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January 13, 2016

VIA ELECTRONIC DELIVERY

Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Investment Company Act Release No. 31835 (File No. S7-16-15) Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release

Dear Mr. Fields,

We appreciate the opportunity to respond to the request by the U.S. Securities and Exchange Commission ("***SEC***" or "***Commission***") for comments regarding the above-referenced release (the "***Proposing Release***").[1] The Proposing Release proposes a new rule as well as amendments to existing rules and forms to promote stronger and more effective liquidity risk management across registered open-end investment companies.[2] The intent of this rulemaking initiative is to reduce the risk that a fund will be unable to meet shareholder redemption obligations and minimize the dilutive impact of shareholder purchase and redemption transactions. The Proposing Release contains three key components: (i) proposed Rule 22e-4 under the Investment Company Act of 1940 (the "***1940 Act***"), which would require funds to adopt written liquidity risk management programs; (ii) proposed amendments to Rule 22c-1 under the 1940 Act, which would permit funds, other than ETFs, to utilize "swing pricing" under certain circumstances; and (iii) proposed disclosure- and reporting-related amendments to Form N-1A, Regulation S-X, proposed Form N-PORT and proposed Form N-CEN to provide greater transparency with respect to funds' liquidity risks and risk management.

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[1] *See* Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, 80 Fed. Reg. 62273 (October 15, 2015).

[2] Unless the context indicates otherwise, the term "***funds***" refers to registered mutual funds and open-end exchange-traded funds ("***ETFs***"), other than money market funds ("***Money Funds***").

Dechert LLP is an international law firm with a wide-ranging financial services practice that serves clients in the United States and abroad. In the United States, we represent a substantial number of U.S. mutual fund complexes, closed-end funds, ETFs, fund boards, fund independent directors, fund advisers and fund service providers. In developing these comments, we have drawn on our extensive experience in the financial services industry generally. Although we have discussed certain matters addressed in the Proposing Release with some of our clients, the comments that follow reflect only the views of a group of attorneys in our financial services practice, and do not necessarily reflect the views of our clients, other members of our financial services group or the firm generally.

We acknowledge the obvious care and thoughtfulness that the Commission put into the preparation of the Proposing Release and appreciate the opportunity to offer comments. As the primary regulator of the fund industry, we believe the SEC is uniquely positioned and most qualified to address liquidity risk management.

We agree with the SEC that "[a] hallmark of open-end funds is that they must be able to convert some portion of their portfolio holdings into cash on a frequent basis because they issue redeemable securities,"[3] and, therefore, we support the Commission's goal of promoting effective liquidity risk management throughout the fund industry. Although funds have been highly successful in meeting shareholder redemption obligations on a timely basis since the passage of the 1940 Act, we support the SEC's proposal to require funds to adopt a formal, written liquidity risk management program. However, we believe that a principles-based approach to liquidity risk management would be more effective and less costly than the prescriptive, "one-size-fits-all" approach of proposed Rule 22e-4. We also believe that a principles-based approach would be better able to achieve the Commission's objectives.

I. PROPOSED RULE 22e-4 AND LIQUIDITY RISK MANAGEMENT PROGRAMS

A. A Principles-Based Approach To Liquidity Risk Management Would Be More Effective and Less Costly Than The Prescriptive, "One-Size-Fits-All" Approach Of Proposed Rule 22e-4

Proposed Rule 22e-4 would require each fund to adopt and implement a written liquidity risk management program. Under proposed Rule 22e-4, each fund's program would be required to provide for the:

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[3] Proposing Release at 62277.

(i) classification and ongoing review of the liquidity of the fund's portfolio positions (or portions thereof) into one of six liquidity categories based on nine mandatory factors (the "***Liquidity Classification Factors***");

(ii) assessment and periodic review of the fund's liquidity risk based on numerous mandatory factors (the "***Liquidity Risk Assessment Factors***"); and

(iii) management of the fund's liquidity risk, including the requirement to determine the fund's "three-day liquid asset minimum" (the "***TDLA Minimum***") (*i.e.,* the minimum percentage of a fund's net assets that must be invested in cash and securities that are believed to 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" ("***TDLAs***")).

