MEMORANDUM

To: File Nos. S7-16-15 and S7-08-15

From: Jill S. Henderson
Counsel to Commissioner Kara Stein
U.S. Securities and Exchange Commission

Date: January 15, 2016

Re: Meeting with representatives from BlackRock

On January 14, 2016, Commissioner Stein, Jill S. Henderson, and Mellissa Duru met with Barbara Novick, Kathryn Fulton, and Alexis M. Rosenblum from BlackRock. Among the topics discussed were open-end fund liquidity risk management programs and swing pricing.

BLACKROCK®

January 13, 2016

Submitted via electronic filing: *www.sec.gov/rules/proposed.shtml*

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

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

Dear Mr. Fields:

This letter responds to the request of the Securities and Exchange Commission ("Commission" or "SEC") for comment on topics covered by the proposed rules regarding Open-End Fund Liquidity Risk Management, Swing Pricing (collectively the "Proposal"), and the Re-Opening of the Comment Period for Investment Company Reporting Modernization Release ("Data Reporting Proposal").[1] BlackRock, Inc. (together with its affiliates, "BlackRock")[2] is supportive of the Commission's focus on liquidity risk management ("LRM") and we agree with the Commission's objective of promoting high standards for LRM across the US fund industry, while ensuring funds have the ability to tailor LRM programs to the unique nature of each fund's investment strategy. As history has shown us, financial markets can and do fail to function as we would hope they do on occasion, and neither fund managers nor regulators should assume that high levels of liquidity will necessarily be available for any security or market at all points in time.[3] To this end, we have encouraged policy makers to codify best practices for LRM and consider existing fund features to develop a best-practices "toolkit" which, in addition to thoughtful portfolio construction, can help funds meet redemptions in a variety of scenarios.[4] As such, we commend the Commission's consideration of additional tools that may be beneficial for Investment Company Act of 1940 mutual funds ("1940 Act Funds" or "mutual funds"), and we appreciate the Commission's leadership on LRM as well as other ongoing initiatives to enhance the Commission's rules for 1940 Act Funds and registered investment advisers.

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1 SEC, Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release Proposed Rule, 80 Fed. Reg. 62274 (Oct. 15, 2015), available at https://www.gpo.gov/fdsys/pkg/FR-2015-10-15/pdf/2015-24507.pdf ("Proposal").

2 BlackRock is one of the world's leading asset management firms. We manage assets on behalf of institutional and individual clients worldwide, across equity, fixed income, liquidity, real estate, alternatives, and multi-asset strategies. Our client base includes pension plans, endowments, foundations, charities, official institutions, insurers, and other financial institutions, as well as individuals around the world.

3 *See* Bennett W. Golub and Conun Crum, Risk Management Lessons Worth Remembering from the Credit Crisis of 2007-2009, 36(3) Journal of Portfolio Management 21-44 (Spring 2010).

4 BlackRock, Comment Letter, Request for Comment on Asset Management Products and Activities (Mar. 25, 2015), available at http://www.blackrock.com/corporate/en-us/literature/publication/fsoc-request-for-comment-asset-management-032515.pdf ("FSOC Letter"); BlackRock, *ViewPoint, Addressing Market Liquidity* (July 2015), available at http://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-addressing-market-liquidity-july-2015.pdf ("Liquidity ViewPoint").

Liquidity and redemption risk management are critical components of portfolio management, particularly for open-end mutual funds that seek to provide daily subscriptions and redemptions for shareholders. This is not a new phenomenon. Mutual fund managers have been performing liquidity and redemption risk management for a very long time. Since BlackRock's inception in 1988, BlackRock portfolio managers have been managing liquidity and redemption risk (in addition to many other investment risks) in portfolios and have established investment approaches and a risk management framework that combines portfolio manager experience and judgment, quantitative analysis, market insight, and product knowledge. Yet, it is profoundly important to be clear about what are, and are not, the inextricable elements of liquidity risk for mutual funds. Unlike bank deposits, the liquidity afforded by a mutual fund does not entail a guaranteed price or net asset value ("NAV") to shareholders upon exit. In considering liquidity risk, it is necessary to remember that amongst the risks borne by mutual fund shareholders in return for the expectation of earning attractive investment returns, is that their ability to realize the "intrinsic value" of their investment may be challenged during periods of market distress.[5] Markets typically offer a return as compensation for relative illiquidity. This is an immutable aspect of capital markets. This resultant risk, amongst many others, is clearly disclosed in a fund's constituent documents.

Broadly speaking, effective portfolio management and fund LRM begins with thoughtful portfolio construction that attempts to meet investment objectives within well-defined risk parameters. The portfolio construction process must take into consideration the particular liquidity needs of the portfolio, including the redemption features of the fund. For example, funds that meet redemptions by returning cash to investors, such as the majority of 1940 Act open-end mutual funds, have different liquidity needs than funds that meet redemptions through in-kind transfers of securities, such as the majority of exchange-traded funds ("ETFs"). These key differences necessitate different approaches to both portfolio construction and LRM. Portfolio managers must take these elements into consideration and manage portfolios and monitor portfolio positioning and risk characteristics with acute awareness of the dynamics occurring in the markets within which they invest. For fund managers, this includes carefully managing the composition of assets being liquidated in response to redemptions to prevent, to the maximum extent possible, the fund from becoming materially less liquid by disproportionately selling liquid positions.

Fund managers should have a formal and well-defined firm-wide risk governance framework that starts at the top of the organization with the management company board of directors (or other governing body) and includes a dedicated risk sub-committee, as well as control committees that focus on key risk control issues across the organization. The risk governance process should include a risk management function that is independent of portfolio management (for independent oversight of investment, liquidity, counterparty credit, operational, and technology risks) with direct access to the fund management company board of directors (or other governing bodies of the fund manager). This is essential to ensuring that all risks including liquidity risks in a fund, are properly managed. In addition, the risk governance framework should include other control groups, such as portfolio compliance and valuation oversight, that are responsible for elements of the independent risk management process. Legal & Compliance are also involved in this framework and play an important role in overseeing related compliance matters. BlackRock follows the approach described above and

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[5] Even the notion of the "intrinsic value" of a security generates disagreement. While in theory, a security may have an "intrinsic value," in reality, a security can only be sold at a price a buyer is willing to pay. Mutual funds do not guarantee that some notion of the "intrinsic value" of mutual fund shares will be realized. Rather, mutual funds are valued once a day at their end-of-day NAV.

employs a "three lines of defense" model as part of its risk governance framework. As a first line of defense, the firm expects individual portfolio management teams to take primary responsibility for managing the investment risks including liquidity risk management associated with the portfolios that they manage, and to ensure that they are following key controls, fund mandates, and regulations. The second line of defense is our dedicated risk management group, which monitors the risk profiles of portfolios managed on behalf of clients and regularly engages with the portfolio management teams to ensure risk positioning is deliberate, diversified, and scaled. Risk management provides a layer of oversight or "checks and balances" on the portfolio management process to ensure that best practices are being applied, that risk is evaluated independently, and that portfolio managers are constructing client portfolios consistent with clients' reasonable expectations. Our Chief Risk Officer along with senior members of our risk management team are in regular dialogue with BlackRock mutual funds' boards on pertinent risk issues, including liquidity risk. The third line of defense is our internal audit function that independently validates investment businesses' adherence to key controls and policies and provides independent substantiation of control issues either self-identified by investment teams or flagged by independent risk management and evidences compliance with key controls. The three lines of defense operate in the context of our Legal & Compliance framework, overseen by the Chief Compliance Officer ("CCO") for our mutual funds.

Our comments on the Proposal arrive from this perspective. In this letter, we outline elements of the Proposal that we support, and we provide recommendations on how certain aspects of the Proposal could be enhanced to help the Commission achieve its objectives regarding both investor protection and systemic risk. We responded to the Commission's proposal on Investment Company Reporting Modernization in a letter dated August 11, 2015 ("Data Reporting Letter").[6] We have supplemented the comments made in that letter throughout this response.

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[6] BlackRock, Comment Letter, Investment Company Reporting Modernization, File Number S7-08-15 (Aug. 11, 2015), available at https://www.blackrock.com/corporate/en-at/literature/publication/sec-investment-company-reporting-modernization-081115.pdf ("Data Reporting Letter").

Executive Summary

1. We agree with the Commission's assessment that <u>every</u> fund should conduct LRM.

We believe that formalizing the requirement that 1940 Act Funds consider LRM and have LRM policies and procedures in place will prove beneficial for fund shareholders, while mitigating potential systemic risk. LRM procedures for open-end mutual funds should ideally include:

(i) Dedicated individuals responsible and accountable for investment risk management who are independent from portfolio management;
(ii) Assessments of a fund's liquidity risk based on the unique characteristics of the fund's investment strategy and investor profile;
(iii) Policies on the use of in-kind redemptions;
(iv) Analysis of available back up sources of liquidity;
(v) Outline of how a fund intends to meet redemptions in various circumstances; and
(vi) Liquidity stress testing of both assets and liabilities using several scenarios.[7]

2. We are supportive of enhanced disclosure regarding a fund's LRM practices.

Understanding the liquidity dynamics of an investment strategy employed by a mutual fund would be beneficial for investors. Investors should understand how funds can meet redemptions, in normal and stressed market conditions. Greater disclosure of LRM processes and procedures that are in place to help a fund be able to meet redemptions will enhance understanding of these important investor protections. Additionally, we recommend that the Commission consider whether funds should be required to explicitly address the level of position concentration that is appropriate for the fund's investment strategy and investor profile in LRM policies and procedures. While the level of tolerance for concentrated positions will differ by fund, thought should be given to this issue as part of the overall fund risk management process and the associated disclosure.

3. "Days-to-liquidate" is not appropriate as a classification mechanism, particularly for public disclosure. We recommend adopting an objective liquidity "tiering" approach instead.

Like other ex-ante risk measures, forecasts of days-to-liquidate holdings are limited by simplifying assumptions and data availability. While ex-ante risk measures are appropriate when used as tools to evaluate aspects of portfolio risk, they are much less appropriate for use as regulatory mandated classification mechanisms. In other words, predicting the time it will take to liquidate a position for cash at a given price in the future is a highly subjective exercise for many types of assets and even the best intentioned and quantitatively sophisticated manager's ability to accurately predict days-to-liquidate for those assets is, for many types of securities, extremely limited by required assumptions and market data availability. As a result, there can be no guarantee that the results of any forecast of days-to-liquidate will hold true in any circumstance in the future, making such predictions extremely unreliable and, therefore, inappropriate for use as a classification mechanism. Even more disconcerting is that there can

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[7] Given that liquidity stress testing is an important component of LRM, we suggest that the Commission's forthcoming rule on stress testing be connected to the Proposal. *See e.g.,* Chair Mary Jo White, *Five Years On: Regulation of Private Fund Advisers After Dodd-Frank*, Keynote Address at the Managed Fund Association (Oct. 16, 2015), available at http://www.sec.gov/news/speech/white-regulation-of-private-fund-advisers-after-dodd-frank.html ("the Commission staff is considering ways to implement the Dodd-Frank requirements for annual stress testing by large registered advisers and registered funds").

be no reasonable expectation that the forecasts will be accurate. This means that days-to-liquidate forecasts will be subject to a significant margin of error, and they may materially change regularly as market conditions evolve. Further, since at this point in time, the underlying methodological science and data availability for estimating days-to-liquidate for large parts of the fixed income markets are not consistent across market participants, each fund will likely employ a different methodology. This creates the real possibility that two funds holding the same security could classify the liquidity of that holding differently. Further exacerbating this issue, introducing position sizes into the determination of days-to-liquidate will create additional confusion. For all these reasons, we believe that requiring a days-to-liquidate analysis to be reported to the public will be confusing and will not provide useable information.

As an alternative to the proposed days-to-liquidate buckets, we recommend that a more categorical approach be adopted; we will refer to this approach as liquidity "tiering". This is an approach that BlackRock risk managers and portfolio managers actually use for internal purposes when they are assessing the liquidity risk of a portfolio's assets. Like days-to-liquidate buckets, liquidity tiering recognizes that there is a spectrum of liquidity. In contrast to days-to-liquidate bucketing, however, liquidity tiering categorizes portfolio holdings based on asset type (e.g., asset class, credit quality, etc.) into one of several tiers. While the assignment of asset types to liquidity tiers is necessarily subjective, the underlying tiering matrix can be easily made transparent and potentially even be standardized across market participants. Once a tiering matrix is agreed upon, liquidity tiering eliminates the vast majority of subjectivity and inconsistency associated with the proposed days-to-liquidate buckets by removing references to and false precision around price, position size, and days to trade and settle. Instead, the descriptions of each liquidity tier refer to attributes of fund holdings based on the general characteristics of the asset type represented by each holding. Finally, we believe that aggregated information on liquidity tiers such as the percentage of a fund held in each tier or the weighted average liquidity tier for a fund would be more useful points of information than reporting the liquidity tier for each individual fund holding.

4. *We support the 15% limitation on illiquid holdings and we recommend harmonizing this rule with the liquidity tiering framework.*

We agree that a limitation on the amount of illiquid assets that can be held by an open-end mutual fund is appropriate. Setting reasonable controls on and monitoring the use of illiquid asset classes to reduce the risk that the liquidity offered to investors is not compromised is an important element of properly managing funds. To achieve this, the 15% illiquid asset limitation should be synchronized with liquidity tiering by stating that no more than 15% of the portfolio can be held in securities that fall under the least liquid tier. We recommend adding a requirement that funds notify their mutual fund board and the Commission on a timely basis if the 15% illiquid asset limit is breached for any reason (e.g., if liquid assets are used to meet redemptions and the fund becomes more concentrated in illiquid positions) on a timely basis.

5. *Maintaining adequate levels of liquid assets is essential to effectively managing open-end mutual funds. However, requiring a three-day liquid asset minimum will not ensure sufficient levels of liquid assets are maintained and could encourage procyclical behavior. Moreover, such a requirement could conflict with the prospectus-stated mandates of many funds. Instead, we recommend the Commission require funds to take several steps to ensure an appropriate level of Tier 1 and Tier 2 assets is maintained.*

Open-end mutual fund managers should maintain appropriate levels of Tier 1 and Tier 2 assets as an important element of an effective LRM program. Historical data over multiple market cycles demonstrate that open-end mutual fund managers adjust cash balances as a function of the market environment and anticipated redemptions.[8] However, we have several concerns regarding the three-day liquid asset minimum. Firstly, good risk management dictates that open-end mutual fund managers should be encouraged to meet redemptions by selling securities in order to maintain the fund's risk profile, wherever possible; managers should not be encouraged to meet redemptions primarily by using the most liquid securities held by the fund. We believe that the fund's redemption "waterfall" (i.e., outline of ways a fund can meet redemptions), which can include the use of cash and Tier 1 / Tier 2 assets as well as available backup sources of liquidity, should be addressed in an open-end mutual fund's LRM program. This broad approach to LRM is critical for portfolio managers to accurately manage funds relative to prescribed benchmarks and sector mandates. Further, LRM strategies should not be inconsistent with management of the active risk of a mutual fund, or the volatility of the difference between the return of the fund's assets relative to the return of the fund's prescribed benchmark.

From a systemic risk perspective, mechanical application of static liquidity requirements, even if self-imposed, can easily become pro-cyclical because funds may need to sell securities in stressed markets to maintain the required liquidity, exacerbating downward pressure on asset prices. In addition, prohibiting the purchase of non-three-day liquid assets when a fund has fallen below a mandated minimum level to meet redemption requests could encourage more redemptions, as remaining investors may believe that the fund will no longer be able to effectively employ its investment strategy. This could actually increase redemption risk, which is contrary to the objectives of the Proposal. Further, minimum cash requirements are unlikely to be sufficient to solve a major redemption issue. For example, the Third Avenue Focused Credit Fund raised $200 million in cash[9] (over 20% of the $942 million fund[10]) and still believed it was in the best interest of fund shareholders to cease redemptions. Therefore, consideration of how to avoid having a redemption issue and ensuring the availability of backup measures are paramount to prudent LRM. We recommend removing the three-day liquid asset minimum from the Proposal and replacing it with a requirement that funds take several steps to ensure an appropriate level of Tier 1 and Tier 2 assets is maintained and portfolio managers are able to follow the redemption "waterfall" for the fund. The appropriate level of Tier 1 and Tier 2 assets

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8 BlackRock, *ViewPoint*, Who Owns the Assets? A Closer Look at Bank Loans, High Yield Bonds and Emerging Markets Debt (Sep. 2014), available at http://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-closer-look-selected-asset-classes-sept2014.pdf.

9 SEC Release No. IC-31943 (Third Avenue Trust and Third Avenue Management LLC; Notice of application and temporary order under Section 22(e)(3) of the Investment Company Act) (Dec. 16, 2015), available at https://www.sec.gov/rules/ic/2015/ic-31943.pdf ("SEC Order"). The order states that "the Fund increased its cash position to over $200 million by early December 2015 in anticipation of tax selling and other redemptions".

10 McLaughlin, Tim, "RPT – Update 2 – Third Avenue to Liquidate Junk Bond Fund that Bet Big on Illiquid Assets" (Dec. 10, 2015), available at http://www.cnbc.com/2015/12/10/reuters-america-rpt-update-2-third-avenue-to-liquidate-junk-bond-fund-that-bet-big-on-illiquid-assets.html ("CNBC Third Avenue Update"). AUM listed as of November 30, 2015.

could be articulated as a range or target and subject to review by independent risk management.

Nevertheless, if the Commission rejects this alternative recommendation and imposes some sort of minimum cash or liquid asset requirement, we strongly suggest that the rule only apply after a fund has employed 10% or more of its permitted leverage. If a fund is trying to manage against a benchmark and holds securities that can easily be financed on a short-term basis, the existence of leverage capacity is a valuable source of liquidity. Absent such a "safe harbor", a mandatory liquid asset requirement may end up driving funds to use their leverage capacity defensively to maintain the liquid asset buffer or to increase their use of derivatives to synthetically demonstrate higher cash holdings.

6. *We are supportive of swing pricing as a tool to protect long-term shareholders from dilution and mitigate the potential for a first-mover advantage. However, changes to operational infrastructure are needed before swing pricing can be adopted effectively in the US.*

We have consistently supported permitting mutual funds to have mechanisms to allocate transaction and market impact costs associated with the sale (purchase) of fund assets to redeeming (subscribing) shareholders as a way to reimburse or economically buffer a fund's remaining shareholders while at the same time providing a price signal to subscribing and redeeming fund shareholders of the genuine economic cost of obtaining liquidity.[11] The long-term total return impact of compensating long-term fund shareholders for the transactions and market impact costs incurred by more transient investors can be quite significant. A price signal to redeeming (or subscribing) investors will also have a counter-cyclical impact on investor behavior over time, which will tend to reduce the risk of generalized runs on a particular type of asset class.

Swing pricing is one such mechanism, which has been used effectively in several jurisdictions in Europe for many years. BlackRock currently manages many European-domiciled funds whose shareholders benefit from the application of swing pricing. For this reason, we are supportive of the Commission's permitting US mutual funds to utilize swing pricing. That said, for this to become a practical reality for 1940 Act funds, the Commission must recognize that because the technology and operational processes that manage mutual fund flows in the US were not developed to support swing pricing, the operational infrastructure required to practically enable swing pricing does not readily exist for the vast majority of US mutual funds. Depending on the method by which a fund is distributed, there are complexities that will need to be and should be addressed by the Commission.

The main challenge lies in obtaining same-day investor net flows prior to publishing the fund's NAV, since the magnitude and direction of net flows determine whether the NAV will be "swung" on a given day and if so, in which direction. In Europe, the dealing cutoff (i.e., the time when investors can subscribe to or redeem from a fund and get the next available NAV) typically occurs several hours before a fund's NAV is published. This gap in time between the dealing cutoff and the NAV determination permits much greater certainty around the direction and level of flows by the time funds are valued. In the US, fund valuation and receipt of fund flows data currently are effectively two separate processes. The current timing of these distinct processes, in most cases, does not permit substantial visibility on fund flows before a fund's NAV is published.

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[11] *See* FSOC Letter.

The Global Association of Risk Professionals ("GARP") Buy-Side Risk Managers Forum formed a sub-committee that studied the US mutual fund infrastructure with an eye towards determining how to best adapt it to facilitate the use of swing pricing in the US. GARP has submitted a letter to the Commission detailing a roadmap for changes to processes and technology that would be needed to enable swing pricing in the US.[12] Implementation of these recommended changes will require the Commission to take a leadership role in facilitating the US mutual fund industry's ability to employ swing pricing. It should also be recognized that the technological modernization required for broad adoption of swing pricing will not be costless, and some of these costs may need to be borne by investors (i.e., upgrading technology and changing processes may increase third party service providers' costs of providing services to mutual funds). Nevertheless, in our view, over time, the aggregate long-term benefits to both US mutual fund shareholders and to the stability of the overall financial system should be significant, likely outweighing the transitional costs.

