CFA Institute

560 Ray C. Hunt Drive
Charlottesville, VA
22903-2981 USA

+1 (434) 951 5499 tel
+1 (434) 951 5262 fax
info@cfainstitute.org
www.cfainstitute.org

12 January 2016

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: 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; File No. S7-16-15)

Dear Mr. Fields:

CFA Institute[1] appreciates the opportunity to comment on the Securities and Exchange Commission's (SEC or Commission) proposals to promote effective liquidity risk management by open-end investment companies (the "Proposals"). CFA Institute represents the views of those investment professionals who are its members before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and on issues that affect the efficiency, integrity and accountability of global financial markets.

Executive Summary

- We question the utility and appropriateness of regulatory actions to mandate "risk contagion" efforts across the fund industry, particularly where there are substantial questions about their effectiveness. Instead, we recognize that some degree of risk is inherent in, and vital to, our capital markets. To that end, we recommend that the Commission consider a more principles-based approach that provides guidance, instead of the proposed requirements.
- Should the Commission decide to address liquidity concerns relating to non-money market mutual funds and ETFs through additional regulation, we recommend

[1] CFA Institute is a global, not-for-profit professional association of more than 135,000 investment analysts, advisers, portfolio managers, and other investment professionals in 145 countries, of more than 129,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 147 member societies in 73 countries and territories

consideration of the use of gates and optional swing pricing, rather than cash buffers, as ways to better ensure their ability to meet redemption requests in times of severe stress.

- We support the proposed option of allowing funds to use "swing pricing" as a means of protecting existing fund shareholders from dilution due to the trading activity associated with purchase and redemption.

Background

The SEC is proposing new and amended requirements aimed at better managing liquidity issues by open-end investment companies (hereafter "funds"), including open-end exchange-traded funds ("ETFs"). Noting that it has been 20 years since it last updated guidance relating to liquidity requirements for funds, and in light of dramatic changes to the markets since then, including the use of more complex investment strategies and instruments, and issues that were raised in connection with the review of the asset management industry by the Financial Stability Oversight Council ("FSOC")[2], the SEC reasons updates are overdue.

A number of questions posed in the Release ask for information on existing fund practices, potential costs relating to the proposal, and the liquidity management programs that funds currently use. We primarily focus our comments in this comment letter on the issues raised in the proposal from our perspective on promoting investor protection, ensuring fairness and increasing market stability.

Outreach by Commission staff has revealed that while many funds perform comprehensive risk management programs on an ongoing basis, some do not have formalized programs. The proposal thus aims at three basic goals: (1) to better ensure that funds can meet their redemption requests; (2) minimize the dilution of existing shareowners' shares due to trading costs (purchases and redemptions); and (3) help funds establish more uniform polices and approaches in addressing liquidity needs.

The proposal notes that changes in the mutual fund industry have increased the need to address liquidity issues. In particular, growth in fixed-income and alternative funds has raised regulatory concerns that underlying liquidity and limited investor redemption rights could significantly impact the financial market under certain scenarios. Concerned that certain market conditions could threaten funds' ability to meet their redemption needs, the SEC now seeks to require funds and ETFs to implement liquidity management programs to (1) classify the liquidity of fund portfolio assets; (2) assess liquidity risk; (3) establish a three-day liquidity minimum; and (4) require board review and approval. Final rules would also codify the existing guidance for funds that require them to limit illiquid holdings to 15 percent of fund assets.

---

[2] In December 2014, the FSOC issued a notice for public comment in which it noted potential risks posed by the asset management industry in terms of liquidity and redemptions. That same month, a speech by Chair White noted that the SEC intended to address areas of the asset management industry that needed updating in terms of disclosure and practices that could lead to systemic risk.

Concerned about how trading activity (including purchases and redemptions) affect and may dilute share value for existing shareholders, the Commission also proposes to allow funds the option to use “swing pricing,” a technique already used in a number of foreign jurisdictions. Swing pricing passes trading activity costs (purchases and redemptions) to shareholders engaging in those activities and thus protects existing shareholders from dilution.

Finally, the proposal seeks to increase the disclosure of fund liquidity and redemption practices through Form N-1A, Form N-CEN and Form N-PORT. These changes would provide meaningful information to investors, and allow the SEC to better monitor risks through a structured data format.

Discussion

As an organization, CFA Institute strongly supports meaningful measures to increase investor protections. However, we also recognize that investing in our capital markets is not without risk, and that attempts to eliminate risks may produce more undesirable results, including limiting investor returns, discouraging investment in potentially important businesses, shifting risks to less-transparent markets or instruments, and diluting the robust nature of our capital markets.