Although we support the adoption of liquidity risk management programs, we believe that proposed Rule 22e-4 would impose a prescriptive, rigid approach to liquidity risk management that would not adequately differentiate among the spectrum of funds that currently operate. For reasons discussed below, we believe that this "one-size-fits-all" approach is impractical, expensive and unsuitable for many funds, and that a more flexible, principles-based approach would be more effective, less costly and better able to achieve the Commission's objectives.

Under current Commission guidelines, funds are prohibited from investing more than 15% of their net assets in "illiquid" securities.[4] For these purposes, a security is considered "illiquid" if it cannot 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. In addition to this binary formulation that a security is either "liquid" or "illiquid," funds currently employ a variety of liquidity risk management practices and determine the desired level of liquidity in their portfolios based on, among other factors: (i) a fund's investment objective and strategies, including the asset classes in which it primarily invests; (ii) the composition of a fund's shareholder base; (iii) a fund's then-current portfolio holdings; (iv) a fund's historical shareholder inflows and outflows; (v) any fund commitment to pay redemption proceeds within a shorter period of time than the statutorily prescribed limit of seven calendar days;[5] and (vi) current and foreseeable market

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4 *See* Revisions of Guidelines to Form N-1A, 57 Fed. Reg. 9828 (Mar. 20, 1992). We support the Commission's proposed codification of this limit in proposed Rule 22e-4(b)(2)(iv)(D). However, we note that proposed Rule 22e-4 refers to "total" assets rather than "net" assets. We believe this should be corrected in any final rule.

5 Under Section 22(e) of the 1940 Act, registered investment companies generally may not suspend the right of redemption or postpone the date of payment upon redemption of any redeemable security for more than seven calendar days after the tender of that security, except under very limited circumstances.

conditions. This process typically involves key personnel from several areas, including: (i) portfolio management personnel and traders; (ii) risk management personnel; (iii) compliance and legal personnel; (iv) product management personnel; and (v) senior management. A fund's board of directors or trustees (a "***board***") may also regularly receive reports on fund liquidity and provide independent oversight of these processes and determinations.

We are concerned that proposed Rule 22e-4 fails to take into account the dynamic, flexible liquidity risk management programs that have been adopted by many fund complexes. Indeed, in the Proposing Release, the Commission acknowledged that "some funds and their managers have developed comprehensive liquidity risk management programs."[6] The proposal would impose significant costs, particularly in connection with classifying and reviewing the liquidity of a fund's portfolio positions (or portions thereof) into one of six liquidity categories based on the Liquidity Classification Factors, on fund complexes that have already adopted comprehensive liquidity risk management programs. We believe this is unnecessary.

We are also concerned that proposed Rule 22e-4 does not address the variances in investment objectives and strategies among funds, for many of which the rigid approach that would be imposed by the proposed rule, particularly the TDLA Minimum, would be impractical and unsuitable. For example, the proposed approach would generally be unsuitable for funds primarily invested in publicly-traded, large-capitalization equity securities for which, by definition, there are active, liquid markets. The TDLA Minimum for these funds would have little or no relevance because these securities generally settle in three days or less. Accordingly, the process that would be required to establish the TDLA Minimum for these funds (*e.g.,* initial approval, periodic review, etc.) would do little to enhance the ability of a fund to meet shareholder redemptions and would be a meaningless exercise and waste of resources. As the impetus of proposed Rule 22e-4 is, in part, related to the emergence of less liquid asset classes and alternative strategies,[7] we urge the Commission to revise the "one-size-fits-all" approach of the proposed rule and replace it with a more flexible, principles-based approach that appreciates the varying characteristics of funds.