7. *ETFs and open-end mutual funds have different redemption characteristics. The application of the Proposal to ETFs needs to be reconsidered. We recommend the Commission instead develop a separate and comprehensive rule addressing the different types of ETFs and their respective risks.*

Several of the key provisions in the Proposal assume that all investor redemptions are met by redeeming fund shares for cash. While this assumption correctly applies to open-end mutual funds where investor liquidity is achieved directly from the fund and its portfolio holdings, this mechanism does not accurately describe what happens with almost all ETFs.[13] Unlike open-end mutual funds, ETF investors buy and sell shares on exchanges without directly impacting the actual ETF portfolio's holdings. Imbalances between ETF buyers and sellers impact the exchange price, but do not directly lead to purchases or sales of ETF holdings.

In fact, because many ETFs actively trade on exchanges at tight bid-ask spreads with significant volume, many portfolio managers view ETFs as liquid assets. ETFs are sometimes held by open-end mutual funds as a way to maintain market exposures while ensuring sufficient liquid asset holdings. In this respect, ETFs are much more comparable to single-company exchange traded equities, rather than open-end mutual funds.

The ETF arbitrage mechanism seeks to constrain the ETF's price to be close to the NAV of the ETF's underlying assets by adjusting the supply of available shares through transactions with Authorized Participants ("APs").[14] The majority of ETFs redeem ETF shares with APs *in-*

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[12] Letter from Richard Apostolik, GARP, Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release (Jan. 12, 2016) ("GARP Swing Pricing Letter").

[13] For the subset of ETFs that meet redemptions in cash, the Proposal does have some applicability; however, they can be better addressed in a broader ETF rule.

[14] An Authorized Participant is a sophisticated professional trading firm that for its own reasons chooses to settle purchase and redemption transactions in large blocks of ETF shares (for its own account or for customers) directly with the ETF. APs sign a contract governing the settlement terms of complex in-kind transactions for ETF shares, but are not agents of the ETF – they are not required to create or redeem ETF shares under any circumstances, and only do so when it is in their interest. Some APs act only on their own behalf, while others may act as agents for a variety of clients, including other professional trading firms. APs may be designated market makers, off-exchange liquidity providers, large broker-dealers who trade with or act for institutional clients or specialized computer-based trading firms that trade in large volumes and prefer to clear their own transactions. An Authorized Participant must be a broker-dealer that has access to institutional clearing systems, such as The Depository Trust Company, used to settle ETF share transactions.

kind ("In-Kind ETFs").[15] The notion of liquidating securities for cash to meet redemptions is substantially irrelevant when in-kind transactions are used to meet redemptions. For these reasons, the Proposal is not well-tailored to the liquidity characteristics of In-Kind ETFs and does not appropriately address differences between In-Kind ETFs and open-end mutual funds that primarily meet redemptions in cash.

We recommend the Commission utilize responses to the ETF Issues Release[16] to review the Proposal's application to ETFs. In particular, we recommend that the final rule clarify how the concept of "convertible into cash within three business days" has any meaning or relevance when applied to In-Kind ETFs. As an alternative formulation, should an ETF that routinely redeems in-kind be allowed to treat substantially all of its assets as "convertible into cash within three business days" or, if not, that no "three day liquid assets" may be appropriate for In-Kind ETFs. Further, the adopting release should clarify whether the receipt of assets in-kind should be treated as an acquisition. If the Commission determines that in-kind transactions are not equivalent to conversions for cash and that receipt of assets in-kind should be treated as acquisitions, the Commission needs to clarify how the final rule will apply to ETFs. Given the fundamental differences in redemption mechanisms, a better approach to addressing ETF-specific issues would be for the Commission to propose a separate rule that comprehensively addresses a broad set of topics specific to ETFs.

8. Mutual fund boards should play an oversight role in ensuring appropriate LRM practices; however, mutual fund boards' responsibilities should not entail day-to-day fund management.

We support mutual fund board engagement, oversight, and awareness of LRM practices and issues. Mutual fund boards of directors can and should provide oversight of an investment adviser's management of fund assets. LRM is an important aspect of the portfolio management process so the mutual fund board's oversight of investments should include LRM practices. The Commission must ensure, however, that the distinction between oversight and management is not blurred. We encourage the Commission to clarify in the adopting release that the mutual fund board's role is one of oversight, not day-to-day management and that changes to the LRM policy would not have to be approved by the mutual fund board before they occur. Rather, changes should be noticed and discussed on an annual review basis. Such a requirement would allow mutual fund boards and responsible adviser personnel to operate in the ways that they work most effectively together.

The mutual fund board cannot be responsible for determinations regarding liquidity classifications of fund holdings or the minimum amount of cash or liquid assets a fund should hold. Decisions regarding the amount of liquid assets held by a fund are day-to-day portfolio management decisions, supported by oversight by the fund manager's independent risk managers. That said, we are supportive of periodic reporting to mutual fund boards regarding liquidity matters and board notification of material liquidity issues that arise in the course of managing a mutual fund.

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[15] Because in-kind transactions for ETF shares involve extremely complex settlements often involving thousands of securities, the Commission, through exemptive relief, permits ETFs to transact directly only with APs rather than with the general public.

[16] SEC, Request for Comment on Exchange Traded Products, 80 Fed. Reg. 34729 (Jun. 17, 2015), available at https://www.gpo.gov/fdsys/pkg/FR-2015-06-17/pdf/2015-14890.pdf ("ETF Issues Release"). *See also* Letter from Barbara Novick and Ira Shapiro dated August 11, 2015, available at http:www.sec.gov/comments/s7-11-15/s71115-10.pdf ("BlackRock ETF Comment Letter").

I. Open-End Mutual Funds: Comments on Rule 22e-4

LRM is an important component of portfolio management, and we are supportive of the Commission's proposal to require funds to formally articulate their LRM policies and procedures. Given the significant differences between open-end mutual funds and ETFs, we have provided separate comments for each, beginning with open-end mutual funds in this section. We agree with the Commission that LRM can take different forms depending on the investment strategy employed by an open-end mutual fund, and we appreciate the Commission's efforts to take a principles-based approach to codifying LRM best practices. We note, however, that a regulatory requirement is not a substitute for informed judgment when it comes to matters of risk management. To this end, we agree with the Commission that "the most effective liquidity risk management programs would be multi-faceted and customized to reflect the sources of liquidity risk."[17] From our perspective, effective LRM programs should ideally include the following key principles:

(i) *Dedicated individuals responsible and accountable for investment risk management who are independent from portfolio management.* We strongly support a risk management function that is independent from portfolio management. The risk management function should have direct reporting lines to senior leadership and a regular role in communicating with the fund management company board of directors (or other governing body) and mutual fund boards to ensure that risk is evaluated independently to verify that portfolio managers are constructing portfolios in a manner that is consistent with shareholder expectations and regulatory requirements.

BlackRock follows the model described above and also employs a "three lines of defense" model as part of its risk governance framework. As a first line of defense, the firm expects individual portfolio management teams to take primary responsibility for managing the investment risks associated with the portfolios that they manage and ensure that they are following key controls, fund mandates, and regulations. The second line of defense is our dedicated risk management group, which monitors the risk profiles of portfolios managed on behalf of clients and regularly engages with the portfolio management teams to ensure risk positioning is deliberate, diversified, and scaled. Risk management provides a layer of oversight or "checks and balances" on the portfolio management process to ensure that risk is evaluated independently and to verify that portfolio managers are constructing client portfolios consistent with client expectations. Our Chief Risk Officer along with senior members of our risk management team regularly communicate with BlackRock mutual fund boards on pertinent risk issues, including liquidity risk. The third line of defense is our internal audit function that independently validates investment businesses' adherence to key controls and policies and provides independent substantiation of control issues, either self-identified by investment teams or surfaced by independent risk management, and evidences compliance with key controls. These three lines of defense operate in the context of our Legal & Compliance framework, overseen by mutual funds' Chief Compliance Officers ("CCOs").

(ii) *Assessments of a fund's liquidity risk based on the unique characteristics of the fund, including its investment strategy, mandate, and investor profile*. This analysis should take into consideration the liquidity of the assets in which the fund invests, the fund's investment mandate, investment strategy, regulatory requirements, and current market conditions. For example, high yield mutual funds must be at least 80% invested high yield bonds under existing

[17] Proposal at 62304.

regulatory guidance.[18] Understanding the characteristics of the fund's shareholders, including concentration of shareholders and the types of investors in the fund is useful in assessing a fund's liquidity risk. We, therefore, provide suggestions and additional data transparency that would be useful to help fund managers better assess redemption risk in Section I(G) of this letter.

(iii) *Policies on the use of in-kind redemptions.* In-kind redemptions, where feasible, are a useful method for allocating the cost of selling securities to meet redemptions to redeeming investors – particularly when those costs are imposed by a large redemption by a single institutional investor. In-kind redemptions allow transaction costs to be externalized from the fund without the use of market pricing mechanisms, such as swing pricing. While in-kind redemptions are not practical for retail investors, they are a tool that can be used effectively to meet a large redemption by an institutional investor when deemed necessary to protect remaining shareholders. We, therefore, agree with the Commission's view that outlining policies and procedures on the use of in-kind redemptions would encourage greater consideration of in-kind transfers of securities as a tool to meet redemptions.

(iv) *Analysis of available back up sources of liquidity such as repurchase agreements ("repo"), lines of credit, or interfund lending.* LRM policies and procedures should outline forms of short-term borrowing that are available to the fund. LRM policies should also discuss when a fund would consider using such backup sources of liquidity (e.g., for investment purposes or to facilitate managing short-term liquidity mismatches). LRM policies should also note limitations on the use of borrowing capacity such as restrictions on the amount of leverage that can be employed. The 1940 Act already places appropriate restrictions on leverage that allow the use of repo and lines of credit for backup liquidity.[19] Further, bank regulators have made both repo markets and committed lines of credit stronger tools by requiring banks to hold significant levels of capital related to their liabilities associated with these tools. Whenever possible, obtaining access to multiple backup sources of liquidity should be considered beneficial, as the flexibility has value to the fund's shareholders.

(v) *Outline of how a fund intends to meet redemptions in various circumstances.* Portfolio managers generally consider all relevant tools available to meet redemptions and follow a redemption "waterfall" when making decisions in specific situations. A redemption "waterfall" illustrates a likely sequencing of all available means to meet redemptions, including structural fund features, while recognizing constraints based on the fund's mandate and regulatory requirements. Exhibit 1 outlines key elements of the typical redemption waterfall for a 1940 Act open-end fixed income mutual fund. In our experience, portfolio managers try to ensure that the portfolio maintains a risk profile that reflects the fund's guidelines, forecasted future redemptions, and the portfolio managers' investment outlook. Redemptions are often met with pro rata sales across the portfolio or with more targeted sales that maintain the desired investment risk profile.

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[18] 17 CFR 270.35d–1.

[19] Many funds have also obtained exemptive relief that permits interfund lending.

Exhibit 1: Key Elements of a Typical Redemption "Waterfall" for a Fixed Income Fund

The below table reflects some elements that might be used by fixed income funds to meet redemptions.
Pro-rata/risk constant sale of bonds in a manner that keeps risk positioning in a fund largely constant and consistent with the fund's mandate, including the fund's investment guidelines. The overwhelming majority of redemptions in fixed income funds are met by the sale of bonds (in a pro rata or "risk constant" fashion).
Cash is maintained for a variety of reasons, including (i) the ability to purchase securities in the new issue market, (ii) as part of an investment strategy where risk may be obtained synthetically by using cash to enter into futures or swap positions, and (iii) market environments in which the portfolio manager chooses to hold excess liquidity. Cash levels in portfolios fluctuate based on these and other factors.
Sale of other Tier 1 / Tier 2 assets. Tier 1 and Tier 2 assets are generally the most liquid assets in a fund portfolio. While the investment mandate of some funds may prescribe that the fund only holds Tier 1 or Tier 2 assets (e.g., a US large cap equity mutual fund), other funds may hold Tier 1 and Tier 2 assets as a source of incremental portfolio liquidity. This can include holding ETFs, which can be used by portfolio managers to add daily liquidity to a fund, while keeping the risk profile of the fund consistent with the benchmark and fund mandate. Similarly, portfolio managers can equitize cash using futures.
Short-term borrowings such as repo, overdraft capacity with custodians, interfund lending, and lines of credit can serve as "back-up" liquidity sources for portfolio managers to utilize (to the extent permitted by leverage constraints) when there are large, unexpected redemptions or idiosyncratic redemption behavior in funds. Use of short-term borrowings to meet redemptions has been a relatively infrequent occurrence for BlackRock portfolio managers. Borrowings for open-end mutual funds are limited under the 1940 Investment Company Act to 33.3% of total fund assets (i.e., the fund must have asset coverage of 300%).[20] However, they are an important liquidity source, particularly if necessary to handle delays in exchange of cash versus delivery of securities (e.g., bank loan assets that do not have a standard settlement period).

(vi) *Liquidity stress testing of both assets and liabilities using several scenarios. Liquidity stress testing can be a useful tool to understanding potential liquidity risks in different scenarios.* Managers of alternative investment funds ("AIFs") in Europe are required to conduct stress tests of liquidity coverage (ability to meet redemptions with liquid assets) under normal and exceptional liquidity scenarios and provide regulators with detailed reporting on the liquidity profile of the AIF, exposure to counterparties, and the nature of leveraged positions whether arising from borrowing cash and securities or from leverage embedded in derivative instruments.[21] Like any ex-ante risk measure, stress testing is limited by data availability and relies on model assumptions. As such, precision on any liquidity stress test must be qualified based on the availability of market data and the inherent limitations of historical observations to predict future investor behavior. To this end, liquidity stress testing does not result in a precise "black and white answer," as our ability to understand what future adjustment processes for market prices would be in stressed market conditions is necessarily limited based on: (i) what has actually happened historically; and (ii) available data to analyze price behavior. Since this data is often either incomplete or limited to small quantities of traded amounts during normal markets versus large quantities in disrupted markets, it is difficult to infer all outcomes that are possible. As such, monitoring by risk management professionals who understand the appropriate uses and limitations of the analysis is needed to correctly interpret liquidity stress testing results. The results of liquidity stress testing are best suited for internal use and for regulators; they are not appropriate for public dissemination.

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[20] 15 U.S.C. § 80a-18(a)(1)(B).

[21] *See* DIRECTIVE 2011/61/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 ("AIFMD"), available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF.

A. Classifying Liquidity of Fund Holdings

We appreciate the Commission's effort to outline an approach to LRM that attempts to focus fund managers' attention on asset coverage to meet their daily redemption obligations in different scenarios. Indeed, the Commission's days-to-liquidate proposal is similar in nature to concepts employed in relation to the AIFMD liquidity stress testing requirements and a similar question is included on Form PF.[22] However, we are concerned that the proposed days-to-liquidate bucketing includes a significant subjective component that will make fund-to-fund comparisons irrelevant. While days-to-liquidate buckets have been incorporated into AIFMD stress testing reports where a manager applies scenario analysis and is included as a question on Form PF, this approach does not lend itself to public disclosure of discrete figures. In fact, AIFMD and Form PF rightly do not require public reporting of this information. We note that greater disclosure on liquidity risk can be a valuable tool for investors, and we are generally supportive of many of the new disclosures included in the Proposal. Nonetheless, care must be taken to ensure that disclosure is meaningfully comparable across funds and is not subjective or speculative. We are concerned that as proposed, the subjective and predictive nature of publicly disclosing forecasts of days-to-liquidate bucketing could misinform investors. In this section, we suggest a simpler and potentially more consistent approach to the classification of the relative liquidity of fund holdings that is based on an initial qualitative assessment of the general attributes of each type of asset (as opposed to individual position) that can be held by a mutual fund. We will refer to this alternative as liquidity "tiering" for the purposes of differentiating between the Proposal and our recommended alternative approach.

Days-to-Liquidate Bucketing is Not Appropriate for Use as a Classification Mechanism

Days-to-liquidate bucketing requires fund managers to forecast how long it would take to sell a position "at a price that does not materially affect the value of the asset immediately prior to sale."[23] These predictions will inevitably be subjective based on the manager's assessments and assumptions about market impact and market capacity for each fund holding, as well as current and future market conditions. Further, days-to-liquidate fund holdings at a price that does not materially affect the value of the asset immediately prior to sale can change dynamically as market conditions evolve. For example, market impact–or the incremental trading cost associated with each incremental unit traded–fluctuates regularly and is likely to be significantly different during normal and stressed market conditions, meaning that a calculation of market impact today will not necessarily be reflective of market impact in the future. As such, the time needed to liquidate a position at a given price in a normal market environment will not be reflective of the market impact incurred when liquidating positions during stressed markets. For fixed income, using days-to-liquidate as a classification scheme is particularly problematic because of market data limitations. In today's fixed income market, the preponderance of trading is concentrated in large, on-the-run issues, and there are thousands of off-the-run issues that do not trade regularly and are, therefore, not priced in the marketplace. This means that limited pricing data is available for use in predicting days-to-liquidate for individual cusips. When investing in mutual funds, investors accept market risk, including the fact that a security's price may be a function of the market liquidity associated with that security. This is an important

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[22] European Securities and Markets Authority ("ESMA"), Guidelines on Reporting Obligations Under Articles 3(3)(d) and 24(1), (2) and (4) of the AIFMD (Nov. 15, 2013), available at https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-1339_final_report_on_esma_guidelines_on_aifmd_reporting_for_publication_revised.pdf ("ESMA Guidelines on Reporting Obligations"); SEC, *Form PF,* Question 32, available at https://www.sec.gov/rules/final/2011/ia-3308-formpf.pdf.

[23] Proposal at 62292.

differentiation from bank deposits, and there is a need to ensure that public disclosures do not imply a price or performance guarantee for mutual funds, particularly when one's ability to make predictions about the future is limited and likely subject to a margin of error.

Further, the ability to estimate market capacity, which is a quantification of the market's maximum size that can be transacted at non-fire sale prices – is very limited for fixed income, making the predictions of days-to-liquidate a given position difficult to do with accuracy. This is primarily because fixed income is traded over-the-counter ("OTC") and is not traded on an exchange. Fragmented trading limits available market data that can be used to empirically test quantitative models designed to predict market capacity.[24] Further, like market impact, market capacity is conditional and based on the market environment, which can differ significantly in normal versus stressed markets. An important factor is the aggregate sales of a security across multiple holders, which cannot be known in advance for estimating days-to-liquidate. Often, market capacity for a given security must be judged by qualitative assessments made by traders that participate in the market for that security, as opposed to quantitative modelling.

The approach to calculating days-to-liquidate holdings will likely differ across fund managers, meaning that this classification system will be subjective based on a manager's methodology, and that the results will likely be inconsistent across funds, even those with similar holdings. Different asset management firms may legitimately have different estimates of the market capacity, since their own trading activity histories will differ. These reasons will preclude comparisons across funds, limiting the utility of this information for fund shareholders or the Commission. Further, in order to be able to use this information appropriately, investors will need to understand the assumptions and limitations of complex quantitative models–it is unlikely that the vast majority of investors will have the ability to do this.

