| asset management group

January 13, 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—Comments on Proposal to Require Liquidity Risk Management Programs and Related Liquidity Disclosures

File No. S7-16-15

Dear Mr. Fields:

The Asset Management Group (the "**AMG**") of the Securities Industry and Financial Markets Association ("**SIFMA**") appreciates the opportunity to provide comments to the United States Securities and Exchange Commission (the "**Commission**" or "**SEC**") on the Commission's proposal to require liquidity risk management programs for open-end funds and to permit swing pricing by open-end funds on an optional basis (the "**Proposal**").[1] This letter addresses only the AMG's comments on liquidity risk management programs and related disclosures and, except when the context otherwise requires, "Proposal" refers only to those aspects of the Proposal; our comments on swing pricing are provided in a separate letter.[2]

The AMG is the voice for the buy side within the securities industry and broader financial markets, which serves millions of individual and institutional investors as they save for retirement, education, emergencies, and other investment needs and goals. The AMG's members represent U.S. asset management firms whose combined assets under management exceed $30 trillion. The clients of AMG member firms include, among others, registered investment companies, separate accounts, ERISA plans, and state and local government pension funds. Our members, in their capacity as fiduciaries for the

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[1] Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, Release Nos. 33-9922, IC-31835 (Sept. 22, 2015), 80 Fed. Reg. 62274 (Oct. 15, 2015) (the **"Proposing Release"**).

[2] Letter from Timothy W. Cameron, Head, and Lindsey Weber Keljo, Vice President & Assistant General Counsel, SIFMA AMG, to Brent J. Fields, Secretary, SEC (Jan. 13, 2016) (the **"Swing Pricing Comment Letter"**).

millions of investors they serve, are deeply committed to ensuring the Commission's continuing ability to fulfill its three-fold mission: investor protection; maintenance of fair, orderly, and efficient markets; and facilitation of capital formation. We believe that the AMG offers a valuable and unique perspective on the areas where the Commission has requested comments. Our members represent a significant and representative cross section of the registered open-end investment companies that are the subject of the Proposal. Our response to the Commission's request for comment brings together the practical experience and insight of investment, operations, finance, legal, and other relevant personnel from across the broad range of our member organizations.

We support the goal of the Proposal – strengthening liquidity risk management by open-end funds by requiring them to adopt formal liquidity risk management programs – and the Commission's leadership in formulating and publishing the Proposal for comment. We recommend alternatives to two of the components of the liquidity risk management programs that would be required under the Proposal, which we believe will preserve the core features of the Proposal that are important to the Commission's goals while minimizing the potential for adverse consequences from this complex and far-reaching new regulatory regime. We also recommend a different approach to reporting and public disclosure of liquidity information that we believe will better serve both the Commission and fund investors.

I. Introduction and Executive Summary

A. Summary of the Proposal

On September 22, 2015, the Commission proposed a multi-layered set of reforms that seeks to promote effective liquidity risk management throughout the open-end fund industry. The reforms are intended to reduce any perceived or potential risk that open-end funds might not be able to meet redemption obligations in accordance with section 22(e) of, and rule 22c-1 under, the Investment Company Act of 1940 (the **"1940 Act"**) and to mitigate potential dilution of the interests of fund shareholders, particularly among funds that may to date have dedicated fewer resources to managing liquidity risk in a formalized way. The Proposal is part of a broader set of initiatives to address the impact of open-end fund investment activities on investors and the financial markets in light of the increasingly complex composition and operations of the asset management industry.[3]

[3] Among the other initiatives is the Commission's June 2015 proposal on modernizing investment company reporting and disclosure. Investment Company Reporting Modernization, Release No. IC-31610 (May 20, 2015), 80 Fed. Reg. 33590 (June 12, 2015) (the **"Reporting Modernization Proposal"**). We filed a comment letter on that proposal, and it continues to reflect our views. Letter from Timothy W. Cameron, Head, and Lindsey Weber Keljo, Vice President & Assistant General Counsel, AMG, to Brent J. Fields, Secretary, SEC (Aug. 11, 2015), available at http://www.sec.gov/comments/s7-08-15/s70815-309.pdf (the **"Reporting Modernization Comment Letter"**). More recently, the Commission in December 2015 proposed rule changes addressing the use of derivatives by funds and business development companies. Use of Derivatives by Registered Investment Companies and Business Development Companies, Release No. IC-31933 (Dec. 11, 2015), 80 Fed. Reg. 80884 (Dec. 28, 2015) (the **"Derivatives Proposal"**). The Commission also expects to consider proposing rule changes requiring large investment companies and investment advisers to engage in annual stress tests, as required by section 165(i) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, and requiring registered investment advisers to create and maintain transition plans in the event of a major disruption in their business.

The Proposal would create a new rule 22e-4 under the 1940 Act, which would require each open-end fund, including open-end exchange-traded funds (**"ETFs"**) but not including money market funds (collectively, **"open-end funds"**), to establish a liquidity risk management program that is reasonably designed to assess and manage the fund's liquidity risk. In addition, the Proposal prescribes a number of program components that would be required to be included in every fund's liquidity risk management program.

The two most significant proposed program components (the **"Proposed Components"**) are:

> **Classification of Assets**: Funds would be required to classify each portfolio asset (or portion thereof) in one of six specified liquidity categories based on the number of days it would take to convert the asset to cash at a price that does not materially affect the value of that asset immediately prior to the sale (1 business day, 2 – 3 business days, 4 – 7 calendar days, 8 – 15 calendar days, 16 – 30 calendar days, more than 30 calendar days). In classifying the liquidity of each portfolio asset (or portion thereof), funds would be required to consider nine specific factors, to the extent applicable.
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> **Three-Day Liquid Asset Minimum**: Funds would be required to establish a minimum amount of their assets that would be held in cash or assets in the 2 – 3 business-days-to-cash category (**"three-day liquid assets"**) based on a prescribed set of factors (which differ from the classification factors). A fund exceeding this minimum would be prohibited from acquiring any assets other than three-day liquid assets.

The Proposal would also codify existing Commission guidance with respect to illiquid assets. Under proposed rule 22e-4, as under the existing guidance, a fund would not be able to acquire additional illiquid assets (assets that cannot be sold within seven days at approximately the value ascribed by the fund, referred to in the rule as "15% standard assets") if, immediately after the acquisition, the fund would have invested more than 15% of its assets in such illiquid assets.

The Proposal also includes amendments to proposed Form N-PORT that would require funds to report to the Commission on a monthly basis the liquidity classification of each portfolio holding, or portion thereof (that is, which of the six prescribed days-to-cash classification categories that holding or portion has been assigned to), as of the end of the month. These asset-by-asset (or portion-by-portion) classifications would be available to the public for the last day of each quarter, on a 60-day delayed basis.

B. Summary of SIFMA AMG Position

1. Support for Liquidity Risk Management Programs

We support the Commission's goal of strengthening liquidity risk management by open-end funds, particularly among funds that may to date have dedicated fewer resources to managing liquidity risk in a formalized way. In particular, we support what we view as the cornerstone of the Proposal, which is the requirement that all open-end funds adopt formal liquidity risk

management programs that are reasonably designed to assess and manage the fund's liquidity risk.

As the Commission has observed, many fund organizations already have in place effective programs for managing liquidity risk. Nonetheless, we believe that a requirement for all open-end funds to adopt formal liquidity risk management programs will provide more consistent discipline and focus in this important area and thus will "raise the bar" and thereby benefit funds and investors.

We strongly believe that the Commission, as the primary regulator of the asset management industry, is the appropriate regulator to address open-end fund liquidity concerns, and we applaud the Commission's leadership in this regard. The Commission's deep and unique knowledge of and regulatory experience with the open-end fund industry, together with its commitment both to its own multi-faceted regulatory mission and the broader financial system goals of the global regulatory community, are demonstrated repeatedly throughout the Proposing Release.

2. Recommendation of Alternative Components

While we support the Commission's goals, for the reasons we explain in the body of this letter we believe that these goals would be better served by a more flexible and less prescriptive approach to the Proposed Components. The open-end fund industry is highly diverse. Effective liquidity risk management across the open-end fund industry will best be achieved when all open-end funds have in place liquidity risk management programs that are developed and implemented based on sound principles in a manner that reflects and takes into account their specific circumstances. We urge the Commission to adopt a rule that is flexible enough to allow funds with effective liquidity risk management programs in place to continue to use and build on them, while requiring funds with less robust practices to develop and adopt programs that benefit from the experience and examples set by the industry leaders the Commission has observed.

We recognize that the Commission seeks a uniform liquidity classification approach that can be used by all funds in order to provide standardized data that can be compared across the industry. We also recognize that the Commission believes that every open-end fund should have in place a process for determining and maintaining an appropriate level of highly liquid assets relative to its redemption expectations, as a component of overall liquidity risk management. However, we believe that the Proposed Components, which are designed with these goals in mind, would not be effective in achieving them. As explained below, we are concerned that, on the contrary, the Proposed Components are more likely both to impede the Commission's understanding of fund liquidity and to undermine effective liquidity management for open-end funds.

We believe that the goals of the Proposed Components can be better served by alternative means. To that end, we recommend alternatives to the proposed liquidity classification system and three-day liquid asset minimum, as described below (the **"Alternative Components"**). The Alternative Components are based on effective liquidity risk management programs currently in use by some of our members. We believe the Alternative Components will achieve the goals of

the Proposal, and thus foster superior liquidity risk management practices, without the adverse consequences we foresee from the Proposed Components.

We also urge the Commission to reconsider its proposal to make detailed liquidity classification information public. The Commission bases its disclosure proposal on the assumption that such information will help investors make intelligent comparisons across funds and thus make better informed investment decision. We strongly disagree. While additional liquidity information may be useful to the Commission in performing its regulatory oversight function, as proposed to be reported to the public it will be entirely at odds with disclosure principles that the Commission has traditionally followed in order to protect investors making investment decisions and otherwise fulfill its three-part mission, and thus will thwart rather than fulfill that mission.

3. Alternative Components for Liquidity Risk Management Programs

The following is a summary of the Alternative Components we recommend the Commission adopt in place of the Proposed Components. We believe these alternatives will provide a reasonable balance between providing the Commission with data it seeks and imposing robust program requirements, on the one hand, and leaving funds adequate flexibility to manage liquidity risk effectively, on the other. The Alternative Components are designed (1) to fulfill the overarching goal of improving liquidity risk management across the fund industry, and in particular among organizations that do not currently have robust liquidity risk management programs in place; (2) to achieve the Commission's specific goal of requiring funds to adopt a more nuanced, spectrum-based approach to liquidity classification of fund assets (in place of existing Commission guidance which imposes only a binary classification requirement); (3) to provide uniformity and comparability, to the extent reasonably possible, in fund liquidity risk management programs across funds; and (4) to provide sufficient flexibility that most fund organizations with existing robust liquidity risk management programs could reasonably adapt their existing classification systems, and thus preserve the valuable and time-tested liquidity risk management processes that funds with the most robust existing programs have developed.

To provide the context of our recommendations, for each alternative we explain briefly the basis for our concern with the component as proposed.

a. Liquidity Classification Categories; Prescribed Factors

The six-category "days-to-cash" classification system proposed by the Commission seeks to impose a level of precision and granularity that is inherently incompatible with the nature of liquidity determinations in diverse markets. The proposed system is unprecedented, and thus untested (our members know of no fund groups that use a similar system); would produce data conveying a false sense of exactitude and comparability, rather than information that is meaningful to understanding or managing liquidity risk; and would require massive initial and ongoing resources to implement, at the expense of far more effective classification systems currently used by fund groups with robust liquidity risk management programs in place.

To meet the Commission's goal of a uniform classification system to be used by all open-end funds, we recommend the following alternative classification system.

Funds would classify the liquidity of their portfolios along a liquidity spectrum, using four different liquidity categories. The categories would range from (1) highly liquid (which would correspond in most respects to the Proposal's three-day liquid asset designation) to (4) illiquid (which would include assets designated in the Proposal as "15% standard assets"). Holdings falling between these two levels of liquidity would be divided into two categories based on relative liquidity, determined by a mix of quantitative and qualitative factors, depending on the nature of the holding and the relevant markets.

- ***Category 1***. Cash, cash equivalents, and assets that the fund believes it can liquidate (sell and receive settlement proceeds) within approximately three business days in the context of normal trading (also referred to as **"highly liquid"** assets).
- ***Category 2***. Assets that are considered liquid in ordinary markets, but which may become less liquid in stressed conditions or may, for other reasons, be expected to require more than three business days to liquidate.
- ***Category 3***. Assets that are considered less liquid than assets in Category 2 (e.g., there are fewer active participants in the relevant market and execution is more sporadic and in smaller sizes), but are still considered liquid (and thus not appropriate for classification in Category 4).
- ***Category 4***. Assets that the fund believes could not reasonably be expected to be sold by the fund within seven calendar days at approximately the value ascribed by the fund (i.e., "15% standard assets," as that term is used in the Proposal, which we refer to as "**illiquid**").