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6 Proposing Release at 62275. However, the SEC also noted that "others have dedicated significantly fewer resources to managing liquidity risk in a formalized way." *Id.*

7 *See id.* at 62275 ("The U.S. fund industry has experienced significant growth in the last 20 years, markets have grown more complex, and funds pursue more complex investment strategies, including fixed income and alternative investment strategies that are focused on less liquid asset classes. Yet, it has been over twenty years since we have provided guidance regarding the liquidity of open-end funds other than money market funds.") (internal citations omitted).

As an alternative to the prescriptive, rigid approach of proposed Rule 22e-4, we recommend that the Commission adopt a principles-based approach, that would require, for example, funds to adopt and implement written policies and procedures that are reasonably designed to maintain sufficient portfolio liquidity to meet reasonably foreseeable shareholder redemptions in light of the fund's obligations under Section 22(e) of the 1940 Act and any other commitments the fund has made to shareholders.[8] As part of these policies and procedures, funds could establish liquidity "targets" or "ranges" and any deviation from these targets or ranges could be reported periodically to a fund's board. Funds could also periodically stress test their portfolios to reasonably ensure that they will be able to maintain sufficient portfolio liquidity to meet reasonably foreseeable redemption requests.[9] We also believe that the Commission could issue formal conceptual guidance that could assist funds in managing liquidity risk. In providing this guidance, the Commission could share any staff observations that occurred during its outreach with fund complexes to better understand funds' management of liquidity risk. For example, the SEC could publish board and fund practices that are believed to be "best practices" by the staff when considering liquidity risks.

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8 We note that other jurisdictions have adopted a principles-based approach to liquidity risk management. For example, liquidity is a key requirement of a UCITS, a European scheme equivalent to a mutual fund, which is authorized as an undertaking for the collective investment in transferable securities ("***UCITS***") and sold publicly in Europe. At a high level, a UCITS is obliged to repurchase or redeem its units at the request of any unit-holder (with exceptions) and to trade at least twice a month (unless otherwise permitted). In order to manage liquidity risk (*i.e.,* the risk that a position in the UCITS portfolio cannot be sold, liquidated or closed at limited cost in an adequately short time frame thus compromising the ability of the UCITS to comply with the requirement to redeem its units at the request of a unit-holder at any time), a UCITS must establish an adequate liquidity risk management system (as part of the general risk management framework which UCITS are required to establish, document, implement and maintain) to ensure that the UCITS can comply at any time with the general obligation to have sufficient liquid assets to meet potential redemptions. A UCITS must ensure that the liquidity profile of each investment is appropriate to its redemption policy. Where appropriate, a UCITS must conduct stress tests which enable assessment of the liquidity risk of a UCITS under exceptional circumstances. *See also* Comment Letter of Investment Company Institute (January 13, 2016) (providing a summary of certain liquidity risk management requirements for funds domiciled in non-U.S. jurisdictions).

9 We understand that many fund complexes already employ stress testing as part of their liquidity risk management programs. We note that Chair Mary Jo White has stated that the Commission staff is "considering ways to implement the new requirements for annual stress testing by large investment advisers and large funds, as required by the Dodd-Frank Act." *See* Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, Chair Mary Jo White, Securities and Exchange Commission (Dec. 11, 2014).

This principles-based approach would be similar to the general liquidity requirement under Rule 2a-7 under the 1940 Act, which requires Money Funds to "hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions in light of the fund's obligations under section 22(e) of the [1940] Act and any commitments . . . made to shareholders."[10] In adopting this general liquidity requirement for Money Funds, the Commission recognized that "[f]unds will have different liquidity needs that [the SEC] cannot sufficiently anticipate and codify in a rule beyond the minimums" under Rule 2a-7, and that "it is incumbent upon the management of each fund and its board of directors to evaluate the fund's liquidity needs and to protect the fund and its shareholders from the harm that can occur from failure to properly anticipate and provide for those needs."[11] We emphatically agree. The Commission also enumerated a variety of factors that funds and their managers should consider when assessing liquidity needs, including: (i) the composition of a fund's shareholder base; and (ii) a fund's historical shareholder inflows and outflows.[12] We believe the SEC should follow a similar approach to address liquidity risk management for non-Money Funds.

