CMFI
Coalition of Mutual Fund Investors

January 18, 2016

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

VIA ELECTRONIC MAIL
rule-comments@sec.gov

Subject: Proposed Rule – Open-End Fund Liquidity Risk Management Programs; Swing Pricing, File No. S7-16-15

Dear Mr. Fields:

The Coalition of Mutual Fund Investors ("CMFI")[1] appreciates the opportunity to submit comments to the Securities and Exchange Commission ("SEC"), regarding its proposals to improve liquidity risk management programs utilized by mutual funds.[2]

CMFI believes that the widespread use of omnibus accounts by broker-dealers and other financial intermediaries will be a hindrance to the proper and fair implementation of several of the SEC's regulatory proposals to address the management of mutual fund liquidity risks. In an omnibus account, intermediaries aggregate daily purchases and redemptions of fund shares for their customers and submit a netted transaction amount to each fund when orders are placed. These same intermediaries rarely share investor-level information with the funds, to help the latter with prospectus and regulatory compliance requirements. As the SEC is well aware, the typical mutual fund now has more than 50% of its outstanding shares being held within these opaque intermediary accounts.

What follows are CMFI's comments regarding the problems caused by omnibus accounts when mutual funds seek to implement robust programs to evaluate and manage their liquidity risks.

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[1] The Coalition of Mutual Fund Investors ("CMFI") is an Internet-based shareholder advocacy organization established to represent the interests of individual mutual fund investors on public policy and regulatory issues. CMFI is based in Washington, D.C. and maintains a website at www.investorscoalition.com.

[2] Open-End Fund Liquidity Risk Management Programs, 80 Fed. Reg. 62,274 (Oct. 15, 2015), *available at* https://www.gpo.gov/fdsys/pkg/FR-2015-10-15/pdf/2015-24507.pdf (hereinafter "SEC Liquidity Risk Management Programs").

<u>The Difficulties in Evaluating and Managing Liquidity Risks within Omnibus Accounts</u>

The SEC's proposed rule would require each mutual fund to establish a liquidity risk management program to "assess and periodically review the fund's liquidity risk."[3] As a part of this evaluation, the SEC expects each fund to develop short-term and long-term cash flow projections, examining—at the very least—the following indicia:

- The size, frequency, and volatility of historical purchases and redemptions of fund shares during normal and stressed periods;
- A fund's redemption policies;
- A fund's shareholder ownership concentration;
- A fund's distribution channels; and
- The degree of certainty associated with the fund's short-term and long-term cash flow projections.[4]

The SEC acknowledges that the better a mutual fund can predict its cash flows (including expected purchases and redemptions), the better the fund will be able to assess and manage its liquidity risks.[5] And a growing number of large fund complexes agree that a granular look at redemption patterns by underlying investors transacting through intermediary platforms should be a part of any evaluation of cash flow projections, for liquidity management purposes.[6]

Unfortunately, the lack of transparency at the investor-level within omnibus accounts is a significant obstacle to getting accurate—instead of aggregated—information about the identity and underlying transactions of investors within these intermediary accounts. In this rulemaking, the SEC concedes that this is a problem:

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[3] Proposed Rule 22e-4(b)(2)(iii).

[4] *See* Proposed Rule 22e-4(b)(2)(iii)(A)(1) – (5).

[5] *SEC Liquidity Risk Management Programs* at 62,305 ("In general, we believe that the better a fund's portfolio and risk managers are able to predict the fund's net flows, the better they will be able to measure and manage the fund's liquidity risk.").

[6] *See e.g.*, Letter from Barbara G. Novick, Vice Chairman, BlackRock, to the Financial Stability Oversight Council, at 6, March 25, 2015, *available at* http://www.regulations.gov/#!documentDetail;D=FSOC-2014-0001-0034 (Prudent market liquidity risk management includes estimating "potential fund redemptions based on (a) historical behavior under normal as well as under adverse market conditions, and (b) monitoring investor profiles and related redemption behaviors to help identify potential liquidity needs, recognizing the differences between institutional and retail investors, large and small investors, categories of assets (e.g., retirement versus non-retirement assets), and the platforms on which funds are sold (e.g., self-directed versus through an intermediary)."); and Letter from Mortimer J. Buckley, Chief Investment Officer, Vanguard, to Brent Fields, Secretary, Securities and Exchange Commission, at A1, January 6, 2016, *available at* http://www.sec.gov/comments/s7-16-15/s71615-29.pdf ("We use historical cash flow data for each Vanguard fund, as well as comparable funds within the industry, to examine redemption activity under times of stress. Redemption activity during historical market events such as the Taper Tantrum, global financial crisis, and the U.S. bond bear market of 1987 is assessed in the context of current portfolio construction, market liquidity, and composition of the fund's investor base.").