As explained in more detail below, in classifying the portfolio, funds would take into account appropriate qualitative and quantitative factors relevant to the type of asset and related markets, including, where appropriate, the factors set forth in the Proposal. The factors could differ substantially among the four categories. Accordingly, these factors would not be prescribed in the final rule, but would be considered guidelines and be set forth in the release adopting the Proposal (**"Adopting Release"**). The Adopting Release would make clear that funds could consider additional factors not expressly stated in the guidelines and would not be required to consider any particular factor in classifying individual assets.

b. Highly Liquid Asset Target

We believe the proposed three-day liquid asset minimum requirement would effectively function as a cash (or highly liquid asset) buffer requirement, which would unnecessarily constrain a fund's ability to employ its investment strategy and in some cases would actually increase liquidity risk. As proposed, therefore, the requirement would run counter to both the Commission's goals and investor interests.

Instead of a three-day liquid asset minimum, we recommend a liquidity risk management program component that would require fund managers to evaluate whether it would be prudent to

identify a target percentage of highly liquid assets described in Category 1 above (a **"Highly Liquid Asset Target"**) that the fund should maintain in the context of the fund's liquidity risk profile. This Highly Liquid Asset Target would be disclosed to the fund board for its consideration in the context of the board's approval of the fund's liquidity risk management program as a whole but not as a separate approval item. A fund manager would include in its reports to the board, together with any explanation, instances (if any) where a fund dipped below its Highly Liquid Asset Target. Funds would not be required to report to the public whether they have established a Highly Liquid Asset Target or, if so, the amount of the target.

Funds would determine whether to establish a Highly Liquid Asset Target and, if so, the amount of the target, considering all factors that are relevant to the fund's liquidity risk profile, which may include the factors identified in the proposed rule plus other factors not identified in the proposed rule. We recommend that the factors identified in the proposed rule be included as guidance in the Adopting Release instead of required considerations so as not to create an overly rigid structure or an unnecessary expense resulting from having to document consideration of factors that have no bearing on a fund's liquidity risk. With respect to the proposed cash flow factor, we recommend that the Commission clarify in the Adopting Release that a fund may determine its Highly Liquid Asset Target on the basis of market conditions existing or reasonably foreseeable at the time such determination is made and not be required to forecast stressed conditions that may impact a fund. We also recommend that the Adopting Release clarify that new or recently launched funds, which may have a small number of shareholders, will not necessarily be expected to set a higher Highly Liquid Asset Target than more established funds that have a broad shareholder base. This clarification would avoid imposing unwarranted entry barriers on the introduction of new funds.

4. Reporting and Disclosure

Funds would report on Form N-PORT the percentage of a fund's portfolio in each of the classification categories under the alternative system described above. We also recommend that Form N-PORT provide an opportunity for funds to explain the methodologies used for classification, including factors that would provide the Commission with appropriate context. We believe that portfolio level reporting, together with narrative disclosure where deemed appropriate by the fund, would provide the Commission with more meaningful information – with the potential for more comparability – than a classification assigned to individual fund holdings.

Reporting of this information on Form N-PORT by all open-end funds would provide the Commission with far more comprehensive and detailed information about liquidity than it receives now or has been able to obtain in its outreach efforts. The Commission could study and use this data to determine whether a more detailed and prescriptive classification system might be appropriate and should be the subject of a further proposal, which could then be formulated with the benefit of the experience and insight this comprehensive reporting will have provided.

We strongly oppose public disclosure of this information. For the reasons we set forth in our Reporting Modernization Comment Letter, we believe that in order to maximize the utility of

Form N-PORT for its primary purpose, which is to provide data to the Commission that improves the Commission's ability to perform its regulatory oversight responsibility and protect investors, information reported on Form N-PORT should not be publicly available.[4] As described below, our concerns with the harm to investors that public availability of information required under proposed Form N-PORT would cause are substantially magnified by the new disclosures that would be required in the Proposal.

We understand that the Commission wishes to ensure that investors have information that will help them make better investment decisions, which will, in turn, promote capital formation. As discussed below, we do not believe that the liquidity information proposed to be reported on Form N-PORT would serve this purpose. At the very least, we urge the Commission to study the information it receives for a reasonable period of time before reaching a determination as to whether making some or all of it publicly available will, in fact, benefit the investing public.

5. Additional Recommendations

a. Standard of Liability

In light of the high degree of subjectivity necessarily involved in managing liquidity, and in particular classifying the liquidity of portfolio assets, the Commission should include a safe harbor as part of the final rule. Such a provision should explicitly provide that funds and their affiliates will not face liability for errors in classification or otherwise in implementing their liquidity risk management programs, and related reports and (if applicable) disclosures, unless (i) the error is material and (ii) the fund or affiliate acted knowingly or recklessly. The provision would also make clear that where fund redemption prices decline, funds and managers would not face liability for violation of rule 22e-4 based on second guessing, either by the Commission or by fund shareholders, of the design of the liquidity risk management program.

b. Application To Funds Using Redemptions in Kind

The liquidity risk management program requirement should not apply to funds that issue and redeem shares primarily by means of in-kind transactions.

c. Compliance Date

The compliance date for the liquidity risk management program components of the Proposal, and any related reporting requirements, should be 30 months after the effective date for all funds, not just smaller funds.

II. Background

As explained in the Proposing Release, the Proposal follows engagement by Commission staff with large and small fund complexes to better understand open-end funds' management of

[4] *See* Reporting Modernization Comment Letter, *supra* note 3.

liquidity risk.[5] Through these outreach efforts Commission staff learned that, while some funds and their managers have developed comprehensive liquidity risk management programs, others have dedicated significantly fewer resources to managing liquidity risk in a formalized way. The Commission observed that some of the funds with more thorough liquidity risk management practices have appeared better able to meet periods of higher than typical redemptions without significantly altering the risk profile of the fund or materially affecting the fund's performance, but expressed concern that some funds employ liquidity risk management practices that are substantially less rigorous.[6]

The Commission believes that proposing to address these variations in practices is appropriate and that it is in the interest of funds and fund investors to create a regulatory framework that would reduce the risk that any fund might be unable to meet its redemption obligations and minimize dilution of shareholder interests by promoting stronger and more effective liquidity risk management across open-end funds.[7] While the Commission found a wide range of liquidity risk management practices already in place for many fund organizations, the proposed reforms are designed to provide investors with increased protections regarding how liquidity is managed in all open-end funds in which they might invest. According to the Commission, these reforms are also intended to give investors better information with which to make investment decisions, and to give the Commission better information with which to conduct comprehensive monitoring and oversight of the fund industry.[8]

The Commission does not base its Proposal on specific instances of failures of open-end funds to meet their redemption obligations. Indeed, the Commission has recognized that historically instances of such failures have been extremely rare.[9] The Proposing Release notes, however, that in recent years there has been strong growth in the assets of fixed income funds and alternative funds, which hold relatively less liquid assets, and the Commission is concerned that the growth in these strategies could give rise to increased concerns regarding these funds' liquidity risk.[10]

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[5] Proposing Release, *supra* note 1, at 62275.

[6] *Id.* at 62285.

[7] *Id.* at 62275.

[8] *Id.* at 62276.

[9] The Proposing Release cites only two orders allowing suspensions of redemptions under section 22(e) of the 1940 Act; one of these was to two money market funds, which are not covered by the Proposal. *Id.* at 62283 n.82. Since the issuance of the Proposing Release, the Commission has issued a third such order, to Third Avenue Trust (**"Third Avenue"**). Third Avenue Trust and Third Avenue Management LLC; Notice of Application and Temporary Order, Release No. IC-31943 (Dec. 16, 2015), 80 Fed. Reg. 79638 (Dec. 22, 2015).

[10] *See* Proposing Release, *supra* note 1, at 62281 – 82, 62355 – 57. The data referred to in the Proposing Release with respect to alternative funds relate to a several year period ending in 2014. More recent reports indicate that alternative funds as a class had only minimal net sales in the first eleven months of 2015. *See* Peter Ortiz, *Liquid Alts Sales Fizzle in 2015*, Ignites (Dec. 24, 2015), *available at*

III. Comments and Recommendations

A. General Support for Liquidity Program Requirement

1. Benefits of Formal Liquidity Risk Management Programs

Proposed rule 22e-4 would require that each open-end fund (which includes ETFs but not money market funds) establish a written liquidity risk management program that is reasonably designed to assess and manage the fund's liquidity risk (a **"Liquidity Program"**). **"Liquidity risk"** is defined in the proposed rule as the risk that a 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.[11]

We support this aspect of the Proposal, with one reservation noted below related to the appropriate definition of liquidity risk. We believe that while the vast majority of fund organizations currently manage liquidity risk effectively, a requirement for open-end funds generally to adopt formal liquidity risk management programs will bring attention and discipline to the management of liquidity risk across the industry. This is likely to "raise the bar" for liquidity risk management and thus benefit the industry and investors. We believe the Commission, as the primary regulator of the asset management industry, is the appropriate regulatory agency to take the initiative in this area. We believe that this aspect of the Proposal is also valuable as a means of addressing perceptions of potential systemic risk across the broader regulatory community.

Given the concern among regulators all over the world about systemic risk, we support the Commission's leadership efforts to provide additional confidence that open-end funds are prepared with adequate liquidity to meet shareholder redemptions. We believe these efforts are aligned with the goals of the industry, which has made substantial strides in the same direction on its own, without regulatory requirements, simply because doing so is both inherent in the fiduciary nature of fund management and vital to the industry's survival.

2. Concern with the Proposed Definition of Liquidity Risk

As stated above, the proposed rule would define "liquidity risk" as the risk that a 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** (emphasis added). We believe that the definition of liquidity risk should not include the qualifying phrase "without materially affecting the fund's net asset value."

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http://ignites.com/c/1260913/141343/liquid_alts_sales_fizzle?referrer_module=emailForwarded&module_order=0.

[11] Proposed rule 22e-4(a)(7).

The proposed qualifying language is inappropriate in the context of liquidity risk management, and potentially misleading, for a number of reasons. First, it merges liquidity and valuation, which are subject to quite different regulatory and compliance controls, including different statutory standards and different fund procedures.[12] Second, this addition to the definition assumes that market impact, as a distinct element of market price movements, can be accurately identified, and thereby measured separately from price movements generally. The Commission's experience in promulgating a concept release on this issue, and the comments received in response, demonstrate that there is no consensus on either how or whether this can be done.[13]

Finally, such a definition is likely to mislead investors into believing that appropriate liquidity risk management will protect their investments from declining in value. Capital markets involve price risk; that is the trade-off for seeking returns in excess of those provided by banks and other institutions offering stability. Fund investors need and want the option to take the risks necessary to provide returns that will support them in retirement and for their other long-term needs. As SEC Chair Mary Jo White noted in a December 2014 speech, "Investment risk is inherent in our capital markets – it is the engine that gives life to new companies and provides opportunities for investors."[14] Similarly, the Financial Stability Oversight Council has recognized that investment risk is inherent in capital markets and represents a normal part of market functioning.[15]

The right to redeem promises shareholders their proportional share of the fund's investments, such as they are and as valued in accordance with the 1940 Act. It does not promise them redemption at a price

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[12] "Value" is defined in section 2(a)(41) of the 1940 Act, which assigns specific responsibilities for valuation to fund directors, and "current net asset value" is defined in rule 2a-4. For additional resources on valuation, *see* Valuation of Portfolio Securities and other Assets Held by Registered Investment Companies — Select Bibliography of the Division of Investment Management, *available at* https://www.sec.gov/divisions/investment/icvaluation.htm. Fund liquidity is addressed by section 22(e) of the 1940 Act, which provides that a fund may not suspend the right of redemption or postpone the date of payment for more than seven days, except for certain periods described in that provision.

[13] The Commission gathered information on market impact and other fund transaction costs in 2003. *See* Request for Comments on Measures To Improve Disclosure of Mutual Fund Transaction Costs, Release Nos. 33-8349, 34-48952, IC-26313 (Dec. 18, 2003), 68 Fed. Reg. 74820 (Dec. 24, 2003) (**"Transaction Costs Concept Release"**). Commenters, including our predecessor organization, explained that there is no standard and accurate way to measure market impact and other implicit costs, and attempting to do so would impose substantial expense on funds. *See* Letter from Stuart R. Strachan, Chairman, Investment Company Committee, Securities Industry Association, to Jonathan G. Katz, Secretary, SEC, at 3 (Feb. 20, 2004), *available at* http://www.sec.gov/rules/concept/s72903/sia022004.htm (**"Transaction Costs Comment Letter"**). The Commission did not propose any rulemaking following the Transaction Costs Concept Release, which is further discussed below.

