MEMORANDUM

To: Liquidity Risk Management Programs Proposal File

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

Date: February 24, 2016

Re: Meeting with Representatives of the Investment Company Institute and Vanguard

On February 23, 2016, David Grim (Director, U.S. Securities and Exchange Commission ("SEC"), Division of Investment Management ("IM")), Jennifer McHugh (Senior Policy Advisor, IM), Diane Blizzard (Associate Director, IM), Elizabeth Osterman (Associate Director and Deputy General Counsel, IM), Sarah ten Siethoff (Assistant Director, IM), Sara Cortes (Senior Special Counsel, IM), Marian Fowler (Senior Special Counsel, IM), Melissa Gainor (Senior Special Counsel, IM), Christopher Stavrakos (Senior Financial Analyst, IM), Thoreau Bartmann (Branch Chief, IM), Naseem Nixon (Senior Counsel, IM), Amanda Wagner (Senior Counsel, IM), Christof Stahel (Assistant Director, Division of Economic and Risk Analysis ("DERA")), and James McLoughlin (Financial Economist, DERA) met with the following representatives of the Investment Company Institute ("ICI") and the Vanguard Group ("Vanguard"):

- F. William McNabb (Chairman and CEO, Vanguard; Chairman of ICI Board of Governors)
- Paul Schott Stevens (President and CEO, ICI)
- David Blass (General Counsel, ICI)
- Sean Collins (Senior Director of Industry and Financial Analysis, ICI)
- Dorothy Donohue (Deputy General Counsel, ICI)
- Matthew Thornton (Counsel, ICI)

The parties discussed the Commission's proposal on liquidity risk management programs and swing pricing.

February 23, 2016

Summary of ICI's Views on SEC's Liquidity Risk Management Proposal

Meeting with SEC's Division of Investment Management

Outline of Presentation

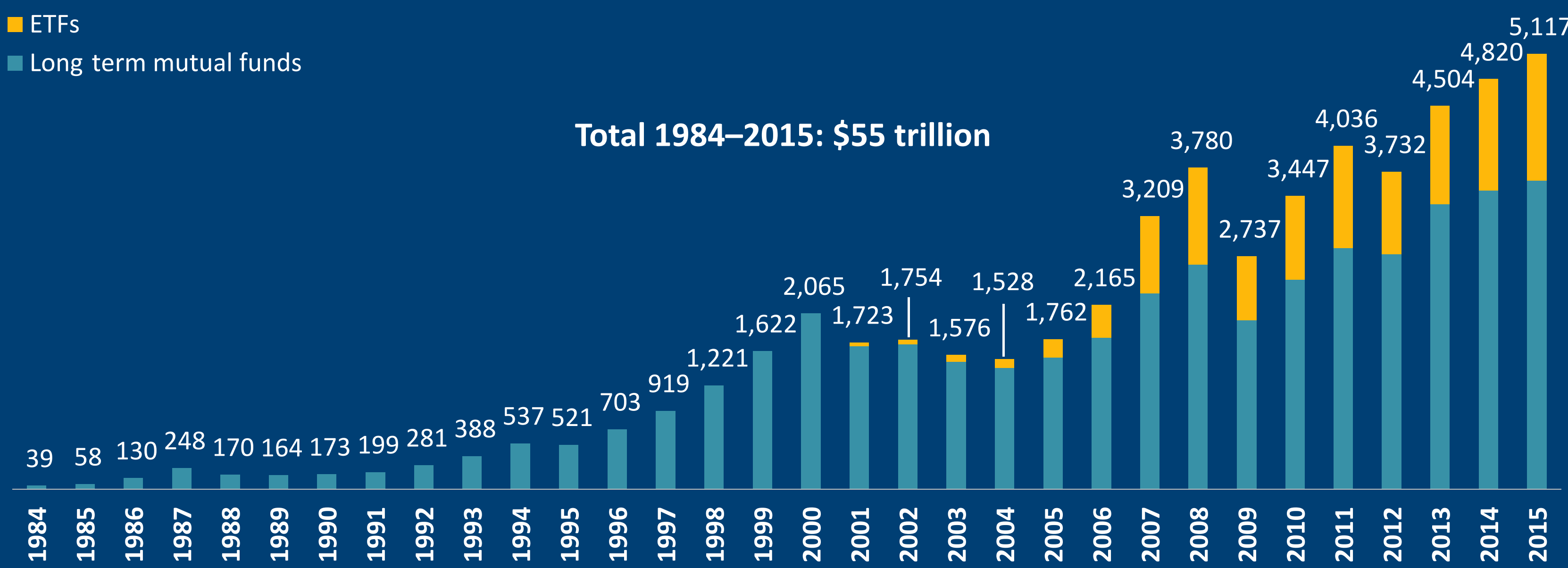
» Funds' History of Meeting Redemptions
» Current Fund Trends
» ICI Research
» Liquidity Risk Management Rule
» Swing Pricing
» Proposed Disclosure
» ETF-Related Matters
» Compliance with New Requirements

