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Submitted Electronically

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

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

Dear Mr. Fields:

I. Introduction

On behalf of Wells Fargo & Company and its subsidiaries, Wells Fargo Funds Management, LLC appreciates the opportunity to comment on the proposed rule and amendments designed to promote effective liquidity risk management throughout the open-end fund industry and permit the use of swing pricing (the "Proposal") issued by the Securities and Exchange Commission (the "Commission") on September 22, 2015.[1]

Subsidiaries of Wells Fargo & Company manage and distribute the *Wells Fargo Funds®*. As of December 31, 2015, the *Wells Fargo Funds* had a total of approximately $235 billion in assets under management in our managed open-end funds, making Wells Fargo the 14th largest U.S. mutual fund provider in the industry. Our fund family offers a diverse set of funds across multiple distribution platforms that include retail and institutional investors.

A shareholder's right to daily redemptions is a critical attribute of mutual funds. Funds must stand ready to satisfy their daily redemption obligations to shareholders by maintaining sufficient portfolio liquidity for that purpose. A confluence of new market conditions may be reducing the liquidity of certain types of fixed-income securities, as underscored by a recent liquidation of a mutual fund with unusually significant exposure to a highly volatile segment of

[1] *See* 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; (September 22, 2015) [80 FR 62273 (October 15, 2015)] (the "Release").

the distressed debt market. However, considering the unusual liquidity risk profile of that fund and the industry's long history of consistently delivering on redemption requests, this event should not be misinterpreted as representative of management of liquidity risk in the mutual fund industry as a whole, nor should it provide a predicate for regulation that is out of proportion with such risk. Rather, we believe that new regulation to be broadly applied to mutual funds should be tailored to common levels of liquidity risk and that the demonstrable benefits of such regulation should outweigh the additional costs and complexity created by it.

We applaud the goals of the Commission's Proposal and support those aspects of the Proposal that are reasonably designed to achieve demonstrable benefits for shareholders. As discussed below, we are pleased to offer our comments on certain aspects of the Proposal that, in our view, warrant further refinement or reconsideration.

II. Discussion

a. Liquidity Risk Management Programs

We support the baseline requirement of proposed new rule 22e-4 under the Investment Company Act of 1940 (the "1940 Act") that open-end funds establish a written liquidity risk management program that would be approved and overseen by a fund's board of directors. The approach of requiring a risk management program accounts for the diversity of funds in the industry and largely avoids the pitfalls and deficiencies of a "one-size-fits-all" alternative. However,e discuss below the drawbacks of two aspects of prescribed program elements that we believe ultimately will undermine, rather than strengthen, the effectiveness of a fund's management of liquidity risk.

i. The excessively granular design of the proposed six-category classification and related reporting proposal is fundamentally at odds with the imprecise nature of liquidity judgements and estimates.

The Proposal would require each fund, as an element of its liquidity risk management program, to classify positions in a portfolio asset (or portions of a position in a particular asset) into one of six standardized liquidity categories, and report such determinations on proposed Form N-PORT.[2]

We support the goal of the Proposal to incorporate ongoing liquidity assessments as part of a fund's broader liquidity risk management program. We disagree, however, that the six-category classification framework and related reporting to the Commission significantly reduces the risk that funds will fail to satisfy redemption obligations or provides meaningful information to shareholders. The proposal to classify individual holdings (and even portions of individual

[2] *See* proposed rule 22e-4(b)(2)(i) and proposed Item C.13 of proposed Form N-PORT.

holdings) into six specified categories would require funds to perform an undertaking that does not comport with the uncertainties and imprecision inherent in the liquidity assessment process and the impacts of ever shifting market conditions. In this regard, liquidity is not a constant in any market, as the "bottom up" six-category classification scheme appears to implicitly assume. In our experience, narrow bid-ask spreads, high volume, and other indicators of liquidity can evaporate quickly.