[14] Mary Jo White, Chair, SEC, Speech at The New York Times DealBook Opportunities for Tomorrow Conference: Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry (Dec. 11, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370543677722.

[15] Notice Seeking Comment on Asset Management Products and Activities, Docket No. FSOC–2014–0001 (Dec. 18, 2014), 79 Fed. Reg. 77488, 77489 (Dec. 24, 2014).

materially similar to any previous price, or any other particular price, and liquidity risk should not be defined in a manner that encourages investors to believe otherwise.

3. Need for Flexible Alternatives to the Proposed Components

As the Commission's outreach efforts have amply demonstrated, there is a broad range of industry best practices in place that have proven to be both feasible and effective. The Proposing Release states that some of the funds with relatively more thorough liquidity risk management practices have appeared to be able to meet periods of high redemptions without significantly altering the risk profile of the fund or materially affecting the fund's performance, and thus with few dilutive impacts. It therefore appears that these funds have generally aligned their portfolio liquidity with their liquidity needs, and that their liquidity risk management permits them to efficiently meet redemption requests.[16] We strongly recommend that the Commission draw on and preserve those real world best practices in designing the core liquidity risk management program components that will be required for all open-end funds.

In addition to reflecting the results of the outreach efforts, the Commission's approach should be flexible enough to take into account, and adequately accommodate, the great diversity among mutual funds. As of November 2015, there were 7,641 long-term mutual funds, holding an aggregate of more than $13.2 trillion in assets.[17] These thousands of funds reflect a broad range of fund sizes, asset classes, investment strategies, management styles, and shareholder bases, among other differentiating factors. This diversity, which is itself multi-faceted, reflects a regulatory environment that, so far, has fostered innovation and competition and now benefits retail investors by providing them a rich and varied array of investment options.

To focus on but one aspect of this diversity that is relevant to liquidity management – diversity among asset classes – there are funds that hold investments in domestic and foreign equities at every capitalization level, fixed income securities at every maturity horizon and repayment risk level, and taxable and tax-free investments, as well as special cases such as alternative funds and bank loan funds. The characteristics of the markets for many of these investments – which are a dominant driver of liquidity – could hardly be more disparate. At the highest level of differentiation, equity markets bear little relation to fixed income markets, and exchange-traded markets provide trading depth and transparency that is entirely different from over-the-counter markets. Within fixed income instruments, Treasury bills, investment grade corporate bonds, high yield bonds, bank loans, and municipal securities, to name just a few of the more common categories, share little overlap in characteristics underlying liquidity assessment. While the relative liquidity of fund holdings in different asset classes can be assessed within the context of a fund portfolio, there is no single set of metrics that can accurately quantify liquidity uniformly, either by number of days, reference to market impact, or other criteria, across all asset classes and markets and by all managers.

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[16] Proposing Release, *supra* note 1, at 62352.

[17] Investment Company Institute, Trends in Mutual Fund Investing, November 2015 (Dec. 30, 2015), *available at* https://www.ici.org/research/stats/trends/trends_11_15.

Finally, the Commission's approach should take into account that liquidity risk is only one of many risks to which funds are subject, and by no means the largest or most important.[18] To be sure, the right of redemption is a core feature of open-end funds. But, as the Proposing Release emphasizes at the outset, open-end funds are the investment of choice for many investors, and retail investors in particular, for a variety of reasons that are unrelated to redemption rights.

> Open-end funds are an attractive investment option for many different types of investors because they provide diversification, economies of scale, and professional management. They also facilitate retail investors' access to certain investment strategies or markets that might be difficult (if not impossible) or time consuming for investors to replicate on their own. Additionally, open-end funds have become a popular investment vehicle because they may provide a cost-efficient way for investors to track a benchmark index or strategy.[19]

Significantly, as the Commission also notes, many retail investors would have difficulty gaining access to many asset classes that offer important diversification, absent the opportunities provided by open-end funds.[20] We hope that as it focuses in this Proposal on liquidity risk, the Commission will not lose sight of the broader context in which both regulators and investors should understand the risks, as well as the potential rewards, of mutual fund investment.

B. The Proposed Liquidity Classification System

1. Description of the Proposed Requirement

Under the Proposal, each open-end fund would be required to classify (and review the classification on an ongoing basis) the liquidity of each of the fund's positions in a portfolio asset (or portions of a position in a particular asset), based on a prescribed six-category classification system set forth in the rule. The six categories would require a determination, for each portfolio asset (or portion thereof), of the number of days within which the fund could convert its position in the asset (or portion thereof) to cash, including collection of settlement proceeds, at a price that does not materially affect the value of the asset immediately prior to the sale, based on six different specified time frames:

- o Convertible to cash within 1 business day.
- o Convertible to cash within 2 – 3 business days.

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[18] The importance of viewing liquidity risk within the context of investment risk generally is well illustrated by the recent and heavily publicized Third Avenue liquidation. *See supra* note 9. In the aftermath of Third Avenue's announcement of its liquidation, commentators noted the interplay of a variety of risks, including investments among the riskiest of all high-yield funds (reflecting substantial deviations from the risk distribution in the fund's benchmark) and concerns about fund management. *See* Charles Stein, *Third Avenue Bled Managers, Assets Before Fund Shut Down*, Bloomberg (Dec. 16, 2015), *available at* http://www.bloomberg.com/news/articles/2015-12-16/third-avenue-bled-managers-billions-of-assets-before-fund-shut; Landon Thomas Jr., *A Junk Bond Fund Freezes Out Investors, and the Chills Spread*, N.Y. Times (Dec. 11, 2015), *available at* http://www.nytimes.com/2015/12/12/business/dealbook/a-junk-bond-fund-freezes-out-investors-and-the-chills-spread.html.

[19] Proposing Release, *supra* note 1, at 62277 (footnotes omitted).

[20] *Id.* at 62277 n.16.

- o Convertible to cash within 4 – 7 calendar days.
- o Convertible to cash within 8 – 15 calendar days.
- o Convertible to cash within 16 – 30 calendar days.
- o Convertible to cash in more than 30 calendar days.

2. Our Concerns with the Proposed Classification System

The proposed six-category "days-to-cash" classification system would impose a new and highly complex requirement on all open-end funds. Under the Proposal, this classification system would be required even for fund groups that, as the Commission has recognized, have already developed robust and effective, spectrum-based liquidity risk management classification systems on their own.

We have a number of concerns with this aspect of the proposal. We describe them at some length, in part to demonstrate the depth of our concerns, but also because we hope that by explaining the aspects of the proposed system that our members view as most problematic, this discussion will assist the Commission in considering and developing an alternative approach. In this section, with respect to each concern, we explain the manner in which our recommended alternative classification system would address the concern.

a. The Proposed Classification System is Novel and Untested

As a preliminary matter, we believe it is important to note that there appears to be limited, if any, precedent for the proposed classification program. While the Commission recognizes that many funds have robust and effective liquidity risk management programs in place, and describes a number of them in the Proposing Release, the Commission does not indicate that its outreach efforts found any fund groups that currently use a six-category days-to-cash classification system that resembles the classification system that would be required by the Proposal.[21]

Two significant concerns arise from this absence of precedent. First, the proposed classification system is untested. The Proposing Release does not provide an empirical basis for concluding that the proposed system would be either feasible or effective, much less better in practice for achieving the Commission's goals than those that funds have already developed. It gives pause that while fund groups have developed a range of sophisticated, robust, and effective approaches, the proposed classification system does not

[21] The Commission states that it has observed practices consistent with certain specific aspects of the proposed system. For example, the Commission states that it has observed that some funds use similar factors, or may use a "tiered" approach to assessing liquidity of a portion of a portfolio holding, where the fund may determine that different portions of a position in a particular asset could be converted to cash within different times (for example, a fund may conclude that it would take the fund longer to convert its entire position in an asset to cash than it would to convert only a portion of that position to cash, and thus could consider 50% of the position to be at a different place on the liquidity spectrum than the remainder of the position). Proposing Release, *supra* note 1, at 62292. The Commission also states that some funds currently consider some of the time frames used in the Commission's proposed classification system. *Id.* at 62294. Finally, the Commission notes that Question 32 on Form PF requests information regarding the percentages of the reporting fund's portfolio capable of being liquidated within certain time frames, although this does not require asset-by-asset reporting, and the Commission acknowledges that the time frames proposed for the liquidity categories in proposed rule 22e-4 are different from those incorporated in Form PF Question 32, based on differences between mutual funds and private funds and their portfolio assets. *Id.* at 62294 n.187.

number among them. This suggests that the proposed approach is a "regulatory" solution, rather than one rooted either in best practices or investor best interests, and raises fundamental, unanswered questions about whether it will work in the real world to accomplish its intended goals.[22]

Second, even though many fund groups have developed robust and effective programs, and expended significant effort and resources to do so, they would all have to jettison their infrastructure and adopt the Commission's regulatory solution instead, or else develop and maintain parallel programs – one to effectively manage liquidity risk and the other to satisfy regulatory requirements. We believe that a mandate for all funds to replace existing liquidity risk management programs that have proven to be effective with an entirely new system – or to maintain a parallel system – should not be imposed absent a strong showing that the new system would be an improvement.

Our recommended alternative classification system, by contrast, draws heavily on the experience and existing practices of a number of our members. In addition to reflecting real world experience, the alternative would provide sufficient flexibility that funds with robust systems in place could incorporate and make use of them, and thus require far less replacement cost and diversion of resources than the proposed system

b. The Proposed Classification System Would Not Provide the Commission with Meaningful Liquidity Data or Funds with a Meaningful Liquidity Risk Management Tool

From a substantive point of view, we believe the proposed classification system, which seeks to divide liquidity into six precise "days-to-cash" categories assigned to each portion of each asset held by a fund based on predicted "effect on market value," would prove, in practice, both unworkable and ineffective. As explained more fully below, we are concerned that the proposed system would require substantial expenditure of effort and resources without either generating meaningful liquidity risk data for the Commission or serving as a meaningful risk management tool for the open-end fund industry.

i. Excessive granularity and false sense of precision

The finely tuned distinctions that the proposed classification system would require funds to make about the liquidity of specific holdings (or portions of holdings) at a given point in time, while creating the impression of precision and objectivity, will, of necessity, be subjective and often arbitrary. Liquidity is fluid and dynamic, especially for fixed income instruments and other instruments traded over the counter (the special characteristics of fixed income securities are addressed further below). There is no "science" currently available, or likely to develop in the near term, to make these determinations objectively, as liquidity determinations are, at core, predictions as to whether a person will purchase an asset within a certain time frame. Different fund groups, or even funds within the same complex, will inevitably assess "days to cash" differently. In addition, fund groups may have different philosophies – on a scale of "conservative" to "aggressive" – that affect the classifications, with perverse results. For example, funds that are more conservative in assigning liquidity levels, and thus are in fact less risky, will appear to be less liquid, and thus more risky. Funds that more aggressively classify liquidity will appear more liquid

[22] In addition, to our knowledge, no other regulated entities are subject to such an approach. As a result, the proposed classification approach is also untested in any regulatory system.

and less risky. Under the proposed classification system, comparability, which requires objectivity, will thus be at best an illusion and at worst a trap for the unwary.

The "days-to-cash" criterion for each of the six categories introduces further subjectivity in that it combines two different timing concepts, trading liquidity and time to settlement. Each of these two components of the time frame can incorporate different types and levels of uncertainty. Choosing a specific number of days that attempts to express both together can send mixed or even misleading signals to recipients of the information.