Funds' History of Meeting Redemptions

- Funds manage redemptions effectively
  - 75-year history of meeting redemptions (see following slide)
  - Strong legal and market incentives
  - Sales of new fund shares, other portfolio management techniques available to funds
- Third Avenue Focused Credit Fund was anomalous
  - Almost 90% of its debt was rated CCC or lower, or not rated at all
  - We identified only 6 instances of SEC issuing orders suspending redemptions of long-term funds
- We support SEC's decision not to provide funds more latitude to suspend redemptions
  - Right to redeem shares and receive proceeds promptly is a hallmark of open-end funds
  - SEC has ample authority to suspend redemptions when appropriate and can act quickly

Gross Redemptions of Shares of Long-Term Mutual Funds and ETFs

Billions of dollars, 1984–2015



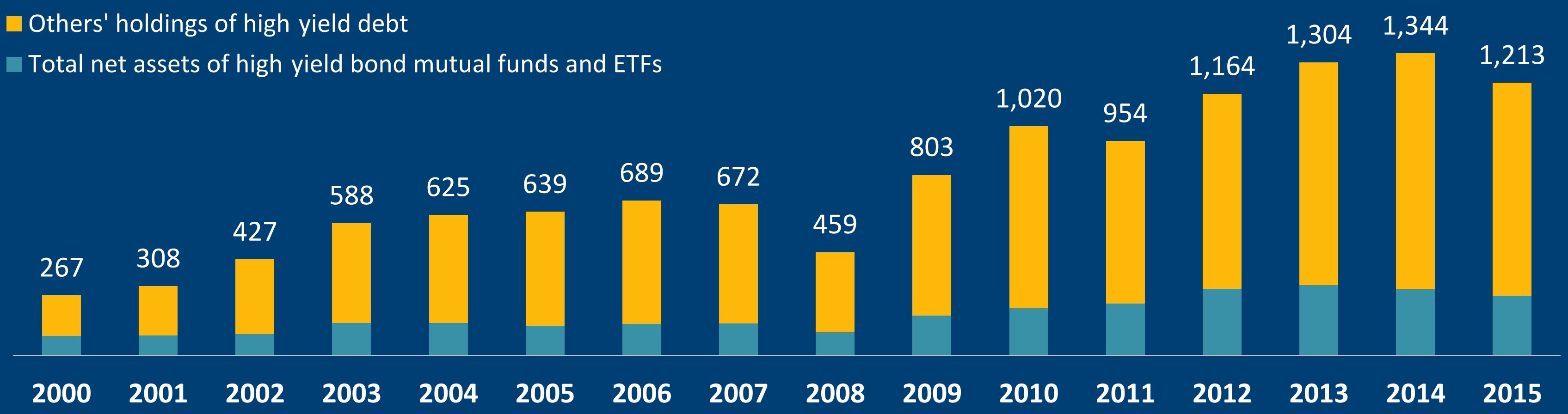
Note: Data for ETFs begin in 2001.
Source: Investment Company Institute

Current Fund Trends

- Variability of fund flows and growth in assets not cause for concern
  - Advisers manage in light of flow variability and portfolio liquidity (*e.g.*, DERA shows “alt” funds hold more cash)
  - Growth in bond funds reflects secular trends (*e.g.*, aging population and shift toward holding bonds through funds)
  - Bond fund assets still small share of market despite growth, and growth in high yield bond fund assets has not increased flow variability (see following slides)
- Payment of redemption proceeds in substantially less than required 7 days is indicative of funds’ ability to meet redemptions

