approving . . . risk management policies and procedures . . . and periodically reviewing the policies and procedures for material departures.[3]

The role that the Commission outlines for directors – a role that describes, for example, the directors "reviewing summaries of the risk management program prepared by the fund's investment adviser or officers administering the program" and its emphasis that directors should be familiar with the "salient features" rather than the details of the program – is broadly consistent with the approach that we outlined, and we thus believe it provides an effective model for board oversight.

In relying on this model, however, we believe that the Commission and others must consistently be mindful of the board's oversight role and not expand the role of directors in a manner that makes them responsible for directly managing risk or that judges the performance of the board or of the risk management program it oversees in hindsight. Neither a risk management program nor effective board oversight of that program can fully eliminate risk; indeed, well-constructed, effective risk management programs are not designed to do so. Rather, risk management policies and procedures are designed to allow risks to be accurately identified and appropriately mitigated, given the information available. Yet even the best constructed risk management program may fail to accurately forecast how markets or individual securities will react in all circumstances. As a result, boards and risk management programs should not be judged as failures in hindsight merely because a fund, particularly a fund operating in stressed circumstances, ultimately faces liquidity difficulties.

III. The Commission's Approach to Liquidity Risk Management

From the perspective of our members, the nature of board oversight of liquidity risk management is the most important part of the release. We do, however, have concerns about the substance of the Commission's proposal which we outline below. We have no fundamental objection to the Commission's attempts both to require funds to address liquidity risk management and to lay out appropriate principles to govern those efforts in a written liquidity

3 *See* Mutual Fund Directors Forum, *Risk Principles for Fund Directors: Practical Guidance for Fund Directors on Effective Risk Management Oversight* at 4 (Apr. 2010) (available at http://mfdf.org/images/Newsroom/Risk_Publication_Electronic.pdf).

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risk management plan. However, the proposal put forth by the Commission is unduly rigid, expensive and prescriptive – and seemingly driven by a concern that too many funds have not adopted a sufficiently rigorous approach to liquidity risk management. Even if that latter concern is accurate, we fail to see how the Commission's proposal truly addresses it.

The Commission identifies three key policy goals as underlying its proposal: promoting effective liquidity risk management; reducing the risk that funds will not be able to meet redemption requests within the relevant statutorily required period; and mitigating the dilution experienced by remaining shareholders when a fund receives large redemption requests, particularly in stressed environments.

We generally agree that these are appropriate policy goals.[4] The Commission seeks to achieve these goals by requiring that funds classify the securities in their portfolios based on how liquid they are, by further requiring that funds adopt a fund-specific minimum percentage of portfolio securities that can easily be converted to cash within three days and by limiting the ability of funds to make investments in less liquid securities when their portfolio does not meet the three-day minimum liquidity standard. For the following the reasons, we believe that the Commission's proposed approach is not an effective way of achieving its goals.

A. *Classification of Portfolio Securities*

While many of the goals that underlie the proposed requirement that funds classify all portfolio securities into one of six specific liquidity buckets are appropriate, we nonetheless believe that the proposal is unnecessarily rigid and prescriptive. For example, we agree that liquidity is not binary (i.e., that a particular security is either liquid or illiquid depending upon whether it can be converted into cash within seven days). We likewise agree that it makes sense for funds to understand which portfolio securities can be converted to cash quickly (within the three-day redemption period or even a shorter period if a fund has committed to meet redemption requests more quickly than the law otherwise requires), which securities can be converted to cash relatively quickly to support a second layer of liquidity, which securities are relatively less liquid and which securities are effectively illiquid.

In many cases, as a result of the legal requirements regarding when redemption requests must be met, funds will want to assess the percentage of the portfolio that can be easily liquidated within three or seven days. The Commission's approach, however, is much more specific. It is simply not clear why this rigid and highly granular classification-based approach is the best or most effective way to achieve the Commission's goals. While classifying portfolio securities in the manner proposed by the Commission would provide boards, portfolio managers and other management personnel with additional data about a fund's portfolio, it is unclear why requiring data to be generated in this form is the only means of addressing the liquidity risks that funds face.

[4] We do caution, however, that the regulatory structure should not seek to eliminate the possibility of dilution at all costs. As a mutual structure, part of the construct is that shareholders are bound to experience dilution as one of the costs associated with the benefit of mutualization.

In general, the type and amount of liquidity that a fund should have in its portfolio depends on a number of factors, each of which tends to be unique to the fund in question. For example, factors may include the particular investment strategy employed by the fund, the manner in which portfolio securities are likely to perform in both normal and stressed circumstances, the types of investors who own shares in the fund and the level of redemptions that the fund reasonably anticipates under both normal and stressed circumstances. Parallel to this, there are likely numerous ways that a fund can measure the overall liquidity of its portfolio and match that liquidity with the liquidity it anticipates it would need under a variety of market scenarios.