In addition, assessments of liquidity on a position-by-position basis are necessarily stale as soon as they are made. While these assessments can provide some information on relative liquidity, and some organizations find certain types of scoring useful as an internal tool, this is information that can only be interpreted and understood in the context of the fund's risk management as a whole. Thus, despite the effort and resources that funds will be required to devote to making these determinations, they will be outdated and out of context when reported to the Commission and thus of limited value. Commission staff following up on such data may well expend significant Commission resources inquiring into information that has become moot or even counter-indicative.[23]

The categories we recommend, which are relative rather than prescriptive, reflect far more accurately the diverse nature of liquidity characteristics across different markets. The use of these categories will thus avoid the burdensome and even tortured efforts necessary to fit portfolio holdings into multiple rigid and artificial categories while still providing substantial data across a liquidity spectrum. Our proposed alternative would also permit, but not require, funds to assess portions of each holding separately.

ii. Measuring liquidity by "material effect on price"

One aspect of the proposed classification system that has raised the greatest concern among our Members is the requirement that liquidity ("days to cash" in the terms of the Proposal) be measured with reference to sale and settlement "at a price that does not materially affect the value of the asset immediately prior to the sale." These concerns arise for a number of reasons. The Proposing Release explains that the term "immediately prior to sale" is meant to reflect that the fund must determine whether the sales price the fund would receive for the asset is reasonably expected to move the price of the asset in the market, independent of other market forces affecting the asset's value.[24]

First, the concept of measuring liquidity based on anticipated price impact within a "materiality" range introduces an additional and substantial layer of subjectivity. A "materiality" standard in this context is inherently ambiguous and will be extremely difficult to calibrate even internally, much less compare across funds.

[23] Certainly providing static and minute information on these classifications to investors on a quarterly, 60-day delayed basis would be even less meaningful and, on the contrary, is likely to mislead investors. This is discussed further in our comment on the proposed amendments to proposed Form N-PORT.

[24] Proposing Release, *supra* note 1, at 62292.

The Commission is very familiar with the difficulties of measuring market impact.[25] Basic economics dictate that, if the supply of a good or service is held steady, increased or decreased demand drives the price up or down.[26] Thus, trades normally will have some market impact, but the amount of an asset's price movement attributable to market impact is difficult or impossible to measure. As the Commission has recognized, price changes are caused by many market forces; given the volatility of markets in general, the impact of a fund's trading cannot be calculated directly.[27] Predicting for the future an impact that cannot be accurately measured even after the fact is even more a matter of guesswork. As a result, each determination under the proposed system – potentially thousands for some funds – would require a difficult, complex and ultimately futile analysis of whether any future change in price when an asset is sold will be due to market impact, and whether such amount should properly be characterized as "material." Even if a fund developed an internal system for estimating market impact, the uncertainties and subjectivity associated with such an exercise would unavoidably lead to variation among organizations, which would further undermine meaningful comparability across funds.

We recognize that the Commission wishes to impose some price boundary on the concept of liquidity – holdings should not be considered liquid if selling them would yield, for example, pennies on the dollar. While we do not believe any fund group would consider such holdings liquid, we understand that it makes sense to make such a price boundary concept explicit. For this purpose, our proposed alternative uses the language that the Commission adopted in Form PF: "assuming no fire-sale discounting."[28] We note that two of the three liquidity risk management concerns cited in the Introduction section of the Division of Economic and Risk Analysis study (**"DERA Study"**) reference fire sales.[29]

iii. Inadequacy of vendor solutions

Although the Commission suggests that vendors will be able to supply the necessary classifications,[30] this is not realistic. Vendors do not currently have analytical capabilities that are even close to what would be required to comply with the proposed classification system. For example, one dominant vendor in this

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[25] *See* Transaction Costs Concept Release, *supra* note 13. As our predecessor organization stated in a comment letter responding to the Transaction Costs Concept Release, methodologies to measure market impact costs employ a wide variety of estimation techniques and lack uniformity. Transaction Costs Comment Letter, *supra* note 13. Even the more limited task of quantifying brokerage costs has been said to be "similar to attempting to nail Jell-O to a wall." *Oversight Hearing on Mutual Funds: Hidden Fees, Misgovernance and Other Practices That Harm Investors: Hearing Before the Financial Management, the Budget, and International Security Subcomm. of the S. Comm. on Governmental Affairs*, 108th Cong. 196 (2004) (testimony of Jeffrey C. Keil, Vice President – Global Fiduciary Review, Lipper Inc.).

[26] Transaction Costs Concept Release, *supra* note 13, at 74822 n.12.

[27] Proposing Release, *supra* note 1, at 62327 n.415.

[28] Form PF, Question 32.

[29] Paul Hanouna, Jon Novak, Tim Riley & Christof Stahel, Division of Economic & Risk Analysis, SEC, Liquidity and Flows of U.S. Mutual Funds 3 (Sept. 2015), *available at* https://www.sec.gov/dera/staff-papers/white-papers/liquidity-white-paper-09-2015.pdf.

[30] Proposing Release, *supra* note 1, at 62297.

market does not yet include foreign bonds in its service. If the most sophisticated fund groups have not developed reliable quantitative analytics for this purpose, it is unrealistic to believe that vendors are further advanced. In addition, the lack of objectivity in liquidity determinations will be as much, if not more, of an impediment to an effective vendor solution as it is to an internal solution.

Moreover, even assuming future feasibility of a vendor solution, it is not clear that a vendor solution would be desirable. Certainly it is by no means a given that the emergence of a small number of highly sophisticated vendors who can provide a liquidity classification service is a positive development. This raises the specter of past experiences with rating agencies, with the potential for "herding" and homogenization of management, and potential adverse impact industry-wide from vendor "downgrades" of certain instruments**.**

Our recommended alternative is designed to be flexible enough to permit funds to make use of internal classification criteria that match the particular liquidity characteristics of their assets, and therefore would not be dependent on development of a vendor solution.

iv. Portfolio manager skill and expertise

Finally, the proposed classification system, and in particular the effort to impose prescriptive and objective determinations, does not take into account the responsibility and capability of portfolio managers to manage liquidity as an inherent, and extremely valuable, part of their function. Portfolio managers, as fiduciaries, take liquidity management with the utmost seriousness, as fundamental to their management responsibilities. Based on their experience with their strategies and the relevant markets, portfolio managers have insights and judgments about liquidity – when and where it can be found across different markets and asset classes – that are part of the skill set for which they are hired, and the benefits of which investors would be denied under an unduly prescriptive liquidity risk management regime.[31]

Our proposed alternative recognizes the value of portfolio managers and allows greater flexibility to take advantage of the integration of liquidity management in investment decisions.

c. Special Considerations for Fixed Income Securities

As the Proposing Release states, the Proposal is designed in large part to address potential liquidity concerns in fixed income funds. Assets in fixed income open-end funds (both mutual funds and ETFs) grew from $1.5 trillion to $3.5 trillion during the period from 2008 through 2014, with net inflows exceeding $1.3 trillion during that period.[32] In response to this growth, the Commission and its staff have increased their focus on fixed income market structure and have spoken publicly about the need to focus on potential risks relating to the fixed income markets and their underlying liquidity. As one aspect of this

[31] As the International Organization of Securities Commissions ("IOSCO") has recommended as a fundamental principle of liquidity risk management, the fund manager should integrate liquidity management in investment decisions. IOSCO, Principles of Liquidity Risk Management for Collective Investment Schemes: Final Report, Principle 11 (Mar. 2013), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD405.pdf. A liquidity risk management approach that fails to take advantage of this resource is contrary to the spirit and letter of the IOSCO recommendation.

[32] Proposing Release, *supra* note 1, at 62281.

focus, Commission staff selected fixed income funds as an examination priority in 2014 and 2015. These activities have taken place in the context of widespread concern with the anticipation of rising interest rates following a prolonged period of a low interest rate environment.

The focus on liquidity in open-end fixed income funds reflected in the Proposal is appropriate, and this focus is shared throughout the industry.[33] Despite the Commission's heightened focus on monitoring liquidity risk with respect to fixed income securities, however, the proposed classification system appears to be designed with exchange-traded securities in mind. Both the categories and the factors are based on assumptions about market participants, transparency, historical data, and predictability that are far more likely to be features of the established equity markets than existing markets for many types of fixed income securities.

Among the basic challenges in measuring fixed income asset liquidity under the proposed classification system is that tagging by individual security or CUSIP is at odds with market perception.[34] Fixed income securities frequently trade based on an issuer's overall debt structure, not on the individual CUSIP. More generally, the liquidity characteristics of fixed income securities can be determined more by overall markets for the asset class, rather than individual characteristics of a particular security. These asset class drivers of liquidity tend to be accentuated in times of market uncertainty or stress, thus further reducing the value, if any, of CUSIP-by-CUSIP liquidity analysis.

Analyzing liquidity by CUSIP is particularly unhelpful in the case of municipal securities. Only about 1% of outstanding municipal security CUSIPs trade on a typical day. In spite of their infrequent trades, high quality municipal securities are often extremely liquid, illustrating that low trading volumes or a low number of specific active markets for a security does not necessarily equate to low liquidity.

The DERA Study recognizes the problems inherent in using a bottom-up, data-driven liquidity analysis for most asset classes other than exchange-traded equities, including for fixed income securities. The study cites the need for daily trading volume statistics to perform its liquidity analysis; the fact that liquidity measures for fixed income securities are typically more complex and tailored to the data available for each class; and the fact that 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.[35] These problems are equally applicable to a bottom-up analysis performed by a fund.[36]

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[33] This focus has been sharpened both at the Commission and throughout the industry by the Third Avenue liquidation experience.

[34] A CUSIP identifier is a nine-digit number that refers to a specific security issue and is issued by CUSIP Global Services. The "CUSIP" acronym derives from the American Bankers Association Committee on Uniform Security Identification Procedures.

[35] DERA Study, *supra* note 29, at 31–32.

[36] The study also cites difficulty in obtaining high quality data on fund holdings and daily asset prices. *Id.* Of course, funds do have high quality data on their own holdings and price their assets daily, so funds can more readily address these concerns, but that information is insufficient for a bottom-up analysis of the type specified in the Proposal.

As a result, both the rigid categories and the data-based bottom-up model adopted by the proposed classification system are especially unsuited for fixed income securities, a critical area in which both the Commission and the industry are currently focusing their attention on liquidity risk management efforts.

For these reasons, we believe that our recommended alternative approach, which provides conceptual and practical flexibility to accommodate fixed income holdings, is especially important for the Commission's goal of adopting a system that can apply across the fund industry.

d. Lessons Learned from Form PF

As noted in the Proposing Release, Question 32 on Form PF, a non-public data reporting form for managers of private funds, requests information regarding the percentage of a reporting fund's portfolio capable of being liquidated within certain time frames.[37] The time frames in Form PF are quite different from those proposed (primarily much longer), in order to reflect the different redemption obligations of registered funds versus private funds, as well as the typically different liquidity profile of registered funds' portfolio assets versus private funds' portfolio assets. Nonetheless, aspects of Form PF are instructive for the Proposal.

First, Form PF specifically instructs the filing party to "[u]se good faith estimates for liquidity based on market conditions over the reporting period and assuming no fire-sale discounting." Second, in adopting the final version of Form PF, the Commission modified the instructions to allow advisers to rely more on their own methodologies in responding to the question. This change responded to commenters' concerns about additional costs that would be incurred if a rigid "one-size-fits-all" methodology were to be imposed.[38]

Our recommended alternative draws on Form PF in several respects. We recommend incorporating the standard "assuming no fire-sale discounting" as part of the liquidity determination process. We also recommend incorporating the concept of "good faith estimates" and basing such estimates on current market conditions. Our alternative would make clear that, consistent with the rule, funds may use their own internal methodologies to assess liquidity. Finally, we recommend that Form N-PORT include the optional ability for funds to explain their methodology, or aspects thereof, for classifying assets into the four classification categories.

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[37] Proposing Release, *supra* note 1, at 62294 n.187.

[38] *See* Form PF, Instruction 15; Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Release No. IA-3308 (Oct. 31, 2011), 76 Fed. Reg. 71128, 71149 n.258 (Nov. 16, 2011). In response to similar concerns, and to eliminate unnecessary compliance costs, the Commission also adopted in the final form categories that conformed to the liquidity periods proposed by European regulators.

e. The Benefits of the Proposed Classification System Have Not Been Shown To Outweigh Its Costs

As part of its rulemaking process, the Commission must consider and balance the benefits of a proposed rule against its costs.[39] We do not believe the proposed classification system can survive such an analysis.

Based on the concerns expressed above, we do not believe the benefits of the proposed classification system have been demonstrated. For funds that already have comprehensive and effective liquidity risk management practices in place, the benefits are even more questionable.

In addition, we believe that the Commission has seriously underestimated the costs of implementing the proposed classification system. The Commission's estimate is based in part on the view, which we believe is not correct, that the proposed classification system or something similar is already in use by some funds.[40] We also believe the Commission has underestimated the manual effort, which cannot be delegated to vendors or automated, of CUSIP-by-CUSIP analysis of holdings in fixed income securities. We also urge the Commission to consider the costs, which may be far greater in the long run, of draining fund resources and diverting key personnel away from the liquidity risk practices funds believe are in fact meaningful and have proven effective in managing liquidity risk. The diversion of resources and personnel will be greatest during periods of market stress, precisely when it would be most important for funds to devote their attention to proven methods to maintain liquidity.