We also recommend that the Commission utilize the procedural framework of Rule 38a-1 under the 1940 Act for requiring a fund to adopt and implement any liquidity risk management policies and procedures. In adopting Rule 38a-1 under the 1940 Act, the Commission noted that the rule "provides fund complexes with flexibility so that each complex may apply the rule in a manner best suited to its organization."[13] The SEC's rationale for providing this flexible framework is based, in part, on the recognition that there are fundamental differences among funds, and a "one-size-fits-all" approach is a poor substitute for a tailored compliance program that requires approval by, and reporting to, the fund's "independent watchdogs" – that is, its board. We believe that the purposes of Rule 38a-1 are analogous to the policy objectives of proposed Rule 22e-4, such that a similar principles-based approach should be adopted in place of proposed Rule 22e-4.

The flexibility of a principles-based approach to liquidity risk management would be efficient from a cost perspective and would allow each fund to balance its anticipated liquidity needs with the fund's own investment objective and strategies and other fund characteristics, including the

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[10] Rule 2a-7(d)(4). Because Money Funds are typically used as short-term investment vehicles, Money Funds are also subject to additional liquidity requirements, including minimum daily and weekly liquidity requirements. *See* Rule 2a-7(d)(4)(i) – (iii).

[11] Money Market Fund Reform, 75 Fed. Reg. 10060, 10075 (Mar. 4, 2010).

[12] *See id.*

[13] *See* Compliance Programs of Investment Companies and Investment Advisers, 68 Fed. Reg. 74714, 74717 (Dec. 24, 2003) (internal citations omitted).

composition of its shareholder base. Historically, funds have been highly successful in meeting shareholder redemption obligations. We believe this success is largely attributable to the current liquidity risk management programs established by funds as well as the effective oversight provided by fund boards. We also believe that this success is attributable to the SEC and its staff, which has provided effective oversight of the fund industry and developed and enforced an effective regulatory regime (*e.g.,* the 15% limit in "illiquid" securities) that has permitted funds to flourish for over 75 years. Indeed, suspensions of the right of redemption are exceptional and uncommon, as recently noted by the Commission in the Proposing Release.[14] Nonetheless, a very small number of funds have, over this 75-year period, requested permission to suspend the right of redemption, including very recently.[15] To allow the fund industry to continue to manage liquidity in an effective and appropriate fashion, we strongly support the Commission's proposal to require funds to adopt a formal, written liquidity risk management program. However, while we believe that regulation is appropriate to ensure that all funds have comprehensive programs in place to address liquidity risks, the rigid approach that would be imposed by proposed Rule 22e-4 is unnecessary in light of the historical ability of funds to meet shareholder redemption obligations on a timely basis as well as inappropriate from a cost perspective.

B. The Six Liquidity Categories Would Impose Significant Costs And Operational Burdens Without A Clear Benefit; Public Disclosure Of Liquidity Classifications Would Be Misleading And Potentially Harmful

Proposed Rule 22e-4 would require each fund to classify each of the fund's portfolio positions or portions of a position into one of six liquidity categories.[16] Under the proposal, the fund would also be required to engage in an ongoing review of each such classification. The liquidity categories would describe the number of days in which the fund's position (or portion thereof) would be convertible to cash at a price that does not materially affect the value of the asset immediately prior to sale.[17] The determination to place an asset in a particular liquidity category

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14 *See* Proposing Release at n. 82 ("The Commission has rarely issued orders permitting the suspension of redemptions for periods of restricted trading or emergency circumstances but has done so on a few occasions.").

15 *See* Third Avenue Trust, et al., 80 Fed. Reg. 79638 (Dec. 22, 2015).

16 Specifically, positions would be categorized as "convertible to cash" within 1 business day, 2-3 business days, 4-7 calendar days, 8-15 calendar days, 16-30 calendar days or more than 30 calendar days. The phrase "convertible to cash" is defined as "the ability to be sold, with the sale settled." *See* proposed Rule 22e-4(a)(3).

