BETTER
MARKETS

January 13, 2015

Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release; Proposed Rule (File No. S7-19-15).

Dear Secretary Fields:

Better Markets[1] appreciates the opportunity to comment on the above-captioned proposed rule ("Proposal") issued by the Securities and Exchange Commission ("Commission").[2]

In sum, the Proposal is too focused on merely requiring "factor-based" analyses, coupled with disclosure obligations, in lieu of establishing meaningful and mandatory liquidity risk management practices. For example, the liquidity risk management program provisions rely too heavily on disclosure obligations to incentivize funds to implement strong liquidity risk management protocols. And the key new feature of the liquidity risk management program, the three-day liquid asset minimum, has great conceptual potential but must be strengthened before it can be effective.

Ultimately, the Proposal's factor-based determination approach renders it vulnerable to gaming, evasion, and ineffectiveness. And, at minimum, the Proposal should prescribe definite intervals of time over which liquidity classification assessments and overall liquidity risk reviews must occur, as it does for liquidity risk management measures.

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1 Better Markets, Inc. is a nonprofit organization that promotes the public interest in the domestic and global capital and commodity markets. It advocates for transparency, oversight, and accountability in the financial markets.

2 *See* Release No. 33-9922, 80 Fed. Reg. 62274 (Oct. 5, 2015).

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BACKGROUND

Mutual funds have experienced extraordinary growth in just the last two decades. Today, over 45 million Americans rely on open-end funds as an investment vehicle. Mutual funds now hold nearly $16 trillion in individual and institutional investment funds.[3]

Mutual funds are important in another sense. They played a critical role in the financial crisis that engulfed the global economy in 2008. Indeed, in September of 2008, the collapse of Lehman Brothers prompted a run on the Reserve Primary Fund. Although Lehman debt instruments represented only a small portion of the Reserve Fund's assets, investors became concerned about the condition of the rest of the fund's holdings, and many sought to liquidate their shares. Unable to meet redemption requests, the Reserve Fund froze redemptions for a week and eventually suspended operations and commenced liquidation proceedings.

With the credit markets melting down and the broader economy roiling, the risk of a run on the broader money market fund industry was palpable and imminent. All funds had to face the possibility of investors issuing redemption requests *en masse*. Fearing just such a scenario, the U.S. Treasury Department stepped in and effectively guaranteed the entire $3.7 trillion money market fund industry—placing that potential liability squarely on the shoulders of the U.S. taxpayers.

In December of 2014, the Financial Stability Oversight Council ("the FSOC") issued a notice seeking comment on the systemic risks posed by asset management products with respect to liquidity and redemptions.[4] The FSOC's interest is a recognition of the crucial importance of liquidity risk management to the safety and stability of our financial markets.

The sheer scale of Americans' reliance on open-end funds as an investment instrument and the potential for systemic contagion that arises when funds confront liquidity challenges must inform any consideration of the Commission's Proposal.

SUMMARY OF KEY PROVISIONS OF THE PROPOSAL

I. Classification of liquidity and portfolio assets

The Proposal requires funds to classify each of a fund's portfolio positions (or portions thereof) based on its relative liquidity and engage in an ongoing review of such classifications. The six classification categories are based on whether the positions are convertible to cash immediately prior to sale at a price that does not materially affect the value of the asset:

- within 1 business day,

[3] Investment Company Institute, *A Review of Trends and Activities in the U.S. Investment Company Industry*, 2015 Investment Company Fact Book, *available at:* http://www.icifactbook.org/fb_data.html.

[4] Notice Seeking Comment on Asset Management Products and Activities, 79 Federal Register 77,488 (Dec. 24, 2014).