We believe that if the cost-benefit analysis requirement is to have its intended effect, the Commission should not require funds with existing liquidity risk management programs that have proven to be effective to either replace them with an entirely new system or maintain a parallel system, without a much stronger inquiry into whether the new system would be an improvement.

We believe our recommended alternative will be less expensive to implement, because it is less complex and artificial and it will enable funds to draw on and, in some cases, continue to use, their existing practices, while providing the Commission with substantially enhanced and improved data for its regulatory purposes at least equal, and in some sense superior, to the data that would be generated by the proposed system.[41]

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[39] The U.S. Court of Appeals for the D.C. Circuit has ruled that the Commission has a "statutory obligation to determine as best it can the economic implications of the rule" and has a unique obligation under the 1940 Act to consider the effect of a new rule upon "efficiency, competition, and capital formation." *Business Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011); *see* 1940 Act § 2(c).

[40] The Commission suggests that costs may be less than its estimates, because third parties may develop programs that fund complexes could purchase for less than the estimated cost to develop the programs themselves. Proposing Release, *supra* note 1, at 62360. Because we do not believe that vendors will be able to provide these resources (except, perhaps, for funds that have simple liquidity risk needs and do not, therefore, really need a vendor solution), we discount this as a possibility.

[41] In addition to legal issues raised by the cost-benefit analysis requirement, we note that questions have been raised about the legal authority for the Proposal in other respects. *Cf.* Simpson Thacher Registered Funds Alert 5 – 6 (Nov. 2015), *available at* http://www.stblaw.com/docs/default-

3. Recommended Alternative Classification System

We believe that any effort to impose a standardized classification system across all funds will suffer from some of the issues discussed above. Many of our members believe strongly that no liquidity classification system should be imposed, and that neither the proposed system nor any other single set of categories will improve liquidity risk management or provide meaningful information, while the burdens of such a system and the potential for providing misleading information will be substantial.

Nonetheless, in the interest of seeking an approach that can better achieve the main goal of the proposed classification system – a more nuanced, spectrum-based approach to liquidity risk management that will provide the Commission with additional information in order to fulfill its regulatory mission – while mitigating many of the concerns raised by the Commission's classification proposal that we address above, we recommend the following alternative classification system.

a. Overview of Alternative Classification System

Our recommended alternative classification system has four categories, based on a spectrum from "highly liquid" (Category 1) to "illiquid" (Category 4). The factors and methodology for allocating portfolio assets among the categories will differ among the categories, reflecting the different levels of precision that are appropriate for different points along the spectrum, and the purpose of each category.

At one end of the spectrum, the "highly liquid" category would substantially correspond to the first two categories in the Proposal combined (i.e., assets convertible to cash within one business day and within 2 – 3 business days), with the differences noted below, and thus would include the types of assets that would be expected to qualify for the "three-day liquid asset minimum" in the Proposal. Assets in this category would also form the basis for the "Highly Liquid Asset Target" component of the fund's program, which we propose below as an alternative to the proposed "three-day liquid asset minimum."

At the other end of the spectrum, the "illiquid" category would include assets currently considered illiquid under the "15% guidance," and that would be considered "15% standard assets" under the Proposal, subject to the prohibition on acquisition of such assets when the 15% limit is reached, as proposed to be codified in the rule.

The second and third categories would be used to classify assets that fall between the two ends of the spectrum. For many funds these middle categories will cover the great majority of fund assets, and thus the bulk of the assets that portfolio managers rely on to implement their investment strategies and that they will purchase and sell for that purpose. In these middle categories, fund assets are considered liquid, but are not relied on as "highly liquid," and can be viewed as more or less relatively liquid (which would determine whether they fall in Category 2 or 3), depending on a variety of qualitative (subjective) and quantitative (objective) factors.

b. General Considerations

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source/Publications/registeredfundsalert_november2015.pdf (questioning the Commission's authority to adopt a minimum liquidity requirement).

Among our members, some of the greatest concerns with the Proposal arise from the following aspects of the proposed classification system: (1) identifying a precise number of "days to cash;" (2) applying the standard "without materially affecting" the asset's price; and (3) classifying each "portion" of every asset separately.[42] We address these aspects in our recommended alternative as follows.

We incorporate the concept of "days to cash" in Category 1, where we believe it can be workable when taken in the right context, and serves a legitimate purpose. Category 1 is designed to identify highly liquid assets, both for general liquidity risk management purposes and for purposes of our recommended Highly Liquid Asset Target alternative, described below. Because of this purpose, it is appropriate to consider a stated number of days (in this case approximately three business days) expected to convert the position to cash in the context of normal trading (based on normal trading lots).

The other categories (Categories 2 – 4) are not based on any particular number of "days to cash." Classification in Category 4, which refers to illiquid or "15% standard" assets, would be based on expected sale within seven days at approximately the value ascribed to the asset by the fund, in accordance with the longstanding Commission position which it codifies. Classification in Categories 2 and 3 would be based on a range of qualitative and quantitative considerations, of which timing would be a factor but would not be identified with reference to a specific number of days (other than relative to the three-day and seven-day criteria for the categories at either end).

Classification of assets in all categories would represent a good faith estimate of liquidity based on current market conditions. Classification would not require an evaluation of whether the asset can be sold "without materially affecting" the asset's price immediately prior to sale. Normally, we believe the Commission's concern that the ability to sell an asset at any price is not a good measure of liquidity will be addressed by prudent portfolio management and consideration of the interests of the fund and its shareholders. However, if the Commission believes such a boundary must be part of the rule, we recommend instead requiring an assumption that the asset would be sold with no fire-sale discounting.[43]

Finally, with respect to the proposed treatment of position size (reflected in the Proposal as a requirement that classifications be assigned to "portions" of a holding), our recommended alternative would permit but not require funds to differentiate classifications within a single holding. We believe requiring such differentiation would import exactly the granularity and subjectivity that causes our concern with the proposed categories, without commensurate benefit in measuring a fund's liquidity. In addition, we

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[42] With respect to "portions" of an asset, the Proposing Release states a fund could determine that different portions of a position in a particular asset could be converted to cash within different times and that "[s]taff outreach has shown that some funds currently consider the liquidity character of their portfolio holdings—particularly relatively large holdings—to be tiered in this manner, with a certain percentage of the holding deemed to be more liquid than the remainder of the holding." Proposing Release, *supra* note 1, at 62292. Based on these observations, proposed rule 22e-4 would thus specify that a fund would be required to adopt policies and procedures for classifying the liquidity of each of the fund's positions in its portfolio assets, or portions of the fund's position in a particular asset. *Id.* at 62292 – 93.

[43] This requirement is based on Form PF, Question 32, which states in part: "Use good faith estimates for liquidity based on market conditions over the reporting period and assuming no fire-sale discounting." However, we recommend an estimate based on current market conditions at the end of the reporting report, rather than over the reporting period.

believe that the position size element can be unevenly restrictive, in that it would most often impact large funds, which are more likely to have holdings that represent a significant portion of the market, but which typically have greater overall liquidity and resources to manage liquidity effectively.[44]

c. Description of Categories

The following is a description of the four liquidity categories we propose.

- ***Category 1***. Cash, cash equivalents, and assets that the fund believes it can liquidate (sell and receive settlement proceeds) within approximately three business days in the context of normal trading (also referred to as highly liquid assets).

- ***Category 2***. Assets that are considered liquid in ordinary markets, but which may become less liquid in stressed conditions or may, for other reasons, be expected to require more than three business days to liquidate.

- ***Category 3***. Assets that are considered less liquid than assets in Category 2 (e.g., there are fewer active participants in the relevant market and execution is more sporadic and in smaller sizes), but are still considered liquid (and thus not appropriate for classification in Category 4).

- ***Category 4***. Assets that the fund believes could not reasonably be expected to be sold by the fund within seven calendar days at approximately the value ascribed by the fund (i.e., "15% standard assets," as that term is used in the Proposal, which we refer to as illiquid assets).

C. The Prescribed Factors

1. Description of the Proposed Requirement

The Proposal would require funds to classify assets based on nine specific factors prescribed in the rule, to the extent applicable. The factors are:

a. existence of an active market for the asset, including whether the asset is listed on an exchange, as well as the number, diversity and quality of market participants;

b. frequency of trades or quotes for the asset and average daily trading volume of the asset (regardless of whether the asset is a security traded on an exchange);

c. volatility of trading prices for the asset;

d. bid-ask spreads for the asset;

e. whether the asset has a relatively standardized and simple structure;

f. maturity and date of issue (for fixed income assets);

g. restrictions on trading of the asset and limitations on transfer of the asset;

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[44] The DERA Study found that flow volatility decreases and portfolio liquidity increases as fund size increases. DERA Study, supra note 29, at 17, 30.

h. size of the fund's position in the asset relative to the asset's average daily trading volume and, as applicable, number of units of the asset outstanding (analysis of position size should consider the extent to which the timing of disposing of the position could create any market value impact); and

i. relationship of the asset to another portfolio asset.[45]

2. Our Concerns with the Proposed Factors

We believe that this requirement is subject to the objections noted above in that it seeks a "regulatory" overlay that could actually hinder a process that most funds already perform well. The factors suffer from many of the same problems as the classification categories to which they relate: They are too specific and mechanical; they attempt to prescribe a precision that does not exist; they do not take into account the diversity of asset classes and the relevant markets, especially for fixed income securities; and they fail to take advantage of managers' large body of knowledge and experience in assessing liquidity.[46]

Our members have identified a number of gaps and other inadequacies in the prescribed factors that undermine their utility as a controlling set of considerations for assessing liquidity in a diverse industry. As one salient example, the factors focus disproportionately on trading volume and frequency at the security level. These factors do not reflect the trading characteristics of many fixed income markets, where instruments trade based on a set of attributes rather than a specific issuance. As explained above with respect to municipal securities, low apparent trading volume can belie substantial present and potential liquidity, which a skilled portfolio manager can access but which cannot be measured by applying the nine factors. Moreover, the data and transparency that would be necessary to use these factors are not currently available in many fixed income markets.

3. Recommended Alternative

We recommend that the factors be characterized as non-mandatory guidelines and set forth in the Adopting Release, not the text of the rule. The Adopting Release should also clarify that funds could consider additional guidelines and would not be required to consider any particular guidelines in classifying individual assets, and that funds could weigh any one guideline or group of guidelines, and could ignore certain guidelines entirely, as they see fit in categorizing a particular asset or asset class. In applying these guidelines, data from vendors could be used in considering particular guidelines (e.g., daily average trading volume) if deemed necessary or helpful, but consideration of vendor data should not be required.

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[45] *See* proposed rule 22e-4(b)(2)(ii).

[46] The Proposing Release states that assets placed in segregated accounts for use by a fund to "cover" derivatives and other transactions pursuant to SEC Release 10666 are available for sale to meet redemptions only once the related derivatives position is disposed of or unwound, and, therefore, a fund should classify the liquidity of these segregated assets using the liquidity of the derivative instruments they are covering. Proposing Release, *supra* note 1, at 62301 – 02. We will address this statement in our comment letter on the Derivatives Proposal. *See* Derivatives Proposal, *supra* note 3.

The Adopting Release should also recognize that some assets are generally homogeneous and do not require each holding to be evaluated separately. For example, a fund should be able to determine that its holdings of Treasury notes and large-capitalization equities are classified as Category 1, unless it knows or has a reason to know that the issue should fall within another category.

D. Three-Day Liquid Asset Minimum

1. Description of the Proposed Requirement

Proposed rule 22e-4 would require each open-end fund to establish a minimum amount of its assets to be invested in three-day liquid assets, considering certain prescribed factors. The prescribed factors are:

> (A) the fund's short-term and long-term cash flow projections, taking into account the following considerations:
>
> > (1) the size, frequency, and volatility of historical purchases and redemptions of fund shares during normal and stressed periods;
> >
> > (2) the fund's redemption policies;
> >
> > (3) the fund's shareholder ownership concentration;
> >
> > (4) the fund's distribution channels; and
> >
> > (5) the degree of certainty associated with the fund's short-term and long-term cash flow projections.
>
> (B) the fund's investment strategy and liquidity of portfolio assets;
>
> (C) the fund's use of borrowings and derivatives for investment purposes; and
>
> (D) the fund's holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources.[47]

A fund would not be permitted to acquire any assets other than three-day liquid assets if, immediately after the acquisition, the fund would have invested less than its three-day liquid asset minimum in three-day liquid assets.

