MEMORANDUM

To: Liquidity Risk Management Programs Proposal File

From: Amanda Hollander Wagner
Senior Counsel, Division of Investment Management

Date: January 20, 2016

Re: Meeting with Representatives of BlackRock, Inc.

On January 14, 2016, Andrew J. Donohue (Chief of Staff, U.S. Securities and Exchange Commission ("SEC")), Jennifer Porter (Counsel to SEC Chair Mary Jo White), David Grim (Director, Division of Investment Management ("IM")), Jennifer McHugh (Senior Policy Advisor, IM), Diane Blizzard (Associate Director, IM), Sarah ten Siethoff (Assistant Director, IM), Sara Cortes (Senior Special Counsel, IM), Melissa Gainor (Senior Special Counsel, IM), Kathleen Joaquin (Senior Financial Analyst, IM), Thoreau Bartmann (Branch Chief, IM), Naseem Nixon (Senior Counsel, IM), and Amanda Wagner (Senior Counsel, IM) met with the following representatives of BlackRock, Inc.:

- Barbara Novick, Vice Chairman;
- Benjamin Archibald, Managing Director (via teleconference);
- Kathryn Fulton, Managing Director;
- Joanne Medero, Managing Director (via teleconference);
- Jasmin Sethi, Vice President; and
- Alexis Rosenblum, Director, Government Relations.

Among other things, the participants discussed the Commission's proposal on liquidity risk management programs and swing pricing.

HIGH YIELD CASE STUDY: POST CLOSING OF THIRD AVENUE FOCUSED CREDIT FUND

JANUARY 2016

BLACKROCK®

On Wednesday, December 9, 2015, Third Avenue Management Company (Third Avenue) notified shareholders of its Focused Credit Fund (TFCIX) that it would be making a distribution on or about December 16, 2015 of cash assets to shareholders as of December 9, 2015, and placing the remaining assets into a liquidating trust. According to Third Avenue's letter to shareholders, no further subscriptions or redemptions of fund shares would be permitted as of December 9, 2015, and liquidation of the assets in the liquidating trust would be expected to take up to a year or more. As a 1940 Investment Company Act (1940 Act) open-end mutual fund, this was a highly unusual announcement and the Securities and Exchange Commission (SEC) "expressed concerns during discussions with the Fund and the Adviser".[1] The board decision to move assets to a liquidating trust was subsequently rescinded by Third Avenue and on December 16, 2015, Third Avenue submitted an application to the SEC to request an order to suspend the right of redemption with respect to shares of TFCIX for the protection of shareholders (the Redemption Suspension Request), to be retroactively effective on December 10, 2015. On that same day, the SEC granted the request, issuing a temporary order[2] (the SEC Order) with conditions including that the fund reduce its holdings to cash, post its net asset value (NAV) on its website, and otherwise act only to liquidate the fund. Notably, the Redemption Suspension Request cites a "significant level of redemption requests by [TFCIX's] investors over the past six months" as a reason the fund felt it was in the best interest of shareholders to cease redemptions.

An analysis of the fund's portfolio as shown in Exhibits 1 through 5 indicates that TFCIX was not a typical high yield open-end mutual fund. Rather, TFCIX was a concentrated distressed debt portfolio with significant investments in securities in default, pay-in-kind bonds, Lehman claims, Fannie and Freddie preferred stock, and securities that were otherwise restricted from trading. Starting in mid-2014 and accelerating during 2015, the fund experienced significant outflows. According to Third Avenue, amid redemption requests at the fund and reduced liquidity in some parts of the bond market, it was "impractical" for the fund to pay off redeeming investors without selling holdings at fire-sale prices that would unfairly disadvantage the remaining shareholders. This was despite the fact that TFCIX had raised its cash position to over $200 million by early December 2015.[3] This combination of factors led Third Avenue to close TFCIX in this atypical manner.

SUMMARY

1. Third Avenue Focused Credit Fund's announcement that it would abruptly cease redemptions was a highly unusual occurrence for US open-end mutual funds.
2. TFCIX's inability to meet redemptions did not result in problems at other open-end mutual funds; meaning we did not observe the "contagion" that some had hypothesized would occur if a daily open-end mutual fund was unable to meet redemptions.
3. TFCIX's portfolio composition was different from other high yield bond mutual funds, including lower credit quality, higher coupons, and less liquid assets.
4. This episode provides an opportunity to revisit existing regulation and best practices around managing daily open-end mutual funds to ensure adequate investor protection and prevent future issues of this nature.
5. Bond ETFs played a helpful role during this period of market stress by introducing a secondary source of liquidity via exchanges.
6. We recommend several policy measures that can be taken by regulators and industry to avoid this issue in the future including:
   a. Re-consider guidelines around fund classification and naming conventions.
   b. Data reporting to regulators regarding the relative liquidity of open-end mutual fund holdings;
   c. Communication with regulators and fund boards regarding illiquid assets, and
   d. Supervision of funds experiencing distress.

Given the current regulatory focus on holdings of less liquid or hard to sell securities in funds that provide daily redemptions, attention moved immediately to questions of potential "contagion" in other parts of the high yield market. Concerns were expressed about the state of the high yield bond market, high yield mutual funds, high yield exchange traded funds (ETFs), and credit hedge funds. These concerns did not come to fruition as no other open-end mutual funds appear to have experienced the issues that were experienced by TFCIX. While the reporting on

The opinions expressed are as of January 2016 and may change as subsequent conditions vary.

Friday, December 11, 2015 discussed TFCIX as a high yield fund, by Saturday, the media had acknowledged that TFCIX holdings appeared closer to a distressed debt portfolio. Adding to the drama, on Friday, December 11, 2015, Stone Lion Capital Partners L.P., a hedge fund firm specializing in distressed debt, indicated that it had suspended redemptions (as authorized by its constituent documents) in the $400 million Stone Lion Portfolio L.P., one of its hedge funds, after many investors submitted redemption requests.[4] This paper examines investors' reactions in high yield markets and related products to Third Avenue's announcement, and draws some lessons from this experience.

Background on Third Avenue

The following excerpt from Third Avenue Management Company's website explains the origins of the company.