- within 2-3 business days,
- within 4-7 calendar days,
- within 8-15 calendar days,
- within 16-30 calendar days, or
- within more than 30 calendar days.[5]

The Proposal also sets forth specific factors to consider in classifying the liquidity of a portfolio asset, including:

- the existence of an active market;
- the frequency of trades or quotes and average daily trading volume;
- the volatility of trading prices;
- bid-ask spreads;
- whether the asset has a relatively standardized and simple structure;
- the maturity and date of issue (for fixed-income securities);
- any restrictions on trading and limitations on transfer;
- the size of the fund's position relative to the asset's average daily trading volume;
- the number of units of the asset outstanding; and
- the relationship of the asset to other portfolio assets.[6]

II. Assessment and review of overall liquidity risk

Beyond the requirement to classify each position with respect to its liquidity risk, the Proposal would also require funds to assess and "periodically" review a fund's **overall** liquidity risk. Factors that must be accounted for in the funds' assessments of overall liquidity risk include:

5 80 Fed. Reg. 62293.
6 80 Fed. Reg. 62297.

- short and long-term cash flow projections;
- redemption policies;
- shareholder ownership concentration;
- distribution channels;
- investment strategy and liquidity of portfolio assets;
- use of borrowings and derivatives for investment purposes; and
- holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources.[7]

This list of factors is not intended to be exhaustive. Funds may account for additional factors beyond those outlined in the Proposal. The Proposal further recognizes that some factors may be inapplicable to certain funds and that funds would not be required to consider any such inapplicable factors.

The Proposal does not specify how often the required periodic review must be conducted, nor does it prescribe any particular procedures that must be completed to satisfy a minimum standard of adequacy of review. Instead, funds would be required to develop their own individualized procedures to review liquidity risk.[8]

III. Management of liquidity risk

The Proposal requires funds to adopt and implement a liquidity risk management program ("LRMP"). The LRMP must include a three-day liquid asset minimum percentage, and this portion of the Proposal also codifies existing SEC guidance that restricts funds from investing more than 15% of their net assets in illiquid assets.[9]

As part of its LRMP, each fund would be required to determine a "three-day liquid asset minimum," that is, a minimum percentage of net assets that the fund believes could be converted to cash within three business days at a price that does not materially affect the value of the asset immediately prior to sale.

The Proposal does not establish a minimum percentage of "three-day liquid assets" that funds must hold. Instead, each fund would be required to determine its own three-day

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7 80 Fed. Reg. 62311.
8 *Id.*
9 80 Fed. Reg. 62317.

liquid asset minimum based on the same list of factors outlined in connection with the fund's periodic review of liquidity risk.

The Proposal mandates that funds must review the adequacy of their three-day liquid asset minimum on at least a semi-annual basis. Funds are free to develop and maintain their own procedures for conducting such a review provided that it incorporates consideration of the appropriate liquidity risk factors.

Funds would not be required to liquidate assets to raise the percentage of assets above the three-day liquid asset minimum if their percentage of net assets fell below their three-day liquid asset minimum standard.[10]

IV. Board approval and recordkeeping requirements

A fund's board of directors, including a majority of independent directors, must approve and oversee the operation of the fund's LRMP. The fund must provide a summary of the key features of the LRMP, including how the three-day liquid asset minimum was determined, to directors.

The fund must also maintain copies of its policies and procedures relating to the LRMP, copies of materials provided to the board of directors in connection with their approval and oversight of the LRMP, and written records of how the three-day liquid asset minimum was determined.[11]

V. Disclosure requirements

A fund must disclose its three-day liquid asset minimum, the liquidity classification for each portfolio asset, and whether an asset is illiquid on a monthly basis thirty days after the end of each month. Data reported for the first two months of each quarter would be nonpublic; data related to the third month of the quarter would be made public sixty days after the quarter end.

VI. Swing pricing

The Proposal permits, but does not require, open-end funds (other than ETFs and money market funds) to use "swing pricing." Swing pricing would allow a fund to adjust its NAV to pass on to redeeming or purchasing shareholders more of the costs stemming from their redemptions and purchases to protect other shareholders from dilution arising from these costs.[12]

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10 80 Fed. Reg. 62314.
11 80 Fed. Reg. 62323-25.
12 80 Fed. Reg. 62331.