Finding the appropriate balance between risk and investor protection is not a perfect science and often lacks a clear path. Concerns about certain activities, products, and entities in light of the 2008 financial crisis makes finding this balance more difficult given the understandable tendency to implement new regulatory requirements to “get ahead” of the next crisis. In many instances, however, this focus may be misplaced, given the challenges to identify and prevent systemic risks ahead of time.

Finally, we recognize the difficulty in identifying “natural” risks inherent in investing as distinct from the types of risks that may lead to systemic contagion. The complexity of markets in terms of strategies and products complicates this identification process. Nevertheless, we think efforts to proscribe uniform policies and procedures for the widely diverse range of open-ended mutual funds (excluding money market funds) and ETFs may miss the mark.

Our concerns about this proposal, therefore, are two-fold, and do not focus on the investor protection goals of the Commission. Rather, they relate to the feasibility of certain aspects of the proposal and the consequences of casting the net too widely.

First, we are unsure that a systemic risk issue exists in regard to the vast majority of open-end funds. The regulatory requirements already in place under the Investment Company Act of 1940 provide a robust barrier against that kind of contagion. The total assets under management in this sector are so large that focus on this area is understandable. However, defining the shifting pockets of risk that may lead to systemic problems lacks precision to warrant the kind of regulation proposed here, as does defining liquidity, particularly given the fund practice of pricing at the end of the day rather than after each trade. Consequently, what may be appropriate or work for one fund at a particular point in time will not necessarily have relevance or protective value for all other funds or fund types at other times.

The non-money market funds industry has presented little evidence that liquidity practices pose the type of issues that promote systemic risk. The recent troubles related to the Focused Credit Fund of Third Avenue Management are a case in point. While the fund refused to meet redemption requests, the action did not produce follow-on reactions that threatened the financial system. According to Investment Company Institute statistics[3], cumulative high-yield fund redemptions during November and through 16 December amounted to 4.3% of their month-end October 2015 levels. ICI reported that while high, redemptions at this rate weren't unprecedented, pointing to June to August 2011 when they were 4.4%, and again to July/August 2014 when redemptions reached 4.6%. The point is that none of these instances led to disastrous market contagion, either.

Second, we believe that imposition of the proposed liquidity limits on funds may, in and of themselves, give investors a false sense of security that cash-like buffers will eliminate risk. In particular, it could encourage investors to forego the kind of due diligence needed to make informed-investment decisions.

In the past, we have strongly advocated for meaningful disclosure, a level-playing field for investors and fund issuers, and ethical practices in the investment management industry. At the same time, we understand that regulators cannot eliminate all risk without fundamentally changing the nature of capital markets. It is our view that investors should not be encouraged, implicitly or explicitly, to think otherwise, but instead should continue to weigh their investing decisions against their views about the risk of potential loss.

Third, we believe that many aspects of the proposed requirements are too specific and do not consider the changing nature of "asset buckets" or the role of funds' investment horizons. To that end, certain aspects of the proposal will not only require numerous additional compliance actions, but also increases the tendency of funds toward investment decisions that are similar to those of other funds, potentially making matters worse.

Based on these views, we encourage the Commission to consider a more principles-based approach and to offer guidance and options instead of the proposed precise requirements. We agree that maintaining adequate liquidity is an important consideration for funds. But mandating specific factors and limits that need to apply across the board to a diverse cross-section of funds may not be realistic or productive.

With these concerns noted, we turn our attention in the remainder of this letter to the specific provisions within the Proposals should the Commission decide to proceed as proposed.

---

[3] See: "High-Yield Bond Mutual Fund Flows: An Update," dated 23 December 2015, available at https://www.ici.org/viewpoints/view_15_hybf_flows_02

New Rule 22e-4—Liquidity Risk Management Program

Proposed new Rule 22e-4 would require all open-end funds (including open-end ETFs, but not money market funds) to establish written liquidity risk management programs in the belief that such programs will provide more effective risk management, help mitigate dilution of existing shareowners' shares and provide enhanced protections for investors. The proposed rule would define "liquidity risk" as the risk that a fund could not meet requests to redeem shares under normal conditions, or are reasonably foreseeable under stressed conditions, without materially affecting net asset value.