> *Marty [Whitman] founded M.J. Whitman & Co. in 1974 and invested in the mortgage bonds of then-bankrupt Penn Central Railroad. The excess return on his investment earned him a following from prospective investors, creating the foundation of Third Avenue Management. A decade later, Marty led the takeover of a closed end mutual fund, which he converted into an open-end fund. He invested the assets of that fund in the secured debt of a bankrupt oil drilling services company that is now known as Nabors Industries. As Nabors emerged from bankruptcy, the return to investors in the fund, who had exchanged their fund shares for equity in Nabors, was quite significant. The returns caught the notice of Morningstar, which named Marty Mutual Fund Manager of the Year in 1990.*[5]

Over time, Third Avenue expanded its product line and its management team. According to news reports, in 2002, Third Avenue sold 60% of the company to Affiliated Managers Group.[6] Assets under management (AUM) grew to $26 billion in 2006 before falling by more than half during the 2008 financial crisis.[7] As of March 31, 2015, Third Avenue had just over $10 billion in AUM across a series of mutual funds and private funds. In 2009, Third Avenue launched TFCIX.[8] The fund grew steadily from launch to 2014, peaking at over $3.5 billion in July 2014.[9] As of the end of November 2015, TFCIX had net assets of $942 million[10] reflecting a combination of significant underperformance and investor withdrawals.

Although TFCIX was described as a "high yield fund" and was in this category for performance comparisons,[11] our analysis of TFCIX holdings and the description of the TFCIX's investment strategy in fund documents (see sidebar) suggests that TFCIX would be more accurately described as a concentrated distressed debt fund. In other words, the fund took concentrated bets on securities that were in default, restricted from trading, or subject to other issues that distinguished the bonds from other high yield securities of companies that are experiencing financial and operational distress, default, or are under bankruptcy. Distressed securities often carry ratings of CCC or below and have yield-to-maturities in excess of 1,000 basis points over the risk-free rate of return.

TFCIX Prospectus Language

The principal investment strategies were described in the prospectus using language that is typical for mutual funds employing traditional high yield investment strategies:

> *The Fund seeks to achieve its objective mainly by investing in bonds and other types of credit instruments and intends to invest a substantial amount of its assets in credit instruments that are rated below investment grade by some or all relevant independent rating agencies, including Moody's Investors Service, Inc. (Moody's), Standard and Poor's Ratings Services (S&P) and Fitch Ratings (Fitch). Additionally, certain other high-yield bonds may be unrated by rating agencies, but determined to be of similar quality as other below investment grade bonds and credit instruments by the Adviser. Under normal circumstances, at least 80% of the Fund's net assets (plus the amount of any borrowing for investment purposes) will be invested in bonds and other types of credit instruments.*

The prospectus also contains a lengthy discussion of principal investment risks, which includes the following statement:

> *The Fund may have significant investments in distressed and defaulted securities and intends to focus on a relatively small number of issuers. The Fund may also purchase equity securities or hold significant positions in equity or other assets that the Fund receives as part of a reorganization process, and may hold those assets until such time as the Adviser believes that a disposition is most advantageous.*

This type of language is not common among other high yield mutual funds and reflects an investment strategy that seeks to be highly concentrated in a small number of distressed assets. While TFCIX disclosed that it was non-diversified and planned to make significant investments in distressed assets, it was nonetheless categorized with other traditional high yield funds. This highlights the need to establish clearer guidelines for labeling and classifying funds.

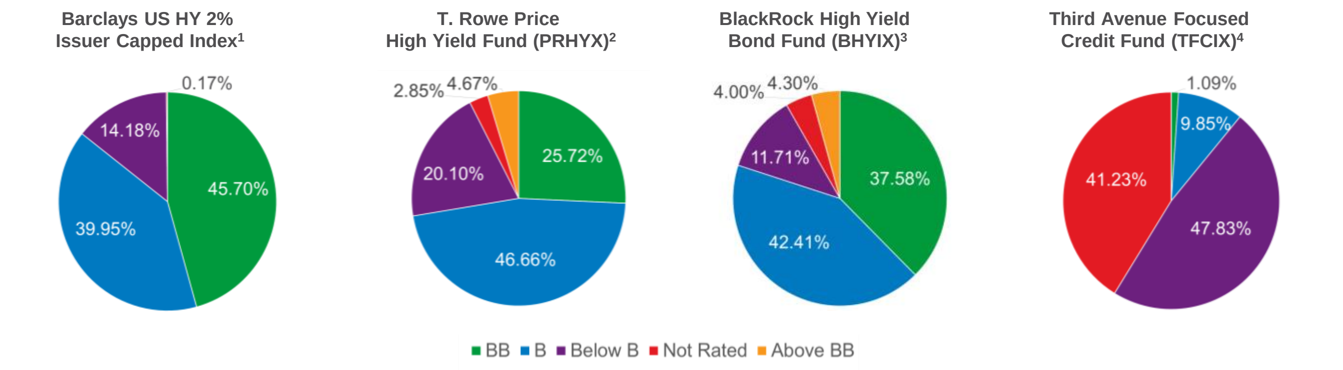
Analysis of TFCIX Portfolio Composition

We examined the composition of TFCIX and compared it to other high yield mutual funds. For purposes of the analysis, we compared TFCIX holdings to the BlackRock High Yield Bond Fund (BHYIX) and the T. Rowe Price High Yield Fund (PRHYX). We selected the other two funds for illustrative purposes as representative of traditional high yield open-end mutual funds. BHYIX and PRHYX have $16.2 billion[12] and $8.6 billion[13] in AUM, respectively, as of December 31, 2015. A simple analysis of the TFCIX portfolio as of July 31, 2015[14] highlights that this portfolio included a significant allocation to distressed debt with credit quality that skewed noticeably lower than the other two high yield funds.

As illustrated in Exhibit 1, TFCIX had nearly 90% invested in assets that were rated Below B or not rated (NR). This figure compares to the Barclays US High Yield 2% Issuer Capped Index (the Benchmark), which has approximately 14% in Below B assets. Furthermore, TFCIX held over 41% of the portfolio in not rated securities, compared to less than 5% for each of the other two funds. Assets that are "not rated" are often less liquid than rated securities.

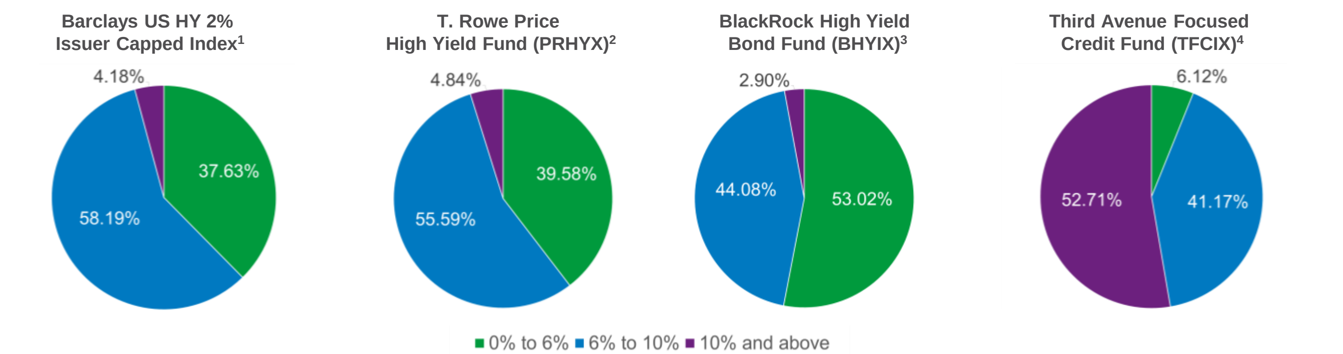
In addition, the TFCIX portfolio was focused on assets with significantly higher coupons than other high yield funds, and these holdings were much higher than the securities represented in the Benchmark.[15] Exhibit 2 shows the TFCIX portfolio invested more than half of its assets in securities with coupons of 10% or higher. In comparison, the Morningstar High Yield category average has only 3% in such securities and the Benchmark has just over 4% in securities with coupons greater than 10%.