Before a fund can employ swing pricing, it must institute policies and procedures that provide for an increase or decrease in the fund's NAV by a specified amount (known as the "swing factor") once the level of net purchases or redemptions exceeds a specified percentage of the fund's NAV (designated as the "swing threshold"). A fund has discretion as to whether it should establish a swing threshold and swing factor. But once such policies have been adopted and approved by its board, a fund would generally be required to adjust its NAV by the swing factor when net purchases or redemptions cross the swing threshold.

A fund would be required to consider a number of factors when determining its swing threshold, including:

- the size, frequency, and volatility of historical net purchase or redemptions during normal periods and stress scenarios;
- the fund's investment strategy;
- the liquidity of its portfolio assets;
- the fund's holdings of cash and cash equivalents; and
- transaction costs in the markets in which the fund invests.[13]

A fund would be required to account for the following factors when how its swing factor would be used, including:

- near-term costs expected to be incurred from net purchases or redemptions on the day the swing factor is used; and
- the value of assets purchased or sold by the fund due to net purchases or redemptions on the day the swing factor is used.[14]

COMMENTS

The Commission is to be commended for advancing a Proposal that is constructive and valuable in a number of respects. However, the Proposal is fundamentally flawed in its basic approach: As explained in Part I below, it inappropriately allows funds themselves to establish the key liquidity related benchmarks that they must follow. Even when coupled with detailed disclosure obligations, this "precatory" philosophy of regulation is no substitute for robust, mandatory requirements. This deficiency is especially troubling because it fails to adequately account for the potential systemic threat to our nation's financial stability posed by large funds' liquidity risk.

[13] 80 Fed. Reg. 62333.
[14] 80 Fed. Reg. 62336.

As discussed in Part II below, this core weakness in the Proposal will lead to multiple problems—widespread evasion, compliance and oversight challenges, and an enforcement vacuum. If the Commission adheres to this weak proposed framework, then at a minimum, it must enhance the Proposal by incorporating some additional technical requirements, as discussed below in Part III.

I. The Proposal is too focused on merely requiring a "factor-based analysis," coupled with disclosure obligations, without establishing meaningful and mandatory liquidity risk management practices.

The Proposal ultimately suffers from an approach that leaves funds with far too much discretion in their approach to liquidity risk management. Occupying more than one hundred pages in the Federal Register, the Proposal details one set of factors after the next that must be considered as funds classify assets within their portfolio according to their liquidity characteristics, conduct periodic reviews of their overall liquidity risk profile, and implement a liquidity risk management program. It combines this duty to "consider" various factors with some disclosure obligations. But even this two-pronged approach falls well short of meaningful macroprudential risk mitigation measures.

A. The LRMP provisions rely too heavily on disclosure obligations in the hope that funds will implement strong liquidity risk management protocols.

At the heart of the Proposal is the LRMP. The LRMP has two mainstay components: a requirement that funds self-impose a three-day liquid asset minimum and a requirement that firms not allow the proportion of illiquid assets in their portfolio to exceed 15%.

Even so, firms are free to define for themselves (in accordance with a series of factors) what constitutes a three-day liquid asset and the minimum percentage of their portfolio that must be comprised of three-day liquid assets. As discussed further in Part IB, this requirement is so discretionary that it is largely meaningless.

The accompanying disclosure requirements are somewhat helpful, but they don't cure the problem. Funds must ultimately disclose the three-day liquid asset minimum percentage that they choose to adopt. Funds must also disclose which of their assets are illiquid. But, even these disclosure requirements, while detailed, are nonetheless weak. Activity undertaken at the start of the first month of a quarter would not flow through the Proposal's contemplated disclosure mechanism to the public until five months later, a lifetime in today's markets.

More importantly, even more robust disclosure is no substitute for concrete, clear and uniform restrictions and requirements. For example, one could imagine a Proposal that declares that certain asset classes are simply too illiquid and risky to be permitted in funds in the first place, or urges funds to hold substantially less than 15% of their net assets in illiquid assets if possible. But rather than embracing concrete means to encourage funds to minimize the proportion of illiquid assets that they hold even below the 15% maximum standard, the Proposal relies on disclosure to create that incentive instead.