Liquidity management programs would have to include:

1. Classification of the liquidity of each fund position (or portion of position) in a portfolio asset, with ongoing review of the classification;
2. Assessment of a fund's liquidity risk, with ongoing periodic review; and
3. Management of liquidity risk, including the investing of a portion of the fund's net assets in assets it believes could be convertible into cash "within three business days at a price that does not materially affect the value of that asset immediately prior to sale."

Each fund's board of directors would be responsible for approving a program, material changes and the designation of the persons responsible for administering the program.

Classification (Categories)

Many funds today make liquidity determinations in accordance with whether an asset is liquid or illiquid, often referred to as a "binary" determination. The proposal would require funds instead to use a "spectrum" approach whereby they would classify the liquidity of each position in a portfolio asset (or a portion of a position) along a more-liquid to less-liquid line, and then review this classification on an ongoing basis.[4]

We agree that using a spectrum approach rather than a binary approach is more useful in assessing relative liquidity. While an asset may be illiquid, it could be highly illiquid e.g., over 100 days). By using the different time categories, the liquidity reality is more transparent.

We agree with the approach that staff has taken not to create rules specifying which asset classes fall into specific categories. Nevertheless, we believe the requirement that a fund classify each position into one of six "liquidity categories" is an overly-complicated system that seeks information on a too-granular level. Fund liquidity is highly dependent on the investment horizons stipulated in the funds' prospectuses, and won't always easily relate to the proposed six categories. Moreover, the fund industry embraces constantly changing holdings. Classification

[4] This "relative liquidity" determination would be in addition to the 15 percent rule, and would consider not only the liquidity of individual positions, but also of funds as a whole.

into these categories could only be accomplished at a point in time and would not necessarily be reflective of the overall composition of fund assets.

Classification (Factors)

In considering how to classify the liquidity of portfolio positions, the proposed rule sets out a list of factors that funds must consider, which includes:

- 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;
- 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);
- Volatility of trading prices for the asset;
- Bid-ask spreads for the asset;
- Whether the asset has a relatively standardized and simple structure;
- For fixed-income securities, maturity and date of issue;
- Restrictions on trading of the asset and limitations on transfer of the asset;
- The size of the fund's position in the asset relative to the asset's average daily trading volume and, as applicable, the number of units of the asset outstanding; and
- Relationship of the asset to another portfolio asset.

We urge reconsideration of this approach. Mandating a list of factors that funds must consider creates a potentially disruptive and time-consuming process that will produce few meaningful benefits.

Instead, we recommend that the Commission take a principles-based approach and provide this list as guidance for consideration. We also suggest that the final rule include additional guidance on the proposed factors to be considered. We believe that access to expanded discussions and analyses of the factors, the reasoning behind the use of the factors, and examples of how each factor may affect liquidity will be particularly helpful, especially in cases where funds must look to assets comparable to those they hold in order to classify their positions.

Under the proposal, a fund would have to conduct a review of the liquidity classifications for its asset holdings on an ongoing basis. This review would have to be of the position-level classifications that were made, not just on an overall liquidity basis. However, the proposed rule does not specify how that review must be conducted or dictate what developments a fund must monitor. We agree that funds should be allowed to exercise discretion to comply with the rule's requirements, and that specifying certain things that must be monitored invites a tendency to ignore other, but perhaps just as relevant, events.

Assessment

The SEC notes that a fund's ability to comprehensively assess and manage its liquidity risk is key to its ability to make timely redemptions. To that end, it has proposed that funds assess and periodically review their liquidity risks by (1) determining a minimum percentage of net assets that must be invested in three-day liquid assets; (2) prohibiting acquisition of less-liquid assets if doing so would mean that the minimum would not be met; and (3) prohibiting funds from acquiring a "15% standard asset" if doing so results in more than 15% of net assets being invested in that category.

While setting these parameters, the SEC notes that it intends this approach to be principles-based, so that funds have the flexibility to tailor their liquidity assessments and management. To conduct such assessments, the proposal notes a number of factors that funds must consider.

We support the principles-based approach proposed in this case and agree that the final rule provide that the fund *should* consider certain factors, rather than *must* consider them. With respect to the factors noted in the Release, we particularly agree that funds should consider use of derivatives when assessing liquidity risk, as we agree that certain uses, such as to obtain leverage or investment exposures may directly affect liquidity. As noted in the Release, we agree that funds should consider the extent and types of derivatives use, as well as the structure and terms of the transactions.

Consistent with our comment with respect to providing guidance relating to classification, we recommend that the final Rule note the guidance in the Adopting Release relating how a fund applies the required factors to its assessment of liquidity.