Exhibit 1: BREAKDOWN OF BOND HOLDINGS BY RATING



1 Source: Barclays POINT®. As of 11/30/2015.
2 Source: Morningstar. As of 9/30/2015.
3 Source: BlackRock. As of 12/29/2015.
4 Source: Morningstar. As of 7/31/2015.
Different as of dates reflect limitations on publicly available data.

Exhibit 2: BREAKDOWN OF BOND HOLDINGS BY AVERAGE COUPON



1 Source: Barclays POINT®. As of 11/30/2015.
2 Source: Morningstar. As of 9/30/2015.
3 Source: BlackRock. As of 12/29/2015.
4 Source: Morningstar. As of 7/31/2015.
Different as of dates reflect limitations on publicly available data.

Another indicator that a portfolio may experience liquidity constraints is the degree of concentration of portfolio holdings. The TFCIX portfolio held significantly more concentrated positions than other high yield funds as evidenced by the top ten holdings of TFCIX versus the other two funds. Exhibit 3 shows the top 10 holdings of TFCIX, BHYIX, and PRHYX, along with the percentage each holding contributed to the total portfolio. In aggregate, the top ten holdings of TFCIX comprised 28.4% of TFCIX's total assets, compared to 9.7% and 6.8% for BHYIX and PRHYX, respectively. Further, as Exhibit 4 shows, TFCIX's top ten holdings had very high yields and significantly discounted prices reflecting the relatively low quality of these assets.

Exhibit 3: COMPARISON OF TOP 10 HOLDINGS

	Third Avenue Focused Credit Fund (TFCIX)[1]	%	BlackRock High Yield Bond Fund (BHYIX)[2]	%	T. Rowe Price High Yield Fund (PRHYX)[3]	%
1	iHeart Communications (IHRT 14 02/01/21)	4.8	Ally Financial Inc. (ALLY Equity)	1.2	First Data Corporation (FDC 12.6 1/15/2021)	1
2	Energy Future Holdings (TXU 11 1/4 12/01/18)	3.7	First Data Corporation (FDC 7 12/01/2023)	1.2	Arqiva Broadcast Holdings (9.5 03/31/2020)	0.7
3	Sun Products Corp. (SUNPRD 7 3/4 03/15/21)	3.6	Ally Financial Inc. (ALLY 8 11/01/2031)	1	CHS/Community Health Systems (CYH 6.9 02/01/2022)	0.7
4	Altegrity (USINV 14 07/01/20)	2.9	HD Supply Inc. (HDSUPP 7.5 07/15/2020)	1	T-Mobile USA Inc. (TMUS 6 03/01/2023)	0.7
5	Liberty Tire Recycling (LBRTY 11 03/31/21)	2.8	New Light Squared LLC (NLS 12.95 12/07/2020)	1	Neptune Finco. Corp. (10.1 01/15/2023)	0.7
6	Longview Power Equity (Private Equity)	2.4	Sprint Nextel Corporation (S 9 11/15/2018)	1	Sirius XM Radio Inc. (SIRI 5 3/4 08/01/2021)	0.7
7	Affinion Group Holdings (AFFINI 13 3/4 09/15/18)	2.2	Blackstone CQP Holdco LP (BX 9.3 03/31/2019)	1	Wind Acquisition Fin. SA (7.4 04/23/2021)	0.6
8	Intelsat Luxembourg SA (INTEL 7 3/4 06/01/21)	2.1	American Capital Ltd. (ACAS Equity)	0.8	Sprint Corp. (S 7.1 06/15/2024)	0.6
9	New Enterprise Stone & Lime (NEENST 11 09/01/18)	2	First Data Corporation (FDC 5 3/4 01/15/2024)	0.8	Noble Energy Inc. (NBL 5.9 06/01/2024)	0.6
10	Claires Stores (CLE 7 3/4 06/01/20)	1.9	Family Tree Escrow LLC (DLTR 5 3/4 03/01/2023)	0.7	Energy Future Holdings (TXU 11 3/4 03/01/2022)	0.5
		28.4		**9.7**		**6.8**

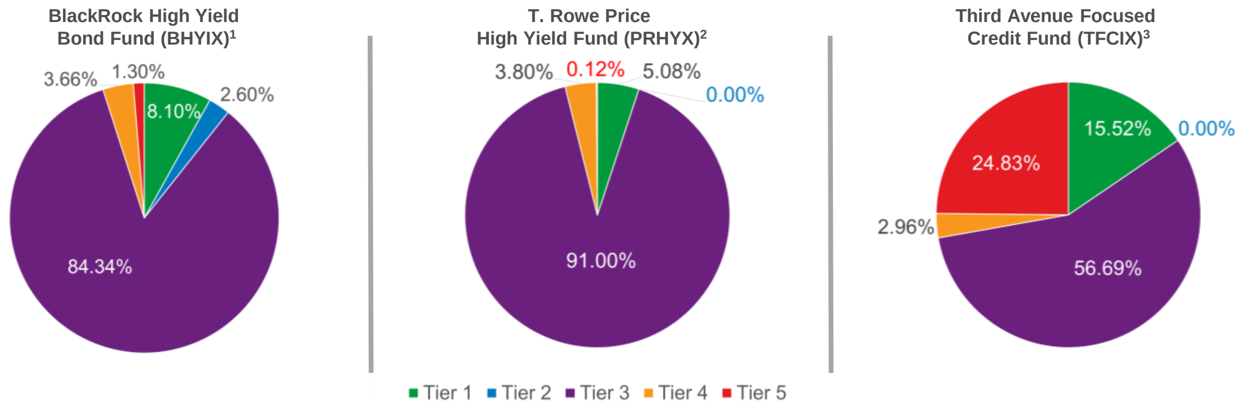
Excludes cash.
1 Source: Morningstar. As of 7/31/2015.
2 Source: BlackRock. As of 12/29/15.
3 Source: T. Rowe Price. As of 9/30/2015.