It is useful to note that BlackRock does incorporate an analysis similar to "days-to-liquidate" bucketing to classify assets for regulatory reporting under ESMA's 2013 guidance.[25] Liquidity stress tests are reviewed internally by risk managers, and stress testing results are solely reported to mutual fund boards and regulators, pursuant to regulatory requirements in each jurisdiction. Days-to-liquidate fluctuates based on time and market conditions, meaning that it is not a static or stationary calculation. This analysis calculates the days-to-liquidate fund assets under several market scenarios, in recognition that days-to-liquidate will change in varying market conditions, and that there is no precise "answer" to the question of how many days it will take to liquidate a given position at a given price, particularly for fixed income. Liquidity stress testing simulates the value of fund assets during normal and stressed market scenarios, as well as fund liabilities (redemptions) using both historical and theoretical redemption scenarios. Scenario analysis is useful in evaluating a fund's redemption risk, but, given reliance on limited data and models, it is not a precise tool to predict the future liquidity risk of a fund. To this end, liquidity stress tests are necessarily based on several assumptions

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[24] This problem was encountered by DERA. *See* Paul Hanouna, Jon Novak, Tim Riley, Christof Stahel, Liquidity and Flows of U.S. Mutual Funds (Sep. 2015), Memorandum prepared for Mark Flannery, Director and Chief Economist of the Division of Economic and Risk Analysis, available at https://www.sec.gov/dera/staff-papers/white-papers/liquidity-white-paper-09-2015.pdf ("SEC Mutual Fund Liquidity Study") (noting difficulties in calculating a measure of portfolio liquidity for open-end mutual funds that invest in fixed income, and stating "In comparison [to US equities], liquidity measures for fixed-income securities are typically more complex and tailored to the data available for each class. Further, if the liquidity measure we use varies between fixed-income classes, then it is not possible to calculate average portfolio liquidity for funds that invest in multiple fixed-income classes. In addition, the infrequent trading of many fixed-income securities can introduce both stale and inaccurate measures of liquidity into the calculation of a fund's bottom-up liquidity"). As a result of these difficulties, the SEC Mutual Fund Study analysis of bottom-up liquidity of open-end mutual funds was limited only to US equity funds.

[25] ESMA Guidelines on Reporting Obligations.

and entail numerous limitations, requiring expert practitioner knowledge to appropriately interpret and use this information.

Because predictions regarding days-to-liquidate are likely to entail a very large margin of error that may not be consistent with what is observed during a stressed market scenario, disclosing such predictions could materially misinform investors. We are concerned that investors could interpret the disclosure of days-to-liquidate on Form N-PORT to suggest that securities in a given mutual fund could be sold at the current price in stressed markets, even though the analysis is not designed to draw such a conclusion. For example, a fund shareholder or prospective investor may not appreciate that days-to-liquidate can change rapidly, which could lead that investor to believe that a fund is more liquid than is actually the case. Further, disclosure of days-to-liquidate could cause investors to interpret this information as suggesting that small funds are more liquid than large funds. As data and market experience have shown, this is not necessarily the case. For example, the SEC Mutual Fund Liquidity Study concluded that: "As fund size increases, the liquidity of the equity portfolio of U.S. equity funds also increases".[26] Further, some commentators have suggested that because large funds are likely to hold larger positions than smaller funds, large funds may entail greater liquidity risk.[27] While it may be true that larger funds hold bigger positions in certain securities, this does not necessarily imply greater liquidity risk.

With respect to transactional dynamics, large funds often have more diversified holdings and may wield more negotiating power with broker-dealers. The increased flexibility afforded to larger funds can be a significant offset to larger position sizes. Further, as recently demonstrated by the issues meeting redemption requests that were experienced by the Third Avenue Focused Credit Fund, a small and highly concentrated portfolio can present its own liquidity challenges.[28] This suggests that the days-to-liquidate bucketing approach, which will likely make larger funds appear less liquid, will not always be in line with the reality demonstrated by market data. As such, we are concerned that disclosing days-to-liquidate predictions to the public could lead to misinformed decisions by investors when evaluating a given mutual fund, based on the assumption that fund holdings will be sold at a certain price in the future. Further, the predictive nature of disclosing days-to-liquidate seems to be in conflict with existing regulatory guidance that dissuades speculative communications with investors.[29] Therefore, while this approach may be helpful in the context of liquidity stress testing, it would create unnecessary problems for making representations to the public.

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[26] The SEC Mutual Fund Liquidity Study at 30.

[27] FSB and IOSCO, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (Mar. 4, 2015), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD479.pdf ("If an individual fund is very large and a significant investor in a particular market segment, its abrupt asset sales could cause distortions in that market's liquidity and have negative effects to the extent that it could amplify distress to other market participants that hold these assets.).

[28] Bush, Sarah, Morningstar, "Junk-Bond Funds Settle Down After a Rough Week" (Dec. 17, 2015), available at http://news.morningstar.com/articlenet/article.aspx?id=733736 ("The [Third Avenue] portfolio stood out for its substantial allocation to the lowest credit quality tiers of the junk-bond market, its sizeable stake in non-rated credit, and its concentrated portfolio.")

[29] *See e.g.,* FINRA Rule 2210(B) ("[Members] may not predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast").

Categorical Liquidity Classification Methodology – Liquidity Tiering

Recognizing that the Commission is interested in constructing a methodology to classify the liquidity of fund holdings, we recommend an alternative, categorical approach that can be applied consistently across funds. We believe that a liquidity classification system that is based on attributes of holdings that do not vary significantly through time and do not require forecast assumptions is preferable to classification schemes that are constantly changing. Categorical classification schemes promote consistency across funds and time periods and will allow for comparisons among funds.

We recommend the Commission consider liquidity tiering methodologies to create a categorical liquidity classification scheme. Like days-to-liquidate bucketing, liquidity tiering recognizes that there is a spectrum of liquidity. However, liquidity tiering removes the speculative elements and inconsistency associated with the proposed days-to-liquidate buckets by removing references to and false precision around price, position size, and days to trade and settle; instead liquidity tiers refer to these attributes qualitatively. Liquidity tiering categorizes the liquidity of fund holdings based on asset type (e.g., asset class, credit quality, etc.) instead of classifying holdings based on the unique attributes of a position (e.g., position size, valuation, etc.). Liquidity tiering 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. Fully disclosed exceptions to the categorical tiering should be allowed when the specific attributes of a particular position differ materially from the nature of the asset type as a whole, as long as the reasoning for moving the position to a different liquidity tier is noted. Liquidity tiering does not incorporate position size into the determination of the liquidity of an asset type. The use of liquidity tiers instead of days-to-liquidate buckets would remove the vast majority of inconsistency from the classification of the liquidity of portfolio holdings and allow portfolio liquidity composition to be compared across funds, making it a more useful tool.

Asset managers can and do have different views on the number of tiers that are desirable, and we believe that the merits of different numbers of tiers should be discussed further. BlackRock currently employs a five-tier methodology to classify holdings of our open-end fixed income mutual funds. For the purposes of this letter, we modified our existing methodology to apply it to a broader set of asset classes to reflect the scope of the Proposal. Covering all asset classes in a single tiering matrix provides consistency of approach. BlackRock's five-tier approach defines each tier as follows:

- *Tier 1:* Cash and securities that can be readily converted to cash in normal and stressed markets at close to the existing market price.

- *Tier 2:* Securities that can be readily transacted in normal market environments and remain readily transactable (at wider bid-ask spreads than Tier 1), even during stressed markets.

- *Tier 3:* Securities that can be transacted (at wider bid-ask spreads than Tier 2) in normal market environments, but can become somewhat more difficult to transact with immediacy (or are transactable at wider bid-ask spreads than Tier 2) in stressed markets.

- *Tier 4:* Securities that can be transacted (at wider bid-ask spreads than Tier 3) in normal market environments, but, due to a smaller investor base or other reasons, may become more difficult to transact with immediacy (if at all or are transactable at much wider bid-ask spreads than Tier 3) in stressed markets.

- *Tier 5:* Securities that require heavy negotiations to trade in normal and stressed markets.

We recommend the Commission develop a similar objective classification scheme by defining tiers qualitatively and developing guidance to map asset types to each tier. To do this, we suggest the Commission convene an industry roundtable to determine the appropriate number of tiers and the initial mapping of asset types. As a starting point, we have made suggestions on an appropriate mapping of asset types using a five-tier classification scheme in Exhibit 2. The mapping is primarily based on security type, credit quality, deal size, and seniority in the capital structure. The Commission's guidance on mapping asset types to the liquidity tiers should be reviewed periodically (perhaps bi-annually) to ensure that the liquidity tiering classifications conform to changing market conditions and provide flexibility to address new security types or other significant developments.

The benefits of a tiering methodology is that it is categorical as opposed to speculative, it is consistent through varying market conditions, and it is comparable across managers. As discussed in the following section, liquidity tiering could be used to harmonize the 15% illiquid asset limitation with the liquidity classification scheme. Liquidity tiering is most useful at the aggregate portfolio level rather than at the individual security level. Aggregate statistics such as the percentage of a portfolio in each tier and/or the weighted average tier of the entire portfolio would provide a measure of portfolio liquidity that can be compared across funds, which could provide the Commission with useful information about the relative liquidity of a fund's investment strategy. From a monitoring perspective, monthly reporting of aggregate statistics regarding fund liquidity tiers would likely have alerted the Commission to the escalating liquidity issue that led to the Third Avenue Focused Credit Fund's redemption halt. Further, liquidity tiering could be used to help the Commission ascertain the relevance of a fund's LRM procedures in the context of the liquidity tiers of fund holdings.

Exhibit 2: Example of Five-Tier Liquidity Classification Asset Type Mapping

	Tier 1	Tier 2	Tier 3	Tier 4	Tier 5
Definition	Cash and securities that can be readily converted to cash in normal and stressed markets at close to the existing market price.	Securities that can be readily transacted in normal market environments and remain readily transactable (at wider bid-ask spreads than Tier 1) even during stressed markets.	Securities that can be transacted (at wider bid-ask spreads than Tier 2) in normal market environments but become somewhat more difficult to transact with immediacy (or at higher bid-ask spreads than Tier 2) in stressed markets	Securities that can be transacted at wider bid-ask spreads than Tier 3) in normal market environments, but due to a smaller investor base or other reasons, may become more difficult to transact with immediacy (if at all or at much wider bid-ask spreads than Tier 3) in stressed markets	Securities which require heavy negotiations to trade in normal and stressed markets
Types of Securities	• Cash				
	• AAA / AA / A Rated Govt. Bonds • Agency MBS TBAs • Pre-Refunded Munis	• BBB / BB / B Rated Govt. Bonds • Agency MBS (ex TBAs) • On-the-Run Senior ABS • IG Munis • IG Corporate (ex EM)	• Below B Rated Govt. Bonds • Senior CMBS • Off-the-Run Senior ABS • Subordinate ABS • Senior Non-Agency RMBS • GSE Risk Sharing Deals • HY Munis • Tender Option Bonds • EM IG Corporates • HY Corporates (ex EM) • Syndicated Bank Loans > $250m issue size • AAA / AA / A CLOs • Capital Securities	• Subordinate CMBS • Subordinate Non-Agency RMBS • Securitized Asset Residuals/Equity • Non-Rated Munis • EM HY Corporates • Middle Market Loans < $250m issue size • BBB and below CLOs • Defaulted Securities with public pricing	• Securities with non-public pricing (e.g., certain defaulted securities, bankruptcy claims, etc.) • Securities restricted from trading • Mortgage Servicing Rights • Securities labeled as 'Private', including unlisted equities
	• Listed Developed and EM Equity • ETFs	• Frontier Markets Equity	• Preferred Equity		
	• Interest Rate Swaps and Swaptions • FX • Futures				
	MOST LIQUID				LEAST LIQUID

Addressing Settlement Timing

We recognize that the liquidity tiering scheme shown in Exhibit 2 does not explicitly reference settlement times for different asset types, though Tiers 1 and 2 consist of securities that generally settle within two to seven days. The Proposal noted that bank loans lack a standardized settlement period, and bank loan holdings by mutual funds may cause a mismatch between the timing of receipt of cash from the sale of assets and payment of shareholder proceeds.[30] We agree that the lack of a standard settlement cycle is a concern for mutual funds that hold bank loans and that this issue necessitates that open-end mutual funds holding these assets establish protections to account for a potential settlement mismatch. In the absence of action by bank regulators to standardize the settlement cycle for bank loans,[31] open-end mutual funds that invest in bank loans must have backup measures in place to avoid issues associated with a potential settlement mismatch. One effective approach to achieve this is by establishing a bank line of credit to ensure that any settlement mismatch can be covered by available borrowing capacity. We note, however, that in our experience managing open-end mutual funds, bank lines of credit are rarely used. Importantly, we view addressing concerns related to non-standard settlement issues as an entirely different discussion from considering the ability to transact in a particular asset. Given the unique settlement of bank loans, we do not believe that the concepts of the ability to transact and settlement should be conflated in a liquidity classification scheme. Rather, the liquidity classification scheme should consider the ability to transact in a given asset type and separate guidance should ensure that measures are taken to address the settlement mismatch associated with bank loans. In our five-tier approach, we treat syndicated bank loans greater than $250 million issue size as a lower tier than smaller issues, based on our experience that larger issues are more liquid in this sector.

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30 Proposal at 62283 ("However, the settlement periods associated with some bank loans and loan participations may extend beyond the period of time the fund would be required to meet shareholder redemptions, creating a potential mismatch between the timing of the receipt of cash upon sale of these assets and the payment of cash for shareholder redemptions").

31 *See* FSOC Letter where we encouraged the FSOC to consider standardizing the settlement period for bank loans.

B. Three-Day Liquid Asset Minimum

We agree that it is appropriate for the Commission to expect open-end mutual fund managers to maintain appropriate levels of cash and liquid assets, in line with the unique circumstances of each fund, as part of an effective LRM program. Further, as described above, we believe that a redemption "waterfall" – or an outline of the different ways a fund can meet redemptions – should be an important component of LRM. However, we have several concerns regarding the three-day liquid asset minimum proposal. Firstly, good risk management dictates that open-end mutual fund managers should be encouraged to meet redemptions by selling securities in order to maintain the fund's risk profile, wherever possible; managers should not be encouraged to meet redemptions primarily by using the most liquid securities held by the fund. This approach is critical not only to preserving the fund's risk characteristics and adhering to the fund's investment mandate, but this approach precludes concentrating the remaining fund holdings in increasingly less liquid assets. Instead of the three-day liquid asset minimum, we recommend the Commission require that funds take several steps to ensure that an appropriate level of Tier 1 and Tier 2 assets is maintained.

From a systemic risk perspective, static liquidity minimums – even if self-imposed by funds – are pro-cyclical, meaning that this policy could contribute to systemic risk. In addition, instead of promoting a fund's ability to meet redemptions, the three-day liquid asset minimum will create a first-mover-advantage that could spark additional redemptions from funds in certain circumstances.[32] Further, as demonstrated by the experience of the Third Avenue Focused Credit Fund, which raised $200 million in cash[33] (over 20% of the $942 million fund[34]), and still found themselves in a situation where they believed it was in the best interest of fund shareholders to cease redemptions. As such, maintaining a three-day liquid asset minimum could create a false sense of confidence in a fund's ability to meet redemptions. Consideration of how to avoid having a redemption issue in the first place and ensuring the availability of backup measures are more important to prudent LRM than liquid asset minimums.

Portfolio managers typically monitor and review cash and liquid asset balances on an ongoing basis based on a variety of factors, including evolving market conditions and anticipated redemptions. This includes consideration of the asset classes in which the fund invests, the investment strategy employed by the fund, the fund's stated investment mandate and benchmark, the current market environment, idiosyncratic firm or fund reputational issues, and other issues that may arise in the course of managing open-end mutual funds. The result is that cash and liquid asset balances often fluctuate in line with current market conditions and circumstances. This is demonstrated by Exhibits 3 and 4, which show aggregate historical cash balances for high yield and emerging market bond mutual funds.

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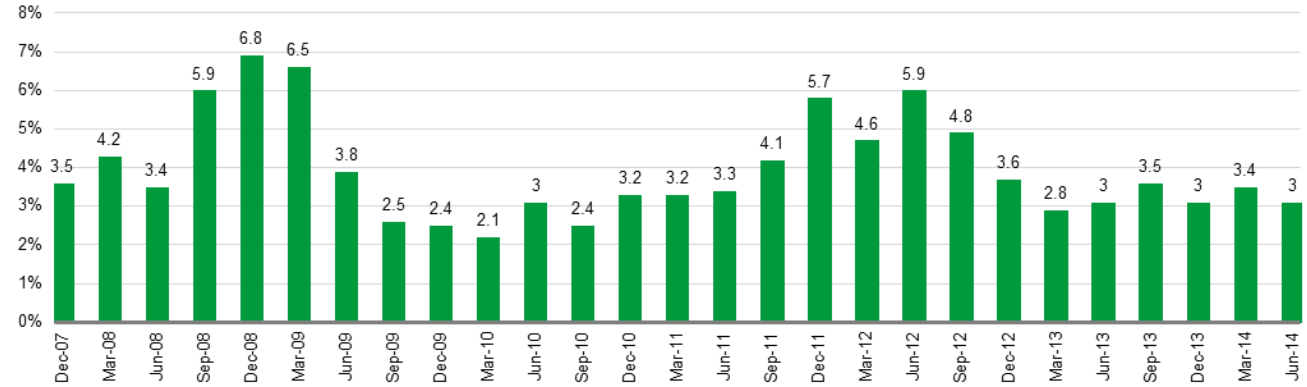
[32] SEC Mutual Fund Liquidity Study at 3 ("a first-mover advantage can create a spiral where each redemption increases the incentive for other investors to redeem to avoid the increasing costs paid by non-redeeming investors.").

[33] *See* SEC Order.

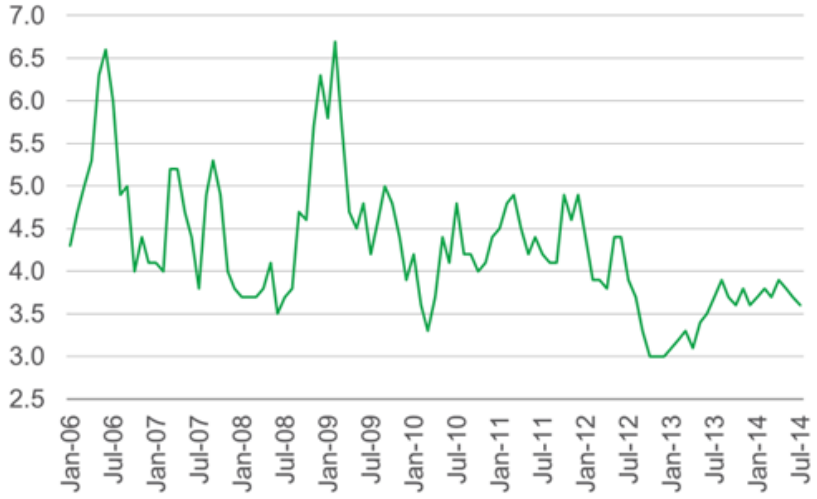
[34] *See* CNBC Third Avenue Update.

Exhibit 3: Aggregate Cash Balances for High Yield Mutual Funds



Source: JP Morgan Securities. As of June 2014.

Exhibit 4: Aggregate Cash Balances for Emerging Market Debt Mutual Funds



Source: JP Morgan. As of July 2014.

The Proposal appears to presume that it is acceptable for funds to meet redemptions by liquidating the most liquid assets in the portfolio.[35] While this approach is a means to meet redemptions, it does so at the expense of the remaining shareholders in the fund by leaving them with a less liquid portfolio whose risk exposures may have become distorted. This is why funds often attempt to meet redemptions by pro rata or risk constant selling of securities to maintain the risk profile of the fund for remaining shareholders. While it may not always be possible or prudent to sell an exact pro rata slice of a fund to meet redemptions, selling only liquid assets is certainly not the most optimal approach and should not be encouraged by the Commission as a means of conducting fund LRM. Further, we are concerned that the codification of the three-day liquid asset minimum may provide the Commission and fund managers with false comfort that a fund can meet redemptions under stress scenarios. In particular, it is unlikely that the three-day liquid asset minimum will be sufficient to cover a large

[35] Proposal at 62312. ("We are proposing the requirement for each fund to determine a three-day liquid asset minimum to increase the likelihood that the fund will hold adequate liquid assets to meet redemption requests without materially affecting the fund's NAV.").

and unexpected net outflow, meaning that other holdings in the fund will need to be sold or additional protections such as backup sources of liquidity will need to be in place. Therefore, the liquidity profile of the entire fund must be considered holistically in order to determine whether and how a fund will meet redemptions. Mechanical focus on meeting redemptions with the most liquid assets could have significant negative consequences, including a negative impact on the preservation of value for long-term shareholders of funds, such as those investing in mutual funds in order to save for retirement.

Additionally, employing a three-day liquid asset minimum would be inconsistent with the investment mandate of a large percentage of mutual funds. For example, in order to achieve the objectives of index strategies, index funds cannot hold significant amounts of cash or other types of securities that deviate from the construction of the index. Further, if the result of the three-day liquid asset minimum is to compel greater cash holdings by mutual funds, this policy measure will likely incent migration to investment products that are not subject to the 1940 Act, such as separate accounts or private funds. This will disadvantage individual investors who may not be eligible to invest in other products, as their investment options will be limited to funds that have a significant cash drag, which will compound to the detriment of individual investors over time. Further, the increased demand for cash from mutual funds in addition to other regulatory dynamics that are driving increased demand for cash may exhaust the supply of available cash and could have distortive impacts on capital markets.