The proposed rule requires each fund to conduct periodic reviews of their liquidity risks, but also would allow them to develop their own policies and procedures for doing so. We agree that this is a reasonable approach.

Three-day liquidity minimum

Noting that federal securities laws do not currently require funds (other than money market funds) to maintain a specified level of portfolio liquidity, the proposed rule would change that by requiring funds to maintain a three-day liquid asset minimum. The SEC reasons that this requirement will mitigate the risk that funds could not meet their redemption requests on a timely basis.

As part of their responsibilities under the rule, funds would have to maintain written records of how they determined their three-day liquidity minimum, and their consideration of a number of factors. While funds would have to consider each factor, the SEC is leaving the setting of the actual liquidity minimum to the funds (although it advises that a zero minimum would not be appropriate). Funds could not, however, acquire less-liquid assets if such acquisitions would produce deficiencies in meeting their three-day minimums. We question the basis for using a three-day limit and whether it will create further dislocation.

We suggest that those funds that adhere to maximum permitted redemption periods be allowed to have a correspondingly longer minimum liquid asset periods. If the three-day minimum is adopted, funds that have demonstrated a history of investing in only three-day liquid assets should be excluded from the proposed three-day minimum liquidity requirements and thus not incur the costs of conducting such reviews. But we encourage the SEC not to overly prescribe the particulars of how funds should manage their liquidity risks.

Codification of SEC guidance (15 percent rule)

Longstanding guidance from the SEC generally has limited funds' holdings of illiquid securities to 15% of net assets. Under that approach, securities were considered "illiquid" if they could "not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the fund has valued the investment." While this guidance established a de facto standard, it was never codified nor were factors established to consider when making these determinations. As proposed, new rule 22e-4 would codify this approach and limit funds' ability to acquire "15% standard assets," defined as "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." We support this codification.

In-kind redemptions

Proposed rule 22e-4 would require funds that can make in-kind redemptions to adopt and implement written policies and procedures to address the processes and circumstances for those that reserve that right. We agree that such policies and procedures would be helpful as part of funds' efforts to manage their liquidity risks, and we therefore support this requirement.

We also urge the Commission to consider greater transparency about policies that should be adopted to address situations when funds suspend redemptions. We were reminded by the actions of Third Avenue that whether or not a fund has adopted "gating" procedures, it may face situations where that is the only viable option. Nevertheless, investors should be apprised of that possibility. We recommend that at a minimum funds be required to provide disclosures noting the possibility of suspending redemptions and how the fund will handle redemption requests in that situation.

Recordkeeping requirements

Funds would have to keep for five years the written records of the policies and procedures that they develop relating to their liquidity risk management programs, written reports provided to their boards, and records of their boards' initial approval of, and material changes to, the programs. We find this to be consistent with similar fund recordkeeping requirements that funds are currently required to maintain.

Amendments to Rule 22c-1—Swing Pricing

In deciding how to best address the dilution to existing shareowners stemming from costs related to purchase and redemption, the SEC has considered a number of options, including imposing purchase or redemption fees, and dual pricing. Instead, the SEC is proposing new rule 22c-1(a)(3) that would give mutual funds (excluding ETFs and money market funds) the option to use "swing pricing" in certain situations to mitigate dilution of existing shareowner value due to trading (purchase or redemption) activity.

As noted above, we recommend consideration of the use of gates and optional swing pricing rather than cash buffers to better ensure that funds meet their redemption requests in times of severe stress. With that in mind, we generally support giving funds the option to use swing pricing as a way to mitigate the dilution of share value for fund shareowners as a result of transaction costs related to purchases and redemptions. On its face, finding a method to more fairly assess the transactional costs of trading activity is an attractive goal. This also helps a fund more evenly balance and manage its liquidity needs by reducing the first-mover advantage in redemptions during stressed market conditions.

We believe that this option may have potential pitfalls. While swing pricing would benefit shareowners remaining in their funds, it could do so at the expense of purchasing or redeeming investors, who could see the per-share value of their shares disproportionately affected. While we believe swing pricing should be optional and not required, we recognize that investors unfamiliar with the pricing mechanism may be confused by the practice or fail to understand its practical effects on share values during trading activity. Operationally, we believe that implementing this may be challenging, although we do understand swing pricing is already used in a number of foreign jurisdiction. We understand that it is typically triggered when investors make large purchases or redemptions that may negatively affect liquidity in a fund's shares, though a large number of smaller transactions also may trigger swing pricing. Still, we understand that the pricing mechanism also affects small investors, nevertheless.