Exhibit 4: YIELDS OF TFCIX TOP 10 HOLDINGS

Issuer	Position	% Exposure	Yield to Worst	Price
iHeart Communications	IHRT 14 02/01/21	4.8	56.2	29.0
Energy Future Holdings	TXU 11 1/4 12/01/18	3.7	NA	107.5
Sun Products Corp.	SUNPRD 7 3/4 03/15/21	3.6	10.9	87.5
Altegrity	USINV 14 07/01/20	2.9	NA	NA
Liberty Tire Recycling	LBRTY 11 03/31/21	2.8	20.3	65.6
Longview Power Equity	Private Equity	2.4	NA	NA
Affinion Group Holdings	AFFINI 13 3/4 09/15/18	2.2	NA	27.5
Intelsat Luxembourg SA	INTEL 7 3/4 06/01/21	2.1	28.4	44.3
New Enterprise Stone & Lime	NEENST 11 09/01/18	2.0	19.2	83.3
Claires Stores	CLE 7 3/4 06/01/20	1.9	71.9	16.5
Total		**28.4**	**35.0**	**60.1**

Note: Positions and exposure are as of 7/31/15. Total prices and yields calculated based on weighted averages as of 12/10/15 from Bloomberg and broker levels and excluding positions where prices and yields were not available.

Exhibit 5: LIQUIDITY TIERING BREAKDOWN



1 Source: BlackRock. As of 12/29/2015.
2 Source: T. Rowe Price. As of 9/30/15.
3 Source: Morningstar. As of 7/31/2015.
Different as of dates reflect limitations on publicly available data.

Using several different measures, TFCIX held a significant percent of the portfolio in less liquid or hard to sell assets. Liquidity tiering is one means of classifying the liquidity of portfolio holdings that assigns a liquidity "tier" to each asset type that a fund can invest in based on a qualitative and general assessment of the relative liquidity of each asset type (e.g., investment grade bonds versus high yield bonds) in both normal and stressed markets. Holdings are classified based on which asset type they fall under and exceptions can be made where the specific attributes of a particular position differ materially from the nature of the asset type as a whole. Exhibit 5 provides a breakdown of the percentage of TFCIX, BHYIX, and PRHYX that would fall under each tier using this liquidity tiering methodology. Under this approach, TFCIX held nearly 25% of its portfolio in Tier 5 assets, as compared to less than 2% in Tier 5 assets for each of the other two funds. While no single indicator alone can dictate that a fund has a liquidity problem, the liquidity problem becomes clear when looking holistically at the TFCIX portfolio.

Another measure that can be used as a proxy to determine whether a security may be relatively illiquid, is whether the security is a "Level 3" asset. Level 3 is an accounting / valuation concept that denotes securities that cannot be valued based on observable prices. While this does not necessarily mean that all Level 3 assets are illiquid, a high percentage of Level 3 assets in a portfolio can be an indicator of liquidity constrained holdings. The differences in the percentage of Level 3 holdings of TFCIX versus the other two funds is quite stark. TFCIX held almost 20% in Level 3 assets, while BHYIX and PRHYX held 3.8%[16] and 0.02%[17] in Level 3 assets, respectively. Put simply, the analysis shows that the composition of TFCIX's portfolio was quite different from that of other actively managed high yield open-end mutual funds.

Comparing the holdings, TFCIX held a higher percentage of assets that fit in one or more of these categories: (i) below B and not rated, (ii) yields over 10%, and (iii) designated Level 3. In addition, the TFCIX portfolio assets were highly concentrated. These portfolio characteristics combined with the daily liquidity of a 1940 Act Fund resulted in a fund portfolio with liquidity issues.

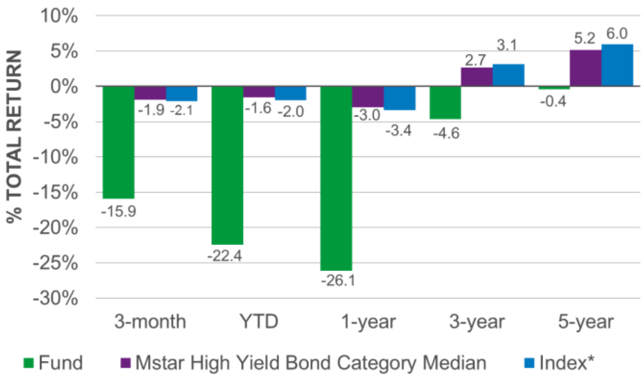
Analysis of TFCIX Performance

In the Redemption Suspension Request, Third Avenue shared additional light on TFCIX's redemption experience:

> *The circumstances leading to the request for relief are linked to the extraordinary level of redemptions requested from the Fund's investors over the past six months. The Fund has experienced a total of $1.1 billion in estimated net outflows for the year to date through December 9, 2015, which was more than 145% of its remaining net asset value at December 9, 2015. In November 2015, the Fund experienced a total of $317 million in estimated net redemptions,…*

Presumably, one of the reasons that TFCIX had received such significant redemption requests in the past several months was its significant underperformance. As shown in Exhibit 6, TFCIX year-to-date performance as of November 30, 2015 was negative 22.4%, putting TFCIX in the 99th percentile of high yield fund performance. This is compared to a decline of only 2.0% in the Barclays High Yield 2% Issuer Capped Index for the same period and a median decline of 1.6% for the Morningstar high yield bond category. To add further perspective, a 75th percentile high yield fund was down 4.2% year-to-date and a 97th percentile fund is down 8.5% year-to-date as of November 30, 2015.