From a systemic risk perspective, static liquidity buffers, even if self-imposed, are pro-cyclical because funds could be forced to sell securities in stressed markets to maintain the liquidity buffer. This could be triggered either by securities being reclassified out of the three-day liquid asset bucket or by the need to meet large redemption requests – exacerbating downward pressure on asset prices. Much of the discourse on systemic risk views pro-cyclical investment behavior as contributing to systemic risk.[36] The presence of the three-day liquid asset minimum could also prevent mutual funds from acting counter-cyclically during temporary market dislocations. A fund that has breached its minimum will be prohibited from acquiring any assets that are not three-day liquid assets, even though those assets may have fallen in value and would otherwise represent good investments for the fund and encourage counter-cyclical investment behavior.

Disallowing investing in non-three-day liquid assets when a fund has fallen below its minimum to meet a redemption could encourage additional shareholder redemptions from funds. This is because if fund shareholders observe that a large redemption has taken place, they may assume that the fund will not be able to effectively employ its investment strategy due to the prohibition on acquiring any assets that are not three-day-liquid assets. The presence of the three-day liquid asset minimum could, therefore, represent a first-mover advantage, where remaining investors in a fund may believe they are being harmed by redemptions made by other investors. This increases the likelihood that fund shareholders redeem earlier than they might otherwise, which materially increases fund redemption risk. Additionally, funds could

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[36] *See e.g.,* Michael G. Papaioannou, Joonkyu Park, Jukka Pihlman, and Han van der Hoorn, *Procyclical Behavior of Institutional Investors during the Recent Financial Crisis: Causes, Impacts, and Challenges,* International Monetary Fund, Working Paper No. 13/193, 9-15 (2013), available at https://www.imf.org/external/pubs/ft/wp/2013/wp13193.pdf (providing evidence of procyclical behavior by institutions during the recent global financial crisis); Office of Financial Research, 2012 Annual Report, 13 (2012), available at https://www.treasury.gov/initiatives/wsr/ofr/Documents/OFR_Annual_Report_071912_Final.pdf ("OFR 2012 Annual Report") ("stability analysis focuses on (1) the propensity of the financial system to generate risks—in particular, on procyclicality, which is the tendency of swings in financial activity, especially downswings, to magnify the business cycle and possibly trigger financial instability—and (2) the vulnerabilities or resilience of the financial system in the event of a shock"). OFR argues that regulation should be utilized to counter procyclicality. *See* OFR 2012 Annual Report at 17.

conceivably use leverage to meet the three-day liquid asset minimum, which could exhaust available borrowing capacity for backup liquidity purposes. Given that one of the main objectives of the Proposal is to mitigate fund redemption risk, we do not believe that the three-day-liquid-asset minimum is consistent with the Proposal's objectives.

Instead of the three-day liquid asset minimum, we recommend the Commission require that funds take several steps to ensure that an appropriate level of Tier 1 and Tier 2 assets is maintained. As shown in Exhibit 2, Tier 1 and Tier 2 denote highly liquid assets that can be readily converted to cash under the vast majority of circumstances. The appropriate level of Tier 1 and Tier 2 assets could be articulated as a range or target and subject to review by independent risk management. We note that this should be viewed as a guideline, but not a strict minimum. If treated as a strict minimum requirement, this approach suffers from the same limitations of the three-day liquid asset minimum described above. There should be several steps to determine an appropriate range or target of Tier 1 and Tier 2 assets including:

(i) *Assessment of a fund's liquidity risk based on the unique characteristics of the fund, including its investment strategy, mandate, and investor profile*. For example, funds that do not meet redemptions using cash (e.g., funds that primarily use in-kind redemptions) could determine that no Tier 1 or Tier 2 assets are needed or that Tier 1 / Tier 2 asset holdings should be in line with benchmark composition, providing needed flexibility to tailor liquid asset levels to the unique circumstances of each fund. In a different example, funds whose investment mandate is to track an index that includes only Tier 1 and Tier 2 securities could determine that a very high percentage of the portfolio should be held in Tier 1 and Tier 2 assets. Alternatively, a fund whose mandate is to invest in Tier 3 assets will have to balance finding an appropriate level of Tier 1 and Tier 2 assets with their fiduciary (and oftentimes regulatory) responsibility to adhere to their stated investment mandate and benchmark. For example, high yield mutual funds need to be at least 80% invested in high yield securities under existing regulatory guidance.[37]

(ii) *Description of the fund's redemption "waterfall" or liquidity protocol*. The redemption "waterfall" includes all tools available to meet redemptions for a mutual fund. The redemption waterfall should list available back up sources of liquidity such as repo, lines of credit, overdraft capacity with custodians, or interfund lending and outline when such backup sources of liquidity would be used, subject to regulatory restrictions on leverage. The availability of backup sources of liquidity or lack thereof can be telling as to the fund's potential demand for liquidity from the market and, in turn, the need for Tier 1 / Tier 2 assets. For example, funds that have access to a bank line of credit may have less need for liquidity from the market to address short-term mismatches between the receipt of cash for securities and the return of cash to redeeming shareholders. Alternatively, funds whose portfolio holdings cannot be financed through the repo market may demand greater liquidity from the market to meet redemptions and may, therefore, need to consider larger holdings of Tier 1 and Tier 2 assets.

The use of in-kind redemptions should also be taken into consideration in the liquidity waterfall. If a fund routinely uses or has procedures in place that permit the use of in-kind redemptions under certain or all circumstances (e.g., mutual funds with large

[37] 17 CFR 270.35d–1.

institutional investors that typically receive or have the ability to receive redemptions in-kind, or ETFs), could reduce a fund's demand for liquidity from the market.

The elements of the redemption waterfall should be considered holistically.

(iii) *Ongoing monitoring of the percentage of the portfolio held in Tier 5 assets.* If a fund is holding sizeable positions in Tier 5 assets, this could suggest that the fund should hold a higher percentage of liquid assets.

(iv) *Consideration of the concentration of positions in the fund.* As demonstrated by the experience of the Third Avenue Focused Credit Fund, highly concentrated funds can experience liquidity issues under certain circumstances. Therefore, concentration of positions should be a consideration in the range or target of Tier 1 and Tier 2 assets that are appropriate for the fund.

(v) *Assessment of current market liquidity conditions.* As mentioned above, cash balances and liquid asset holdings can vary with market conditions. This should be included in the fund's assessment of its Tier 1/Tier 2 liquidity needs.

(vi) *Historical and anticipated redemption rates*. Funds should consider historical redemption rates and to the extent possible, anticipated future redemptions. For example, funds experiencing reputational issues (e.g., departure of the lead portfolio manager) or underperformance issues may determine that there is a need to hold higher levels of liquid assets in anticipation of a potential increase in redemptions. This analysis could also consider the results of liquidity stress testing. In Section I(G), we outline additional data that would be helpful in this effort.

Finally, if the Commission rejects this alternative recommendation and imposes some sort of minimum cash or liquid asset requirement, we suggest the rule only apply after a fund has employed 10% or more leverage. If a fund is trying to manage against a benchmark and holds securities that can easily be financed on a short-term basis, the existence of leverage capacity is a valuable source of liquidity. Absent such an exclusion, a mandatory liquid asset requirement may end up driving funds to use their leverage capacity defensively to maintain the liquid asset buffer or to increase their use of derivatives to synthetically demonstrate higher cash holdings.

C. 15% Illiquid Asset Limitation

We agree that a limitation on the amount of illiquid assets that can be held by an open-end mutual fund is appropriate. Setting reasonable controls on and monitoring the use of illiquid asset classes to ensure they do not compromise the liquidity offered to investors within the fund is an important element of properly managing daily open-end mutual funds. We recommend clarifying the definition of "illiquid assets" as described in the Proposal and harmonizing this definition with other elements of the Proposal to ensure consistency and clarity of approach. One obvious way to achieve this would be to harmonize this definition with the lowest tier in a tiering classification system – Tier 5 in the liquidity tiering scheme shown in Exhibit 2.

We further recommend that the 15% illiquid asset limitation be tied to notification requirements. In particular, it would be helpful for the Commission to specify that the mutual fund board and the Commission should be notified by a fund's manager when a fund exceeds

the 15% illiquid asset limitation, either because the fund has met redemptions with more liquid assets or for any other reason. Today, there is no notification requirement associated with breaching the 15% illiquid asset limitation. We believe that this information, provided in a timely manner to the mutual fund board and the Commission would be helpful in ensuring that the Commission and mutual fund boards are apprised of any developing fund liquidity issues. This will also ensure that there is oversight of measures taken by the fund to avoid becoming materially less liquid once the 15% illiquid asset limitation is breached and that efforts are made to reduce the fund's illiquid asset holdings, when possible. Further, in the event such a fund experienced a redemption issue requiring a stop order from the Commission to halt redemptions, the Commission would already be aware of and involved in the situation.

D. In-kind Redemptions

In-kind redemptions, where feasible, are a useful method for allocating transaction costs to redeeming shareholders – particularly when those costs are imposed from a large redemption by a single institutional investor. In-kind redemptions are a practical tool for institutional investors who have the ability to hold and trade the securities that may be held in a particular fund. However, we agree with the Commission that redemptions in-kind are not practical for retail investors, as retail investors may lack the proper custodial accounts to hold a particular security and they may be less likely to have the necessary expertise and/or the operational ability to trade the securities that could be held in a fund. For example, a retail investor may not have a custodial account set up to hold a security that is traded in another country, nor the sophistication to be able to trade such a security. Further, there are often thousands of retail investors in a single fund, and splitting securities on a pro rata basis may not be possible across such a large number of individuals. These practical impediments make in-kind redemptions impractical for retail investors.

On the other hand, some fund managers use in-kind redemptions to meet large redemption requests by institutional investors. We believe that in-kind redemptions are an important tool that externalizes transaction and market impact costs from the fund. For large institutional clients, in-kind redemptions reduce the transaction costs that could be associated with redeeming a large position in a fund for cash and then re-establishing a similar set of exposures either through direct purchases or by subscribing to a different fund. The use of in-kind redemptions for institutional investors merits further consideration as a means to meet redemptions during normal and stressed scenarios.

We are supportive of funds defining procedures for managing in-kind redemptions as a method to allocate transaction costs to redeeming institutional investors. The 1940 Act currently permits funds to make redemptions in-kind.[38] We agree with the Commission's assessment that having in place "policies and procedures that dictate the fund's in-kind redemption procedures…would increase the likelihood that in-kind redemptions would be a feasible risk management tool."[39] Such policies and procedures should not be prescriptive as to when in-kind redemptions *must* be used; rather, they should provide flexibility and clarity on how in-kind

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[38] 1940 Act Funds, excluding closed-end funds, often elect to be governed by Rule 18f-1, which obligates the fund to redeem in cash up to the lesser of $250,000 or 1% of NAV during any 90-day period. These 1940 Act Funds can then elect to redeem greater amounts in-kind. In general, BlackRock 1940 Act open-end mutual funds elect to be governed by Rule 18f-1 and, therefore, have the ability to use in-kind redemptions.

[39] Proposal at 62320.

redemptions would be administered and when in-kind redemptions will be considered, allowing discretion on the part of the fund managers to protect the best interests of all shareholders.

In addition to requiring written policies and procedures on the use of in-kind redemptions, we suggest that the Commission provide guidance on the appropriate use of in-kind redemptions for funds that have institutional investors. In particular, this guidance should encourage fund sponsors (or state that fund sponsors have a responsibility) to *consider* redemptions in-kind if withdrawal requests exceed a certain percentage of a fund's total assets. Fund managers should be allowed to decide the best course of action in managing redemptions based on the circumstances. Such guidance might encourage the use of in-kind redemptions with greater frequency in the normal course of managing open-end mutual funds, which would facilitate the use of in-kind redemptions during stressed market conditions. Such guidance from the Commission would remove any perceived stigma that some asset managers and investors might associate today with meeting large redemptions in-kind.

E. Additional Mutual Fund Board Responsibilities

Under the Proposal, several new mutual fund board responsibilities will come into effect, including the following: (i) initial approval of the LRM program; (ii) approval of material changes to the LRM program; (iii) approval of the 3-day liquid asset minimum; (iv) review of the written report at least annually on the adequacy of the LRM program, including the 3-day liquid asset minimum, and the implementation of the LRM program; and (v) designation of Administrative Responsibilities to the Fund Investment Adviser or Officers.[40] We agree that mutual fund boards should provide appropriate oversight of LRM practices. The operative term here is "oversight": mutual fund boards are not responsible for day-to-day fund management. Thus, while we support mutual fund board engagement, oversight, and awareness of LRM practices and issues, we encourage the Commission to take steps to distinguish clearly between oversight and management. For example, the decision regarding the appropriate level of three-day liquid assets held by a fund is a portfolio management decision. It is neither appropriate nor practical for a mutual fund board to make such a decision. It is important to distinguish clearly fund oversight from portfolio management, not only to ensure that the appropriate parties are responsible for LRM but also to ensure that new LRM responsibilities do not overburden mutual fund boards at the expense of focusing on other important issues.

Rule 38a-1 provides a useful analogy: rule 38a-1 requires "the fund's chief compliance officer to discuss material changes to the compliance policies and procedures in his or her annual report to the mutual fund board."[41] Discussion with the Board of material changes to the LRM program in annual updates strikes the right balance between allowing the fund manager the flexibility to make changes to the LRM program as market conditions may require, while also keeping the mutual fund board informed. Such notification and discussion requirements will incentivize changes to LRM practices to be reasonable and justifiable while simultaneously avoiding delaying changes that need to be made. Therefore, we recommend the Commission follow the precedent set by Rule 38a-1 and remove the requirement that mutual fund boards approve changes to LRM policies and procedures in the adopting release.

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[40] Proposal at 62386.

[41] SEC, Compliance Programs of Investment Companies and Investment Advisers, 68 Fed. Reg. 74717 (Dec. 24, 2003), available at https://www.gpo.gov/fdsys/pkg/FR-2003-12-24/pdf/03-31544.pdf.

We agree with the Commission that there should be accountability for adherence to LRM policies and procedures. The mutual fund board could designate an individual (who is independent of portfolio management) at the adviser with expertise in LRM practices to oversee and report on the application of LRM policies and procedures. Portfolio managers should provide day-to-day management of funds, with an additional layer of oversight provided by the risk and compliance framework, which provides for periodic reporting to the board.

We encourage the Commission to clarify in the adopting release that the mutual fund board's role is one of oversight, not day-to-day management, and that changes to the LRM policy would not have to be approved by the mutual fund board before they occur. Rather, they should be noticed and discussed on an annual review basis. Moreover, the mutual fund board should not be required to make determinations regarding liquidity classifications of fund holdings or the minimum amount of cash or liquid assets a fund should hold. These determinations should be made by the adviser and discussed with the board during periodic portfolio reviews.

F. Compliance Period

A significant amount of time will be needed by fund managers in order to effectively implement the provisions of the Proposal, including review and approval by mutual fund boards. We believe that allowing adequate time for both fund managers and mutual fund boards to develop the documentation and review and update operational processes and procedures will be important to the success of the Proposal. Mutual fund boards will need time to develop an understanding of the LRM programs, ask questions of risk officers and other knowledgeable individuals, and receive thorough responses.

We note that the Commission has proposed two separate compliance deadlines for large and small fund managers. In particular, the Commission proposed that for larger entities (funds that together with other funds in the same "group of related investment companies" have net assets of $1 billion or more), the compliance period would be 18 months. Smaller entities would have 30 months to comply.[42] Given the complexity of this rulemaking and the need to tailor LRM policies and procedures to the unique nature of many different funds, we recommend that all funds be given at least 30 months to comply with these requirements to ensure the appropriate research and review can be performed. This will allow managers to adjust operational processes and develop reporting capabilities while also allowing mutual fund boards enough time to review and make decisions on a significant number of issues.

G. Additional Data that Would be Helpful

The Proposal "contemplates that a fund consider both expected requests to redeem (e.g., shareholder flows relating to seasonality or shareholder tax considerations), as well as requests to redeem that may not be expected, but are reasonably foreseeable under stressed conditions (e.g., shareholder outflows related to stressed market conditions or increased volatility, or outflows that are reasonable to expect in light of a reputation event affecting the fund or the departure of a fund's portfolio manager)" in the course of assessing a fund's liquidity risk. To make this assessment, fund managers would need to take into account (i) short-term and long-term cash flow projections, (ii) fund investment strategy and liquidity of portfolio assets,

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[42] Liquidity Proposal at 62380.

(iii) use of borrowings and derivatives for investment purposes, and (iv) holdings of cash and cash equivalents as well as borrowing arrangements and other funding sources.[43]

We agree with the Commission's view that prudent LRM entails considering expected and potential future redemptions under reasonably foreseeable stressed conditions. Given that the Commission has recognized the importance of attempting to predict potential future redemptions as part of LRM, we believe it is important to reiterate our recommendation that the Commission specify in the adopting release, data that fund distributors and/or transfer agents will need to provide to fund managers to allow fund managers to make "short-term and long-term cash flow projections". In particular, we note that consistent data regarding the types of investors redeeming from and subscribing to funds via omnibus accounts[44] is needed to model potential future redemptions in a complete manner.[45] Other points of data that are needed include the size of individual investor holdings to ascertain investor concentration and the length of time each investor has been invested in the fund. A similar precedent has been set in Rule 22c-2, which specifies the information that fund managers must have access to in order to monitor potential market timing in funds.[46] We recommend the Commission utilize the same approach in the adopting release to ensure that fund managers have access to the data that is needed to fully comply with the proposed provision in a comprehensive and consistent manner. The need for this data is generally recognized in the industry, and the GARP Swing Pricing Letter also addressed the need for this information to be available to fund managers.[47]

Another dataset that would be useful in this regard is historical worst-case net redemption rates. We are not aware of a data source that currently aggregates this data on a consistent and industry-wide basis for periods of less than one month. Given the relevance of short-term redemption rates for open-end mutual funds, it would be beneficial for this data to be collected and aggregated by the Commission. To this end, we recommend that the Commission collect statistics on 99% worst-case net redemptions as a percentage of total fund assets for historical periods as shown in Exhibit 5.[48] We do not recommend having this data be publicly available for individual funds, as this could present reputational risks to funds that have recently experienced large net outflows. Instead, we believe that the Commission should consider collecting this data on a confidential basis. Once data on individual funds is collected

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[43] Proposal at 62303-62304.

[44] We note that transparency to individual client-level information would not be useful or needed to implement this recommendation.

[45] In connection with the adoption of 1940 Act Rule 22c-2, Registered Investment Companies ("RICs") found that obtaining information on underlying shareholders in omnibus accounts is difficult in the absence of an express requirement that financial intermediaries supply the relevant information. We suggest that the Commission consider this experience in crafting any request for detailed omnibus account data.

[46] "The fund or its principal underwriter must enter into a written agreement with each financial intermediary of the fund, under which the intermediary agrees to: (i) Provide, promptly upon request by the fund, the Taxpayer Identification Number of all shareholders that purchased, redeemed, transferred, or exchanged shares held through an account with the financial intermediary, and the amount and dates of such shareholder purchases, redemptions, transfers, and exchanges." 17 C.F.R. §270.22c-2(a)(2)(i). *See* SEC, Mutual Fund Redemption Fees Final Rule, 70 Fed. Reg. 13337 (Mar. 18, 2005), available at https://www.gpo.gov/fdsys/pkg/FR-2005-03-18/pdf/05-5318.pdf ("Rule 22c-2 also is designed to enable funds to monitor the frequency of short-term trading in omnibus accounts and to take steps, where appropriate, to respond to this trading. We believe that this requirement will facilitate greater cooperation between funds and their intermediaries. The right to access this trading information provides funds with an important new tool to monitor trading activity in order to detect market timing and to assure consistent enforcement of their market timing policies.").

[47] GARP Swing Pricing Letter.

[48] There would need to be a process to exclude funds with de minimis AUM as very small funds can skew redemption statistics. This is because small funds may experience large redemptions when measured as a percentage of NAV but this is likely more due to the small size of the fund's asset base.

confidentially, the Commission could aggregate the data by category of funds and then publish aggregate statistics for public consumption. This would help both the Commission and mutual fund managers obtain a more holistic frame of reference regarding historical worst-case redemption rates. To the extent that a breakdown of fund flows by investor type can be obtained, this information could be used to further analyze the data to understand redemption rates of different types of investors.