In multiple instances, the Release directly and indirectly acknowledges that the liquidity classifications contemplated by the Proposal would constitute mere estimates and judgements. For example, in the Release, the Commission recognizes "that liquidity classifications inherently involve some level of judgment by the fund and estimation as market conditions can change."[3] Elsewhere, in discussing the rationale for a switch to a calendar day framework for certain proposed liquidity categories, the Commission notes that "the longer the timeframe is to convert the asset to cash, the more we recognize the timeframe is likely to be a less precise estimate and thus the additional precision from the business day categorization is less likely to be material to the classification."[4] Furthermore, in discussing why the Proposal does not specify that certain asset classes fall within assigned liquidity categories, the Release explains that "an approach involving Commission-imposed liquidity classifications would likely result in certain assets' liquidity being overestimated and others' liquidity being underestimated..."[5] Although not forming part of the Release, we believe the public statement of Commissioner Aguilar accompanying the Release aptly captures one of the key challenges underlying the design of the Proposal: "Needless to say, liquidity risk management is not an exact science."[6]

Despite this recognition, the level of precision implicit in the proposed six category framework belies the subjective and qualitative nature of liquidity assessments. And without acknowledging the significant degree of imprecision and uncertainty in forming liquidity estimates based on judgements, the Proposal has the effect of creating a picture of liquidity assessment that simply does not align with market dynamics—an impression that can also lead to unintended and undesirable consequences. For example, the "Peltzman Effect" or "risk compensation" is a studied phenomenon whereby a safety mechanism can lead to riskier activity, offsetting the safety mechanism. In a similar vein, fund shareholders may assign less weight to liquidity risks inherent in certain asset classes if they conclude that detailed liquidity categorizations of portfolio holdings effectively reduce or eliminate liquidity risks, leading to investments in funds with liquidity profiles that are risker than actually anticipated. All the while, the degree of precision underlying the Proposal's classification scheme—both with respect to individual investment determinations and the undue number of liquidity categories—is

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[3] Release at 260.

[4] *Id.*, footnote 188 at 72.

[5] *Id.* at 68.

[6] "The Importance of Being Earnest About Liquidity Risk Management" (Sept. 2015) available at http://www.sec.gov/news/statement/aguilar-liquidity-risk-management.html#_edn1.

not, in our view, a necessary condition to effectively ensuring a fund can meet its redemption obligations.

The exercise of classifying liquidity of individual investments in a manner not materially affecting a fund's net asset value is inherently difficult and imprecise due to, among other reasons, the unpredictable impacts of myriad interrelated market factors on an investment's liquidity. The challenges of such an exercise become particularly pronounced when seeking to forecast liquidity determinations based on hypothetical rather than actual market activity and on each individual holding of every fund (and even portions of each holding) as the Proposal would require. For example, while a lack of market activity in an individual security could mean it is relatively illiquid, it could also mean that the security is one of many issued by a large issuer and that market trading tends to occur in a different, perhaps larger and more recent issue by that issuer. In the latter case, the availability of the liquid, closely-related substitute means that a desire to sell the less-traded issue is easily accommodated in the market. More generally, the amount of a particular issue that can be sold easily and quickly may differ substantially in different market environments and may also depend on how many similar-type securities one is trying to sell or buy at a particular time. The interconnectedness of factors affecting liquidity is illustrated by impacts generated from orders without actual sales. A published study on the market impacts of limit orders provides evidence that every security order has an effect of some magnitude, even if it simply enters the limit order book without being executed. The order sends a signal to some investor about supply and demand conditions.[7]

Because the impacts and interconnectedness of market conditions on liquidity are not known in advance and highly difficult or even impossible to predict with certainty, classifications at the level of precision contemplated by the Proposal would require an increasingly greater number of assumptions. A fund, for example, would need to assume what other firms will do in the same circumstances. There would need to be assumptions made about the existence and degree of synchronized selling across funds—in a scenario of synchronized selling, even a small liquidation could have an outsized impact on price, while non-synchronized selling means a large liquidation could easily be absorbed by the market. Yet, as more liquidity factors are assumed, the less meaningful the classifications become to liquidity risk mitigation. This becomes increasingly pronounced for investments that may be deemed illiquid or less liquid.