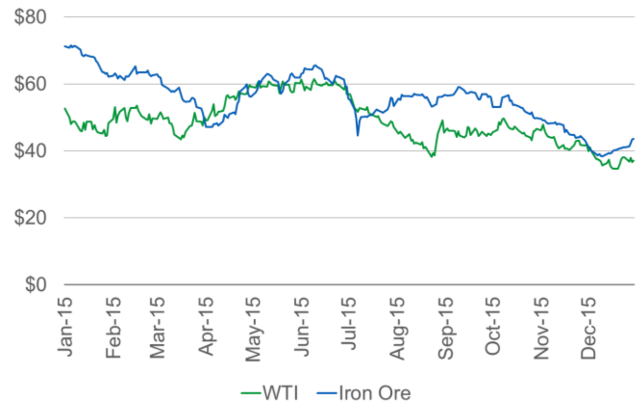
Exhibit 6: TFCIX AVERAGE TOTAL RETURN AS OF NOVEMBER 30, 2015



Morningstar High Yield Bond Funds Category Percentile Rankings (Institutional Shares) as of November 30, 2015			
YTD (771/777 funds)	**1 year (766/772 funds)**	**3 years (622/627 funds)**	**5 years (526/531 funds)**
99th percentile	99th percentile	99th percentile	99th percentile

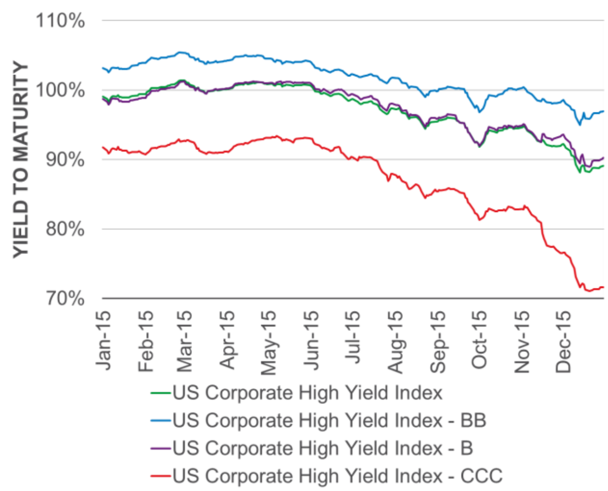
Source: Morningstar. Fund Inception August 31, 2009.
*Index = Barclays High Yield 2% Issuer Capped Index.

Exhibit 7: OIL PRICE AND IRON ORE PRICES



As of December 2015.
Source: Barclays POINT, Bloomberg, BlackRock.

Exhibit 8: HIGH YIELD AVERAGE BOND PRICES



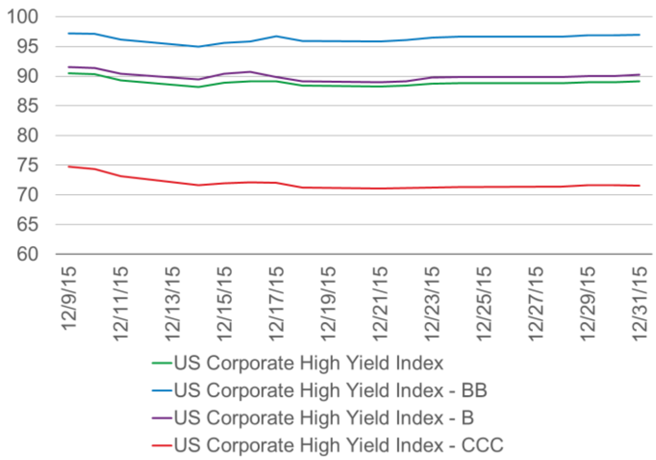
As of December 31, 2015.
Source: Barclays Live.
Average Bond Price shown for the Barclays US Corporate High Yield Index.

Experience of High Yield Bond Market

In looking at the high yield bond market and the performance of high yield bonds, it is important to understand the context of the economic environment. In particular, the high yield sector has a large weighting to energy as well as metals and mining companies. As of December 31, 2015, energy and metals and mining companies alone made up over 15% of the Barclays US High Yield 2% Issuer Capped Index. Given the performance of energy prices and energy stocks over the course of 2015, it is not surprising that high yield bonds in this sector have performed poorly. As shown in Exhibit 7, oil prices dropped approximately 40% from a peak in June 2015 of $61.43 a barrel to $37.04 a barrel at year-end. Likewise, other commodities have seen significant price declines. For example, iron ore has dropped from a 2015 high of $71.49 in January 2015 to $43.57 as of year-end 2015. In this environment, high yield bond prices have declined as highlighted by several high yield indices shown in Exhibit 8. Further, we are anticipating increased market volatility as the Federal Open Market Committee (FOMC) rate decisions and associated rhetoric, multi-year lows in oil, and weak earnings growth potentially put pressure on risk assets.

In the wake of Third Avenue's decision to close TFCIX, some commentators predicted the high yield market would come under pressure with waves of selling. These predictions were fueled in large part by hypotheses over the past few years regarding the potential for "contagion" triggered by one open-end mutual fund being unable to meet redemptions.[18] The actual market experience of the week following Third Avenue's announcement presents an interesting case study in the asset management ecosystem. Both price behavior and turnover activity are worth analyzing. Exhibit 9 highlights the dispersion of price behavior between higher quality names and lower quality names within the high yield sector as BB and B bond prices did not change much while CCC bond prices declined by about 4.2% in the two weeks between the announcement and year-end. Looking at TRACE[19] data as shown in Exhibits 10 and 11, high yield bonds traded over $6 billion in average daily trading volume through December 2015. Daily high yield bond trading volume from December 1, 2015 through December 17, 2015 averaged over $8 billion and then declined at the end of the year, reflecting the seasonal decrease.

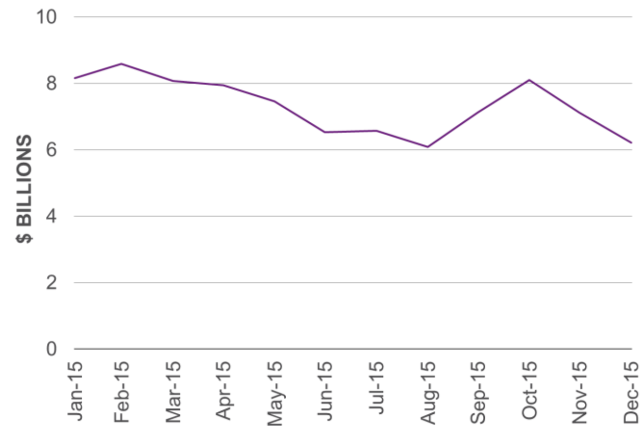
Exhibit 9: AVERAGE HIGH YIELD BOND PRICES
(Dec. 9 – Dec. 31, 2015)



As of December 31, 2015.
Source: Barclays Live.
Average Bond Price shown for the Barclays US Corporate High Yield Index.