17 Under the proposal, a position (or portion thereof) would be convertible to cash "at a price that does not materially affect the value of that asset immediately prior to sale" if the price the fund

would be made "using information obtained after reasonable inquiry" and would have to take into account, to the extent applicable, the Liquidity Classification Factors.[18]

Proposed Rule 22e-4 would also require a fund to review the liquidity classification of each of the fund's portfolio positions (and portions thereof) on an ongoing basis using the Liquidity Classification Factors (and to revise such liquidity classifications as appropriate). The Proposing Release also notes that a fund should have policies and procedures intended to identify market developments and security- and asset-class-specific developments that could impact the liquidity classification of a portfolio position. The Proposing Release notes that the frequency of a fund's ongoing review may be determined based, in part, on the liquidity of its portfolio holdings and the timing of portfolio acquisitions and turnover. In this regard, the Proposing Release notes that daily – *or even hourly* – review of liquidity classifications may be appropriate in some circumstances, such as where portfolio liquidity may depend significantly on current market conditions.[19]

We strongly oppose the proposed classification system for the following reasons: (i) it would impose significant costs and operational burdens – without a clear benefit – on funds; (ii) it could create an environment in which undue reliance is placed on third-party vendors; (iii) liquidity determinations may be speculative, subjective and not easily reduced to the level of granularity required under proposed Rule 22e-4 (*e.g.,* 2-3 business days versus 4-7 calendar days); and (iv) public disclosure of liquidity classifications would not necessarily facilitate comparisons among funds and could be potentially misleading to shareholders.

Industry participants have expressed significant concern for the estimated costs and operational requirements that would be necessary to classify a fund's portfolio positions using the level of

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would receive is not reasonably expected to move the price of the asset in the market, independent of other market forces. The Proposing Release notes that this requirement is not meant to imply that funds are required to determine the current market price or fair value of an asset "immediately prior to sale." *See* Proposing Release at 62292.

[18] Although the Proposing Release does not explain or expand upon the "reasonable inquiry" requirement, the Commission notes that an SEC staff examination of a fund's liquidity classifications (which may be triggered by "outlier classifications" reported on Form N-PORT, for example) would permit examination of "whether the fund considered the [Liquidity Classification Factors]" when determining liquidity classifications. *See* Proposing Release at 62294.

[19] At a minimum, monthly review of liquidity classifications would be required in order to ensure the accuracy of information reported on proposed Form N-PORT.

granularity required under proposed Rule 22e-4.[20] These concerns are heightened for larger fund complexes that invest in tens of thousands of securities across hundreds of funds, each of which may have varying levels of assets invested in a particular position, which would require separate determinations (and in some cases, hourly determinations). These concerns are also heightened for smaller fund complexes that do not have the significant resources that would be necessary to develop and implement an infrastructure to comply with these classification requirements. The amount of labor required to comply with this continuous categorization process could be enormous and should not be underestimated. Furthermore, the undue emphasis placed on these categorizations may actually be counterproductive for funds trying to manage their liquidity risks during a time of crisis. At a time of stressed liquidity conditions, liquidity risk management personnel may find themselves devoting an inordinate amount of time and effort to determining the category in which individual securities (or portions thereof) belong, rather than focusing on the more important overall liquidity risk management needs of the fund.

These concerns would likely cause many fund complexes to employ third-party vendors to assist with these classification requirements. This could create an environment in which undue reliance is placed on these vendors. We recommend caution in proceeding with any rule that would essentially force funds to employ third-party vendors to alleviate the operational burdens and other requirements of a rule, particularly where such vendors have no history of providing these services on the scale the proposed rule contemplates.[21]

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[20] *See, e.g.,* Comment Letter of Vanguard (January 7, 2016) ("We are concerned that the Proposed Classification Framework would materially increase the cost of a fund's compliance without providing a corresponding benefit in terms of materially enhancing a fund's liquidity risk management practices or strengthening the Commission's oversight capabilities. Because shareholders would ultimately bear the burden of these increased costs without any commensurate benefit, we strongly urge the Commission to reconsider this proposal.").