High-Yield Bond Mutual Funds’ and ETFs’ Share of Outstanding High-Yield Bonds

Billions of dollars; year-end, 2000–2015



Percent of total

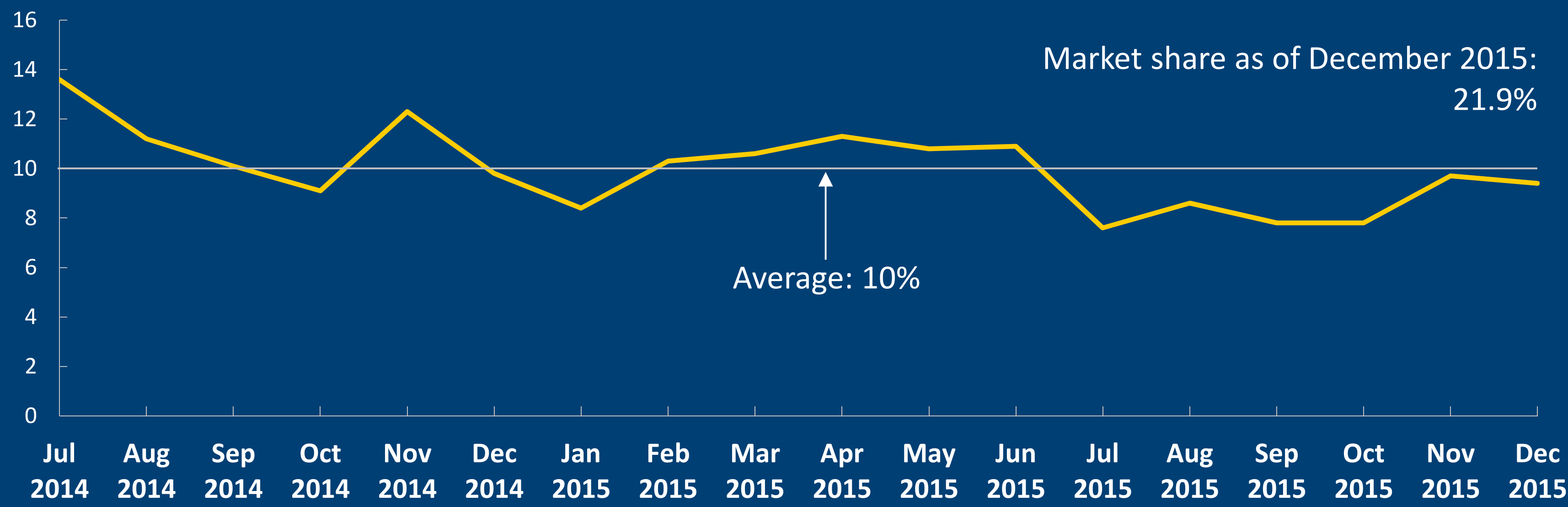
32.2	28.9	22.2	24.5	23.0	20.7	20.6	21.3	22.7	22.2	20.6	24.3	25.5	24.0	21.9	21.9

Note: Data include ETFs but exclude high yield funds designated as floating rate funds. Outstanding high yield bonds measured as the market value of the bonds in the BofA Merrill Lynch US High Yield Index. Data exclude funds that invest primarily in other funds.

Sources: Investment Company Institute and Bloomberg

U.S. High-Yield Mutual Funds' Corporate Bond Trading As a Share of All High-Yield Transactions