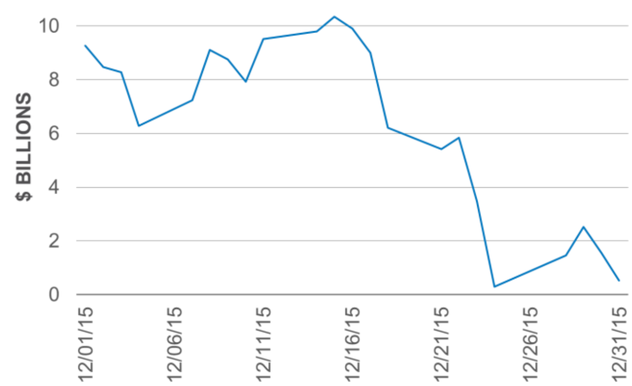
Despite predictions that liquidity would evaporate and prices would plummet, the high yield markets demonstrated resilience. Even on Friday, December 11, 2015 during intense media coverage of Third Avenue and predictions of a "rout" in high yield, while we saw increased volatility and some selling pressure, this was hardly a "rout". As noted above, bonds of higher quality liquid issuers traded down a point or two, whereas lower quality, less liquid names dropped three to five points. By the end of the day on Friday, we saw buyers of higher quality issues stepping in with bids for the BB/B-rated product and improved liquidity measured by two-way flows. While some investors were choosing to sell high yield, others found the sector increasingly attractive. In particular, from what we have observed, insurers and other opportunistic fixed income buyers increased their allocations to high yield bonds.[20] In terms of our own asset management business, we were able to transact normally and used the opportunity to raise cash levels in our high yield funds going into year-end. During the first week of 2016, high yield bonds performed well relative to equities.

Exhibit 10: 2015 MONTHLY HIGH YIELD BOND TRADING VOLUMES



Source: SIFMA, FINRA TRACE. Excludes144A trading volumes.

Exhibit 11: DECEMBER 2015 DAILY HIGH YIELD BOND TRADING VOLUMES

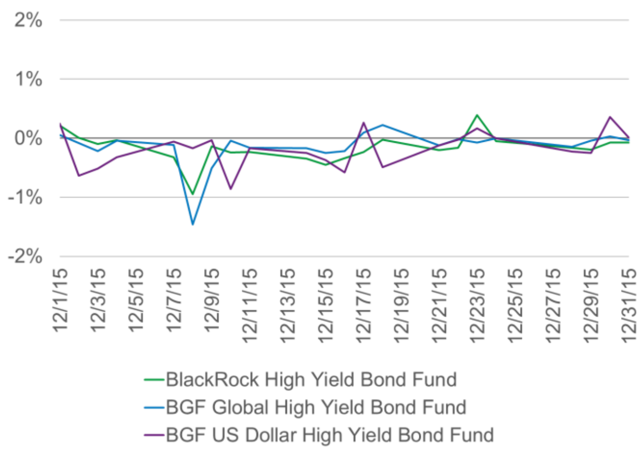


Source: MarketAxess, FINRA TRACE. Excludes144A trading volumes.

Experience of High Yield Bond Funds

Predictions of potential contagion to other high yield bond mutual funds did not materialize. Using our own experience, incoming investor calls spiked on Friday, December 11, 2015 and Monday, December 14, 2015 as investors wanted to understand both the specifics of the Third Avenue situation and then asked questions about high yield funds under management at BlackRock. Exhibit 12 shows net flows for three high yield bond funds managed by BlackRock, one in the US (BHYIX) and two domiciled in Europe – BGF Global High Yield Bond Fund and BGF US Dollar High Yield Bond Fund. None of these funds experienced material changes in

Exhibit 12: DAILY NET FLOWS FOR BLACKROCK HIGH YIELD FUNDS (DEC. 1-31, 2015)



Source: BlackRock.

flows following the Third Avenue announcement. In fact, the largest daily flow as a percentage of fund NAV experienced in the month of December 2015 occurred on December 8, where the BGF Global High Yield Bond Fund experienced a net outflow of $33 million, which represented 1.46% of that fund's NAV. Daily net outflows for each of these three funds were less than 1% for all other days in December 2015.

Looking more broadly at high yield bond funds, Exhibit 13 shows both performance and net flows on a monthly basis for the ten largest high yield mutual funds that are classified in Morningstar's high yield bond category. Note that flows on individual funds are generally released monthly, not daily. Given the environment for high yield bonds, it is not surprising to see these funds have returns of -4.08% to -1.66% as compared to the Barclays US High Yield 2% Issuer Capped Index, which returned -4.43% for the year. Likewise, these funds experienced both inflows and outflows as investor sentiment changed with some investors choosing to reduce their exposure and others choosing to increase their allocations as valuations and yields became more attractive. Notably, fund investor behavior has been consistent with the behavior of investors who own high yield bonds directly instead of through funds.

High Yield Bond ETFs

Since the 2008 financial crisis, fixed income markets have experienced a decline in the turnover of individual bonds even as the amount of bonds outstanding has grown in size due to increased debt issuance. The combination of increased supply, proliferation of trading CUSIPS, and reduced inventories has led to more fragmented fixed income markets. In this environment, corporate bonds face discontinuous liquidity in which many individual securities trade infrequently. Over time, bond investors are increasingly considering using fixed income ETFs as part of their portfolio strategy. To this end, since 2008, US fixed income ETF AUM has grown 485% while secondary trading volumes have also increased significantly, growing 421%.

In response to this growth, questions have been raised regarding how bond ETFs would perform during periods of market stress. Indeed, given the high yield market environment during the month of December 2015, high yield ETFs experienced significant trading volume. In the days just before Third Avenue's announcement, high yield ETFs were experiencing record high volumes in secondary market trading, and these records were broken in the aftermath of the announcement. On December 11, 2015, high yield bond ETFs traded in aggregate volume of $6.1 billion on exchange while high yield bonds traded $9.5 billion[21], indicating that exchange trading in high yield ETFs was nearly 65% of the

Exhibit 13: TEN LARGEST HIGH YIELD FUNDS

Fund Name	AUM ($ billions)	YTD Performance	December Performance	YTD Net Flows ($ millions)	December Net Flows ($ millions)
Vanguard High-Yield Corporate Fund	$17.7	-1.40%	-1.76%	$1,031.94	$75.98
BlackRock High Yield Bond Fund	$16.2	-4.04%	-2.69%	$2,385.14	-$826.33
American Funds American High-Income Trust	$15.7	-7.11%	-2.83%	-$1,940.92	-$622.49
Fidelity Capital & Income Fund	$10.2	-0.92%	-1.98%	$9.96	-$175.86
JPMorgan High Yield Fund Ultra	$9.7	-4.59%	-2.33%	$487.77	-$263.09
T. Rowe Price High-Yield Fund	$9.1	-3.27%	-2.00%	-$119.98	-$188.95
MainStay High Yield Corporate Bond Fund	$8.7	-1.60%	-2.54%	$851.45	-$157.24
PIMCO High Yield Bond Fund	$8.5	-1.87%	-1.66%	-$1,733.58	-$667.72
Ivy High Income Fund	$6.2	-7.13%	-4.08%	-$1,814.70	-$289.79
Eaton Vance Income Fund of Boston	$5.2	-1.96%	-1.80%	$719.92	$64.54