Exhibit 5: Suggested Worst-Case Redemption History Form

	99% Largest 1 Day	99% Largest 3 Day	99% Largest 7 Day	99% Largest 1 Month	99% Largest 3 Months
1 Year					
3 Years					
5 Years					
10 Years					
Since Inception					

H. Overall Approach to Data Collection & Data Confidentiality

As noted in our Data Reporting Letter, we are supportive of the Commission's efforts to obtain more data about mutual funds. As we consider this Proposal in light of the Data Reporting Proposal and the recent issues experienced by the Third Avenue Focused Credit Fund, we believe it is important to re-consider the volume and detailed nature of additional position-level data that the Commission has proposed to be publicly disclosed on Form N-PORT. As the experience of Third Avenue demonstrated, greater transparency to the Commission regarding this fund's positions would have certainly been helpful in identifying an outlier fund. However, *publicly available* position-level data actually exacerbated Third Avenue's troubles as other market participants knew the holdings of the Focused Credit Fund and used that information to the detriment of the fund.[49]

In light of these circumstances, we believe it is important for the Commission to revisit its call in the Data Reporting Proposal for more frequent and detailed public reporting of fund positions. While this transparency may be helpful to some investors, the downside may exceed the potential benefits. This brings us back to the recommendation we made previously in our Data Reporting Letter, where we suggested that the Commission leverage the existing Form PF infrastructure instead of creating an entirely new form and a new reporting regime. Given that Form PF is a private form reported directly to the Commission, the inclusion of detailed position-level data on Form PF instead of the public Form N-PORT would enable the Commission to obtain data without creating public disclosure. For example, Question 32 on Form PF asks about the number of days it would take to liquidate the fund's portfolio. This could address the issues described above with respect to publicly reporting days-to-liquidate forecasts. Once the Commission has reviewed the data it begins receiving, it could subsequently determine whether this information is appropriate for public disclosure.

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[49] Matt Wurz, Gregory Zuckerman and Daisy Maxey, *"Junk Fund's Demise Fuels Concern Over Bond Rout"* (Dec. 10, 2015), Wall Street Journal, available at http://www.wsj.com/articles/as-high-yield-debt-reels-mutual-fund-blocks-holders-from-redeeming-1449767526 ("As the Third Avenue fund's holdings began to decline, rival traders at hedge funds shorted, or bet against, some of the mutual fund's holdings, wagering that Third Avenue would experience investor withdrawals and be forced to sell some of its holdings, according to the company and one trader who made this move.").

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II. Exchange-Traded Funds: Comments on Rule 22e-4

The Commission recently requested comment on numerous topics relating to ETFs[50] and received a range of responses, including one from BlackRock,[51] seeking to provide information and feedback. ETFs differ from mutual funds in many respects, most importantly regarding how liquidity is provided to investors. BlackRock commends the Commission for recognizing the differences between ETFs and open-end mutual funds and seeking to better inform itself on issues unique to ETFs through the ETF Issues Release. Indeed, the differences were recognized by DERA in the SEC Mutual Fund Liquidity Study, which stated: "We exclude ETFs because their structure and method of redemption are significantly different from open-end funds. For instance, only authorized participants are allowed to redeem from ETFs; redemptions from ETFs are often performed in-kind rather than in-cash; and the majority of ETFs are passively managed portfolios designed to track a benchmark."[52] We are concerned that the Proposal is designed to meet the structural needs of open-end mutual funds and the same rules cannot be easily applied to ETFs. In fact, the majority of ETFs meet redemptions in-kind, making the proposed rules inappropriate to these structures. As detailed below, we strongly encourage the Commission to develop a comprehensive ETF rule, including a classification system, guidance on baskets, and tailored rules for the subset of ETFs that meet redemptions primarily in cash ("Cash ETFs").

ETFs have different mechanisms than mutual funds for providing liquidity to investors and establishing prices at which share transactions occur. Investors in a mutual fund buy new shares and redeem existing shares directly with the mutual fund at a specified time each day at a price determined by the fund that is the fund's best estimation of NAV per share. As a result, when there is a significant imbalance between buyers and sellers, a mutual fund frequently must purchase or sell portfolio holdings in response to subscriptions and redemptions. Investor liquidity is derived directly from the mutual fund and its portfolio holdings. In contrast, ETFs operate subject to specific exemptive orders issued by the Commission designed to permit ETF shares to be listed on a stock exchange. Listing ETF shares means that any buying and selling occurs at a market-determined price agreed between investors on the exchange without the ETF's involvement. Exchange transactions directly between buyers and sellers provide each with liquidity based on market demand. Any imbalance between buyers and sellers affects the exchange price but does not directly lead to purchases or sales of holdings by the ETF. Instead, ETFs incorporate a feature (commonly referred to as the arbitrage mechanism) that seeks to keep the market price within close range of an ETF's NAV by adjusting the supply of available shares through transactions with a small group of institutional investors, known as APs, who are permitted to trade large blocks of shares directly with an ETF. As the Commission notes in the Proposal,[53] unlike mutual fund shares, redemptions of ETF shares by APs are designed to be, and typically are, effected ***in-kind***.[54]

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50 ETF Issues Release.

51 BlackRock ETF Comment Letter.

52 SEC Mutual Fund Liquidity Study at 4.

53 Proposal at 62344.

54 Because in-kind transactions for ETF shares involve extremely complex settlements often involving thousands of securities, the Commission, through exemptive relief, permits ETFs to transact directly only with APs rather than the general public.

As explained in greater detail in the BlackRock ETF Comment Letter, the fact that redemptions of ETF shares are typically effected in-kind is vital to a properly-functioning ETF arbitrage mechanism and results in numerous benefits to ETF shareholders. For purposes of this letter, the key point is that, unlike open-end mutual funds, ETFs do not typically sell portfolio holdings for cash in the market in response to share redemptions.[55] Instead, ETFs transfer blocks of portfolio securities to APs in exchange for redeemed shares (which saves ETF shareholders from transaction costs and tax consequences). APs may, or may not, in turn sell the securities received from the ETF in the market.[56]

In the Proposal, the Commission questions whether transferring less liquid securities from an ETF to an AP could adversely affect APs or ETF shareholders.[57] BlackRock notes that the Commission specifically requested comment on what issues, if any, are raised by ETFs holding less liquid securities (including consequences of transferring such securities in-kind to APs) in the ETF Issues Release. Given the timing of the ETF Issues Release and the Proposal, we realize that the Commission may not have had the opportunity to fully incorporate the information and feedback received.[58] Since most ETFs do not sell portfolio holdings in response to share redemptions, we question whether the same liquidity rules should apply to both open-end mutual funds and ETFs.

The proposed rules exempt ETFs that are "unit investment trusts" ("UITs"), as defined by the 1940 Act, because UITs "generally track established and widely recognized indices" and "fully replicate their underlying indices including with respect to basket assets" and therefore "a liquidity risk management program" would not be "necessary or beneficial" for such ETFs.[59] In practice, most ETFs track established and widely recognized indices.[60] Although the Proposal differentiates between those ETFs structured as UITs and those ETFs structured as open-end funds, the differences between ETFs structured as UITs and index-based open-end ETFs are difficult to distinguish. As a result, ETF analysts and investors do not view the differences as material.[61] Therefore, we do not see any reason to support distinguishing between ETFs

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55 As discussed in the Proposal, ETFs may substitute cash for in-kind securities under certain circumstances. The use of cash is, for most ETFs, an exception to normal (in-kind) practices required by circumstances. BlackRock understands that certain ETFs sell and redeem shares solely for cash, usually because they invest primarily in assets that cannot be transferred in-kind, such as bank loans. BlackRock believes such ETFs are atypical and, to the extent they operate like open-end mutual funds, should be covered by the same rules as open-end mutual funds.

56 APs may also (a) hold some or all of the securities as trading inventory or as hedges for other positions, (b) transfer the securities to a client on whose behalf the redemption was effected, or (c) use the securities to settle and close out existing short positions incurred prior to the redemption of ETF shares, in connection with client trades, market making or other activities.

57 Proposal at 62277.

58 BlackRock refers the Commission to the BlackRock ETF Comment Letter, in which BlackRock discusses in some detail the consequences, and benefits to ETF shareholders, of ETFs' holding less liquid securities.

59 Proposal at 62289.

60 Over 99% of assets in US ETFs subject to the 1940 Act are in index-based ETFs. *See* Cinthia Murphy, ETF.com, When, if Ever, Will Active ETFs Take Off? (Jul. 7, 2015), available at http://www.etf.com/sections/features-and-news/when-if-ever-will-active-etfs-take?nopaging=1; Phil Mackintosh and Ka Wo Chen, KCG, It's All About Active ETFs (Jan. 12, 2016), available at https://ptportal.kcg.com/kresearch/do/research/getDownload?attachmentId=4107&username=8FEW5ecT13JTdHAY7Qm0TA==.

61 While differences between index-tracking open-end ETFs and UIT ETFs tracking the same index are small and often immaterial, ETFs are now typically organized as open-end funds rather than UITs because, among other things, UITs are forced to incur cash drag that open-end funds are not. *See e.g.*, Morningstar's analysis of iShares Core S&P 500 ETF (IVV), a fully-replicating index-based open-end ETF, comparing it with SPDR S&P 500 (SPY), a UIT, and Vanguard S&P 500 ETF, a share class of an open-end mutual fund, available at http://analysis.morningstar.com/analystreport/ear.aspx?Symbol=IVV&Country=usa.

structured as UITs and virtually identical open-end ETFs for purposes of the proposed liquidity rules.

At the very least, we suggest that the Commission consider exempting any ETF that can demonstrate it tracks an "established and recognized index". As explained more fully below, we recommend that the Commission consider exempting any ETF that routinely settles redemptions in-kind and therefore does not, in the usual course of its operations, sell portfolio assets to fund shareholder liquidity from this Proposal. Instead, we recommend the Commission develop a holistic rule that specifically addresses issues unique to ETFs. If the Commission instead determines that a set of rules for both open-end mutual funds and ETFs is appropriate, we believe a number of interpretive issues must be addressed before the Proposal could sensibly apply to ETFs, as explained below.

A. In-Kind ETFs and Days-to-Liquidate

ETFs are not designed to meet shareholder redemptions directly – they redeem only to APs, which act as a buffer between general investors and the ETF for purposes of managing share liquidity through their market making activities.[62] Additionally, the majority of ETFs meet redemptions from APs primarily through in-kind exchanges. We have significant concerns regarding the applicability to In-Kind ETFs of the days-to-liquidate bucketing contemplated by the Proposal. Among the issues described in Section I(A) regarding days-to-liquidate bucketing and open-end mutual funds, the results for ETFs would depend much less on the *type or liquidity of assets* held by the ETF than on the *size* of the ETF. For example, consider Exhibit 6 below. As proposed, days-to-liquidate bucketing assumes that small funds are more liquid based on an assumption of smaller absolute position size. In this example, days-to-liquidate bucketing would make ETF 1 appear "more liquid" than ETF 2. Actual market experience, however, demonstrates that the shares in larger ETFs trade at tighter spreads and can be traded in larger size.[63] Therefore, in practice, ETF 2 is the more liquid ETF. Given that a methodology based on days-to-liquidate is irrelevant to meeting redemptions for In-Kind ETFs, and not in line with the market data on relative ETF liquidity, days-to-liquidate data is irrelevant for ETFs.

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[62] While not all APs are ETF market makers, and not all ETF market makers are APs, there is substantial overlap between the groups. Market makers acquire ETF shares for trading inventory during periods of excess selling demand, and sell down shares held in trading inventory or short sell shares during periods of excess buying demand.

[63] David J. Abner, The ETF Handbook: How to Value and Trade Exchange-Traded Funds (Wiley, 2016); Joanne Hill, Dave Nadig and Matt Hougan, A Comprehensive Guide to Exchange-Traded Funds (ETFs) (E-book, 2015); Gordon Rose, Morningstar ETF Research and Insights (Feb. 2012), available at http://www.morninstar.co.uk/uk/news/69355/total-cost-of-etf-ownership-the-bid-offer-spread.aspx.

Exhibit 6: Example of Days-to-Liquidate Application to ETFs

	ETF 1	ETF2
Seeks to Track Index of:	Stocks from Frontier Market Countries	US Large Cap Healthcare Stocks
ETF's AUM	$10 million	$25 billion
Size of Largest Holding (% of ETF)	7%	10%
Size of Largest Holding ($)	$700,000	$2.5 billion
Average Daily Trading Volume ("ADV") of Largest Holding	$750,000	$820 million[64]
Days to Sell Largest Holding at <50% of ADV[65]	2	7

B. In-Kind ETFs and the Three-Day Liquid Asset Minimum and 15% Illiquid Asset Limit

As described in Section I(B), we recommend that the three-day liquid asset minimum be removed from the Proposal entirely as it will have negative consequences for redemption risk of mutual funds and will contribute to pro-cyclical investment behavior. If the Commission does not remove the three-day liquid asset minimum from the Proposal and does not exempt ETFs from the Proposal, a number of clarifications will need to be made with respect to the application of the three-day liquid asset minimum to ETFs.

Firstly, the Proposal requires each mutual fund or ETF to adopt a liquidity risk management program that includes a minimum percentage of net assets that must be invested in three-day liquid assets. A "three-day liquid asset" is defined to mean ". . . any position of a fund in an asset (or portion of a fund's position in an asset) that the fund believes is *convertible into cash* within three business days at a price that does not materially affect the value of that asset *immediately prior to sale*" (emphasis added).[66] The proposed definition does not contemplate in-kind redemptions. It is, therefore, unclear how the Commission intends this definition would be applied by an In-Kind ETF. An in-kind redemption accomplishes in one step – exchange of portfolio assets for redeemed fund shares – what would otherwise require two steps – a sale of portfolio assets for cash, followed by an exchange of cash for redeemed fund shares. With this understanding, it is possible to interpret an in-kind redemption as equivalent to a conversion to cash, in which case substantially all of the assets of any In-Kind ETF would be treated as three-day liquid assets.

Alternatively, it is possible the Commission intends the definition to be interpreted literally – meaning that an In-Kind ETF should make a determination as to what constitutes a three-day liquid asset based on its ability to sell *for cash*, without regard to whether the In-Kind ETF would ever need to sell assets for cash to meet redemptions. In this case, we urge the Commission to make clear expressly that it would be reasonable, and consistent with the Commission's expectations, for an In-Kind ETF to adopt a liquidity program with a three-day liquid asset minimum of *zero* (so long as the ETF's management believes it will continue to be able to meet redemptions in-kind, consistent with previous practice). Though, as explained in Section I(B), the three-day liquid asset minimum runs contrary to the objectives of the Proposal and we recommend removing this altogether in the adopting release. As noted earlier, the vast

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[64] This example assumes Johnson & Johnson is the largest holding of the fund on this particular day. We assume Johnson & Johnson has average daily trading volume of 8 million shares and a stock price of approximately $102.50.

[65] This is a rudimentary means of calculating days-to-liquidate with respect to equities for illustrative purposes only.

[66] Proposal at 62385.

majority of ETFs meet redemptions in-kind making the three-day liquid asset minimum confusing and difficult to apply. For the small portion of ETFs that meet redemptions in cash, we recommend including tailored liquidity risk management rules within a comprehensive ETF rule.

Further, the Proposal would prohibit an ETF from *acquiring* any less liquid asset or 15% standard asset, respectively, if immediately after the *acquisition*, the ETF would be below applicable thresholds. We ask the Commission to clarify the meaning of the words "acquire" and "acquisition", as used in this context. Is receipt of a security included in an In-Kind ETF's creation basket an "acquisition"? If so, the proposed rules would seem to require In-Kind ETFs to exclude less liquid securities from their creation baskets under certain circumstances. As with index-tracking open-end mutual funds, this result could present issues for index-tracking ETFs, which under some circumstances might be challenged to both comply with these requirements and meet their objective of tracking their benchmark index.[67] The Proposal would force ETFs to deviate from this requirement by removing less liquid securities from creation baskets to avoid "acquiring" more while above a threshold. Given the Commission's long-standing interest in the use of baskets, we recommend addressing the issues in a comprehensive ETF rule, as explained more fully in the next section.

C. ETF Basket Flexibility

The Commission alludes in the Proposal to the interaction of the proposed rules and provisions of Commission exemptive orders applicable to ETFs relating to basket construction, and requests comment on whether additional flexibility in ETF basket construction would result in favorable or unfavorable changes in how ETFs manage the liquidity of their holdings.[68] In our view, additional ETF basket flexibility would be desirable.

The overwhelming majority of assets invested in ETFs subject to the 1940 Act is in ETFs that have an investment objective of tracking an index. ETFs (and open-end mutual funds) that seek to track an index use one of two index-tracking techniques: (a) full replication, in which all of the components of an index are held at the same weight as the index, or (b) optimization, in which a subset of the components of an index is held in weightings determined by mathematical techniques for matching key risk characteristics of the index as a whole. Many ETFs are fully-replicating, but ETFs that track very broad indices, comprised in some cases of several thousand securities, are typically optimized. An ETF that is fully-replicating by definition exactly matches its index, so its portfolio liquidity based on the Commission's proposed days-to-liquidate methodology is determined by the interaction of the index's composition and the ETF's size.[69] An ETF that is optimized requires selection from among an index's components, and therefore its portfolio liquidity could be greater or lesser than the full index (but only within the risk tolerance of the optimization).

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[67] Under the Proposal, an ETF could be prohibited from including holdings in its creation basket if either (a) the ETF grows sufficiently large that a portion of some holdings could not converted into cash within 3 days without affecting the price, or (b) the ETF's index becomes less liquid over time (due to changes in index constituents and weightings as the result of normal market activity such as, for example, bond issuance patterns, rather than a change of index rules).

[68] Proposal at 62291.

[69] Indexes, unlike funds, can be of indeterminate size, and use "weightings" rather than specific amounts of holdings. It would therefore not be possible to determine an index's "portfolio liquidity" using a "days-to-trade" methodology similar to that proposed by the Commission.

ETFs that use optimization – which includes nearly all ETFs that seek to track bond indexes of credit or municipal debt – typically seek to hold the most liquid assets to the extent possible while seeking to match all other key risk characteristics of the index. Creating a portfolio that favors the most liquid assets within an index has several benefits, including lower transaction costs when index rebalancing forces portfolio turnover. For an ETF that is subject to a requirement of *pro rata* baskets, having the ability to tilt the portfolio toward the more liquid components of an index could lead to baskets that are easier for APs to assemble when they seek to create new ETF shares. ETFs that are forced to include less liquid assets in their creation baskets are more likely to trade at small premiums to their NAV, because it is harder for APs to assemble creation baskets and therefore it tends to take time to create new shares in response to market demand.

Giving ETF sponsors greater basket flexibility would allow ETFs that use optimization a greater ability to apply optimization techniques to the selection of basket constituents, and would be used to assemble creation baskets that are more liquid than the ETF's portfolio or benchmark index. Importantly, the liquidity of a security can vary over time. Bonds which may be readily available to trade today, may be more difficult to transact in the future. Many bonds become less liquid over time (as they are purchased by "buy and hold" investors), so creation baskets that are not required to reflect an ETF's portfolio *pro rata* make it possible to favor (to the extent consistent with the portfolio's optimization risk tolerance) newer, more liquid issues that are available in the market but that also match the risk characteristics of the index. More liquid baskets are easier for APs to trade, which benefits ETF shareholders by limiting the potential for premiums and discounts and encouraging tighter spreads.[70] Basket flexibility can also be used to manage portfolio rebalancing more efficiently, reducing transaction costs and tax effects to ETF shareholders that would otherwise be incurred.

As discussed above, provisions of proposed Rule 22e-4 that prohibit an ETF from "acquiring" less liquid portfolio holdings under certain circumstances would seem to *require* some degree of flexibility to deviate from *pro rata* creation baskets. We believe there is little risk that ETFs would use basket flexibility to *decrease* portfolio liquidity materially. The techniques underlying portfolio optimization limit the degree to which portfolio liquidity could deviate from the level of liquidity implicit in an ETF's benchmark index before the ETF risks significant tracking error, detracting from its ability to meet its investment objective. We do not see any reason an ETF portfolio manager would seek such risk. The proposed prohibition against acquisition of 15% Standard Assets if more than 15% of the portfolio is invested in illiquid assets should serve as an effective regulatory backstop.

D. ETFs that Rely on Cash Baskets

While most ETFs meet redemptions in-kind, the Commission correctly observes in the Proposal that some ETFs provide APs with the option to redeem for cash rather than receive an in-kind basket, and some ETFs typically only redeem for cash.[71] The former may be used by some ETF sponsors to encourage APs to engage with an ETF that they might otherwise find too

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[70] *See* BlackRock ETF Comment Letter for an explanation of the relationship between portfolio liquidity, premiums/discounts and spreads.