By imposing an unduly complex standardized classification and reporting scheme, the Proposal may have the unintended consequence of contributing to broader risks to the markets, financial system, and funds and their shareholders. The Release projects that many funds under the prescribed six-category scheme will utilize third party service providers (at significant aggregate cost) to satisfy their liquidity categorization obligations under a final regulation. We

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7 *See* Hautsch N. and Huang R., *The Market Impact of a Limit Order*, Journal of Economic Dynamics and Control (April 2012), demonstrating how limit orders that are not executed can impact market prices.

are concerned that the widespread use of external service providers in order to comply with an unnecessarily granular taxonomy under the Proposal may lead to an increase in systemic risk as the judgements of a relatively small number of service providers provide an outsized influence on the management of liquidity risk among mutual funds. Such a trend may bear certain resemblances to broad reliance on nationally recognized statistical rating organizations, which contributed to serious systemic risk issues in the last financial crisis. To the extent that funds are allowed to reasonably determine their own manner of liquidity assessment without prescribed categories, we believe there would be less reliance on external service providers and a concomitant reduction in associated systemic risk.

We believe it would be more reasonable to account for these challenges by permitting funds to determine their own manner of liquidity assessment, without prescribed categories, as an aspect of their liquidity risk management programs. As the Release indicates, many funds currently engage in this type of undertaking. If, however, the Commission determines to require funds to follow a standardized classification and reporting scheme, the categories should be reduced from six to three shown below.

- Assets that can be converted to cash in the ordinary course of business within three business days at approximately the value ascribed to such assets by the fund;
- Assets that can be converted to cash in the ordinary course of business between four and seven business days at approximately the value ascribed to such assets by the fund; and
- All other assets.

Because the Release indicates that a fund is not required to assess position size in determining whether a particular portfolio asset is a 15% standard asset, we expect that many funds in certain asset classes will hold a portion of assets in the "all other assets" category that exceeds (perhaps by a significant margin) 15% of a fund's net assets and concurrently hold 15% standard assets at a level that is below 15%.

In addition, for the reasons discussed above, fund liquidity assessments should be allowed to be made by investment type and investment characteristics in a "top down" manner rather than at the individual investment and lot level. Funds can more efficiently and effectively make a broad assessment of portfolio liquidity based on certain shared characteristics and attributes common to a type of investment. For example, among investment-grade corporate credits it would often be reasonable to make distinctions among larger and smaller issues, larger and smaller issuers, and recent and highly seasoned issues. Insofar as the ability to sell one position may depend on whether one is trying to sell just one position or many such positions, a "top down" approach allows a fund to make a judgment on the potential importance of such interaction effects. Moreover, there is a demonstrable degree of substitutability between different specific securities, especially in the fixed income markets. In this regard, while a specific security might not show trading activity, a comparable substitute might. We understand this to mean that returns in the fixed income market are more highly correlated than in the equity market due to the impact of a smaller number of factors (level, curve, slope, credit), and that accordingly, bonds with similar characteristics are presumed to trade at similar prices.[8]

For the reasons discussed above, the proposal to require determinations of liquidity at the individual investment- and lot-level assumes an almost scientific degree of precision that simply does not align with the complexities and uncertainties associated with these judgements and estimates. A less rigid top-down approach will help avoid an unhelpful semblance of scientific precision that funds would be expected to perform in making good faith liquidity assessments. The alternative to categorize liquidity by investment type and investment characteristics is designed to ensure that funds proactively maintain an adequate base of investments to serve as liquidity sources from which shareholder redemptions can be satisfied without undue impact on a fund's net asset value or the flexibility of its investment strategy.

ii. Funds should employ a three-day liquid asset target rather than manage to a "hard" investment policy minimum.