> [T]o the extent that mutual fund shares are held through omnibus accounts, it could be difficult for a mutual fund to be fully aware of the composition of the underlying investor base, including investor characteristics that could affect the mutual fund's short-term and long-term flows (*e.g.*, whether ownership in the mutual fund is relatively concentrated, and whether the mutual fund's underlying investors share any common investment goals affecting redemption frequency and timing). [Additionally] a mutual fund's distribution channels could affect its cash flow predictions insofar as certain distribution channels are generally correlated with particular purchase and redemption patterns.[7]

While acknowledging the problem, the SEC does not propose any tools to help mutual funds address this lack of transparency within omnibus accounts. However, this problem can be addressed in an effective and efficient manner by amending SEC Rule 22c-2, to require intermediaries to share investor-level information with funds on a daily or "same-day" basis.

Amending SEC Rule 22c-2 Provides a Transparency Solution for Mutual Funds

Rule 22c-2 was adopted in response to the market timing problems in the mutual fund industry more than nine years ago.[8] The Rule requires financial intermediaries to provide a mutual fund with investor-level identity and transaction information, when requested by such fund.[9]

The original purpose of Rule 22c-2 was to provide funds with a tool to deter arbitrage trading in certain funds through the use of redemption fees and other types of short-term trading restrictions. The Rule also seeks to help funds with the implementation of their frequent trading policies and procedures, by authorizing an information-sharing tool that provides full transparency within omnibus accounts.

Despite the best of intentions, Rule 22c-2 has not been used very frequently by the fund industry. The primary reason appears to be the difficulty on the fund side of requesting, on a regular basis, beneficial owner information from the same broker-dealers and other intermediaries that are distributing fund shares each day. Standardizing and mandating information-sharing at the investor level is a solution to this dilemma and it will help funds assess and manage their liquidity risks in a more precise manner, by permitting them to have access to investor-level identity and transaction information for all shareholders and all distribution channels.

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[7] *SEC Liquidity Risk Management Programs* at 62,307.
[8] *See* Mutual Fund Redemption Fees, 71 Fed. Reg. 58,257 (Oct. 3, 2006); Mutual Fund Redemption Fees, 71 Fed. Reg. 11,351 (Mar. 7, 2006); and Mutual Fund Redemption Fees, 70 Fed. Reg. 13,328 (Mar. 18, 2005).
[9] 17 C.F.R. § 270.22c-2(a)(2)(i) and 22c-2(c)(5).

As CMFI has argued in numerous comment letters, Rule 22c-2 should be amended to require that intermediaries share investor-level information with funds on a daily basis, as opposed to the periodic information-sharing approach that is currently being used by funds and their intermediaries.[10]

For most intermediaries, a daily or same-day disclosure regime can be managed in a standardized, automated, and cost-effective manner through the Networking service of the National Securities Clearing Corporation ("NSCC"), a processing platform that is widely used today in the financial services industry—and has been in place since 1989—to facilitate the sharing and reconciliation of shareholder-level transactions between mutual funds and their financial intermediaries.

Despite being developed by the brokerage and fund industries for just this purpose more than 25 years ago, large broker-dealers have been successfully replacing this efficient processing platform with a more cumbersome and expensive omnibus accounts structure, primarily because it provides them with an opportunity to generate more fee income through the use of their own proprietary recordkeeping systems.[11]

CMFI believes that the protection of investor interests should be a higher priority for regulators than additional opportunities for broker-dealer fee income and so the SEC should require full transparency into all investor accounts through an amended Rule 22c-2 that requires daily (or same-day) disclosure of investor-level data within omnibus accounts.