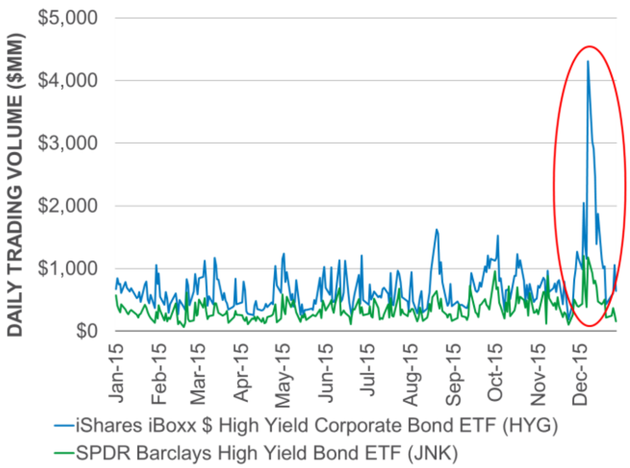
Source: Morningstar. As of 12/31/2015.

size of total over-the-counter trading in high yield bonds. Exhibit 14 shows iShares iBoxx High Yield Corporate Bond ETF (ticker: HYG) posted trading volume of $4.3 billion, which was the most ever seen and more than three times the amount that any other corporate bond ETF had ever traded.

It is worth noting that in the period just after Bill Gross departed PIMCO, broad-based bond market ETFs saw a similar spike in volume as investors used them to maintain their fixed income exposure while deciding on a longer-term strategy. This case study is documented in BlackRock's October 2014 paper titled, "ETFs Help Improve Market Stability: A Closer Look at Fixed Income ETF Behavior during Recent Bond Market Movement".

In each of these periods of market volatility, ETFs have demonstrated that they are able to provide an additional source of liquidity through the exchange and away from the primary market for the underlying bonds, serving as shock absorbers to activity in the asset class without putting stress on the underlying bond market.

Exhibit 14: HIGH YIELD ETF TRADING VOLUME

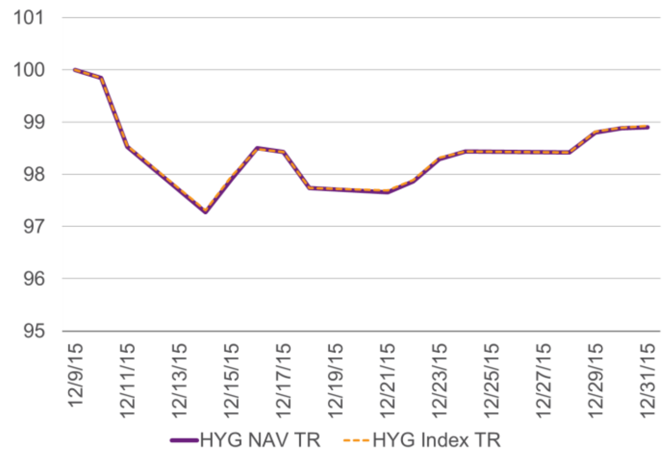


Source: Bloomberg, BlackRock, as of 12/31/2015

During this period, high yield ETFs continued to function normally, despite the extreme market conditions. For example, HYG closed on December 11, 2015 with a price just 0.7% below its NAV, despite the historic 2% drop in its total share price and the extraordinary volume of secondary trading. At the same time, all fund flows into and out of HYG were done via in-kind transactions by "authorized participants". The transaction costs created by this type of creation and redemption activity are externalized outside the HYG fund, and do not impact fund returns or shareholders. This is evidenced in the fund's consistent tracking versus its index during this period, as shown in Exhibit 15.

Exhibit 15: HYG PERFORMANCE RELATIVE TO INDEX

Total Return Comparison – HYG vs Markit iBoxx USD Liquid High Yield Index (HYG Index), Indexed to 100



Source: BlackRock, Bloomberg, as of 12/31/2015

Lessons Learned and Recommendations for Enhanced Regulation

Unusual events, such as Third Avenue shutting this fund, can be an opportunity to test our hypotheses and to learn from the event. Just as the 2008 Financial Crisis highlighted the need to focus on bank capital, mortgage lending standards, OTC derivatives, money market funds, and more valuable insights can be gained by reviewing the Third Avenue case study. Regulators are currently contemplating enhancing redemption risk and liquidity risk management requirements for mutual funds. We support the importance of having robust policies and procedures in place to manage liquidity and redemption risk in open-end funds. Based on the experiences of Third Avenue, we recommend considering four areas for enhanced regulation and industry consideration related to open-end mutual funds: (i) re-considering guidelines around fund classification and naming conventions, (ii) data reporting to regulators regarding the relative liquidity of open-end mutual fund holdings, (iii) communication with regulators and fund boards regarding illiquid asset limitations, and (iv) supervision of funds experiencing distress.

1. Re-considering guidelines around fund classification and naming conventions

The classification of TFCIX as "high yield" by Third Avenue and by performance reporting services suggests that closer attention needs to be paid to how fund sponsors and others classify funds. While we are not going to wade into a debate about whether or not the disclosures in the TFCIX prospectus were adequate, too often investment decisions are made based on performance relative to other funds in the same category. Fund managers, performance reporting services, consultants, and regulators need to work together to fine-tune classifications so these reflect the actual strategy and holdings of a fund, and lead to comparisons that are not misleading. Fund managers should be encouraged to correct classifications that they believe are not reflective of the fund's actual investment strategy.

2. Data Reporting to Regulators Regarding the Relative Liquidity of Fund Holdings

Third Avenue's need to shut TFCIX did not happen "suddenly". As it approached this decision point, TFCIX presented a number of red flags. The first flag was the level of outflows. Given that the portfolio already held a significant amount of less liquid assets, the need to liquidate some assets while holding increasingly concentrated amounts of illiquid assets created an unsustainable situation. Data reporting to regulators using a tiering system that addresses the relative liquidity of portfolio holdings would be useful in helping regulators to monitor the liquidity profile of mutual funds and flag funds that become increasingly less liquid.

3. Communication with Regulators and Fund Boards Regarding Illiquid Asset Limitations

The second flag in the Third Avenue situation was that illiquid assets came to exceed what was reasonably expected to meet redemptions in terms of the redemption trends for TFCIX. We recommend that regulators codify notification procedures that would include notifying the fund board and the regulator when illiquid assets exceed the legally required threshold. In the US, this threshold is 15% – meaning that if a mutual fund exceeded 15% of its portfolio in illiquid assets because it met redemptions or for other reasons, the regulator would be notified. We believe such a notification mechanism would have brought the SEC into the Third Avenue situation earlier.