The Proposal would require each fund to determine a minimum percentage of the fund's net assets to be invested in three-day liquid assets based on consideration of specified factors.[9] A fund's board would be required to approve the fund's three-day liquid asset minimum and any changes to such minimum.

We support a requirement for funds to periodically assess the appropriate amount of investments with greater liquidity, such as three-day liquid assets, that a fund should maintain to effectively manage liquidity risk. Liquidity risk management programs that incorporate specific assessments of appropriate levels of investments with greater liquidity will, in our view, provide more robust protection to fund shareholders and better align the programs of broker-sold funds to the redemption requirements of rule 15c6-1 of the Securities Exchange Act of 1934, while still allowing for the effective deployment of a fund's investment strategy. However, for the reasons discussed below, we believe that the Proposal for a three-day liquid asset minimum should be instead formulated as a target rather than absolute minimum level for holdings in three-day liquid assets. The appropriate target level of three-day liquid assets would be based on an ongoing assessment of the fund's total liquidity risk profile as a required component of a fund's liquidity risk management program.

In a world where portfolio managers are balancing potential returns and potential risks—of which liquidity risk is one of many—we agree that holding unusually high or low levels of highly liquid assets (relative to fund norms) should trigger conversations among fund liquidity risk officers, portfolio managers, chief investment officers and investment risk personnel. For example, higher-than-normal holdings of highly liquid assets may well be appropriate to serve

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8 *See* Litterman, R. and Scheinkman, J., *Common Factors Affecting Bond Returns*, Journal of Fixed Income (June 1991).

9 *See* Proposed rule 22e-4(b)(2)(iv).

shareholder interests in times of low investment opportunities, elevated levels of shareholder purchase or redemption activity, or heighted market stress, despite the potential drag on returns. Similarly, lower-than-normal holdings of low yielding but highly liquid assets may be justified in a time of unusually attractive investment values, relative ease in selling assets, and significant anticipated inflows.

By contrast, the "hard" investment policy minimum that the Commission proposes can lead to unintended results. If the investment policy minimum is set to levels where lower-than-normal highly liquid holdings are appropriate (i.e., periods where market liquidity is high), compliance with the policy would not address the need for higher levels of such holdings in more difficult environments. If instead the minimum is set to levels consistent with periods of severe market stress, then the fund would be chronically overinvested in low-yielding but highly liquid assets. Additionally, the appropriate minimum holdings of three-day liquid assets can depend on the level of other assets in the fund that are highly liquid but not included in the three-day liquid asset bucket. Finally, we are concerned that the proposed external reporting of such holding levels compared to hard fund minimums[10] could produce unintended consequences, such as triggering an increase in outflows at a time when managers are seeking to rebuild liquidity (even considering the proposed 60-day lag in disclosure).

There are, in our judgement, other potential detriments to funds and their shareholders associated with formulating the proposed requirement as a hard investment policy. A three-day liquid asset minimum may compel funds to sell securities solely because they are not three-day liquid assets and/or to buy securities solely because they are three-day liquid assets, rather than due to their fundamental investment value or other investment considerations. Forced sales in stressed market conditions can be harmful to fund shareholders and would be less likely to occur with the flexible alternative of a target level. On a macro scale, asset sales triggered by a hard three-day liquid asset minimum can create pro-cyclical liquidity and illiquidity in the markets, leading to more frequent and more severe so-called "fire sales."

In addition, to the extent that it leads to even greater reductions in liquidity for securities than the alternative approach of a target, a hard three-day liquid asset minimum could also detrimentally affect the functioning of the markets. For example, securities that are perceived to be less liquid could face exacerbated illiquidity during times of stress. Potential investors will likely demand a higher-than-normal illiquidity premium to acquire these securities, impairing the ability of issuers of such securities to raise capital.