Full transparency within these third-party accounts will provide a fund with accurate, real-time information about its entire shareholder base. This level of transparency will significantly improve the ability of a fund to develop more accurate short-term and long-term cash flow projections, as a part of a liquidity risk management program.

Omnibus Accounts Present an Obstacle to Implementing the Proposed Three-Day Liquid Asset Minimum

The omnibus accounts problem also is present in the SEC's proposal to require each fund to determine a three-day liquid asset minimum as a part of its liquidity risk management program. In determining its three-day liquid asset minimum, a fund would be required to

[10] As noted above, even though Rule 22c-2 authorizes a mutual fund to request daily shareholder identity and transaction information, the substantial majority of funds only use this tool on a periodic basis and not frequently.
[11] CMFI has documented the history of the NSCC Networking service and its many benefits. A copy of this document is available through the following link:
http://www.investorscoalition.com/sites/default/files/History%20of%20NSCC%20Networking%2010-3-2014.pdf.

consider the same factors used in its general assessment of liquidity risk, including an assessment of short-term and long-term cash flow projections.[12]

In this rulemaking, the SEC acknowledges that funds may have difficulty making accurate short-term and long-term cash flow projections for shares purchased and redeemed through omnibus accounts, in circumstances where the lack of transparency substantially increases the uncertainty of these projections:

> Projections may only be as good as the extent and quality of information that informs them. For example, if a fund does not have great visibility into its shareholder base (*e.g.*, because the fund's shares are principally sold through intermediaries that do not provide shareholder transparency) or if a fund is uncertain about changing market conditions which are likely to materially affect the fund's level of net redemptions, it may make projections but be quite uncertain about these projections.[13]

The SEC's answer to this problem—in requiring the development of a three-day liquid asset minimum—is to have each fund increase its cash cushion to reflect this uncertainty.[14] A more effective approach, however, would be to take advantage of the already developed Rule 22c-2 information-sharing process and require intermediaries to share investor-level data on a daily basis.

<u>Extending Rule 22c-2 to Money Market Funds Would Significantly Improve the Accuracy of Fund Liquidity Evaluations and Projections</u>

The inability of mutual funds to "look through" omnibus accounts also was an unresolved issue in both the 2010 and 2014 money market find reforms adopted by the SEC. Omnibus accounts are an obstacle to properly implementing the general liquidity requirement in the 2010 final rule and in implementing the redemption fee provisions and natural person requirement in the 2014 final rule.

The SEC's 2010 money market fund rule imposed a general liquidity requirement—also referred to as the "know your investor" rule—mandating that money market funds evaluate the

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[12] *See SEC Liquidity Risk Management Programs* at 62,311. *See also id* at 62,312 ("We believe consideration of cash flow projections is pivotal to setting an appropriate three-day liquid asset minimum. ... Doing so requires that the fund's adviser, to the best of its ability, understands potential levels of net redemptions and the causes and timing of those redemptions.").

[13] *SEC Liquidity Risk Management Programs* at 62,313.

[14] *See id.*

risk characteristics of their shareholders and maintain adequate (and potentially larger than normal) liquidity cushions to meet reasonably foreseeable redemptions.[15]

In its final rule, the SEC acknowledged the problems with evaluating the risk characteristics and redemption needs of shareholders within omnibus accounts.[16] Unfortunately, the SEC did not provide money market funds any regulatory tools—such as extending Rule 22c-2 to these funds—to perform this "know your investor" function in any meaningful way. Instead, the SEC stated in a footnote that funds could obtain information about investors in omnibus accounts through contractual arrangements between funds and their financial intermediaries.[17]

This problem surfaced again in the more recent money market fund rulemaking finalized by the SEC in 2014.[18] This new rule authorizes a fund board to impose redemption fees and gates in circumstances where a money market fund falls below certain liquidity thresholds. The rule also presents challenges for funds attempting to ensure that its retail funds only comprise natural persons, when a substantial majority of its investors are transacting through non-transparent omnibus accounts.

The SEC placed these new responsibilities on money market funds without any regulatory tools to address the lack of transparency within omnibus accounts, even though a number of comment letters expressed concerns about the ability of funds to implement these provisions within intermediary accounts.[19]

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[15] *See* 17 C.F.R. §270.2a-7(d)(4) ("The money market fund shall hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions in light of the fund's obligations under section 22(e) of the [Investment Company] Act and any commitments the fund has made to shareholders.").