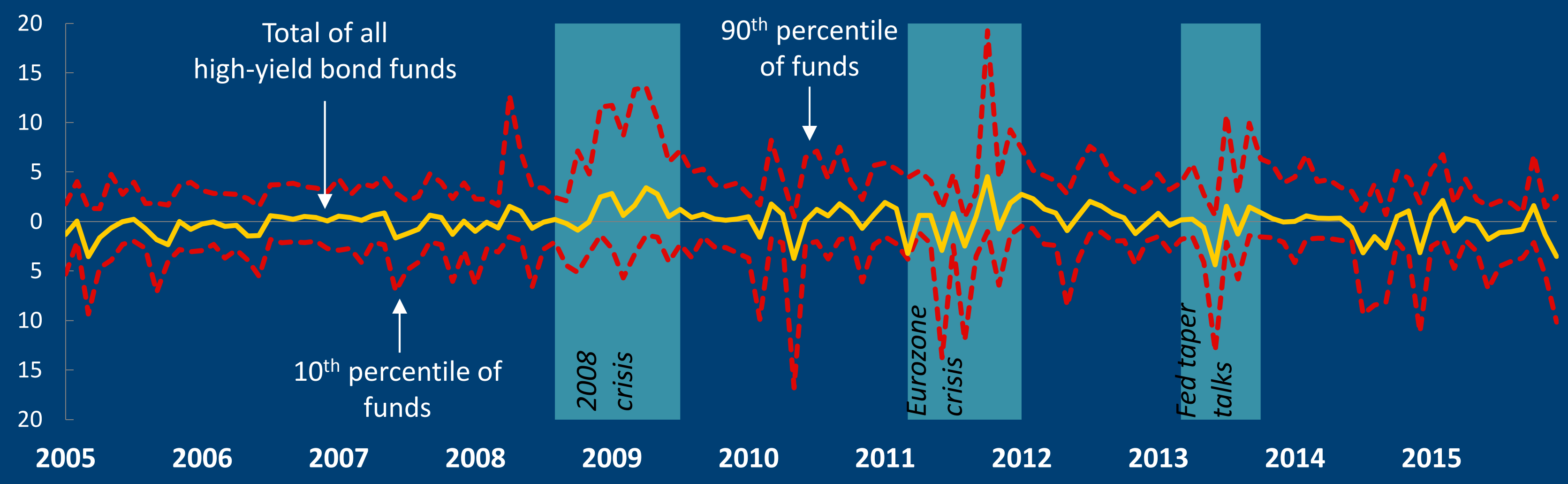
Percentage; monthly, July 2014–December 2015



Note: Data exclude high yield funds designated as floating rate funds. Aggregate data for high yield 144A transactions are only publicly available starting July 2014.
Sources: Investment Company Institute and Bloomberg

High-Yield Bond Funds Overall Have Modest Flows

Net new cash flow as a percentage of assets; monthly, January 2005–December 2015



Note: Data exclude high yield funds designated as floating rate funds. Data also exclude funds with less than $10 million in total net assets over the January 2005–December 2015 period, mutual funds that invest primarily in other mutual funds, and data for funds in any fund month where a merger or liquidation takes place.

Source: Investment Company Institute

ICI Research

» Evidence overwhelming that funds manage liquidity in ways beneficial to shareholders

» No support for theory of funds meeting redemptions by selling most liquid assets first

  » DERA study never states this directly—its evidence is indirect and mixed

  » Funds may sell a range of portfolio assets to maintain overall asset allocation

  » % of short-term assets often *rise* when funds experience large outflows (see following slide)

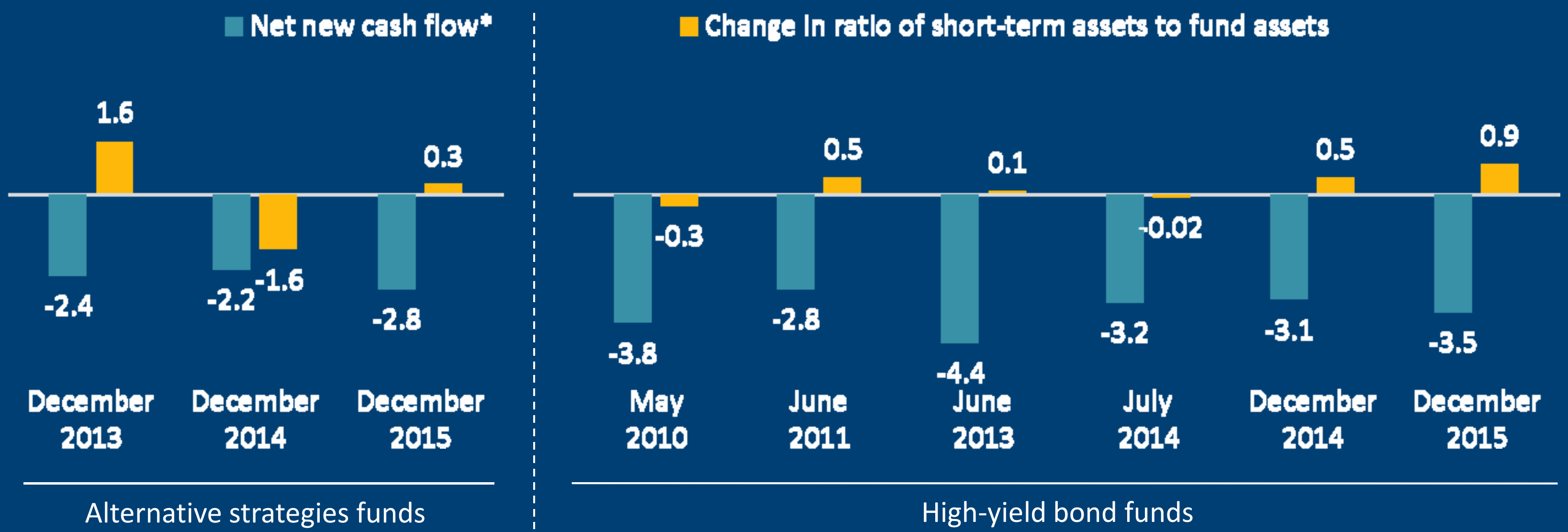
  » Large-cap U.S. equity funds and larger funds have more liquid portfolios