As part of the Proposal, the liquidity risk management program will provide for ongoing monitoring and risk oversight by the designated risk officer as well as reporting to a fund's board of directors. With such oversight and the use of appropriate targets, the three-day liquid asset minimum is not a necessary condition to effective liquidity management, much in the way that hard limits on each and every investment risk metric are not preconditions to effective

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[10] *See* Item B.7 to Part B of proposed Form N-PORT.

investment risk management. A fund's optimal portion of holdings in three-day liquid assets will be more effectively deployed as a target level established by funds with flexibility to account for the totality of investment risks and changing market conditions.

b. Swing Pricing

The Commission has proposed to permit a registered investment company[11] to establish policies and procedures providing for adjustment to its current net asset value ("NAV") to mitigate dilution of the value of its outstanding shares as a result of shareholder purchase and redemption activity ("swing pricing"). For a fund that implements swing pricing, these policies and procedures must provide that the fund will adjust its NAV by an amount designated as the "swing factor" once the level of net purchases into or net redemptions from the fund has exceeded a specified percentage of the fund's NAV known as the "swing threshold." According to the Commission, "a fund's swing threshold should generally reflect the estimated point at which net purchases or net redemptions would trigger the fund's investment adviser to trade portfolio assets in the near term, to a degree or of a type that may generate material liquidity or transaction costs for the fund."[12] A fund's board would be required to approve a swing threshold in advance. The swing factor, which would be determined and applied on any day that the swing threshold is breached, is the "amount, expressed as a percentage of the fund's NAV, that takes into account any near-term costs expected to be incurred by the fund as a result of net purchases or net redemptions that occur on the day the swing factor is used to adjust the fund's NAV."[13] Fund policies and procedures would be required to specify how the swing factor will be determined. Assessing whether a fund's swing threshold has been breached and determining the swing factor to apply to the NAV on any given day would require analysis of that day's purchase and redemption activity.

We agree with the Commission's purposes in proposing swing pricing, which include ameliorating the potential dilutive effects of significant net purchase and redemption activity on shareholders remaining in a fund. However, as described in greater detail below, we have significant concerns about the operational feasibility of swing pricing in the U.S. In particular, U.S. mutual funds have developed long-standing pricing practices to accommodate trading by financial intermediaries and their customers, and we believe that these practices would make swing pricing difficult to implement in the U.S. and prone to misapplication. In fact, implementing swing pricing with appropriate precision may require substantial changes to mutual fund pricing practices, with significant negative effects for shareholders, intermediaries, and funds. We believe that the Commission should further consider and account for these potential effects.

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[11] The Proposal would not apply to money market funds or exchange-traded funds ("ETFs").

[12] Release at 213.

[13] *Id.* at 220-221.

The operational challenges of implementing swing pricing in the U.S. result from the central role that financial intermediaries play in distribution of U.S. mutual fund shares and long-standing operational practices adopted by funds to accommodate financial intermediaries and their customers. A substantial proportion of U.S. mutual fund assets are beneficially held by customers of financial intermediaries through omnibus accounts, and U.S. mutual fund advisers typically lack transparency regarding the purchase and redemption activity of these customers during the trading day. It is only after the trading day has ended, and a fund's NAV has been calculated, that an adviser receives a significant portion of data concerning purchases and redemptions through omnibus accounts—and this is due to the fact that financial intermediary customers may submit purchase and redemption orders to financial intermediaries up until a fund closes. Retirement plans, which hold a significant portion of U.S. mutual fund assets, present a particularly difficult challenge for implementation of swing pricing. These plans often do not process participant transactions until well after a fund closes, and often only submit an aggregate purchase or redemption order on the following morning.

Given the lack of transparency for U.S. mutual fund advisers regarding financial intermediary customer trading activity, we believe that funds that implement swing pricing will be required either to (a) make swing pricing decisions based on incomplete and potentially unreliable information concerning net purchases or redemptions, or (b) change pricing practices in a manner that would negatively affect financial intermediaries and their customers. With regard to the first of these potential consequences, the Commission has recognized that in determining whether the swing threshold has been breached and calculating the swing factor to be imposed, fund advisers will lack complete information about net purchases and redemptions.[14] Given that fact, the Commission has stated that fund advisers may make swing pricing decisions based on "reasonable inquiry."[15] We question what form that reasonable inquiry would take. Currently, financial intermediaries themselves often do not process purchases and redemptions—and therefore could not provide reliable data concerning both—until well after a fund closes and the NAV is struck.