We understand that full swing pricing—allowing NAV adjustments anytime there are net purchases or redemptions—may increase volatility, tracking errors, and investor misperceptions about funds' performance that could lead to market distortions. Instead, we support the proposed partial swing pricing that would allow NAV adjustments only when net purchases or redemptions exceed an established threshold. We agree that this approach will result in lower volatility than full swing pricing, while still reducing dilution on assets. To that end, we do not support an option allowing funds to choose to use full swing pricing.

We also recognize that under a swing pricing approach, some shareowners may see the price of their shares affected disproportionately. For example, in cases where small investors redeem on days that net redemptions cross the swing threshold, they will receive lower redemption prices despite the fact that their holdings did not trigger the action. This causes us some concern as these shareowners are disadvantaged in an attempt to protect other shareowners who remain in the fund.

We agree that transparency and meaningful disclosure are vital to alerting shareowners to the possible scenarios and outcomes of swing pricing so that investors are aware of potential affects before investing in funds that apply such mechanisms. We also recommend that purchases and redemptions made “in kind” -- i.e., not in cash -- be excluded when calculating whether trading activity has crossed the swing threshold, given that these activities do not result in transaction costs in the same way as purchases and redemptions.

We agree that the scope of the proposed rule is appropriate in that it applies to open-end funds but not to money market funds or ETFs. We also generally support the proposed procedures by which a fund could opt to use swing pricing.

We also support the requirements that fund boards approve initial swing thresholds and any material changes to it, and that funds review their thresholds at least annually. We recommend, however, that the final rule prohibit funds from selectively disclosing thresholds to certain investors. While the proposal notes that the SEC believes this would not be appropriate, we encourage going one step further and prohibiting it, so as to prevent the gaming of timing of trading activity in which larger shareowners may attempt to take advantage of pricing adjustments (when the swing threshold is crossed).

We strongly support the requirement that funds' boards of directors, including a majority of their independent directors have a duty to approve initial swing policies and procedures. The boards also would be responsible for designating their funds’ advisers or officers to administer those policies and procedures and set the swing factors. We agree that requiring votes of independent directors is important because the use of swing pricing may produce conflicts for their advisers, and independent perspectives may more fully focus on shareowner interests. To that point, we also support requirements that setting the swing factors has to be independent of their funds’ portfolio management.

Amendments to Disclosure Requirements

Funds that elect to use swing pricing should provide investors and the marketplace with meaningful information, but we urge caution when adding new material to prospectuses. In particular, we recommend that the SEC provide guidance as to what clear and concise statements regarding swing pricing will suffice for prospectus disclosures, with a requirement to provide additional information in funds' statements of additional information. This will alert investors without substantially adding to the length of the prospectuses.

Changes to New Form N-PORT

We generally support the proposed added disclosure in Form N-PORT that would provide information on the liquidity of a fund’s portfolio. Specifically, we support the requirement that funds would have to report their three-day liquid asset minimums and liquidity classifications for each portfolio asset they hold. We prefer a requirement that it be reported to the SEC only and not publicly (i.e., reported in a structured data format). If the final rule requires public reporting of this information, we recommend allowing funds to provide explanatory information in the notes section clarifying the underlying assumptions relating to the liquidity assumptions.

Changes to New Form N-CEN

As proposed, funds would have to provide additional information in Form N-CEN relating to their use of lines of credit, swing pricing, and inter fund lending and borrowing. In particular, the SEC seeks to gain more information about funds' use of credit lines, the amounts and time periods of borrowings and other activities that may affect its ability to meet redemption requests. We generally support these proposed requirements.

Conclusion

We urge caution in mandating many of the specific proposed requirements for assessing fund liquidity and instead recommend a more principles-based approach, accompanied by detailed guidance. We do support providing funds the option of using swing pricing to diminish the dilutive effect on shareholder value due to trading activity by other shareholders. Should you have any questions about our positions, please do not hesitate to contact Kurt N. Schacht, CFA at kurt.schacht@cfainstitute.org, 212.756.7728 or Linda Rittenhouse at linda.rittenhouse@cfainstitute.org, 434.951.5333.

Sincerely,

/s/ Kurt N. Schacht

Kurt N. Schacht, CFA
Managing Director, Standards and Advocacy
CFA Institute

/s/ Linda L. Rittenhouse

Linda L. Rittenhouse
Director, Capital Markets Policy
CFA Institute