A fund would be required to periodically review, no less frequently than semi-annually, the adequacy of the fund's three-day liquid asset minimum, considering the above factors. Fund boards would be required to approve a fund's three-day liquid asset minimum and any material changes to the minimum. Fund boards would also be required to review a written report, no less frequently than annually, that describes

[47] *See* proposed rule 22e-4(b)(2)(iii). In addition to the four factors specified in the proposed rule, the Proposing Release identifies many considerations relevant to each of the four factors. *See, e.g.*, Proposing Release, *supra* note 1, at 62303 – 04 (identifying as potential considerations the seasonality of cash flows, cash flows due to shareholder tax considerations, and potential outflows due to the departure of a portfolio manager, among others).

the adequacy of the fund's three-day liquid asset minimum together with the fund's liquidity risk management program as a whole, and the effectiveness of its implementation.

The Proposing Release states that the Commission's primary goal of requiring open-end funds to set a minimum level of liquidity "is to ensure that each fund is able to meet redemptions and to do so with minimal dilution of shareholders' interests."[48] The Release further states that the Commission believes that "codifying a three-day liquid asset minimum requirement would result in a portfolio liquidity standard that fosters consistency in funds' consideration of the factors relevant to their liquidity risk management, while simultaneously permitting flexibility in implementation…."[49]

2. Our Concerns with the Proposed Three-Day Liquid Asset Minimum

We believe that the proposed three-day liquid asset minimum may prevent funds from fulfilling their investment mandate and may have a pro-cyclical effect during periods of market stress. A core tenet of active portfolio management is that portfolio managers will take advantage of informational imbalances and temporary market dislocations to their advantage. Shareholders expect this type of behavior from actively managed funds. Funds with a passive, index-based strategy are expected to mirror the portfolio composition of their index, regardless of changing market conditions. A three-day liquid asset minimum could constrain both actively managed and passively managed funds from fulfilling their investment mandates. Such a minimum would unnecessarily supplant the judgment of an actively managed fund's portfolio management team on when to capitalize on what it believes is an investment opportunity and may prevent a passively managed fund from adhering to its index. Neither circumstance would be consistent with the fund's investment mandate or shareholder expectations.

In addition, imposing a three-day liquid asset minimum would have the pro-cyclical effect of preventing open-end funds, which may constitute a large group of potential buyers and therefore a potential source of liquidity, from buying assets that are not three-day liquid assets during times of market stress. Eliminating such a potential pool of buyers could exacerbate an already stressed environment. Relatedly, preventing funds from fully implementing their investment strategies and taking advantage of perceived buying opportunities could incite redemptions, rather than prevent them, if would-be longer-term investors believe the fund would not be fulfilling its investment mandate or would suffer from a cash drag as a result of its three-day liquid asset minimum. These consequences run counter to one of the objectives of the Proposal, which is discouraging redemption activity that is based on a perceived first-mover advantage.

Further, we believe requiring funds to consider unpredictable future events, such as the timing or severity of the next stressed market environment or a portfolio manager departure, in determining a three-day liquid asset minimum could result in funds carrying a higher percentage of their assets in three-day liquid assets during normal, non-stressed markets. This "extra liquidity" would come at a cost of potentially lower returns for funds that would ordinarily hold a greater percentage of their portfolio in less liquid,

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[48] *Id.* at 62312.

[49] *Id.*

higher yielding assets. Shareholders of such funds would bear this cost in the form of lower returns.[50] While wealthy and institutional investors would be able to turn instead to alternative investment products in order to seek to achieve their investment goals, the majority of retail investors may be forced to accept lower returns in order to achieve protection against a perceived liquidity risk. This result is particularly troubling when many American workers are facing savings shortfalls as they near or enter retirement and may become even more dependent on income from investments.[51]

Additionally, funds carrying "extra" liquidity will be at a competitive disadvantage to other funds that have formed a more optimistic forecast of the timing or severity of the next stressed period. Open-end funds with extra liquidity may also be at a competitive disadvantage to other investment products not subject to a three-day liquid asset minimum, which could drive investors into such products.

3. Recommended Alternative

We recommend, as an alternative to requiring a three-day liquid asset minimum, that rule 22e-4(b)(2)(iv)(A) require funds to determine whether to establish a Highly Liquid Asset Target, considering all of the liquidity tools available to a fund. **"Highly Liquid Assets"** would be assets classified in Category 1 in our alternative classification system described above. As described above, this classification category would largely replicate the first two classification categories of the classification system in the Proposing Release and thus would include the types of assets that would be expected to qualify for the "three-day liquid asset minimum" in the Proposal. The determination of whether to establish a Highly Liquid Asset Target would be based on the factors identified in rule 22e-4(b)(2)(iii), with the modifications suggested below, as well as any other factors that a fund deems relevant. As a target instead of a required minimum, our recommended alternative would permit a fund to purchase assets that are not Highly Liquid Assets (i.e., assets in Categories 2 – 4 above) during periods when the aggregate amount of the fund's Highly Liquid Assets is below the Highly Liquid Asset Target, if deemed prudent and consistent with the fund's investment objective and strategy.

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[50] In general, mutual funds that hold less liquid stocks significantly outperform those that hold more liquid stocks. Thomas M. Idzorek, James X. Xiong & Roger G. Ibbotson, *The Liquidity Style of Mutual Funds*, 68 Fin. Analysts J. 38 (2012), *available at* http://corporate.morningstar.com/us/documents/MethodologyDocuments/ResearchPapers/LiquidityStyleOfMutualFunds.pdf. We acknowledge there is at least one study, cited in the Proposing Release, that suggests funds with high performing portfolio managers can compensate for cash drag and outperform peers with low relative cash positions by making superior investment decisions with the available cash and avoiding costly fire sales. *See* Proposing Release, supra note 1, at 62304 n.258, *citing* Mikhail Simutin, *Cash Holdings and Mutual Fund Performance*, 18 Rev. of Fin. 1425 (2013) (the **"Simutin Study"**). We note that the Simutin Study analyzed only one segment of the fund universe (certain types of U.S. equity funds) and its conclusions may therefore not be universally applicable. We note further that other research shows that a more dynamic "tilting" towards cash during certain volatile markets, as contrasted with holding high levels of cash in a steady state, leads to higher fund returns. *See, e.g.*, Jiekun Huang, Dynamic Liquidity Preferences of Mutual Funds (June 2015), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=967553.

[51] *See, e.g.*, Keith Miller, David Madland & Christian E. Weller, *The Reality of the Retirement Crisis,* Center for American Progress (Jan. 26, 2015), https://www.americanprogress.org/issues/economy/report/2015/01/26/105394/the-reality-of-the-retirement-crisis/ (noting that millions of American workers saving for retirement are in danger of not having enough money to maintain their standard of living in retirement and that the problem is getting worse over time).

The Highly Liquid Asset Target would be reported to and overseen by the fund board in the context of its evaluation of a fund's overall Liquidity Program. Instances where a fund dipped below its target percentage, if any, would also be reported to the fund board with an explanation from management as to why the fund dipped below its target and any resulting impact on the fund's liquidity risk profile. In this way, fund boards would play their customary role of overseeing the work of the investment manager and other service providers, as guardians of the best interests of fund shareholders.

We recognize that a target instead of a minimum creates a risk that a portfolio manager could misjudge an investment opportunity during stressed conditions and thereby hamper the fund's ability to maintain liquid assets needed to meet redemption requests without causing dilution. In fact, funds face this risk every day in connection with every portfolio manager investment decision. We believe, however, that encouraging additional board oversight of the implementation of a Highly Liquid Asset Target would better calibrate the perceived need for greater protection from undue risk taking with the need for funds to have the flexibility necessary to fulfill their investment mandate. Such express oversight of a fund's maintenance of highly liquid assets, including required reporting to the fund board of instances where the fund falls below an internally set level of highly liquid assets, has not previously been required. We believe that our recommended alternative to the proposed three-day liquid asset minimum would fulfill the Commission's goal of bringing new and valuable structure and governance to this aspect of a fund's Liquidity Program, without unduly hampering funds and potentially harming fund shareholders.

a. Factors Used to Establish A Target Three-Day Liquid Asset Amount

We believe that the factors identified in proposed rule 22e-4(b)(2)(iii) may be relevant to determining whether to establish a Highly Liquid Asset Target but recommend that they be retained as guidance in the Adopting Release that funds *may* consider and not mandatory considerations. Mandatory factors would create an overly rigid structure and a one-size-fits-all approach that may result in unnecessary focus on factors that are irrelevant to certain funds. Mandatory factors may also result in an unnecessary expense resulting from funds having to document consideration of factors that have no bearing on a fund's liquidity risk. In this regard, we recommend that the Adopting Release clarify that funds need not consider any particular factor and can weight factors as they deem appropriate.

Separately, we believe that certain of the factors included in proposed rule 22e-4(b)(2)(iii) should be modified as described in the following sections.

i. Historical Purchases and Redemptions During Stressed Conditions

Proposed rule 22e-4(b)(2)(iii)(A) would require that a fund consider the size, frequency, and volatility of the historical purchases and redemptions (referred to as **"cash flows"**) of fund shares during normal and stressed periods in establishing the fund's three-day liquid asset minimum. The Commission stated that it is "essential that the fund formulate its cash flow projections after considering the factors in both normal *and stressed periods*" because "minimum liquidity would not likely advance the Commission's goal of reducing the risk that funds will be unable to meet redemptions and mitigating dilution if funds can only meet redemptions in stressed conditions through sales of portfolio assets that create dilution and

significantly increase the fund's liquidity risk."[52] The Proposing Release identifies several examples of potential "stressed conditions," such as shareholder outflows related to stressed market conditions, increased outflows due to a reputational event, and the departure of a fund's portfolio manager, among others.[53]

We agree that funds should consider and evaluate historical cash flows during stressed periods in establishing their overall Liquidity Program, including whether to establish a Highly Liquid Asset Target. We do not agree, however, that in making their Highly Liquid Asset Target determinations, funds should be required to forecast the timing, severity or potential impact of stressed market conditions or other events affecting the fund that have occurred in the past but for which there is no reasonable way to accurately predict their recurrence. Such an interpretation may result in funds carrying a higher percentage of highly liquid assets during normal, non-stressed markets. The potential harm to funds resulting from this "extra liquidity" is described above.

For these reasons, we recommend that the Adopting Release clarify that in determining whether to establish a Highly Liquid Asset Target and the amount of any such target, funds can make this determination on the basis of market conditions existing or reasonably foreseeable at the time such determination is made, and not be required to forecast if and when the next stressed condition may occur. For example, a fund that experienced cash outflows due to the unexpected departure of a portfolio manager would not be expected to set a higher Highly Liquid Asset Target simply as a result of having experienced such an event in the past. Funds will instead periodically review whether to establish, or if established, the amount of, a Highly Liquid Asset Target and make adjustments as market conditions change.[54] Such periodic adjustments will be in reaction to actual or near-term expectations of stressed conditions rather than hypothetical stressed conditions based on anomalous historical cash flows or long-term projections. We believe this approach will allow funds to better calibrate their liquidity needs to current or predictable conditions and eliminate the possibility of unnecessary performance drag by holding a higher percentage of the fund's assets in less liquid assets than conditions require.

We are not suggesting that funds would put blinders on with respect to indications of changing market conditions or known, or reasonably foreseeable, cash flows. For example, it may be expected that bond funds would consider adjusting their mix of cash and non-cash assets in the face of imminent increases to interest rates by the Federal Open Market Committee of the Federal Reserve System. Such funds would

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[52] Proposing Release, *supra* note 1, at 62312 (emphasis added).

[53] *See id.* at 62304 (discussing the factors applicable to determining a fund's liquidity risk, which are the same factors the Commission has proposed be used to determine a fund's three-day liquid asset minimum).

[54] *See id.* at 62315 (noting that in addition to the semi-annual reviews of a fund's three-day liquid asset minimum required by rule 22e-4, funds could establish a more frequent review period, even on an ad-hoc basis as conditions demand).

not, however, be expected to incorporate into any Highly Liquid Asset Target projected increases in interest rates that the fund considers too speculative or uncertain as to timing.[55]

As contemplated by the Proposing Release, funds may choose to stress test their ability to meet redemptions during stressed conditions, which would inform the fund of the conditions under which it would need to consider adjusting any Highly Liquid Asset Target and by how much.[56] Stress testing would complement the periodic monitoring of a fund's cash needs and the adequacy of its Highly Liquid Asset Target, if any, and arm funds with information on how to reposition the fund if stressed conditions occur.

ii. Shareholder Ownership Concentration

Proposed rule 22e-4(b)(2)(iii)(3) would require funds to consider shareholder ownership concentration in establishing their three-day liquid asset minimum, as one of five sub-factors that comprise the fund's analysis of its short and long term cash flow projections (fund flows, in turn, comprise one of four main factors identified in the Proposal as relevant to the three-day liquid asset minimum). The Proposing Release states that a fund with a concentrated shareholder base has a high risk that only one or two shareholders deciding to redeem can cause the fund to sell a significant amount of assets that can dilute remaining shareholders.[57] While we agree with this factual premise, we do not agree that shareholder concentration should be a determinative factor, or that funds with a small shareholder base should be viewed as required to carry more highly liquid assets than competitors.