Hence, the Commission notably fails to demonstrate that its proposed requirement that all portfolio securities be placed in one of six liquidity buckets will achieve its goals in a particularly effective or efficient manner.[5] Moreover, the approach poses a number of problems. In particular, because the rigid classification of portfolio securities into six buckets will be time-consuming and potentially complex, the approach is also likely to be expensive, particularly for smaller and midsize fund complexes.[6] This expense does not necessarily produce corresponding benefits for funds and their investors.

Rather, in order to deal with the complexity and expense inherent in the classification approach, many fund complexes will likely retain third party vendors to make liquidity determinations on a security-by-security basis. This will have a number of likely effects. Because many funds will rely on the liquidity determinations of a single (or small number) of third-party providers, any errors or misjudgments made by the provider will cascade throughout the industry, thereby exacerbating the impact of incorrect determinations.

More broadly, by so rigidly defining how funds should approach liquidity risk, the Commission's regulation will tend both to homogenize how funds throughout the industry manage liquidity risk and to stifle the development of different and potentially more effective approaches to managing liquidity risk.

At the end of the day, the only benefit exclusively offered by the classification approach is that similar data from all fund groups will be provided to the Commission. Even here, however, we are unclear why the Commission needs this much precise data on how funds

[5] The Commission also proposes a number of factors that funds would be required to consider in determining into which liquidity bucket each portfolio security should be classified. While we agree that the factors identified by the Commission are generally appropriate, we are again concerned by the inflexibility of the proposed approach. For example, as markets continue to evolve, different factors may take on a greater or lesser importance. Rulemaking processes, which would be required to change the list of factors, would likely not be able to respond quickly and flexibly to the ever-evolving securities markets. We therefore encourage the Commission to list these factors as potentially relevant considerations rather than as mandatory. If the Commission does not do so, we encourage it to at least continue to be clear that a fund can determine that a particular factor is not relevant to determining the liquidity of a particular security or particular type of security.

[6] Further, in a volatile market, the liquidity (particularly when measured in terms of days necessary to liquidate) of a particular security or type of security may change on a frequent basis, thus raising the complexity and expense of this approach while at the same time reducing its effectiveness.

classify their securities and what benefits this data will provide. Under the recently proposed N-PORT rules,[7] the Commission will have detailed and relatively current information on the securities in all funds' portfolios. The Commission should be able to analyze this data in numerous ways, including assessing the portfolio liquidity of single funds, of a specific class of funds or of the industry as a whole. In light of the risks and costs that would be imposed on the industry and ultimately on fund shareholders, we see little reason to require funds to make this determination individually and report it to the Commission on a regular basis.

We believe that a requirement that focused on encouraging funds to classify their portfolio securities into fewer baskets or that required funds to generally rank all portfolio securities across a broad spectrum of liquidity would more effectively accomplish the Commission's goals. In addition, a more principles-oriented approach would be less expensive, would permit different funds to approach the question of liquidity risk management in a more nuanced manner more suitable to their individual circumstances and would avoid many of the risks inherent in forcing the entire industry to address the liquidity of individual portfolio securities in a uniform manner.

B. *The Three-Day Minimum Liquidity Requirement*

The Commission also proposes that every fund determine what portion of its assets should be kept in securities that can be easily liquidated within a three-day period. The Commission identifies a number of factors that funds would need to consider in connection with this determination, but most simply, the requirement is designed to ensure that all funds have adequate liquidity to meet reasonably expected redemption requests in both normal and stressed circumstances without unduly diluting shareholders who remain in the fund. Importantly, the Commission pairs this determination with a requirement that a fund not in compliance with its own three-day liquidity requirement not buy securities that it believes could not be liquidated in three days or less.

Given current redemption practices in the industry, we agree with the Commission that funds should assess how much liquidity they may need, both in normal and stressed market conditions, over a three-day period to effectively meet anticipated redemption requests. Policies and procedures governing liquidity risk management should generally include provisions addressing how short term liquidity needs are assessed and how sufficient liquidity is maintained in the portfolio.

That said, we do not believe that the Commission should bar funds from making investments in securities that would take longer than three days to reduce to cash at any time that the three-day minimum liquidity requirement is breached. In some cases, that will be the appropriate action for a fund experiencing redemptions and a loss of liquidity to take. In other instances, however, the cause of such a breach may be related to transient market conditions that

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7 We note that the N-PORT rules, as originally proposed, do produce significant benefits, and hence we supported and continue to support adoption of these rules. *See* Letter from David B. Smith Jr., General Counsel, Mutual Fund Directors Forum to Brent J. Fields, Secretary, United States Securities and Exchange Commission (Aug. 11, 2015).

have affected the liquidity of existing portfolio securities, the result of a single large redemption that is unlikely to be repeated or for other fund-specific reasons.