[71] Proposal at 62288.

difficult to support,[72] while the latter may be required by legal rules or settlement practices applicable to an ETF's holdings.[73] To put this in perspective, only approximately 2% of US iShares ETFs rely primarily on cash redemptions as of December 2015.

We agree that an ETF that typically redeems for cash, like a traditional open-end mutual fund, would need to ensure sufficient portfolio liquidity (in conjunction with other liquidity resources) to meet shareholder redemptions.[74] BlackRock agrees that, as a general rule, Cash ETFs should be subject to liquidity rules that are comparable to those for open-end mutual funds.

Along the same lines, we would recommend that, if the Commission adopts swing pricing for mutual funds, similar rules be applied for Cash ETFs. We agree with the Commission that swing pricing is not needed by In-Kind ETFs, as in-kind settlement sufficiently externalizes to redeeming APs the liquidity costs of redemptions.[75] On the other hand, swing pricing could be beneficial to Cash ETFs as a means of externalizing costs, for the same reasons it could be beneficial to open-end mutual funds. If the Commission deems it appropriate to treat Cash ETFs like open-end mutual funds for purposes of regulating portfolio liquidity, it seems appropriate to provide Cash ETFs with the same tools as open-end mutual funds for managing liquidity costs.

Rather than extend swing pricing to Cash ETFs, the Commission could alternatively revisit present policy that prevents Cash ETFs from externalizing transaction costs fully. Many Cash ETFs currently use transaction fees to externalize transaction costs. While permitted, transaction fees for redemptions are subject to a Commission policy limiting redemption fees to 2%.[76] This policy, which was intended by the Commission to prevent "harm [to] ordinary [mutual fund] shareholders who make an unexpected redemption as a result of a financial emergency", in the context of ETFs prevents the full externalization of transaction costs to APs for ETFs that focus on markets where the combination of daily asset price movement in local currency, and local currency daily price movement against the US dollar, can on some days exceed 2%. On such days, the Cash ETF and its remaining shareholders are forced to absorb any costs of liquidating portfolio assets to fund redemptions by APs that exceed 2% of the redemption amount. In the context of Cash ETFs, the Commission's policy, designed to protect ordinary shareholders, instead harms ordinary shareholders by limiting transaction costs that would otherwise be absorbed by APs (and are routinely absorbed by APs on creation transactions, to which no such limit applies). If the Commission reversed its policy limiting redemption fees, at least with respect to ETFs, Cash ETFs could fully externalize transaction costs through redemption fees to APs and there would be no need to consider Cash ETFs in the context of swing pricing.

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[72] For example, an AP that is highly experienced trading equities might have little experience or capability with trading municipal bonds, and therefore might be more willing to support a municipal bond ETF that provides the option of receiving redemptions in cash than one that only permits redemptions in-kind.

[73] For example, certain jurisdictions that have restrictions on foreign ownership prevent non-local investors from acquiring ownership of stock except through purchases on an exchange made through regulated and monitored accounts.

[74] Proposal at 62288. We note that many ETFs redeem for cash do not meet liquidity needs in a manner similar to open-end mutual funds and have adopted unique processes that resemble in-kind redemptions economically.

[75] APs pass this cost back to investors through bid quotations.

[76] *See* Mutual Fund Redemption Fees, SEC Release No. IC-26782 (March 11, 2015).

E. ETF Shares as Liquidity Tools

ETF shares are stocks and trade on exchanges alongside single-company stocks. The liquidity of an ETF, like other stocks, is based on the ability to trade at a reasonable market-determined price when desired. Like other stocks, the most liquid ETF shares demonstrate consistent tight spreads and high trading volume, while less liquid ETF shares have wider spreads and less trading volume as liquidity is based on market demand. ETF shares are frequently among the most highly traded stocks.[77]

The Commission observes in the Proposal that mutual funds may invest in ETFs as a tool for managing liquidity, but "should consider the extent" of the practice because "the liquidity of an ETF, particularly in times of declining market liquidity, may be limited by the liquidity of the market for the ETF's underlying securities".[78] The Commission further observes that "[i]n the case of a significant decline in market liquidity, if [APs] were unwilling or unable to trade ETF shares in the primary market, the ETF's shares could trade at a premium or a discount" to NAV. We respectfully submit the Commission's observations are partly at odds with prior market liquidity events, and partly imply that liquidity should always be available at some "fair" price. This assumption does not fully reflect the circumstances of a market disruption. Further, the concern that the liquidity of an ETF may be limited during periods of market stress by the liquidity of its underlying assets is not supported by actual experience during numerous market disruptions. Some examples include the experience of bond ETFs during: (i) the 2008 Financial Crisis, (ii) in the wake of the Taper Tantrum, (iii) following the sudden departure of Bill Gross from PIMCO, and (iv) in the December 2015 sell-off in high yield bonds. All of these examples illustrate that the market was readily able to find prices where buyers and sellers were willing to transact – so much so that exchange trading volume of bond ETFs spiked.[79] During these events, ETFs declined in price and traded at larger-than-usual discounts to NAV. Because ETFs are bought and sold at a market-determined price agreed among investors on the exchange, there is no guarantee that selling shareholders will receive NAV, or even a price approximating NAV, when they seek to sell during a period of market stress. This is the same as any stock – prices decline when selling demand exceeds buying demand. The Commission's observations mix notions of *liquidity* – the ability of an asset to be converted into cash easily at the prevailing market price – with notions of *reasonable price* – the ability to sell an asset at some theoretical value during a period of market disruption, without suffering any price discount for seeking liquidity when liquidity is scarce. We believe ETF shares, like other stocks, may sell at a discount to some measure of intrinsic value during periods of market stress, but have proven time and again that they frequently remain liquid even when their underlying assets are more difficult to trade, or when market conditions would be considered "stressed".

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[77] In our experience, an examination of trading volume via Bloomberg demonstrates that the most highly traded equities by volume would include at least some ETFs on most days.

[78] Proposal at 62321.

[79] *See* Eric Balchunas, Bloomberg, "Five Mind-Blowing Stats from the Selloff in the Biggest Junk Bond ETF: Big numbers from a big day in bonds" (Dec.14, 2015). *See* also BlackRock, *ViewPoint*, Bond ETFs: Benefits, Challenges, Opportunities (Jul. 2015), available at http://www.blackrock.com/corporate/en-pt/literature/whitepaper/viewpoint-bond-etfs-benefits-challenges-opportunities-july-2015.pdf; BlackRock, *ViewPoint*, Exchange Traded Products: Overview, Benefits and Myths (Jun. 2013), available at http://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-etps-overview-benefits-myths-062013.pdf.

III. Comments on Swing Pricing Rule 22c-1

We have consistently supported permitting funds to apply mechanisms that allocate transaction and market impact costs associated with the sale of fund assets to redeeming shareholders as a way to provide a price signal to fund shareholders of the cost of obtaining liquidity.[80] Swing pricing is one such mechanism to achieve this, which has been used effectively in several jurisdictions in Europe for many years. For this reason, we are supportive of the Commission permitting 1940 Act Funds to utilize swing pricing. That said, there must be a recognition that because the technology and processes that manage mutual fund flows were not developed to support swing pricing, the infrastructure to enable swing pricing does not currently readily exist for the vast majority of 1940 Act Funds. Further, depending on the method by which a fund is distributed, there are operational complexities that will need to be addressed to make the use of swing pricing feasible.

We commend the Commission for attempting to introduce swing pricing in the US and we believe that if the Commission takes leadership in encouraging development of the appropriate infrastructure and modernization of technology, swing pricing could eventually be a helpful protection for long-term 1940 Act Fund shareholders. In the US, the main challenge lies in obtaining fund net flows prior to publishing the fund's NAV, since flows determine whether the NAV will be "swung" on a given day. In Europe, the dealing cutoff generally occurs several hours before a fund's NAV is published. This results in greater certainty around flows by the time funds are valued. In the US, fund valuation and receipt of fund flows data currently are effectively two separate and disconnected processes. The current timing of these distinct processes, in most cases, does not permit substantial visibility on fund flows before a fund's NAV is published.

Swing pricing is a common anti-dilution measure employed by UCITS-regulated funds in several EU jurisdictions, such as Ireland and Luxembourg. Over time, the use of swing pricing has increased as education about swing pricing has garnered increased acceptance for the practice and more countries in Europe have permitted swing pricing. For example, the Association of the Luxembourg Fund Industry ("ALFI") conducts a survey on the use of swing pricing by funds in Luxembourg every few years. In the most recent survey, conducted in 2015, ALFI found that 30 fund managers in Luxembourg were employing swing pricing, as opposed to 13 in 2011 and less than 5 in 2006.[81] In the UK, the Financial Conduct Authority ("FCA")[82] first approved the use of swing pricing in 2002 to support a single-priced UCITS fund structure.[83] In the UK, however, a dealing cutoff on or around midday local time was customary, mitigating the timing issue present in the US. The differences between the infrastructure and market practice between the US and jurisdictions that permit swing pricing in Europe provide limited precedent for overcoming the operational challenges that exist in the US today.

The Global Association of Risk Professionals studied the US fund infrastructure and provided a detailed outline of changes to processes that would need to occur to enable broad adoption of swing pricing in the US. GARP submitted a letter to the Commission in relation to

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80 FSOC Letter.

81 *See* ALFI, *Swing Pricing Survey: Update 2015* (Dec. 2015), available at http://www.alfi.lu/sites/alfi.lu/files/ALFI-Swing-Pricing-Survey-2015-FINAL.pdf ("ALFI Swing Pricing Survey").

82 Formerly the UK Financial Services Authority ("FSA").

83 FSA Policy Statement on CP 131: *Single Pricing of Collective Investment Schemes* (1 August 2002).

this comment file.[84] The GARP letter notes that members of GARP reviewed the ALFI 2015 Swing Pricing Guidelines to ascertain best practices for swing pricing that could be adopted or adapted to the US fund infrastructure. The ALFI 2015 Swing Pricing Guidelines provide detailed descriptions of principles for performing swing pricing based on practices of funds domiciled in Luxembourg.[85] Luxembourg is a jurisdiction where a substantial number of funds have employed swing pricing for many years and, therefore, provides a strong basis for GARP's analysis.[86] GARP's recommendations provide a roadmap for implementing swing pricing in the US by leveraging existing technology and infrastructure. The GARP proposal would necessitate changes to systems for transfer agents and other fund service providers, which would likely take a significant amount of time to implement. We agree that these enhancements to the existing US fund infrastructure would need to occur before swing pricing could be broadly adopted by 1940 Act Funds. We encourage the Commission to lead a broad dialogue that includes engagement with all relevant stakeholders to evolve the US infrastructure to support swing pricing. Further, while we agree that the changes described in the GARP Swing Pricing Letter would likely address the operational impediments to adopting swing pricing in the US, implementation of the recommendations is unlikely, unless the Commission takes a leadership role in fostering the necessary industry-wide evolution. The Commission should consider further engagement with the fund industry and fund service providers and distributors to ensure that the necessary changes are effected in a well-thought out and appropriate manner. Further, the technological modernization required for broad adoption of swing pricing will be costly for fund managers and fund service providers. If the implementation of changes to support swing pricing increases the cost of providing services to mutual funds, some of the costs associated with implementing swing pricing may be indirectly borne by fund shareholders. These factors will need to be taken into consideration as the Commission moves forward with this Proposal.

A. Clarifications and Modifications to Rule 22c-1 That Would be Helpful

Recognizing that today there exists significant impediments to the full implementation of swing pricing in the US, we are making several recommendations to clarify and improve proposed Rule 22c-1, to permit swing pricing to operate effectively, should the needed US fund infrastructure modernization occur.

Swing Thresholds

First, with respect to swing thresholds, it appears that the Commission has contemplated that funds would set a single swing threshold, above which the fund's NAV would be swung. We believe that flexibility in determining and defining the swing threshold would allow swing pricing rules to be flexible and adapt over time as technology and infrastructure evolve. This flexibility is permitted in Europe. In particular, the Commission should clarify that funds are permitted to create an "asymmetric" swing threshold where the threshold for inflows is different than the threshold for outflows.[87] We further recommend that the Commission allow funds to set a swing threshold as a dollar-value, not just as a percentage of fund NAV, as proposed. A dollar-value may be more relevant for some funds; in particular, smaller funds may not

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84 GARP Swing Pricing Letter.

85 ALFI, *2015 Swing Pricing Guidelines* (Dec. 2015), available at http://www.alfi.lu/sites/alfi.lu/files/Swing-Pricing-guidelines-final.pdf ("ALFI Swing Pricing Guidelines").

86 ALFI Swing Pricing Survey.

87 According to ALFI, two-thirds of asset managers using swing pricing for Luxembourg-domiciled funds use asymmetric swing thresholds. *See* ALFI Swing Pricing Survey.

experience liquidity or market impact issues, even if a large percentage of the fund is redeemed or purchased. Without flexibility to set a swing threshold as a dollar-value, small but growing funds will need to continuously adjust swing thresholds as the fund grows. Funds should also be permitted to set multiple swing threshold levels for a given fund, where each threshold could be associated with different swing factors. Such a sliding swing threshold would allow partial swing pricing to more precisely reflect different levels of costs associated with the disposition (purchase) of securities for different trade sizes.[88] Lastly, mutual fund boards should not be responsible for determining and approving swing thresholds. Determinations of swing thresholds should be made by a Swing Pricing Committee, establishing a process for timely changes and interventions. The use of a Swing Pricing Committee is generally the practice in Europe. The Swing Pricing Committee should report to the mutual fund board at regular scheduled intervals. Mutual fund boards should not be required to approve all swing thresholds.

Safe Harbor from Liability

In permitting funds to utilize swing pricing, the Commission needs to recognize that certain components of the swing pricing process will be based on estimates. In particular, swing pricing in the US will likely use estimates in the following ways: (i) current day net flows estimates calculated using prior day NAV (to provide advisers with sufficient information to make the decision on whether or not to swing the NAV); (ii) a price impact component of the swing factor, which will be an estimate; and (iii) the swing threshold is an estimate of when costs incurred through the disposition (purchase) of fund assets associated with net flows will have a material impact on the fund. The Commission should clarify in the adopting release that it recognizes there will be an element of estimated components in the determination to swing a NAV and in estimating the amount that the NAV should be swung. The Commission should further clarify that it is comfortable with fund managers and their administrators using these estimates in a disciplined and documented manner when employing swing pricing.

The Commission should further provide a safe harbor from liability for differences between estimates and what is observed ex-post if swing pricing procedures are followed properly. We believe this is important not only because of the reliance of swing pricing on estimates but also because fund managers and mutual fund boards will be more likely to adopt swing pricing if they believe that their liability is limited by the regulation. Without a safe harbor, funds may be reticent to adopt swing pricing.

Compliance Timeline

As outlined in the detailed letter submitted by GARP, we believe at least two years lead time is needed to allow for the changes to infrastructure to take place. We, therefore, recommend that the Commission set the effective date of the swing pricing provisions to at least two years after the final rule is adopted. This will permit an orderly and industry-wide process to make the necessary changes.

Financial Statements and Performance Reporting Regarding Swing Pricing

We agree that the “swung” NAV should be used as the official fund NAV for performance reporting purposes; this is consistent with the practice in Europe. However, given that swing pricing, as proposed, will be optional, there could be inconsistencies in comparing performance

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[88] ALFI Swing Pricing Guidelines reference multiple swing thresholds as a useful practice.

between funds that use swing pricing and those that do not. This will require client education and will likely require further consideration by performance rating organizations to ensure appropriate comparisons can be drawn. Further, the ability to calculate and disclose the various components that would comprise the swung NAV and the impact of swing pricing on performance will require systems enhancements by fund service providers.

With respect to financial statements, we note that the accounting standard setters will need to consider implications and provide appropriate guidance related to swing pricing on 1940 Act Fund financial statements.

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IV. Defining and Assessing Fund Liquidity Risk

The Proposal defines liquidity risk as "the risk that the fund could not meet requests to redeem shares issued by the fund that are expected under normal conditions, or are reasonably foreseeable under stressed conditions, without materially affecting the fund's NAV."[89] Inherent in the proposed definition are two separate notions related to liquidity – (i) immediacy, or the ability to transact readily in a given asset; and (ii) the cost of obtaining liquidity from the market, which is a concept that recognizes that less liquid assets may need to be sold at wider bid-ask spreads than more liquid assets, and that a steeper discount may arise for less liquid assets during stressed market conditions. In other words, the notion of the cost of obtaining liquidity from the market necessarily reflects the fact that liquidity is not "free", albeit the costs of obtaining market liquidity may fluctuate in different market environments and can differ across different asset classes. As the Commission is aware, the NAV of mutual funds necessarily changes to reflect market prices of portfolio holdings and mutual fund investors bear the risk of market fluctuations and the market impact and transaction costs arising from the asset sales required to meet mutual fund redemptions. Unlike banks, which have an obligation to meet liabilities including the repayment of depositor's principal, mutual fund redemptions are executed based upon a pro-rata share of the value of the securities held in the fund, with no guarantee of a particular price. Part of an investor's return is found in the liquidity premia that can be obtained by investing in less liquid assets. Many investors with a long investment time horizon, such as those saving for retirement, are well-placed to benefit from capturing a liquidity premium and often achieve this through investments in mutual funds held in retirement accounts.[90] Of course, the risk-return aspect of investing means that the additional returns associated with less liquid asset classes can also entail additional risk that in a stressed environment, the investor's ability to realize some notion of the asset's "intrinsic value" may be challenged. Further, liquidity varies with market conditions, and the future liquidity (just like the future value) of an asset is not always foreseeable. Neither a fund manager nor the best intentioned regulations can force markets to behave in a manner inconsistent with their innate characteristics.

In this context, it is unclear how the Commission expects the reference to "without materially affecting the fund's NAV" in the proposed definition of liquidity risk to be interpreted, particularly given that it is linked to being "foreseeable under stressed conditions". If the Commission intends the reference to entail a recognition that liquidity conditions change and

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89 Proposal at 62287.

90 According to the Investment Company Institute ("ICI"), 45% of US mutual funds are retirement account assets as of October 31, 2015. Retirement accounts include employer-sponsored defined contribution plans and individual retirement accounts. Mutual fund assets include long-term funds and money market funds. *See* Investment Company Institute, "The U.S. Retirement Market, Third Quarter 2015" (Dec. 2015), available at www.ici.org/info/ret_15_q3_data.xls.

different assets will incur different levels of transaction and market impact costs, it should clarify this in the adopting release. In other words, the adopting release needs to acknowledge the fact that what may be a "material" or adverse effect on the NAV of an equity or US Treasury fund in a highly liquid environment, may be very different from what is deemed material for a high yield bond fund in a stressed market environment. If interpreted more narrowly or literally – that transaction costs should always be low for all securities in all market environments – this is not consistent with how markets function and the intrinsic characteristic of the mutual fund as an investment vehicle. While mutual funds should seek to avoid situations where they have to sell assets at extremely discounted or "fire sale" prices to meet redemptions, they cannot be in the business of guaranteeing investment returns, and regulators must be very careful not suggest or expect otherwise.

We believe that the Commission's emphasis with respect to LRM should be to help facilitate mutual funds' abilities to meet their redemption obligations as opposed to attempting to regulate the potential cost of liquidity in different market scenarios. Given the potential for it to be interpreted in different ways, we suggest the Commission consider removing "without materially affecting the fund's NAV" from the definition of liquidity risk or if not, provide additional clarifications with respect to how mutual funds should interpret the definition. We believe that a literal or narrow interpretation of the definition as proposed would be detrimental to mutual fund shareholders as it could potentially call into question the diversification afforded by many well-constructed mutual funds that cannot reasonably foresee or represent that low transaction costs are achievable at all points in time for all assets. This could have profound implications for the retirement security of many Americans who utilize mutual funds to achieve their retirement savings needs. Similarly, the funding provided to users of mutual fund capital in the real economy would be impaired. Therefore, we do not believe that a literal interpretation was the Commission's intention, and it should be clarified in the adopting release.