[21] In fact, the SEC recently approved amendments to Rule 2a-7 that removed references to credit ratings in Rule 2a-7 under 1940 Act. *See* Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in Money Market Fund Rule, 80 Fed. Reg. 58123 (Sep. 25, 2015). These amendments, which generally removed references to credit ratings by nationally recognized statistical rating organizations, implemented certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). Section 939A of the Dodd-Frank Act required federal agencies, including the SEC, to "review any regulation issued by such agency that requires the use of an assessment of the credit-worthiness of a security or money market instrument and any references to or requirements in such regulations regarding credit ratings." This section also required federal agencies to replace any references to credit ratings with other appropriate standards of credit-worthiness. Some believe that overreliance on credit ratings from nationally recognized statistical rating organizations was a cause of the recent financial crises. *See, e.g.,* Statement on Adoption of Amendments to Remove

Liquidity determinations under proposed Rule 22e-4 would also be speculative and subjective to a large degree, particularly if some funds were to give greater weight to particular Liquidity Classification Factors. Moreover, these determinations would be based on an assessment of the ability to convert to cash "at a price that does not materially affect the value of that asset immediately prior to sale" – a virtually unknowable standard for certain asset classes. Funds would have to make hundreds or thousands of these determinations on a periodic basis, including, under certain circumstances, an hourly basis. Making these determinations with precision, particularly for securities that trade over-the-counter, would be extremely difficult and could lead to: (i) funds investing in securities that are deemed to be more liquid to avoid these difficulties;[22] or (ii) funds assigning a liquidity classification consistent with that assigned by peer funds, thereby creating a "herd mentality," to avoid second guessing by the Commission or its staff.

Lastly, we are concerned that the public disclosure of liquidity classifications on proposed Form N-PORT, which would be available for the third month of a fund's fiscal quarter (subject to a 60-day delay), could mislead shareholders and, for reasons discussed above, create a false illusion of comparability among funds. The proposed liquidity determinations would be simply too speculative and subjective to provide a real "apples-to-apples" comparison. Although additional reporting requirements on fund liquidity could enhance the SEC's risk-based examinations and other risk assessment and monitoring activities, we believe that causing this information to become publicly available would be "neither necessary nor appropriate in the public interest or for the protection of investors."[23] We also believe that there is no significant public interest in this information. Moreover, it is possible that opportunistic investors could use this information to the detriment of the reporting funds. For these reasons, we believe that this information, if required to be filed with the SEC, should not be made publicly available.

As an alternative to classifying the liquidity of a fund's portfolio on a security-by-security basis, the Commission could instead require funds to monitor and report liquidity at the *portfolio* level.

References to Credit Ratings in Money Market Fund Rule 2a-7 and Form N-MFP, Commissioner Daniel M. Gallagher, Securities and Exchange Commission (Sept. 16, 2015) ("Since the passage of Dodd-Frank, I have been a strong proponent for Commission action to satisfy this mandate given that Section 939A is one of the very few provisions of the statute that directly addresses a cause of the financial crisis.").

22 This, in turn, could lead to a reduction in the types of funds currently offered to the public, which, in turn, could lead to more homogenous portfolio holdings and increased correlation among funds offering similar strategies.

23 Section 45(a) of the 1940 Act (requiring information filed with the Commission to be made available to the public, unless the Commission "finds that public disclosure is neither necessary nor appropriate in the public interest or for the protection of investors").

The SEC adopted this approach in Form PF for private funds.[24] We also note that Form PF is not publicly available. The SEC recognized that the "public disclosure of [non-public information about private funds and their trading strategies] could adversely affect the funds and their investors."[25]

C. The TDLA Minimum Is Impractical And Unsuitable For Many Funds

The proposal would require each fund to assess, and periodically review,[26] its "liquidity risk," taking into account the Liquidity Risk Assessment Factors.[27] "Liquidity risk" would be defined as "the risk that the fund could not meet requests to redeem shares issued by the fund that are expected under normal conditions, or are reasonably foreseeable under stressed conditions, without materially affecting the fund's net asset value."