» DERA's bond fund assessment is limited (municipal funds only); findings are consistent with their maintaining sufficient liquidity

» DERA study does not evaluate proposal (*e.g.*, 6-bucket classification scheme and 3-day liquid asset minimum)

Funds' Short-Term Asset Ratios Are Uncorrelated With Shareholder Redemptions

Percentage, selected months



*Represents net new cash flow as a percentage of previous month end total net assets.
Note: Data exclude high yield funds designated as floating rate funds.
Source: Investment Company Institute

Liquidity Risk Management Rule—Areas of Support

- Risk-focused liquidity risk management program
  - Bolster discipline, rigor, and formal processes throughout industry
- Requirement that funds classify and monitor liquidity of portfolio assets (per fund's policies and procedures)
- Requirement that funds reasonably ensure sufficient liquidity to meet redemptions under normal and reasonably foreseeable stressed conditions (per fund's policies)
- Codification and enhancement of 15% limit on illiquid assets
- Policies and procedures for funds wishing to redeem in kind
- Framing of fund board's role (*i.e.*, as one of oversight)

Liquidity Risk Management Rule—Areas of Opposition—Definition of "Liquidity Risk"

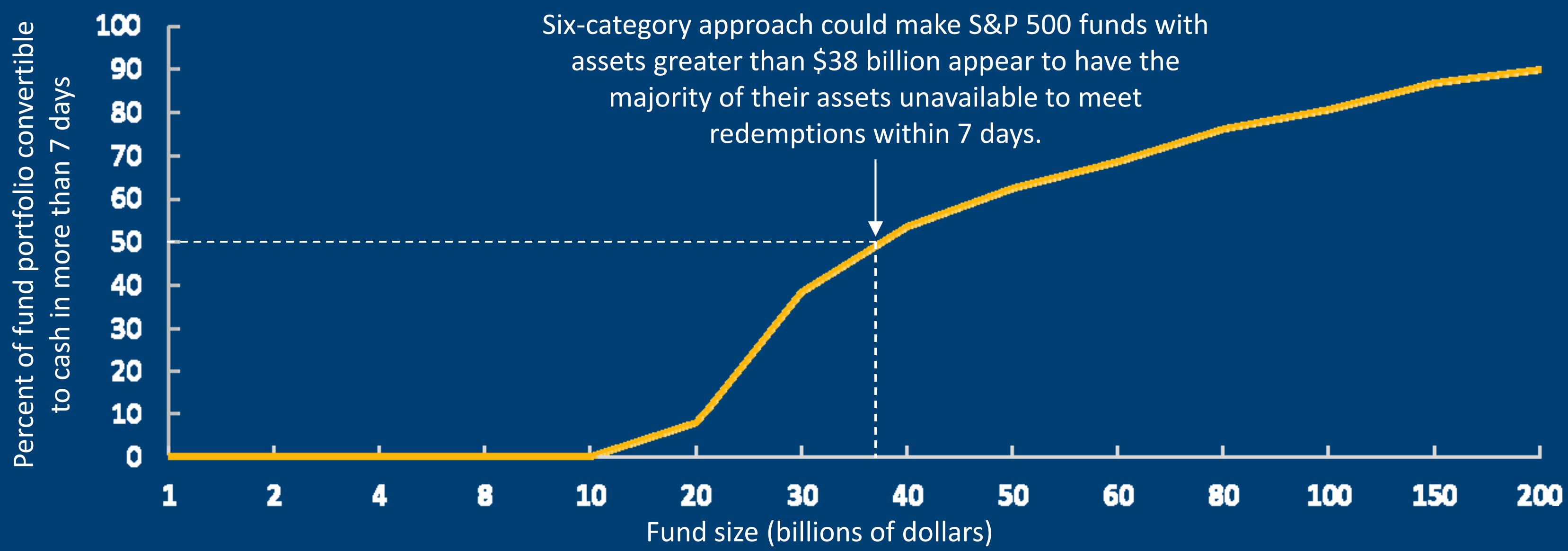
- "Liquidity risk" defined as "the risk that the fund could not meet requests to redeem shares issued by the fund that are expected under normal conditions, or are reasonably foreseeable under stressed conditions, without materially affecting the fund's net asset value"
- Definition's first element appropriately focuses on a fund's ability to meet redemptions under normal and reasonably foreseeable stressed conditions
- But definition's second element would:
  - Unreasonably require a fund to tease out how *fund activity* (opposed to market factors generally) would affect its NAV
  - Suggest to shareholders that funds are managed to protect their NAVs