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V. Revisiting the Fund "Toolkit"

We have consistently advocated that policy makers consider the full range of tools in the "toolkit" to help funds meet redemptions.[91] Given that we cannot predict the future and recognizing that things that have never happened can and do happen, it is important to provide funds with "tail risk tools" to enable fund managers to address "tail risk events". We commend the Commission for considering tools available to US mutual funds and proposing to expand the US mutual fund toolkit. In the context of the Proposal, we thought it worthwhile to review the toolkit of measures that we have previously highlighted as best practices, which are employed in various jurisdictions around the world. In this section, we revisit the tools we outlined in our letter to FSOC.[92] Additionally, we note that the International Organization of Securities Commissions ("IOSCO") recently reiterated the importance of having liquidity management tools available to funds and performed an analysis that compares the tools available to funds in different jurisdictions around the world.[93] As we stated in our FSOC Letter, the toolkit should ideally include backup measures to allow fund managers, mutual fund boards, and regulators to react in the best interests of shareholders, should they be faced with a spike in redemptions or

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91 *See e.g.,* FSOC Letter, Liquidity ViewPoint.

92 FSOC Letter.

93 IOSCO, Liquidity Management Tools in Collective Investment Schemes: Results from an IOSCO Committee 5 Survey to Members (Dec. 2015), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD517.pdf ("IOSCO Liquidity Survey").

other extraordinary circumstances. Further, we have noted that to be effective, the tools in the toolkit should be made available consistently, as opposed to being prescribed only for certain funds or asset classes, as doing so would likely create market distortions without mitigating risk. Therefore, we recommend that industry-wide standards be established.

1. *Mechanism to allocate transaction costs to redeeming shareholders as a way to provide a price signal for the price of market liquidity and to reimburse or buffer a fund's remaining shareholders*.

At present, US open-end mutual funds that meet redemptions in cash do not have a mechanism to allocate the costs associated with selling securities to meet redemptions to redeeming investors. We are supportive of the Commission's proposal to permit swing pricing, as swing pricing is a mechanism that can achieve this objective. That said, it is important to recognize the operational impediments to the implementation of swing pricing in the US that exist today. As such, the Commission will need to encourage modernization of the infrastructure to support swing pricing.

2. Temporary borrowing from non-government sources.

The 1940 Investment Company Act permits borrowing under certain circumstances. This is a useful tool for 1940 Act Funds that can be used as a backup source of liquidity. Today, numerous US mutual fund complexes have established bank credit lines and/or interfund lending facilities as an additional source of liquidity. These backup sources of liquidity are not new and have been made available to US mutual funds for many years.[94]

3. In-kind redemptions, where feasible.

The 1940 Act permits 1940 Act Funds to meet redemptions through in-kind transfers of securities.[95] We commend the Commission for proposing that funds document their policies and procedures for meeting redemptions in-kind to encourage greater use of this tool. Such policies and procedures should not be prescriptive as to when in-kind redemptions *must* be used; rather, they should provide flexibility and clarity on how in-kind redemptions would be administered and when in-kind redemptions will be *considered*, allowing discretion on the part of the fund managers to protect the best interests of all shareholders. In addition to requiring written policies and procedures on the use of in-kind redemptions, we suggest that the Commission provide guidance on the appropriate use of in-kind redemptions for funds that have institutional investors. In particular, this guidance should encourage fund sponsors (or state that fund sponsors have a responsibility) to *consider* redemptions in-kind if withdrawal requests exceed a certain percentage of a fund's total assets. Fund managers should be allowed to decide the best course of action in managing redemptions based on the circumstances.

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[94] Interfund lending facilities are a common feature of US mutual fund complexes. The SEC has granted interfund exemptive relief to many mutual fund registrants since the 1990s. Certain of the more recent interfund exemptive orders are available on the SEC website. *See* Investment Company Act Notices and Orders, Interfund Lending, available at https://www.sec.gov/rules/icreleases.shtml.

[95] 1940 Act Funds, excluding closed-end funds, often elect to be governed by Rule 18f-1, which obligates the fund to redeem in cash up to the lesser of $250,000 or 1% of NAV during any 90-day period. These 1940 Act Funds can then elect to redeem greater amounts in kind. In general, BlackRock 1940 Act open-end mutual funds elect to be governed by Rule 18f-1 and, therefore, have the ability to use in-kind redemptions.

4. *Mechanism to facilitate the suspension of redemptions to protect investors, which in turn would mitigate concerns about the potential for fire sales.*

Some regulatory regimes permit funds to suspend redemptions under certain circumstances.[96] For example, in Europe, depending upon the relevant EU jurisdiction, UCITS funds or their manager have the ability to suspend dealing in the fund when redemption requests exceed a specific level. The UCITS or its manager can also close the fund to new subscriptions. In the US, mutual fund boards and fund managers of 1940 Act Funds are not currently permitted to suspend redemptions without Commission approval. In July 2014, the Commission finalized reforms for money market funds, which include provisions allowing money market fund boards to temporarily restrict redemptions in money market funds under certain circumstances. In the US, the Commission currently has the power to temporarily suspend redemptions in an individual fund or fund sector. In line with the "worst-case scenario" nature of this tool, the Commission has used its authority to suspend redemptions only in rare instances.[97]

5. *Discretion to include "out-of-the-money" ("OTM") gates[98] in fund structures.*

The discretion to incorporate OTM gates into a fund's structure is not currently permitted in the US or included in the Proposal. We note, however, that OTM gates are permitted in other jurisdictions.[99]

6. *Clear, concise disclosure to investors regarding: (a) the potential costs and risks to the fund of significant redemption activity, including the potential dilutive effects of liquidating assets to meet redemptions and the potential transaction costs; (b) the market impact costs that could be associated with redemption activity; (c) the risk that due to unpredictable disruptions in financial markets, under certain circumstances, that various mechanisms in the fund's charter might trigger a suspension of redemptions; and (d) should any of the above fund structural features already be in use or implemented in the future, their risks should also be fully disclosed to investors.*

Such disclosures are in many cases already required under the Investment Company Act of 1940, as amended ("1940 Act"), on Form N-1A. For instance, Form N1-A requires the disclosure of redemption fees,[100] procedures for redeeming the fund's shares, including any restrictions on redemptions,[101] and risks that frequent purchases and redemptions of fund

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96 *See* IOSCO Liquidity Survey at 4 ("Table 2: Availability of policy tools to manage internal fund liquidity in selected jurisdictions.").

97 See *e.g.,* SEC Order.

98 An OTM gate is a gate where the trigger for considering whether to put the gate down is sufficiently unlikely to be triggered (or "out-of-the-money") under normal market circumstances, so as to only be triggered in emergency or extraordinary circumstances.

99 *See* IOSCO Liquidity Survey at 4 ("Table 2: Availability of policy tools to manage internal fund liquidity in selected jurisdictions.").

100 *See* Form N-1A Item 3.

101 See Form N-1A Item 11(c)(1).

shares by fund shareholders may present for other shareholders of the fund.[102] We are supportive of many of the enhanced disclosures outlined in the Proposal.

Taken together, we believe that the Proposal expands the toolkit of available mechanisms to help 1940 Act Funds effectively meet redemptions under a variety of scenarios. The recommendations made throughout this letter are intended to help the Commission achieve its objectives, while limiting potential unintended consequences.

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We thank the Commission for providing BlackRock the opportunity to express our support for your efforts and to provide our comments and suggestions on the Proposal. Please contact the undersigned if you have any questions or comments regarding BlackRock's views.

Sincerely,

Barbara Novick
Vice Chairman

Benjamin Archibald
Managing Director

cc:

The Honorable Mary Jo White
Chairman
Securities and Exchange Commission

The Honorable Michael Piwowar
Commissioner
Securities and Exchange Commission

The Honorable Kara M. Stein
Commissioner
Securities and Exchange Commission

David Grim
Director
Division of Investment Management
Securities and Exchange Commission

[102] See Form N-1A Item 11(e)(1).

GARP | Global Association of Risk Professionals

January 12, 2016

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

Re: Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release

File Number S7-16-15

Response to Proposal to SEC on Swing Pricing and Transparency for Omnibus Accounts

Dear Mr. Fields:

I. Summary

The Global Association of Risk Professionals (GARP)[1], in consultation with its Buy-Side Risk Managers Forum Swing Pricing Sub Committee[2] (Swing Pricing Committee or Committee), reviewed the SEC's proposed Liquidity Risk Management guidance with the objective of responding to the SEC's request for comments. The comments herein are based on, among other things, feedback from the Committee's participants who reviewed in detail the many issues raised to implementing swing pricing for open-ended funds in the U.S., and the proven benefits the adoption of swing pricing would bring to investors and the marketplace.

Specifically, GARP is providing comments on two aspects of the proposed rule: 1) the adoption of swing pricing; and 2) liquidity risk management for fund liabilities (i.e., the redeemable equity claims of individual mutual fund investors).

[1] The Global Association of Risk Professionals (GARP), http://www.garp.org, is a not-for-profit global membership organization dedicated to preparing professionals and organizations to make better-informed risk decisions. The GARP community represents over 150,000 risk management practitioners and researchers from banks, investment management firms, government agencies, academic institutions and corporations from more than 195 countries. GARP's mission is to educate, train and set global standards in financial and energy risk management. The association administers the Financial Risk Manager (FRM®) and Energy Risk Professional (ERP®) exams; certifications

management via comprehensive professional education and training for professionals of all levels.

[2] The Swing Pricing Committee consisted of: AllianceBernstein, BlackRock, Deutsche Asset Management, Goldman Sachs Asset Management, J.P. Morgan Asset Management, Neuberger Berman, Nuveen Fund Advisors, LLC, MFS Investment Management, Oppenheimer Funds and Western Asset Management.

II. Swing Pricing

GARP, and the Swing Pricing Committee, evaluated in detail the SEC's proposal on swing pricing and strongly agrees with the proposal to allow U.S. open-end mutual funds to employ swing pricing on a voluntary basis. However, significant operational challenges exist today which will likely impede the broad adoption of swing pricing by U.S. open-end mutual funds without material changes to the existing mutual fund-related infrastructure. To this end, the Committee met several times to identify and discuss the current operational challenges, develop approaches which may form the basis for further discussions among industry stakeholders to allow for the successful implementation of swing pricing in the U.S. mutual fund industry, and to set out a preliminary proposal, based in part on the successful implementation of swing pricing in Europe, that may allow for the voluntary adoption of swing pricing for open-ended U.S. mutual funds.

As a result of these discussions, we are describing herein a "roadmap" for evolving the US infrastructure to enable swing pricing. Making these changes will take time, and will involve significant expenditures for fund companies, fund distributors, and fund service providers alike, all of which will need to be explored further by the SEC through broader engagement with relevant stakeholders. While the changes suggested in the proposal outlined in this letter will in all probability result in material implementation costs for industry participants, it is our belief that the long-term benefits of enabling swing pricing for U.S. open-end mutual funds outweigh the one-time costs related to implementation for industry participants.

We would like to make you aware that our analysis of swing pricing and the recommendations herein, including the strong recommendation to move forward with the proposal to employ swing pricing for U.S. open-end mutual funds, were based in part on the policies, governance and investor considerations set forth in the December, 2015 Association of the Luxembourg Fund Industry (ALFI) guidelines[3]. The ALFI guidelines objectively address many of the issues raised in the SEC's request for comment as they relate to these areas of importance surrounding the adoption and implementation of swing pricing. We urge the SEC to consider them when promulgating its rules and other guidance related to swing pricing.

Swing pricing results in a number of benefits to end investors and contributes to systemic stability. These benefits and contributions include, but are not limited to, the following.

1) Protecting investors from market effects associated with the current U.S. mutual fund practice of allocating transactions costs to all investors in a mutual fund (based on units of ownership) versus properly aligning transaction versus either redeeming or subscribing investors.
2) Providing a price signal to mutual fund investors based on the transaction and market impact costs their subscriptions and redemptions create. This price signal should attenuate pro-cyclical behavior (i.e., by reducing first mover advantage).
3) Reducing perceived (by some) systemic risks associated with open-end funds (i.e., run on funds).

[3] http://www.alfi.lu/sites/alfi.lu/files/Swing-Pricing-guidelines-final.pdf.

EMEA Swing Pricing – Historical Context

The European (EMEA) mutual fund sector adapted market practices to allow swing pricing to be adopted by open-end funds[4]. As a result, swing pricing has been increasingly used[5] effectively and successfully in EMEA as part of the daily Net Asset Valuation (NAV) process for many years to eliminate the dilutive effect of redemptions and subscriptions on long-term investors in open-end funds. Their experiences have shown that swing pricing can reasonably allocate the costs of fund redemptions and subscriptions to transacting investors (i.e., bid-offer spreads and other fees) if administered using proper governance and disclosure policies (See, ALFI guidelines).

In EMEA, swing pricing is feasible operationally as "actual" trade flows based on estimated prices and trades occurring on the trade date (T) are available on a timely basis on T, providing the information necessary to appropriately swing the NAV of a fund. Individual fund dealing cut-offs for redemptions and subscriptions are generally between 11:00 A.M. and 12:00 P.M. GMT, with valuations and pricing occurring starting around 4:00 P.M. GMT. This "early" dealing cut-off provides sufficient time for funds to obtain final trade flows from internal systems (i.e., for self-administered funds) or from trading platforms of third party distributors (e.g., dealers, retirement plan record-keepers, clearing firms). Trading platforms collect all of that day's activity and supply it to the fund's transfer Agent (TA) where the TA then applies an estimated fund price to generate "estimated" trade values for that trading day. Those values are then passed on to the TAs to aggregate and send estimated subscription and redemption data to the fund manufacturers, enabling them to make a swing pricing decision on T. Once swing pricing decisions are made the "actual" fund prices are released to the TAs and the distributors for them to create final trades for that day's activity.

U.S. Mutual Funds – Operational Issues Affecting Swing Pricing

Ideally, U.S. open-end mutual funds should have the ability to implement swing pricing in a manner analogous to the EMEA model described above. However, there are existing operational and infrastructure support differences in the U.S. versus EMEA that prevent replicating the EMEA approach. Specifically, in the U.S., trade flows are generally not available for funds that are sold via third party distributors until early the morning of T+1. This is due to a variety of factors, including:

- Currently under prospectus guidelines, redemptions and subscriptions may be submitted by investors to the TA or to the third party distributors, as agents for the funds, up until 4:00 P.M. ET (versus 11:00 A.M. to 12:00 P.M. GMT in EMEA), which has defined the investor experience to date, a very important consideration in implementing swing pricing as noted below. However, for the reasons set forth in the immediate following bullet points, simply changing prospectuses would not allow the U.S. mutual fund industry to replicate the EMEA approach;

[4] EMEA funds generally use "partial" swing pricing, whereby the NAV is swung when net subscriptions or redemptions exceed specified % threshold(s) of NAV.
[5] See ALFI Survey results. http://www.alfi.lu/sites/alfi.lu/files/ALFI-Swing-Pricing-Survey-2015-FINAL.pdf

- Legacy system constraints and the batch nature of technology systems supporting TAs and other fund service providers (i.e., systems rely on batch computing processes for data aggregation and reporting);
- Certain platforms of third party distributors (e.g., retirement plan record-keepers, insurance companies, trust companies) require that actual fund prices are received before making trade allocations across accounts; and
- The majority of fund trades flow through National Securities Clearing Corporation (NSCC) or Defined Contribution Clearance & Settlement (DCC&S) which introduces an additional layer of feeds and flow processing.

Currently, without trade flows at end-of-day on T, U.S. fund managers lack the requisite data to determine whether the NAV of a fund should be swung based on net redemptions or subscriptions that exceed prescribed thresholds.

Swing Pricing Implementation Roadmap for U.S. Mutual Funds

In order to implement swing pricing, U.S. mutual fund managers would require access to trade flows occurring on T. Two potential alternatives were evaluated that would allow for earlier fund manager access to trade flows to make swing pricing decisions.

Alternative 1: Implement an Earlier Trade Date Flow Cut-Off Time: Follow the EMEA approach and require "actual" trade date flows at an earlier cutoff (e.g., between 12 P.M. and 2 P.M. ET) to allow for leveraging the prior day's NAV to generate an estimated impact; or

- **Analysis and Conclusions:** Following EMEA market practice would essentially require moving dealing cut-offs from 4:00 P.M. ET to an earlier time (e.g., 12:00 P.M. to 2:00 P.M ET). This approach works in EMEA. As such, a number of ways to obtain earlier estimates of actual trading flows to allow trade date flows to be used to determine whether to swing the NAV of a fund were evaluated. It was found that obtaining earlier estimates of sufficient trade flows would be difficult given the fact that TAs and platform providers do not have a complete set of flows until approximately 4:00 P.M. ET (i.e., only partial flows could be provided earlier in the day). The strong view was that partial flows would not be sufficient to accurately determine whether to swing the NAV of individual funds. Further, there is a long history in the U.S. mutual fund market of providing clients the flexibility to submit redemption and subscription requests up until 4:00 P.M. ET (fund valuation point). We are very concerned about markedly changing the investor experience and ability to redeem or subscribe in funds up until the close of the U.S. equity markets. Among other reasons, swing pricing should be introduced in a way that is not overly disruptive to the end investor. As such, this alternative was ultimately dismissed as not viable.

Alternative 2 *(Proposed Roadmap)*: Use Actual Flows on T and Prior Day NAV: Use "actual flows entered on T before 4 P.M. ET, leverage the prior day's NAV to generate an estimated impact, and push the NAV release to later in the evening.

- **Analysis and Conclusions:** We were concerned about presenting a positive and constructive roadmap from which to build for adopting swing pricing in the U.S. mutual fund industry. As such, it was concluded that the most viable approach which could be proposed at this time would involve shifting the NAV calculation time to later in the day on T and asking TAs and other providers of fund flows to send estimated flows on the evening of T. Notably, this approach has

a number of downstream impacts on third party service providers, including fund administrators, TAs, dealers, insurance companies, trust businesses, 401K retirement plan administrators and the NSCC which are noted in the details of the proposal below.

Using the proposed roadmap (Alternative 2) as a foundational approach to implementing swing pricing in the U.S., the following principal elements would need to be adopted by the SEC to allow swing pricing to be implemented for U.S. open-end funds.

1) Define an "estimated" flow as a subscription or redemption executed on T prior to the prospectus cutoff using the prior day's NAV to create a capital flow into a fund.
2) Maintain dealing cut-off for redemptions and subscriptions at 4:00 P.M. ET as is current market practice.
3) Require providers of fund flows (e.g., TAs, dealers, retirement plan record-keepers, trust companies) to provide "estimated" trading flows occurring on T by 6:00 P.M. ET.
    a. This change would require one-time changes to systems and processes for these third party providers. Manufacturers (i.e., asset managers) would also need to modify their systems to receive these flows.
4) Leverage the existing NSCC pipes to allow third party distributors to send estimated flows to TAs and downstream to fund managers by 6:00 P.M. ET.
    a. This requirement would require system changes by the NSCC to run an early batch of fund flows.
5) Shift the NAV publication time from 6:00 P.M. ET to 8:00 P.M. ET (bypassing the 6:00 P.M. newspaper cut off for publishing prices, recognizing technological advances obviate reliance on this historical practice).
    a. This shift in NAV publication time would also require process changes for third parties involved in publishing and/or consuming the end-of-day official NAVs (e.g., fund administrators, transfer agents, other third party service providers). It would also impact the distribution of funds (such as fund-of-funds providing NAVs to other distributors).
6) Provide a safe harbor to allow fund managers to rely on "estimated" flows and actual prices occurring on T to determine whether to swing the NAV of a fund and calculate the swung NAV by 8:00 P.M. ET. [6]
7) Provide a safe harbor to also allow fund managers the option to adjust the prior day NAV to reflect market movements relative to fund benchmarks which may occur post fund valuation for the purpose of determining whether to swing the NAV. Such adjustments will enhance precision on swing pricing decisions (i.e. capture situations where market moves would result in a swing pricing threshold being exceeded, thus swinging the NAV for the trading day).
8) Maintain the existing batch process and feeds of "final" flows from third party distributors through the NSCC to TAs and fund managers.
9) Continue to rely on "final" flows for actual trading (i.e., redemptions and subscriptions) that will take place on T+1 in the market.

    As noted in #7 above, actual (i.e., final) flows occurring on T will vary slightly from "estimated" flows used to swing the NAV of individual funds. Thus, SEC rules/guidelines on swing pricing would need to ensure that fund managers will not

[6] The time may need to be extended for more complex funds such as fund of fund structures.

be held liable for decisions made in good faith to swing the NAV of a fund based on "estimated" flows that would vary from the decision made using actual fund flows.

10) Mandate a two year (24 month) lead time for fund service providers and fund manufacturers to modify systems and processes to support estimated cash flows by 6:00 P.M. ET and NAV publication by 8:00 P.M. ET to facilitate swing pricing.