[16] *See* Money Market Fund Reform, 75 Fed. Reg. 10,060, at 10,075 (Mar. 4, 2010) ("As some commenters noted, identification of these [liquidity] risks may be more challenging when share ownership is less transparent because the shares are held in omnibus accounts.").

[17] *Id.* at n.201.

[18] Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. 47,736 (Aug. 14, 2014).

[19] *See e.g.*, Letter from John J. Geraghty, Executive Vice President, SunTrust Bank, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, at 6, September 16, 2013, *available at* http://www.sec.gov/comments/s7-03-13/s70313-238.pdf ("The Release recognizes that … '[a]pplying the daily redemption limitation method to omnibus accounts may pose difficulties' … SunTrust believes that such 'difficulties' are, in fact insurmountable ...."); Letter from Marie Chandoha, President, Charles Schwab Investment Management, to Financial Stability Oversight Council, at 13-14, January 17, 2013, *available at* http://www.regulations.gov/#!documentDetail;D=FSOC-2012-0003-0055 ("We are aware of specific concerns about how this [Schwab alternative] proposal would work in an omnibus account environment … Practically speaking, it may be that omnibus accounts, unless they are far under the threshold, would find a Prime Constant NAV Money Market Fund an unworkable option."); and Letter from Phillip Gillespie, Executive Vice President and General Counsel, State Street Global Advisers, to Elizabeth Murphy, Secretary, Securities and Exchange Commission, at 9, September 8, 2009, *available at* http://www.sec.gov/comments/s7-11-09/s71109-108.pdf ("Since the composition of a money market fund's shareholder base is an essential component in determining the level of liquidity required to comply with Section 22(e), we propose that the Commission extend Rule 22c-2 to apply money market funds with respect to sharing shareholder information. We believe that this requirement would permit funds

Extending Rule 22c-2 to money market mutual funds—and requiring same-day information-sharing—would improve the ability of these funds to: (1) evaluate and manage their liquidity risk programs; (2) apply redemption fees in a uniform manner if and when a fund board decides to take this step; and (3) ensure that only natural persons are accessing retail money market funds through intermediary channels.

Amending Rule 22c-2 to Provide Same-Day Information-Sharing Offers Other Regulatory Benefits

An SEC requirement of investor-level transparency within omnibus accounts will also address other regulatory problems that remain unresolved:

- Funds will be able to monitor short-term trading activities by all investors transacting through omnibus accounts, on a same-day basis;
- Investors will be able to receive properly calculated breakpoint discounts on sales load charges;
- Funds will be able to enforce other prospectus policies and procedures—such as Contingent Deferred Sales Charges ("CDSC")—in a uniform manner across all distribution channels; and
- SEC Fair Fund distributions can be made in a more precise and timely manner than under the current process that relies on "best efforts" by third-party intermediaries.

The SEC's Swing Pricing Proposal May Disadvantage Certain Shareholders

As a part of its liquidity risk management rulemaking, the SEC has proposed a concept called "swing pricing," a process by which the daily net asset value of a fund's shares would be adjusted under certain circumstances to "pass on to purchasing or redeeming shareholders more of the costs associated with their trading activity."[20] The SEC believes that swing pricing could be another tool for fund management regarding liquidity risks and it would also protect existing shareholders from dilution when a fund is subject to unusually large share outflows or inflows.[21]

The SEC's proposal—modeled after similar pricing models being used in Europe—would permit funds to establish a "swing threshold" based on a level of net redemptions or

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to periodically examine the nature of their shareholder base, even where much of the fund is held through omnibus accounts.").

[20] *SEC Liquidity Risk Management Programs* at 62,276.

[21] *See id.* at 62,286.

purchases that exceed a normal range. When net purchases or redemptions exceed a swing threshold, it would trigger a pre-determined adjustment—called the "swing factor"—to a fund's Net Asset Value ("NAV") on any given day the swing threshold is exceeded.

On a day in which net purchase orders exceed the threshold, the NAV would be adjusted upward for both purchases and redemptions. On a day in which net redemption orders exceed the threshold, the NAV would be adjusted downward for both purchases and redemptions.