4. Supervision of Funds Experiencing Distress

In the event that a fund's policy triggers notification to its board and the fund's regulator, the fund should be subject to closer supervision (similar to the enhanced oversight of broker-dealers whose net capital decreases hit various "early warning" levels). We recommend that fund regulators receive daily updates on the liquidity of the fund, gross and net redemptions, and the use, if any, of lines of credit or other borrowings. This monitoring would assure that a request for an order to suspend redemptions would not come as a surprise and could be acted on expeditiously by regulators to protect investors and the capital markets. Further in the interest of protecting fund shareholders, these special reports should be considered supervisory in nature and not subject to public disclosure. In the event redemption and/or liquidity pressures eased, the enhanced supervision could be curtailed.

Notes

1. SEC, Third Avenue Trust and Third Avenue Management LLC; Notice of Application and Temporary Order (Dec. 16, 2015), available at https://www.sec.gov/rules/ic/2015/ic-31943.pdf (SEC Order).
2. The order is temporary because interested persons have the ability to request a hearing on the matter.
3. SEC Order.
4. Rob Copeland, The Wall Street Journal, Stone Lion Capital Partners Suspends Redemptions in Credit Hedge Funds (Dec. 11, 2015), available at http://www.wsj.com/articles/stone-lion-capital-partners-suspends-redemptions-in-its-oldest-fund-1449870782?mg=id-wsj.
5. Third Avenue Management, History: How Two Deals Sparked the Rise of Third Avenue Management as a Global Asset Manager, available at http://thirdave.com/who-we-are/history/.
6. Bridget O'Brian, The Wall Street Journal, "AMG Buys 60% Stake in Third Avenue Funds" (May 23, 2002), available at http://www.wsj.com/articles/SB1022106276574591880.
7. Feldman, Amy, Barron's, "Can Third Avenue Get Back on Track?" (May 9, 2015), available at http://www.barrons.com/articles/can-third-avenue-get-back-on-track-1431136270; Charles Stein, Bloomberg, "Third Avenue Bled Managers, Assets Before Fund Shutdown" (Dec. 16, 2015), available at http://www.bloomberg.com/news/articles/2015-12-16/third-avenue-bled-managers-billions-of-assets-before-fund-shut.
8. See TFCIX Prospectus, available at http://thirdave.com/wp-content/uploads/2015/12/Third-Avenue-Funds-2015-Prospectus-with-supplements.pdf. Fund inception date was Aug. 31, 2009.
9. See Third Avenue Form N-Q filing as of Jul. 31, 2014, available at http://www.sec.gov/Archives/edgar/data/1031661/000093041314004004/c78158_nq.htm; Tom Aspray, Forbes, "The Week Ahead: How Long Will Junk Bonds and Crude Oil Crush Stocks?" (Dec. 12, 2015), available at http://www.forbes.com/sites/tomaspray/2015/12/12/the-week-ahead-how-long-will-junk-bonds-and-crude-oil-crush-stocks/.
10. Pensions & Investments, "Third Avenue Plans to Liquidate Credit Fund After Losses" (Dec. 10, 2015), available at http://www.pionline.com/article/20151210/ONLINE/151219990/third-avenue-plans-to-liquidate-credit-fund-after-losses; Reuters, "Third Avenue to Liquidate Junk Bond Fund that Bet Big on Illiquid Assets" (Dec. 10, 2015), available at http://www.reuters.com/article/funds-thirdavenue-liquidation-idUSL1N13Z1Q120151210. AUM as of 11/30/2015.
11. TFCIX was included in the high yield categories of both Lipper and Morningstar.
12. Source: BlackRock. As of Dec. 29, 2015.
13. Source: T. Rowe Price. As of Dec. 31, 2015.
14. The most recent publicly available holding data for TFCIX is from Jul. 31, 2015.
15. Note that the Barclays US High Yield 2% Issuer Capped Index is used for measuring the performance of the BlackRock High Yield Bond Fund. TFCIX is benchmarked to the U.S. Corporate High Yield Index and the Credit Suisse Loan Index. PRHYX is benchmarked to the Credit Suisse High Yield Index. We compare portfolio composition throughout this paper to the Barclays US High Yield 2% Issuer Capped Index for illustrative purposes only. All three funds are considered part of the Morningstar and Lipper High Yield categories, meaning that they are comparable, despite being managed to different benchmarks.
16. Source: BlackRock. As of 9/30/2015.
17. Source: T. Rowe Price. As of 5/31/2015.
18. See e.g., Feroli, Michael, Anil K. Kashyan, Kermit Schoenholtz, and Hyun Song Shin, Market Tantrums and Monetary Policy (Feb. 2014); IMF, Global Financial Stability Report (Apr. 2015) at 100-103, available at https://www.imf.org/External/Pubs/FT/GFSR/2015/01/pdf/c3.pdf; Gaston Gelos, IMF Working Paper, International Mutual Funds, Capital Flow Volaility, and Contagion (Apr. 2011). We note that many hypotheses regarding contagion in mutual funds stem from the experience of MMFs during the crisis. See e.g., Hugh Hoikwang Kim, The Wharton School, University of Pennsylvania, "Contagious Runs in Money Market Funds and the Impact of a Government Guarantee" (Sep. 19, 2012), available at https://bepp.wharton.upenn.edu/bepp/assets/File/AE-F12-Kim.pdf. However, it is important to understand that mutual funds, unlike MMFs, do not have constant NAVs.
19. The Trade Reporting and Compliance Engine (TRACE) is the US post-trade reporting engine for fixed income securities.
20. Rick Baert, Pensions & Investments, "Some see recent high-yield turmoil as buying opportunity" (Dec. 18, 2015), available at http://www.pionline.com/article/20151218/ONLINE/151219882/some-see-recent-high-yield-turmoil-as-buying-opportunity.
21. Source: MarketAxess, FINRA TRACE. Excludes144A trading volumes. Data as of 12/11/2015; accessed on 1/11/2016.

RELATED CONTENT

- *ViewPoint* - Addressing Market Liquidity, July 2015
- *ViewPoint* - Bond ETFs: Benefits, Challenges, Opportunities, July 2015
- ETFs Help Improve Market Stability: A Closer Look at Fixed Income ETF Behavior During Recent Bond Market Movement, Oct 2014
- *ViewPoint* - Who Owns the Assets? A Closer Look at Bank Loans, High Yield Bonds, and Emerging Markets Debt, Sep 2014

For access to our full collection of public policy commentaries, including the *ViewPoint* series and comment letters to regulators, please visit http://www.blackrock.com/corporate/en-us/news-and-insights/public-policy

BLACKROCK®