Relying on disclosure to drive firms toward better liquidity risk management practices when they have considerable countervailing financial incentives is ultimately unlikely to succeed, and is certainly less likely to promote sound liquidity risk management than objective standards.

Further, the LRMP provisions are relatively toothless when one considers the scale of liquidity risk that funds face under severe stress scenarios. Merely codifying existing guidance on the percentage of illiquid assets that firms are permitted to hold and granting funds wide latitude in self-selecting what limits will apply to their liquidity risk profile and how to define those very limits—as the LRMP provisions do—is unlikely to equip firms to survive a liquidity crunch. Instead, the bulk of the rule outlines complex asset classification structures, provides detailed prescriptions on how to conduct general liquidity risk reviews, and proposes thorough disclosure requirements. The Proposal is at once highly bureaucratic and complicated while also granting virtually limitless discretion to funds to fashion their own LRMPs. The complexity and scale of these provisions ultimately achieves little to ensure that funds actually reduce risk.

B. The three-day liquid asset minimum has great conceptual potential but the Proposal grants too much discretion to funds and must be strengthened before it can be effective.

The three-day liquid asset minimum has the potential to be the most effective component of the Proposal. Unlike many of the Proposals' provisions, it represents a concrete and relatively simple requirement that could ensure that a fund must actually take definite action to ensure that it has adequate liquidity to endure a severe stress scenario, as opposed to simply classifying assets and reviewing overall liquidity risk. However, the failure to prescribe a discrete minimum threshold for three-day liquid assets threatens to undercut the effectiveness of this most critical feature of the Proposal.

Under the Proposal, a fund is not required to hold any particular percentage of assets that can be converted into cash within three business days. Instead, a fund must determine its own three-day liquid asset minimum based on the same list of factors delineated for consideration in the fund's periodic review of liquidity risk: short- and long-term cash flows, redemption policies, cash holdings, etc. This effectively confers unbounded discretion on funds to set their own three-day liquid asset minimums. Funds have strong financial incentives to maintain substantial non-three-day liquid asset holdings, and any measure designed to countervail such potent incentives cannot place faith in funds by giving them almost limitless discretion to self-impose restrictions.

Of course, a fund must consider multiple factors before setting their three-day liquid asset minimum, but a requirement to consider a series of factors is unlikely to have much impact on a fund that is highly motivated to avoid imposing a strict three-day liquid asset minimum on itself. Even within the multi-factor evaluation requirement, the Proposal is keen on emphasizing that firms have wide discretion to weigh factors more heavily than others and outright decline to consider factors that it deems inapplicable. Granting funds such latitude in asking them to craft restrictions on their own operations is unwise and unlikely to be effective. A fund that is intent on evading a meaningful three-day liquid asset minimum can almost certainly confect any number of reasons to do so, and that will be enough to work around the factors that are the only deterrent from so doing.

There is another important dimension of the three-day liquid asset minimum requirement that undercuts its effectiveness by conferring undue discretion on funds. The rule mandates that a fund must determine a minimum percentage of net assets that the fund believes could be converted to cash within three business days at a price that does not materially affect the value of the asset immediately prior to sale. This language creates too much leeway for firms to manipulate the very definition of three day liquid assets in accordance with their subjective and potentially self-serving beliefs.

In effect, the Proposal gives a fund virtually unbounded discretion to decide what a three-day liquid asset is and to decide the minimum percentage of three day liquid assets that it should hold. This is a very weak standard (if it is a standard at all) that will not ensure that funds mitigate their liquidity risk.

Instead, the Proposal **should** specify a minimum threshold of three day liquid assets and remove language about a fund's "belief" about what constitutes a three-day liquid asset from the provisions that oblige firms to set three day asset minimums. Otherwise, this potentially effective provision will be hopelessly subject to circumvention.