While we agree that a fund should focus on regaining an appropriate degree of portfolio liquidity, investing solely in short term securities may not be the best answer. In many cases, making short term investments, particularly short term investments that are designed solely to maintain liquidity rather than to be consistent with the fund's broader investment strategy, is unnecessary and may harm longer term shareholders who have an interest in the fund's continuing to invest consistently with its stated investment policy. While it is important that all funds maintain appropriate liquidity, we are also concerned that a requirement of this form is an unwarranted intrusion by the Commission into the day-to-day process of portfolio management. We therefore encourage the Commission to adopt an approach that is more principles-based that would instead require a fund to have a reasonable plan to reestablish an appropriate degree of portfolio liquidity within a reasonable time period rather than requiring a fund to make specific investments.

C. *Conclusions Regarding Liquidity Risk Management*

The Commission's reason for proposing this regulation appears to be that some funds and fund complexes are not adopting a sufficiently serious or rigorous approach to liquidity risk management. While that may be true, we fail to understand how the rigid, prescriptive and expensive approach that the Commission proposes effectively addresses this concern. If the Commission's goal is to ensure that all funds manage liquidity risk in a rigorous manner, while at the same time ensuring that funds have sufficient flexibility to adopt liquidity risk management programs that are well-designed for their specific situations, it would be preferable to adopt a more principles-based approach. We believe that the Commission can ensure sufficient rigor by requiring the adoption of policies and procedures and subjecting those policies and procedures to board oversight without specifying in such detail what the product of those policies and procedures should be.

IV. **Swing Pricing**

Separate from its proposals regarding liquidity risk management, the Commission proposes to give funds the ability to engage in swing pricing as a means of protecting longer-term shareholders from the dilution and trading costs that can result from large, single-day redemption activity or large, single-day purchase activity. As proposed, swing pricing would be a tool that funds would be permitted, but not required, to use.

In general, because the Commission is proposing swing pricing as an option, not as a requirement, we do not object to it in principle. However, because swing pricing raises both significant philosophical questions and difficult operational issues, we encourage the Commission to re-propose and consider the question separate from its broad-based attempts to address liquidity risk management.

Most fundamentally, the pricing of fund shares at net asset value is an almost-sacred principle under the Investment Company Act. Among other things, since 1940, retail investors have come to expect that they will always transact with an open-end fund at NAV. When retail shareholders transact with open-end funds in a different manner, the Commission has been careful to require that the funds employ a different name, as with money market funds or exchange-traded funds, so as not to confuse investors. This proposal would represent a significant break with that principle, and one that may be difficult for retail investors to understand, given that it will impact transaction prices sporadically. Additionally, prior to adopting a swing pricing proposal, we believe that the SEC should fully address whether it is fair to subject all investors transacting with a fund on a specific day to the costs imposed on the fund by a few investors engaging in large transactions with the fund. It is not clear whether this approach is in the best interests of smaller shareholders who unlikely to ever engage in transactions of a significant size with the fund. Overall, we believe that these issues deserve more careful and separate consideration prior to adoption of the proposal.

We also note that swing pricing will raise complex operational issues. For example, given the prominence of intermediaries in the U.S. fund industry, it is not clear that swing pricing can be implemented in the same manner as in other jurisdictions. There are likely other operational issues that should be considered before determining that swing pricing is a practical way of addressing potential investor dilution at times of heavy purchases or heavy redemptions. Again, we believe that the industry and the investing public would be better served by a separate consideration of these issues.

Finally, from our perspective, as is the case with its liquidity risk management proposals, the role that the Commission assigns to fund boards in authorizing and then overseeing swing pricing appears, at the broadest level, to be appropriate and consistent with the traditional role of fund directors. However the Commission proceeds, we again encourage the Commission to assign directors a role that is consistent with their using their business judgment to oversee funds on behalf of the fund's investors and be careful not to give directors and boards operational-type responsibilities.

V. **Conclusion**

In sum, we agree with the Commission that liquidity risk management is a fundamentally important issue for funds – particularly the ability of a fund to meet shareholder redemption requests while at the same time pursuing the fund's investment strategy for the remaining shareholders. While we generally support the role for directors that the Commission has outlined in the release, we have significant concerns with the prescriptive nature of the remainder of the proposal. We are unconvinced that the Commission's proposed approach will achieve the goals in ensuring that funds maintain adequate liquidity risk management programs. Additionally, given the fundamental expectation that shareholders transact with open-end funds at NAV, we encourage the Commission to consider the swing pricing proposal as a separate rulemaking.

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Again, we commend the Commission for undertaking to address this difficult but important concept. We would welcome the opportunity to further discuss our comments with you. Please feel free to contact Susan Wyderko, the Forum's President, at [redacted] or me at [redacted] at any time.

Sincerely,

David B. Smith, Jr.
General Counsel