In particular, we are concerned that accentuating the significance of this sub-factor in the context of new or recently launched funds, which may have a small number of shareholders relative to more established funds, could have a severe anti-competitive effect and create an unwarranted barrier to the introduction of new funds.

New funds or funds that are in the early stages of trying to raise assets or grow their asset base often target one or more institutional investors to serve as "anchor" investors. If successful, these "anchor" investors often comprise a meaningful percentage of a fund's assets while the fund sponsor and distributor seek to raise additional assets. If such a fund is automatically expected to maintain a higher Highly Liquid Asset Target than the fund's established competitors, then the fund's performance returns may lag its peers that have greater investment flexibility. Lower relative returns will decrease the likelihood that the smaller fund may attract sufficient assets to diversify its shareholder base in a manner that permits the fund to establish a Highly Liquid Asset Target that is consistent with its peers, creating a self-defeating cycle. The same concerns arise with respect to recently launched funds that are ramping up

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[55] We note that the Federal Reserve held interest rates at a historically low level for seven years and attempts by a fund to forecast when the Federal Reserve would increase rates could have resulted in the fund being several years early in its forecast, resulting in a significant cash drag on returns.

[56] *See id.* at 62305 (noting that if a fund elects to conduct stress testing to determine whether it has sufficient liquid assets to cover different levels of redemptions, a fund should consider incorporating the results of this stress testing into its liquidity risk assessment).

[57] Proposing Release, *supra* note 1, at 62313.

their distribution efforts. We believe this anti-competitive behavior may result in an even greater concentration of assets in a smaller number of larger funds and is not consistent with the Commission's mission of investor protection.

To address this concern, we believe that the Commission should clarify that shareholder ownership concentration of new or recently launched funds need not be determinative or given greater weight than other factors in considering a fund's Highly Liquid Asset Target. We further propose that the Commission acknowledge that such funds may consider as a factor in establishing any Highly Liquid Asset Target any anti-dilution measures that the fund has adopted, including redemptions in kind, redemption fees and, if adopted, swing pricing.[58] Finally, we recommend that the Commission encourage new or recently launched funds that have or expect to have a small number of shareholders to disclose the risk of redemption by one or more such shareholders in the fund's prospectus. We believe that these measures will provide meaningful protection against investor dilution without the potential for anti-competitive effects and imposition of unwarranted entry barriers that could result from a contrary interpretation of the factors identified in the Proposal.

E. 15% Standard Asset Requirement.

The Proposal includes a requirement, which codifies existing Commission guidance on illiquid assets, that a fund not acquire any asset that may not be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund (**"15% standard asset"**) if, immediately after the acquisition, the fund would have invested more than 15% of its assets in 15% standard assets.

We support codification of the existing guidance.[59] However, we recommend that the Commission continue to refer to these by the less confusing term "illiquid assets."

F. Role of the Fund Board

Proposed rule 22e-4(b)(3)(i) would require a fund's board of directors, including a majority of its independent directors, to approve the fund's Liquidity Program, including its three-day liquid asset minimum. The proposed rule would also require the board to approve any material change to the Liquidity Program and *any* change to the three-day liquid asset minimum. The Commission acknowledges in the Proposing Release that the board approval requirement associated with the three-day liquid asset minimum could add a layer of process if a fund wished to change its liquidity profile, but it believes that this requirement is necessary because it would add independent oversight of funds' liquidity risk management.[60]

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[58] *See id.* at 62332 (noting that open-end funds, except ETFs, may decide to adopt swing pricing as part of their liquidity risk management programs under proposed rule 22e-4).

[59] The text of the proposed rule states that the limitation on 15% standard assets is measured with respect to the fund's *total* assets. *Id.* at 62385. Elsewhere, however, the text of the Proposing Release states that the limitation on 15% standard assets is measured with respect to the fund's *net* assets. *Id.* at 62304, 62317, 62319, 62357, 62360 n.704. We have assumed that the Commission intends a measurement with respect to net assets.

[60] Proposing Release, *supra* note 1, at 62366.

We agree with the Commission that independent oversight by a board of a fund's Liquidity Program is appropriate. Such a requirement is similar to board approval of a fund's compliance program required by rule 38a-1 under the 1940 Act. As with a fund's compliance program, however, we do not believe that fund boards should be required to approve specific elements or components of funds' Liquidity Programs. As previously discussed in this letter, we are not supporting inclusion of a required three-day liquid asset minimum but do support a requirement for funds to consider whether to establish a Highly Liquid Asset Target. As would be the case with establishing a three-day liquid asset minimum, consideration of the Highly Liquid Asset Target will involve a fact-intensive, technical analysis of the multiple factors the Commission has identified, such as liquidity of various instruments and markets and cash flows. As discussed in this letter, determining the liquidity of certain assets, asset classes and markets, which would be elements of determining any Highly Liquid Asset Target, involves significant subjectivity and judgment, which are inherently a component of portfolio management skill and expertise. Certain of the other factors, such as cash flow projections and distribution channel analysis, involve similar subjective, fact-intensive judgments. We do not believe it is appropriate to ask fund boards to assume the responsibility and liability to approve a component of a fund's Liquidity Program that involves judgments that are both technical and subjective. This responsibility more appropriately should fall to a fund's investment adviser, whose job it will be to make these determinations. We therefore do not support requiring a fund board to approve a fund's Highly Liquid Asset Target determination. As discussed in section III.D.3., however, we would support the rule requiring a fund manager to report to the fund board instances where the fund dips below a Highly Liquid Asset Target and to provide an explanation of why this occurred and any resulting impact on the fund's liquidity profile.

G. Application to Funds That Redeem in In-Kind Transactions

As proposed, rule 22e-4 would apply to all mutual funds and ETFs regardless of their investment strategy or actual liquidity risk. The Proposing Release states that the liquidity of an ETF's portfolio securities is a factor that contributes to the effective functioning of the ETF's arbitrage mechanism and to the ETF shares trading at a price that is at or close to the NAV of the ETF.[61]

We believe that rule 22e-4 should not apply to mutual funds and ETFs that primarily effect redemptions of shares in in-kind transactions. As the Proposing Release acknowledges, ETFs typically make in-kind redemptions, which can mitigate liquidity concerns for ETFs compared to mutual funds if (as normally is the case) the in-kind redemptions are of a representative basket of the ETF's portfolio assets that do not alter the ETF's liquidity profile.[62] The Proposing Release also notes that ETFs do not necessarily create the same dilution concerns as mutual funds,[63] and that any first-mover advantage may be mitigated in ETFs to the extent that they conduct in-kind redemptions or charge liquidity fees for cash redemptions.[64]

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[61] *Id.* at 62278.

[62] *Id.* at 62277.

[63] *Id.* at 62280 n.44.

[64] *Id.* at 62280 n.49.

Just as ETFs that redeem primarily in in-kind transactions do not have the same liquidity problems that mutual funds have, they also are not amenable to the same solutions. For example, the proposed three-day liquid asset minimum requirement would have no purpose, since many ETFs would have little need for cash or other highly liquid assets to fund redemptions. Further, it potentially would violate the exemptive order for an index ETF to hold a certain amount of cash or other highly liquid assets, since an index ETF generally must follow a replication strategy and has limited discretion as to the assets it holds. Rather, the Proposal in reality is directed to mutual funds and ETFs that redeem in cash transactions, and it makes little sense to treat ETFs that redeem primarily in in-kind transactions as if they needed to and could maintain liquid reserves to fund cash redemptions. Our recommendation in this section would not extend to mutual funds and ETFs that ordinarily satisfy redemption requests in cash (**"cash only funds"**). Such mutual funds and ETFs would remain subject to proposed rule 22e-4. A fund board could oversee a manager's determination of whether a particular mutual fund or ETF is a cash only fund.[65]

H. Application to Sub-Advised Funds

1. Description of the Proposed Requirement

Proposed rule 22e-4(b)(3)(iii) would require that the fund designate the fund's investment adviser or officers responsible for administering the Liquidity Program. The Proposing Release generally does not discuss the role of a sub-adviser in connection with a fund's Liquidity Program but does note that "a sub-adviser's portfolio management responsibilities would involve investing a fund's assets in accordance with the fund's three-day liquid asset minimum and any other liquidity-related portfolio requirements adopted by the fund."[66] The Proposing Release states further that a fund could designate a sub-adviser as responsible for administration of the fund's Liquidity Program[67] and asks for comment on whether such delegation is appropriate.

2. Recommendation

We agree with the Commission that funds should have the flexibility to appoint a sub-adviser as administrator of the fund's Liquidity Program. In many cases, it will be a sub-adviser's personnel, and not the adviser's personnel, who will have the information necessary to make the liquidity classification and other determinations necessary to implement the fund's Liquidity Program.

Funds should have the flexibility to allocate responsibilities for implementation of a fund's Liquidity Program among its adviser and sub-adviser(s) in whatever manner makes the most economic and practical sense for the fund in the interests of fund shareholders, provided that a single entity retains ultimate responsibility for administration of the Liquidity Program. We believe that because it is likely that advisers of sub-advised funds may look to sub-advisers to assist in implementing a fund's Liquidity Program, sub-advisers and their personnel should be able to rely on the same safe harbors from liability

[65] Note that some ETFs that ordinarily redeem in kind may include a small amount of cash in their redemption baskets to account for odd lots, accumulated dividends, or other instances where redeeming a particular security or part of a security in-kind is impractical. Such funds would not be considered "cash only" and would be eligible for the exclusion from proposed rule 22e-4.

[66] Proposing Release, *supra* note 1, at 62324–25.

[67] *See id.* at 62325 n.405.

on which the adviser is entitled to rely, whether or not the sub-adviser is formally designated as administrator of the Liquidity Program. We therefore recommend that the Commission incorporate into the safe harbor described below the ability of a sub-adviser to rely on the safe harbor to the same extent as an adviser that is ultimately responsible for administering a fund's Liquidity Program.

I. Reporting and Disclosure

1. Description of the Proposed Requirement

The Commission is proposing several disclosure and reporting-related amendments. Among these is a proposed amendment to proposed Form N-PORT that would require reporting of the liquidity classification for each portfolio asset (or portion thereof), using the six classification categories set out in proposed rule 22e-4, as well as reporting of the fund's three-day liquid asset minimum. Form N-PORT is proposed to be filed monthly, and the last filing of each quarter would be made publicly available, 60 days after the quarter end. In addition, the Commission is proposing amendments to Form N-1A to improve disclosure regarding how funds meet redemptions of fund shares, and amendments to proposed Form N-CEN to provide detailed information, to both the Commission and the public, regarding a fund's lines of credit and interfund lending and borrowing.

2. Our Concerns with Public Disclosure of Liquidity Classification Information

We strongly object to public disclosure of either the position-level liquidity classification information that would be reported on Form N-PORT under the Proposal in its current form or the portfolio level liquidity information that we recommend be reported on Form N-PORT as part of our recommended alternative. Our position is based on the concerns we expressed in our comment letter on the Reporting Modernization Proposal, which we believe are magnified as applied to the reporting that would be required by the current Proposal, for the reasons set forth below.[68]

The primary purpose of the proposed classification system is to provide data that will enable the Commission to better monitor liquidity in the open-end fund industry. We believe that this goal is in conflict with public disclosure. Information that is most valuable to the Commission for regulatory oversight of fund liquidity will be fundamentally different – both in content and format – from information that is useful to investors in understanding liquidity for purposes of making investment decisions. Tailoring the data the Commission requests, in order to make the information appropriate for investors, will compromise the regulatory value of the information. Publicly disclosing the information which the Commission seeks in order to fulfill its regulatory oversight goals is more likely to harm investors than to benefit them.[69]

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[68] *See* Reporting Modernization Comment Letter, *supra* note 3, at 42 – 45. We recommended in our comment letter on the Reporting Modernization Proposal that all filings on Form N-PORT should be made on a non-public basis. We continue to hold that view and, as described above, believe that it is particularly compelling with respect to liquidity classification information.

[69] The Commission has authority to determine that information submitted should not be made publicly available, when public disclosure is neither necessary nor appropriate in the public interest or for the protection of

Our main concerns with public availability of detailed liquidity information are the following.