Based on a fund's assessment of its liquidity risk, the proposal would require each fund to determine a TDLA Minimum, taking into account the Liquidity Risk Assessment Factors. Proposed Rule 22e-4 would require that: (i) a written record of this determination be maintained; (ii) the fund's board approve both the TDLA Minimum and *any* changes (material or otherwise) to the TDLA Minimum; (iii) the fund periodically reviews, no less frequently than semi-annually, the adequacy of the TDLA Minimum; and (iv) the TDLA Minimum be publicly disclosed on proposed Form N-PORT (if adopted). In addition, under proposed Rule 22e-4, a fund would be prohibited from acquiring any "***less liquid asset***"[28] if, immediately after the acquisition, the fund would have invested less than its TDLA Minimum in TDLAs. According to the Commission, the

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24 *See* Item 32 of Form PF (requiring registered investment advisers to classify private fund liquidity "based on the shortest period during which [the adviser] believe[s] that such position could reasonably be liquidated at or near its carrying value," using "good faith estimates for liquidity based on market conditions . . . and assuming no fire-sale discounting.").

25 Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. 71127, 71155 (Nov. 16, 2011).

26 The Commission did not propose specific review procedures, timing or events that must be considered in a fund's periodic review of liquidity risk. However, the Proposing Release notes that a fund may wish to include procedures for evaluating regulatory, market and fund-specific developments in its periodic review procedures.

27 Proposed Rule 22e-4 appears to require a fund to consider each Liquidity Risk Assessment Factor, without regard to whether a specific factor is relevant to the fund. If the Commission decides to proceed with this aspect of the proposal, we recommend revising the rule to require only that a fund consider, *to the extent applicable*, each Liquidity Risk Assessment Factor, similar to the approach under proposed Rule 22e-4 with respect to the Liquidity Classification Factors.

28 A less liquid asset is an asset that is not a TDLA.

"primary goal of 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."[29]

First and foremost, we oppose the TDLA Minimum requirement because it relies on the same speculative and subjective classification system discussed above. We also believe that this requirement: (i) is arbitrarily based on the three-day settlement period required under Rule 15c6-1 under the Securities Exchange Act of 1934 (the "***Exchange Act***"), a requirement completely divorced from a fund's obligations to satisfy shareholder redemptions within seven calendar days under Section 22(e) under the 1940 Act or a fund's commitment to satisfy shareholder redemptions within three days;[30] (ii) is unsuitable for funds that primarily invest in liquid asset classes;[31] (iii) is unnecessarily prescriptive in light of the historical ability of funds

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[29] Proposing Release at 62312.

[30] *See also* Statement on Open-End Fund Liquidity Risk Management Programs and Swing Pricing, Commissioner Daniel M. Gallagher, Securities and Exchange Commission (Sept. 22, 2015) ("The theory behind the 'three-day bucket' is that most funds as a practical matter must meet redemptions within three business days as a result of Rule 15c6-1 under the Exchange Act. . . . However, there appears to be a potentially sizable portion of the industry that is not restricted by Rule 15c6-1, and therefore, would only be required to pay redemptions within seven days. I am uncomfortable with the 'one-size-fits-all' three-day approach. On the flip side, there are funds that endeavor to pay redemption proceeds within a period of less than three days. In each of those cases, the 'three day bucket' has limited relevance. . . . I encourage commenters to weigh in on this requirement."); Statement at Open Meeting on Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, Commissioner Michael S. Piwowar, Securities and Exchange Commission (Sept. 22, 2015) ("I support publishing today's proposal for public comment, but I am concerned about the rule's three-day liquid asset minimum requirement. While in practice many funds may make payment to shareholders for securities tendered for redemption in less than seven days, section 22(e) of the [1940] Act only requires that the fund make payment within seven days of the securities being tendered. I would prefer that the rule track the statute and require a seven-day liquid asset minimum rather than the proposed three-day liquid asset minimum. I hope that commenters will provide feedback on this issue."). We also note that the three day settlement standard is under review and subject to change. *See* Joe Morris, SEC Signs On to T+2, *Ignites* (Sept. 17, 2015) ("The Securities and Exchange Commission is officially embracing the industry initiative to shorten the settlement times for stock and bonds trades to two days after trade date.").