Liquidity Risk Management Rule—Areas of Opposition—Asset Classification Scheme

- Proposed 6-category asset classification scheme:
  - Requires subjective, unknowable projections
  - Creates an illusion of comparability
  - Mischaracterizes large and liquid funds (e.g., S&P 500 funds) (see following slide)
  - Could lead to more correlated portfolios, and "cliff" events if funds sell same assets in stressed conditions
  - Imposes enormous operational burdens, leading to reliance on 3rd parties, further increasing correlation and cliff events
- We recommend requiring funds to determine how best to classify and monitor liquidity of their portfolio assets

6-Category Approach Will Make Large and Liquid Funds Appear Highly Illiquid

Possible outcomes for SEC-proposed liquidity buckets of S&P 500 index funds



Note: Analysis assumes an S&P 500 fund can sell up to 20 percent per day of daily market volume of S&P 500 stocks without materially affecting the fund's NAV. Analysis also assumes an S&P 500 fund holds one percent of its assets in cash or cash equivalents.

Source: Investment Company Institute

Liquidity Risk Management Rule—Areas of Opposition—3-Day Liquid Asset Minimum

» Proposed 3-day liquid asset minimum:

- » Could adversely affect fund's ability to adhere to its objectives, policies, and strategies (*e.g.*, holding more cash)
- » Could deprive fund of investment opportunities
- » Could induce "herding" behavior and cliff events
- » Could lead to funds' sales of, reluctance/inability to buy, less liquid assets in stressed conditions, impairing market liquidity and capital formation

» We recommend requiring funds to adopt procedures reasonably designed to ensure the fund can meet redemptions

Swing Pricing

- We urge SEC to explore further swing pricing's potential benefits, disadvantages, and operational challenges
- Members' varying views on swing pricing
- Operational and legal impediments to swing pricing in U.S. are substantial

Proposed Disclosure

- We oppose requiring funds to publicly disclose asset-level liquidity classifications and 3-day liquid asset minimums on Form N-PORT. Instead, funds should provide:
  - *Aggregated* (rather than asset-by-asset) monthly reporting of classification information to *SEC only*
  - Monthly reporting on chosen means of assessing liquidity sufficiency to *SEC only*
- We generally support other proposed disclosure requirements, such as:
  - Prospectus disclosure related to swing pricing (if applicable) and methods for meeting redemption requests
  - Disclosure about lines of credit, interfund lending and borrowing, swing pricing, and ETF collateral posting on proposed Form N-CEN

ETF-Related Matters

- Recommend permitting ETFs to accept in-kind purchases with less liquid assets even if ETF has fallen below its 3-day liquid asset minimum
- We request additional flexibility to:
  - Customize creation and redemption baskets
    - Recent ETF exemptive orders typically restrict the composition of baskets to a *pro rata* slice of the ETF's underlying securities
    - Basket flexibility would allow ETFs to obtain desired securities without incurring transaction costs or capital gains taxes
  - Eliminate restriction on ETF redemption transaction fees
    - Funds currently can impose a redemption fee of up to 2% of fund assets
    - ETF transaction costs may exceed 2% of fund assets, which Authorized Participants should bear

Compliance with New Requirements

- *All* funds (not just smaller entities) should be given at least a 30-month period to comply with the program rule and related Form N-PORT disclosure requirements
- If SEC adopts swing pricing, delay effectiveness for at least two years