Ultimately, without substantial changes to pricing practices, fund advisers will have to make critical decisions about swing pricing without reliable information about net flows for a large portion of fund assets. This can have significant unintended consequences, including (a) unnecessary imposition of a swing factor on purchasing and redeeming shareholders, to their detriment; (b) imposition of a swing factor in the wrong direction (*i.e.*, increasing the NAV when in fact final flow data shows net redemptions, or decreasing the NAV when final flow data shows net purchases) to the detriment of remaining shareholders; or (c) imposition of a swing

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[14] *See* Release at 193 ("Because the deadline by which a fund must strike its NAV may precede the time that a fund receives final information concerning daily net flows from the fund's transfer agent or principal underwriter, we believe it is appropriate to permit the person responsible for administering swing pricing policies and procedures to determine whether net purchases have exceeded the fund's swing threshold on the basis of information obtained after reasonable inquiry.").

[15] *See id.*

factor that is out of proportion to the fund's actual net purchases and redemptions to the detriment of purchasing or redeeming shareholders. While the Commission discussed and considered some of the potential negative shareholder effects of swing pricing like additional NAV volatility and benchmark tracking error in the Proposing Release, we believe that the Commission should further consider and more specifically address the potential for misapplied swing pricing due to the manner in which U.S. mutual funds operate and price. We are concerned that misapplied swing pricing may produce unfair results for certain shareholders, and at the same time are concerned that any need to correct numerous NAV errors due to misapplied swing pricing may result in significant new costs and inefficiency for shareholders, funds, and intermediaries.

Rather than rely on incomplete and faulty information to make swing pricing decisions, funds adopting swing pricing may discontinue allowing intermediaries to submit trades after the funds close. Indeed, European undertakings for collective investments in transferable securities ("UCITS") commonly require financial intermediaries to submit trades to the transfer agent prior to fund closure in order to receive that day's NAV. However, U.S. mutual funds' practice of allowing financial intermediaries to submit trades after fund closure has provided financial intermediaries, and more importantly, their customers, with flexibility and convenience on which they have come to rely and around which shareholder transaction systems have been developed. Specifically, it allows intermediary customers to submit trades at any time during the trading day at that day's NAV. It also provides intermediaries with more time to process customer transactions. Abandoning the practice will remove the convenience for customers and require intermediaries to make substantial changes to systems and the manner in which they process customer transactions. These represent significant potential costs of regulation, and the Commission should weigh them against the benefits of swing pricing.

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We appreciate the opportunity to comment on the Proposal. The effective management of liquidity risk is an increasingly critical undertaking for shareholders and one that presents many complex challenges for funds and their service providers. Permitting funds to determine their own manner of liquidity assessment without prescribed categories and in a top-down manner should enable funds to engage in liquidity assessments that are more effective in managing risk and more meaningfully aligned with the flux of market dynamics and the nature of good faith liquidity judgements. In addition, a target rather than minimum level of holdings in three-day liquid assets should facilitate more effective deployment of a fund's investment strategy operating within the framework of ongoing liquidity risk monitoring and oversight.

We support the Commission's purposes in proposing swing pricing, including reducing the dilutive effects of significant purchase and redemption activity on remaining shareholders. However, we believe that the Commission should consider carefully the potential operational challenges of implementing swing pricing in the U.S. and the potential costs for shareholders, fund sponsors, and financial intermediaries associated with these operational challenges.

Very truly yours,

/s/ Paul J. Haast
Paul J. Haast
Head of Product and Investments
Wells Fargo Funds Management, LLC