- Proposed Form N-PORT would give only static information as of a single past point in time, at least 60 days and as much as five months earlier. In the event of market stress, when investors may be particularly interested in liquidity, this outdated information would be especially unreliable and likely misleading. Because liquidity is intrinsically dynamic and fluid, the information on Form N-PORT would never be reliable to reflect current liquidity.

- The detailed holdings liquidity information proposed to be reported on Form N-PORT, or even portfolio level classifications, would not be accompanied by any explanatory disclosure to investors as to the limitations on use of such information, or other disclosures necessary to understand it. Presentation of this information in structured format would create a false sense of precision and thus mislead investors about fund liquidity, the exact opposite of what the Commission intends, which is to provide more meaningful liquidity information to investors.

- Public disclosure of liquidity classification information may be harmful to funds and to the liquidity of their portfolio assets, particularly when markets are stressed. In such a situation, market participants are likely to look only to the views of the most conservative holders of securities, and other holders' more positive views are likely to be discounted.

- Public disclosure of classifications could have the result that funds copy peers' classifications. When an asset's liquidity changes, therefore, funds may be forced to respond with herding behavior, creating a "common shock" vulnerability.

- The inherent subjectivity of liquidity classifications may not be obvious to, or may be ignored by, public recipients and could lead to exploitation of funds by strike suit lawyers seeking to characterize liquidity classifications as precise measures of risk.

- In the rare event where a fund does experience a liquidity issue, public disclosure of its classifications may expose the fund to predatory trading by market participants that front-run trades of the fund's portfolio securities.[70] To the extent that liquidity risk is manifested, therefore, this strongly suggests that the proposed Form N-PORT disclosures would exacerbate it.[71]

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investors. *See* Section 45(a) of the 1940 Act; Reporting Modernization Comment Letter, *supra* note 3, at 42 – 45.

[70] Teodor Dyakov & Marno Verbeek, *Front-Running of Mutual Fund Fire-Sales*, 37 J. of Bank. & Fin. 4931 (2013); Joshua Coval & Erik Stafford, *Asset Fire Sales (and Purchases) in Equity Markets*, 86 J. Fin. Econ. 479 (2007), *available at* http://www.people.hbs.edu/estafford/Papers/AFS.pdf. The Proposing Release cites this research and suggests that sophisticated investors could anticipate this behavior and could have an incentive to redeem ahead of such trades. Proposing Release, *supra* note 1, at 62358.

[71] Although liquidity information will necessarily be stale by the time it is public, a predatory market participant may under some circumstances be able to use even stale information, together with other information that the fund makes publicly available, to discover the fund's weaknesses.

Although the Proposing Release suggests that investors would find this information helpful, we believe it would be misleading to investors. Form N-PORT filings would provide information as of a past point in time, and there would be no duty to update for changed circumstances. At a time of market stress, therefore, investors would be relying on outdated information and would have no way to know if fund holdings had become less liquid, or conversely if the fund had since taken steps to increase the liquidity of its holdings.

As a general matter, we have grave concerns with the Commission's suggestion that investors would, and should be encouraged to, use this information as a basis for making investment decisions. This appears to reflect a significant departure from the investor protection principles the Commission has traditionally adhered to in its regulation of the disclosure process. We list just a few of the basic disclosure principles that have guided the Commissions' investor protection efforts in this area over the course of 80 years.

- Disclosure should be full and fair. It should not omit information that is material to understanding the context.
- Issuers are prohibited from providing stale or outdated information.
- Information should be available to all, not just those with special access.
- Information provided to investors should not be speculative.

With respect to the first disclosure principle, liquidity information provided on Form N-PORT will be incomplete. The Commission's anti-fraud and other disclosure rules uniformly prohibit not only material misstatements of fact but also the omission of information necessary to prevent information presented from being materially misleading.[72] The purpose of such a prohibition is to protect investors from making investment decisions based on information that is out of context and omits information necessary to understanding the information provided. Liquidity information on Form N-PORT is a classic case of materially incomplete information, demonstrating the wisdom of this prohibition. This information would be provided as structured data with no context, explanation, or other basis for the investor to understand how it fits in to the fund's risk profile as a whole. Form N-PORT is not designed to provide investors with information indicating the subjectivity of the information, or, given such subjectivity, the limits on comparability of the information across funds.

With respect to the second disclosure principle, that information on which investors base decisions should be current, liquidity information reported on Form N-PORT will be stale, by the terms of the reporting requirement. To prevent predatory practices, information on Form N-PORT would be made public only for the end of each quarter and with a 60-day delay. This inherent staleness is exacerbated by the fact that liquidity information is especially fleeting.

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[72] *See, e.g.,* Section 34(b) of the 1940 Act (making it unlawful for any person filing a document with the Commission "to omit to state therein any fact necessary in order to prevent the statements made therein, in the light of the circumstances under which they were made, from being materially misleading"); *see also* Rule 10b-5 under the Securities Exchange Act of 1934.

The dangers to investors from disclosure of information that is both incomplete and stale are twofold. First, the focus on liquidity risk in isolation would encourage investors to exaggerate the importance of liquidity risk relative to other risks that may be far more important to their long-term investment goals. Second, although the subjectivity and staleness of the information makes it intrinsically unfit for investors to use as a basis for comparison among funds, the Commission's singling out this information will encourage just that. Such comparisons are especially treacherous for investors because, as also discussed above, conservative managers may well assess their holdings as less liquid than aggressive managers, thereby making less risky funds appear to have more liquidity risk, and vice versa.

In addition, public disclosure of liquidity classifications, even at the portfolio level, will encourage service providers to attempt to "rate" or "rank" funds based on these classifications. The classifications are simply too subjective to provide the basis for reliable "liquidity" ratings or rankings. Moreover, we do not believe that liquidity ratings, even if they were reliable as a measure of liquidity, are beneficial. Such ratings would, again, isolate liquidity from the fund's risk profile as a whole, and thus provide a skewed impression of its importance to long-term investors.

With respect to the third disclosure principle, that information should be available to all, not just those with special access, to the extent the information is useful at all it would most likely advantage institutional investors at the expense of retail investors. Institutional investors are far more likely to have access to structured data and, if they perceive this information to indicate better or worse investments, will have first mover advantage over retail investors.

For these reasons, we urge the Commission to reconsider its determination to make information on Form N-PORT, but especially detailed liquidity information, available to the public.

3. Our Concerns with Public Disclosure of the Three-Day Liquid Asset Minimum

We oppose the proposed public disclosure of the three-day liquid asset minimum. This information has a high risk of misleading shareholders, as it would be presented without context and would give undue emphasis to a single element of a fund's Liquidity Program. Shareholders would be unaware of the ways in which seemingly similar funds actually have different liquidity needs and resources, and further unaware of any changes to the three-day liquid asset minimum since the date of the last information publicly reported on Form N-PORT. Yet the Commission's requirement for funds to disclose the three-day liquid asset minimum might well encourage them, inappropriately, to use it as a measure to compare and evaluate funds for investment purposes. Of even more concern is the danger that third parties would seize on this single number as a basis for comparing funds, through a rating or ranking system offered to "judge" fund liquidity, even further encouraging undue reliance by investors. Finally, public availability of this information could lead to predatory behavior by market participants who become aware that a fund is close to its three-day liquid asset minimum during a period of stress.

While the use of a Highly Liquid Asset Target, as we recommend, would reduce the likelihood of predatory behavior, the other concerns would remain. In fact, they would be accentuated, as the target amount would be even less of a valid measure for evaluating fund liquidity or comparing funds. Further, a publicly disclosed Highly Liquid Asset Target would lose the flexibility needed for the effective use of this internal tool, as funds would feel that their freedom of action was constrained by the public

availability of this information. Accordingly, we urge the Commission not to make either the three-day liquid asset minimum or the Highly Liquid Asset Target publicly available.

4. Recommendation

We generally support the proposed amendments to Form N-1A and proposed Form N-CEN.[73]

Because we do not support the proposed liquidity classification system, we do not support reporting those classifications on Form N-PORT. For all the reasons that such classifications would not provide meaningful information that we discuss in the section on the classification system, we believe reporting them would serve no useful purpose, while imposing substantial burdens.

With respect to our proposed alternative classification system, this approach would support reporting on Form N-PORT portfolio level information about liquidity classifications (that is, the percentage of each portfolio in each category). We strongly oppose any requirement for reporting liquidity classifications on an asset-by-asset basis. While some fund organizations currently do, and may under our proposed alternative, achieve the classification through a security-by-security tagging system, we view that as an internal process only. Individual holding liquidity classifications, viewed out of context in the structured format that Form N-PORT requires, will not provide meaningful, or even intelligible information to anyone outside the organization.

We also believe that the Commission should follow the model of Form PF, Instruction 15, which provides that filers may respond to the form using their own internal methodologies and the conventions of their service providers and allows them to explain their methodologies, including related assumptions. We believe that the Commission similarly should allow (but not require) funds to provide narrative information concerning their reported portfolio level liquidity classifications, including qualitative and quantitative factors, in the nonpublic section of Form N-PORT.

As discussed above, we strongly oppose public disclosure of any liquidity classification information reported on Form N-PORT, including the portfolio level information that would be reported under our alternative. If the Commission believes that some of the information may be useful to investors, we urge the Commission first to study the information it receives for a period of time before making a determination on public disclosure, and use the information provided as the basis for a disclosure proposal tailored to provide liquidity information to investors in a context that will avoid the concerns we raise above.

Finally, we recommend not requiring a fund to publicly disclose its three-day liquid asset minimum or, if the Commission accepts our Highly Liquid Asset Target recommendation, whether it has adopted a Highly Liquid Asset Target or the amount of any such target, which we believe could be harmful to a fund and its shareholders.

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[73] Note, however, that with respect to proposed Form N-CEN and the proposed amendments to Regulation S-X, as set forth in the Reporting Modernization Proposal, we had a number of recommendations. *See* Reporting Modernization Comment Letter, *supra* note 3, at 47 – 51.

J. Standard of Liability

The adoption of the Proposal could subject funds and their affiliates to broad risk of liability. In addition to the Commission's ability to bring enforcement actions directly for violations of proposed rule 22e-4, section 34(b) of the 1940 Act provides that it shall be unlawful for any person to make any untrue statement of a material fact in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to this title or the keeping of which is required pursuant to section 31(a) of the 1940 Act. Any reports on Form N-PORT, and possibly other information related to Liquidity Programs, will be subject to liability under section 34(b).

Section 34(b) does not require that a violator act willfully,[74] and the Commission has ruled that scienter need not be found to establish a violation.[75] However, liquidity judgments necessarily will be highly subjective and readily subject to second-guessing with the benefit of hindsight. To protect funds and other persons with responsibilities under section 34(b) against undue risk under this demanding liability statute, therefore, we believe that the Commission should affirmatively provide that liability will not attach for errors in adopting and carrying out its Liquidity Program unless the error is material and the fund or other person acted knowingly or recklessly.

The final rule should also make clear that where fund redemption prices decline, funds and managers would not face liability for violation of rule 22e-4 based on second guessing, either by the Commission or by fund shareholders, of the design of the liquidity risk management program.

K. Compliance Date

The Commission proposes a compliance date of 18 months after the effective date to comply with the liquidity risk management program provisions of proposed rule 22e-4, but smaller entities (groups of investment companies with net assets of less than $1 billion as of the end of the most recent fiscal year) would have a compliance date that is 30 months after the effective date.[76] In surveying our members, we are advised that the time required to prepare internal processes, policies and procedures and implement Liquidity Programs that meet the requirements of the rule is very substantial, and that in general larger entities will need as much or more time than smaller entities. Accordingly, we request a compliance date for all entities that is 30 months after the effective date.

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74 *SEC v. Advance Growth Capital Corp.*, 470 F.2d 40, 52 (7th Cir. 1972). A person acts "willfully" under the securities laws if he intentionally did the wrongful acts; no knowledge that he is breaking the law is required. *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000); *United States v. O'Hagan*, 139 F.3d 641, 647 (8th Cir. 1998).

75 *Fundamental Portfolio Advisors*, Release Nos. 33-8251, 34-48177, IA-2146, IC-26099 (July 15, 2003).

76 Proposing Release, *supra* note 1, at 62348–49.

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SIFMA AMG sincerely appreciates the opportunity to comment and your consideration of these views. We stand ready to provide any additional information or assistance that the Commission might find useful. Please do not hesitate to contact either Timothy Cameron at 202-962-7447 or tcameron@sifma.org or Lindsey Keljo at 202-962-7312 or lkeljo@sifma.org with any questions.

Sincerely,

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