The contrast between the three-day liquid asset minimum provisions and the 15% maximum net asset standard for illiquid assets is instructive here. The Proposal is to be lauded for codifying existing guidance to the effect that firms must not hold more than 15% of their net assets in illiquid assets. Such a standard is much more robust than the Proposal's malleable requirements for three-day liquid asset minimums. It sets forth a definite and unambiguous numerical limit instead of trusting funds to determine their own level of restriction. And it does not use vague, subjective terminology about assets that a fund "believes" to be illiquid; it simply declares that funds must not hold more than a certain number of illiquid assets.

The 15% maximum standard for illiquid assets is a clear safeguard against liquidity risk. It has the benefits of simplicity, clarity, and easy administratibility. The three-day liquid asset minimum provisions of the Proposal should conform more closely to these features of the 15% maximum standard for illiquid assets.

II. The Proposal's multi-factor determination approach renders it vulnerable to gaming and evasion.

As noted above, the Proposal requires firms to consider a set of factors before ultimately employing their own discretion in setting a three-day liquid asset minimum; this same multi-factor approach underpins the design of the Proposal's asset classification and overall liquidity risk review provisions. As explained above, this approach stops just short of conferring maximal discretion to funds as they implement liquidity risk policies and programs. This heavy reliance on a passive, "guidance"-oriented approach will spawn numerous problems. We briefly note three here.

First, self-regulation has proven largely ineffective in principle and practice. Where the incentive to evade exists, the Proposal would give funds relatively free reign to evade. Funds that are bent on taking a riskier approach to liquidity management are unlikely to be dissuaded by having to consider a series of factors before ultimately choosing to what extent they should subject themselves to restrictions.

Second, this approach entails excessive complexity to compensate for lack of concrete requirements. Such complexity is doubly harmful: it makes compliance more difficult for the funds, and oversight more difficult for the SEC.

Third, the lack of clear-cut standards will make meaningful enforcement very difficult. The multi-factor tests are sufficiently complex and pliable that funds will be able to confect justifications for nearly any course of action.

III. At a minimum, the Proposal should prescribe definite intervals of time over which liquidity classification assessments and overall liquidity risk reviews must occur, as it does for liquidity risk management measures.

If the Commission does not incorporate fundamentally more rigorous requirements, then it must at least make certain enhancements in the Proposal. For example, it is unclear from the Proposal how frequently funds must update their liquidity classifications. If such classifications are to be useful, they must be reviewed and updated at regular and defined intervals—no less than on a quarterly basis—and immediately upon any appreciable change in the composition of a fund's portfolio of assets. Market conditions and fund portfolios are subject to rapid change, and for liquidity classifications to be meaningful, the classification scheme must be responsive to those potentially sudden shifts. Well-defined, frequent, and ongoing review obligations are a necessary component of any liquidity classification scheme, which is itself an important prerequisite to informed liquidity risk management decisions.

Similarly, the Proposal does not specify how frequently the required periodic review of the firm's overall liquidity risk must be conducted. In theory, a firm could assess its overall liquidity risk every ten years and be in compliance with the Proposal's provisions that mandate "periodic" overall liquidity risk review. Even if a majority of funds will reasonably comply with the spirit of the review provisions, there is no reason that those provisions should be so readily subject to evasion.

Instead, the Proposal should set forth a baseline standard of adequacy for the frequency of funds' overall liquidity risk review. Annual or quarterly review at minimum is appropriate and necessary to effectuate the Proposal's purposes. A minimum threshold for frequency of review still confers substantial discretion to funds to conduct reviews more often while ensuring that funds disinclined to conduct frequent reviews will be unable to circumvent compliance with the spirit of the Proposal.

The Proposal's requirement that funds review the adequacy of their three-day liquid asset minimum on at least a semi-annual basis is instructive here. The difference between requiring a review on a semi-annual basis and requiring "periodic" review is not trivial. It is necessary to specify defined intervals of time over which liquidity classification, overall liquidity risk review, and liquidity risk management exercises must be undertaken if the rule is to be effective in accomplishing its stated ends.

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CONCLUSION

We hope that this comment is helpful as the Commission finalizes its Proposal.

Sincerely,

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