The symmetry of the SEC's proposal, however, would disadvantage certain shareholders in the process, both new and existing. As an example, assume a hypothetical in which a mutual fund establishes its swing threshold at 3% and its swing factor at 1.5%. On any trading day that a large investor purchases an amount of shares that causes total purchases to exceed the 3% threshold, all other investors purchasing and redeeming shares that day would be subject to an NAV that is artificially increased by 1.5%. All purchasing shareholders would have to incur an extra cost—very similar to a sales load—for making the mistake of buying shares on the same day as a large investor. And redeeming shareholders would be obtaining a 1.5% windfall over what the unadjusted NAV should be on that trading day.

Conversely, when net redemptions exceed the 3% swing threshold on a trading day, the NAV for all transactions would be adjusted downward by 1.5%. An investor purchasing shares that day would receive a 1.5% benefit, by being able to buy shares at a discount from the actual NAV. An investor redeeming shares that day would receive 1.5% less than the unadjusted NAV.

In both of these examples, swing pricing would work to capture costs from some of the shareholders transacting in fund shares that day. On a day when net purchases are above the swing threshold, the purchasing shareholders would be reimbursing the fund for its trading and impact costs that day by paying 1.5% more than the actual NAV. Likewise, when net redemptions are above the swing threshold, the redeeming shareholders would help the fund recover its trading and impact costs by receiving 1.5% less than the actual NAV.

Unfortunately, other shareholders—both new and existing—will be harmed by this pricing model. In the first scenario—net purchases above the threshold—any investor redeeming shares will be receiving a windfall of 1.5% over the actual NAV that day. In the second scenario—net redemptions above the threshold—any investor purchasing shares will be able to buy shares at a 1.5% discount that day. Both of these actions are harmful to certain new investors, are dilutive to existing shareholders, and they offset the benefits of the swing pricing concept.

The basis for this rulemaking—including the concerns expressed by the SEC about mutual fund liquidity risks in a financial crisis—involves only circumstances where net redemptions exceed normal thresholds. In CMFI's view, it is far more efficient—and fairer to shareholders—for each fund to charge an appropriate redemption fee in this situation, to recover for the fund the trading and impact costs being imposed on the fund. These costs should be recovered only from the same shareholders whose actions are causing the funds to incur these increased costs.

As the SEC notes in its Release, this circumstance is very similar to the use of redemption fees permitted to be imposed by Rule 22c-2 to recover the costs of excessive short-term trading.

The problem facing the fund industry, however, in implementing redemption fees for any purpose is—once again—the problem of omnibus accounts. Rule 22c-2 tried to address this problem by requiring periodic information-sharing of investor level identity and transaction information. Despite the fact that the infrastructure now exists through the NSCC to share this information in a cost-efficient manner, funds are not taking advantage of this tool.

As noted earlier, the SEC can address this transparency problem within omnibus accounts by amending Rule 22c-2 to require daily information-sharing between intermediaries using omnibus accounts and the mutual funds in which their customers are investing.

Conclusion

As the SEC considers new liquidity risk management requirements for mutual funds, it should give funds the tools to develop accurate short-term and long-term cash flow projections. This can be accomplished in the most effective and efficient manner by amending SEC Rule 22c-2 to provide funds with investor-level identity and transaction information on a daily basis.

Extending Rule 22c-2 to include money market funds also will assist those funds with: (1) assessing and managing their liquidity risks; (2) imposing a liquidity fee on redemptions (if necessary); and (3) ensuring that only natural persons are investing in retail money market funds.

Additionally, amending Rule 22c-2 to provide daily information-sharing will generate other regulatory benefits by providing funds with a communications tool to ensure the uniform application of their short-term trading policies, breakpoint discounts, and other shareholder privileges provided in fund prospectuses.

Please feel free to contact CMFI with any questions, or if the SEC staff needs additional information from our research on these topics. I can be reached at [redacted] or via email at [redacted].

Sincerely,

Niels Holch

Niels Holch
Executive Director
Coalition of Mutual Fund Investors

cc: The Honorable Mary Jo White
The Honorable Michael Piwowar
The Honorable Kara M. Stein
David Grimm, Division of Investment Management