Proposed SEC Rule 22c-1(a) (3) (i) (A)

Further to the above, following a lengthy discussion considering the various operational and practical issues related to implementing swing pricing, the Swing Pricing Committee fully supported the "reasonable inquiry" standard expressed in proposed SEC Rule 22c-1(a) (3) (i) (A). For funds distributed through intermediaries, the process of determining swing pricing will necessarily involve receiving and evaluating net purchase and share activities as communicated through intermediaries. Because of operational and timing considerations, many of these will be preliminary estimates that funds will require in order to determine whether swing thresholds are met.

Financial Intermediaries

SEC swing pricing provisions should also incorporate additional requirements for financial intermediaries (as defined in Rule 22c-2)[7] to provide, at the request of a fund, timely estimates of the net purchase or redemption activity to support the fund's reasonable inquiry. This requirement would assist funds in carrying out their inquiries and help ensure implementation of an appropriate swing pricing mechanism. As is the case for redemption fees under Rule 22c-2, a rule requiring the provision of estimates if requested is important to ensure financial intermediaries actually do provide the requested information on a timely basis.

Conclusion on Swing Pricing

It is strongly recommended that the SEC include within any proposed swing pricing guidelines for U.S. mutual funds the foundational roadmap approach outlined in this Response. Doing so will ensure that processes and support systems will be modified as required to allow swing pricing to be successfully implemented for U.S. open-end funds relying on third parties to distribute and process funds. Further, the draft approach outlined herein would enable swing pricing to be implemented without impacting clients' (i.e., end investors) ability to transact up to 4:00 P.M. ET.

GARP and the Swing Pricing Committee fully support voluntary adoption of swing pricing by the U.S. mutual fund industry. The comments herein, and the roadmap, are being advanced to assist in the process of ensuring that swing pricing can be effectively implemented by the U.S. mutual fund industry. It is recognized that the roadmap outlined will require system and process enhancements for U.S. mutual fund participants such as fund managers, TAs, fund administrators, third party distributors and the NSCC. However, we strongly believe changes to allow for swing pricing are warranted. As has been successfully demonstrated in EMEA, swing pricing is a proven way to protect non-transacting investors from transaction costs and reduce first mover advantage and related systemic risk from open-end funds.

[7] The definition of a financial intermediary in Rule 22c-2 may need to be expanded depending on the information required to be obtained.

III. Transparency for Omnibus Accounts

GARP, also in consultation with the Swing Pricing Committee discussed the SEC Liquidity Risk Management Proposal (LRM), including the proposed LRM guidelines. There was unanimous agreement that mutual funds need effective LRM programs.

In order to truly conduct an effective LRM program, fund managers need granular information on both the assets and liabilities of each mutual fund. For a mutual fund, liquidity risks can arise from the possible inability to meet potential demands for redemptions by the fund's investors. Details of the portfolio asset side are well known to the fund manager. However, fund managers whose funds rely on third party distributors do not have much transparency about the fund's own investors. Additional transparency related to investors would enhance a fund manager's ability to measure redemption profiles across future time buckets to help ensure sufficient liquidity to meet redemptions under normal and/or adverse market environments.

Other than pursuant to Rule 22c-2, there are no regulatory requirements for third party distributors to provide fund managers with details on underlying investors. The data regarding investors necessary to measure redemption profiles is currently either not provided at all, or if it is provided is often incomplete, inconsistently formatted and/or not submitted on a daily basis. This prevents fund managers from optimally evaluating the profile of their investors for basic attributes affecting redemptions, such as:

- Distribution of investors by type (e.g., pension fund, insurance company, retirement).
- Investor concentration (i.e., large concentrations by individual investors).
- Duration of investment by investor (i.e., length of time in fund).
- Size of investment by investor.

It should be noted that the additional data requested on the behavior of fund investors does not require any facts that would compromise personally identifiable information (PII). There is substantial room to improve the fund manager's understanding of the subscription and redemption characteristics of investors without impinging in any way on PII. Fund managers having details on the nature of their investors (i.e., the liabilities of a mutual fund) would materially enhance their ability to measure structural redemption behavior across individual funds under management.

Investor details provide an important lens through which to evaluate potential redemptions based on generic attributes. As a basic example, retirement (i.e., 401K investors) tend to rebalance their investments on a very infrequent basis (i.e., often only once or twice over decades long periods). Pension funds invest counter-cyclically given prescribed asset allocation approaches (e.g., 60% fixed income and 40% equity) which result in pension funds buying fixed income products when prices decline. Thus, 401K and pension fund investors in open-end funds would tend to have liabilities that are resilient to price declines for fixed income holdings versus other institutional investors that might redeem assets more quickly in adverse markets.

Given the importance of access to investor details for LRM purposes, it is requested that the SEC provide for access to transaction level details (including investor attributes) on fund liabilities for mutual funds distributed by third party distributors. This would require changes to SEC guidance and regulations on how intermediaries interact with funds (such as Section 22c-2 of the Investment

Company Act of 1940, as amended). Such changes would improve the ability of fund managers to measure and manage liquidity risk.

While the state of redemption modelling of mutual funds is, for most managers, a relatively undeveloped discipline today, in a world where concerns about systemic risk remain and where the ability to analyze "big data" is only improving, increasing transparency for fund managers by providing, through rulemaking or guidance, more access to relevant investor data builds a very positive bridge for improving the ability to manage redemption risk.

While banks are very different from asset managers, they do face an analogous asset/liability matching problem. However, banks enjoy access to details on both assets and liabilities (i.e., in the latter case "deposits"). This enables the development of deposit modelling which facilitates better asset liability management and liquidity risk measurement. SEC guidance and/or rule changes to require third party distributors to provide additional transparency would enable fund managers to have substantially the same level of access to mutual fund liabilities. This level of transparency would enhance a fund manager's ability to effectively measure and manage liquidity risk for open-end funds.

IV. Proposed Next Steps

Given the aforementioned downstream impacts on fund service providers and other parties, it is strongly recommended that the SEC convene working groups comprised of affected firms (e.g., fund managers, dealers, the NSCC, TAs, fund managers and other third party service providers) to analyze the details of this proposed roadmap to confirm feasibility of implementation and supporting details. However, given the proven benefits of swing pricing to investors, the objective of the working groups would be to finalize a mutually agreeable approach and recommendation(s) to successfully implement swing pricing for the U.S. mutual fund industry in a timely manner. Similarly, increasing the availability of investor level data to mutual fund managers can only lead to improved liquidity risk management over time.

With regard to any aspect of the above, GARP stands ready to assist the SEC and the mutual fund industry in exploring approaches and providing further details that would allow for the implementation of these recommendations and the option of adopting swing pricing by U.S. open-end funds.

We want to thank you for allowing us this opportunity to comment on these important issues. Should you require any additional information, or have any inquiries, please feel free to contact me at: Rich.Apostolik@garp.com, or +1 201 719-7250.

Yours truly,

Richard Apostolik
President and CEO

Cc: Swing Pricing Committee

SPECIAL REPORT

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

JANUARY 2016

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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.

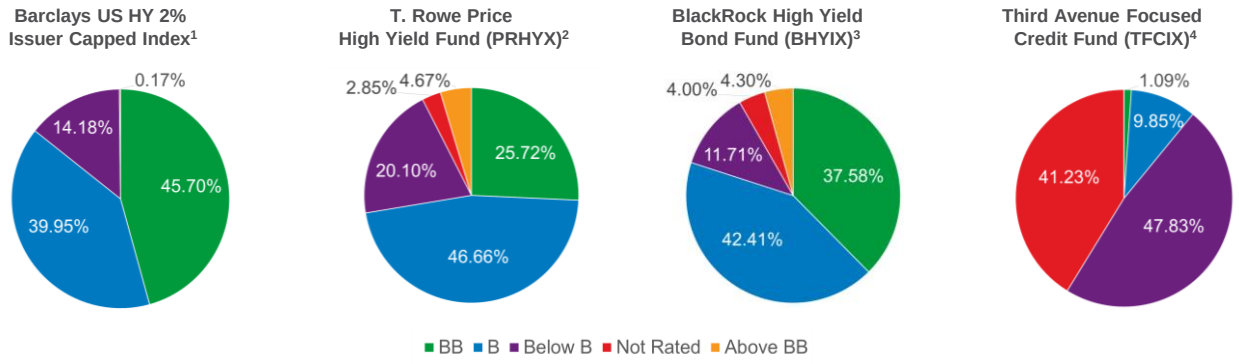
Analysis of TFCIX Portfolio Composition

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.

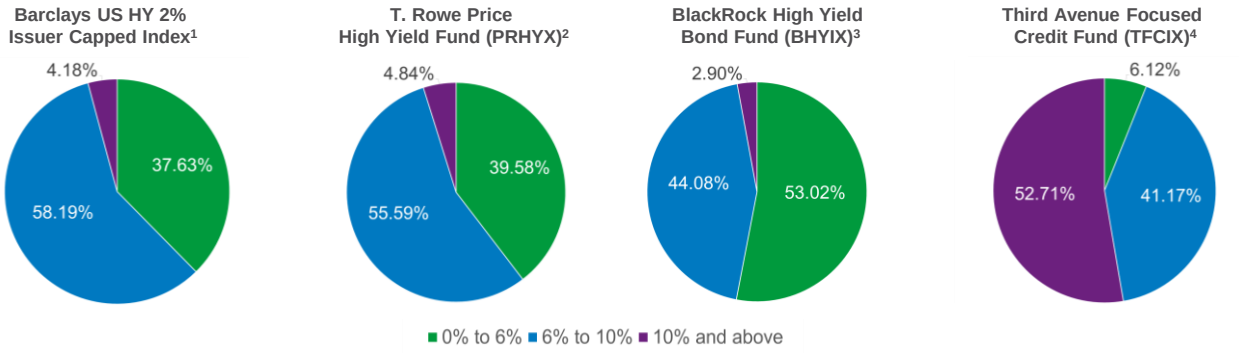
In addition, the TFCIX portfolio was focused on assets with significantly higher coupons than other high yield funds, and these holdings were much higher than the securities represented in the Benchmark.[15] Exhibit 2 shows the TFCIX portfolio invested more than half of its assets in securities with 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**

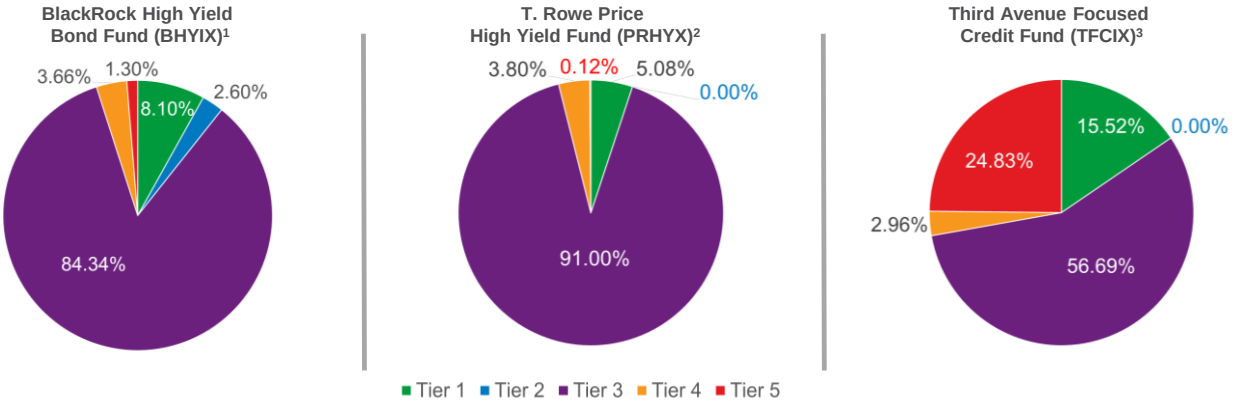
Excludes cash.
1 Source: Morningstar. As of 7/31/2015.
2 Source: BlackRock. As of 12/29/15.
3 Source: T. Rowe Price. As of 9/30/2015.

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.

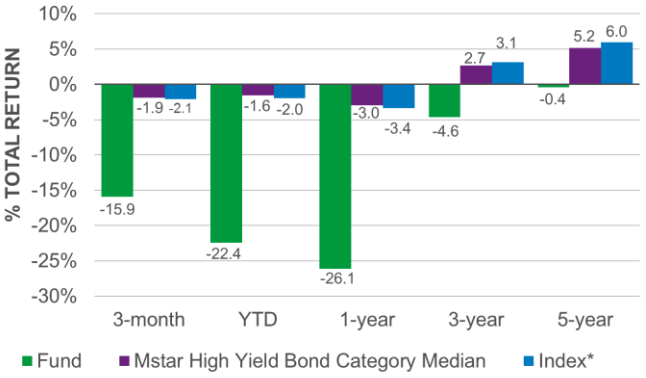
Analysis of TFCIX Performance

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



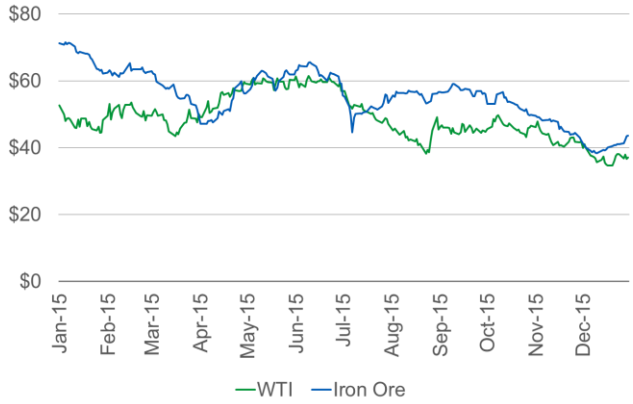
Morningstar High Yield Bond Funds Category Percentile Rankings (Institutional Shares) as of November 30, 2015			
YTD (771/777 funds)	**1 year (766/772 funds)**	**3 years (622/627 funds)**	**5 years (526/531 funds)**
99th percentile	99th percentile	99th percentile	99th percentile

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

Experience of High Yield Bond Market

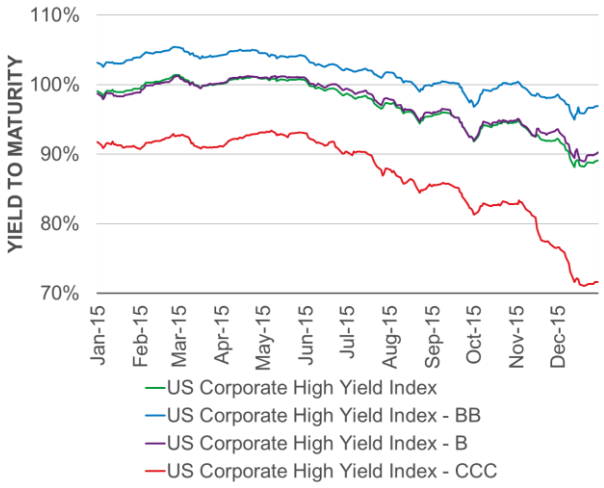
In looking at the high yield bond market and the performance of high yield bonds, it is important to understand the context of the economic environment. In particular, the high yield sector has a large weighting to energy as well as metals and mining companies. As of December 31, 2015, energy and metals 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.

Exhibit 7: OIL PRICE AND IRON ORE PRICES



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

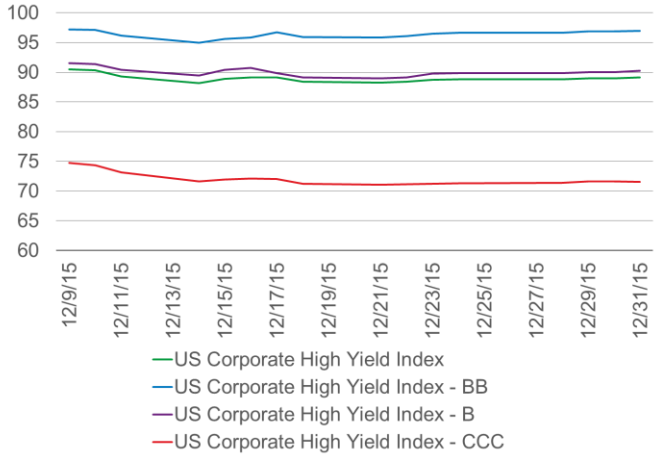
Exhibit 8: HIGH YIELD AVERAGE BOND PRICES



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

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.

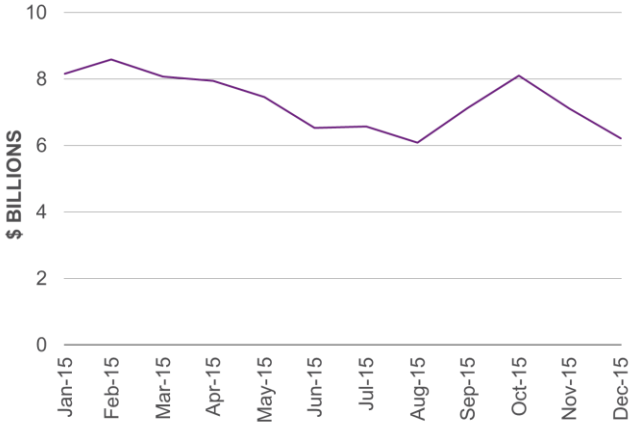
Exhibit 9: AVERAGE HIGH YIELD BOND PRICES
(Dec. 9 – Dec. 31, 2015)



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.

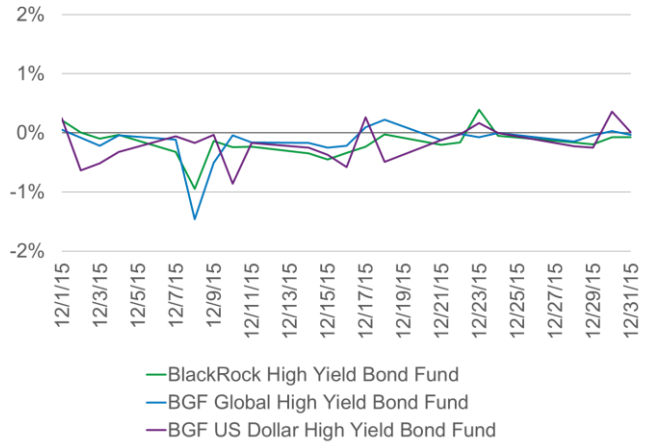
Exhibit 11: DECEMBER 2015 DAILY HIGH YIELD BOND TRADING VOLUMES

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

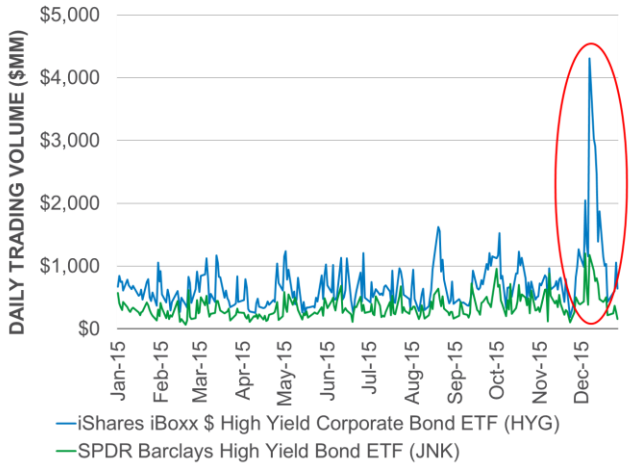
Source: Morningstar. As of 12/31/2015.

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

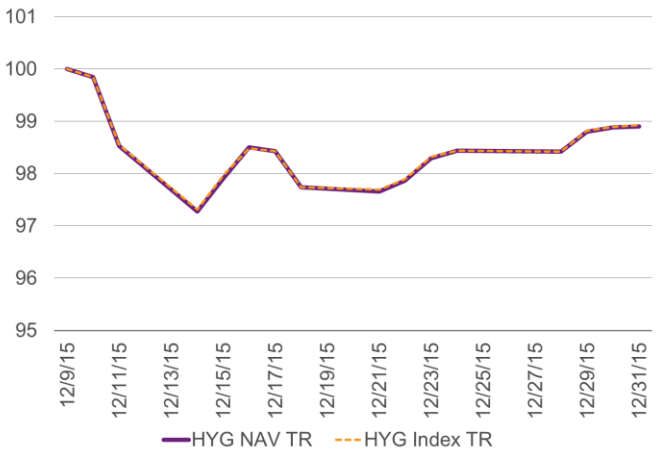


Source: Bloomberg, BlackRock, as of 12/31/2015

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.

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