[31] *See* Statement on Open-End Fund Liquidity Risk Management Programs and Swing Pricing, Commissioner Daniel M. Gallagher, Securities and Exchange Commission (Sept. 22, 2015) ("Furthermore, for funds that invest solely in assets that can be settled in three days or less – for example, a fund that limits its investments to equity securities of S&P 500 companies – the "three-day bucket" has no functional value. Requiring such a fund to set its three-day bucket – whether it

to meet shareholder redemption obligations; and (iv) could unnecessarily curb product innovation.[32] Instead, and as more fully discussed above, we recommend that the Commission adopt a more flexible principles-based approach, that would require, for example, funds to adopt and implement written policies and procedures reasonably designed to maintain sufficient portfolio liquidity to meet reasonably foreseeable shareholder redemptions in light of a fund's obligations under Section 22(e) of the 1940 Act and any commitments the fund has made to shareholders.

D. The TDLA Minimum Does Not Properly Take Into Account The Unique Structural Aspects Of ETFs

We also believe that the TDLA Minimum requirement does not properly take into account the unique structural aspects of ETFs and is unnecessarily prescriptive. Since only authorized participants ("***APs***") may redeem shares directly from an ETF, the vast majority of ETF shareholders liquidate their positions through the sale of their shares in secondary market transactions. Therefore, even if one were to concede the necessity for a TDLA Minimum for funds to insure the funds' ability to satisfy redemption requests, we see no basis to reach a similar conclusion for ETFs. This is particularly true with respect to ETFs that redeem in kind. An ETF that effects redemptions in kind could satisfy every redemption request it receives without holding a single portfolio position that can be converted to cash in three or fewer days: the ability to convert portfolio positions into cash is simply irrelevant to such an ETF's ability to meet redemption requests. While we recognize the Commission's concerns about the potential impact on the behavior of an ETF's APs and the bid-ask spread of the ETF's shares from an ETF's potentially illiquid positions,[33] those concerns do not relate directly to the ability of an ETF to

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be at 1%, or 20% or even 90% – would be a meaningless exercise given that the entire portfolio would be comprised of assets settled in three days or less.").

32 For example, the public disclosure of a fund's TDLA Minimum could cause the fund to invest in securities that are deemed to be more liquid to avoid being an outlier among funds that operate with a similar strategy. However, the Commission has long recognized that the 1940 Act is designed to protect investors as well as to allow for "innovation and diversification" in the fund industry. *See, e.g.*, Opening Remarks at the 75th Anniversary of the Investment Company Act and Investment Advisers Act, "The Investment Company Act and Investment Advisers Act Standing the Test of Time," Chair Mary Jo White, Securities and Exchange Commission (Sept. 29, 2015) ("Between 1938 and 1940, Commission staff led by Commissioner Healy produced reports to Congress on the industry. Ultimately, the Commission recommended legislation designed to address the specific abuses that had been identified, to restore investor confidence through certain protections *and to allow for innovation and diversity in the industry*.") (emphasis added) (internal citations omitted).

33 *See* Proposing Release at n. 23-25 and accompanying text.

satisfy redemption requests, which is the underlying purpose of the liquidity risk management program proposal.

Moreover, the discussion in the Proposing Release regarding the TDLA Minimum requirement does not take into account the potential negative effects on ETFs from such a requirement. A number of indexes tracked by ETFs may include a significant number of securities that, although liquid, cannot be converted to cash in three or fewer days (in particular, certain fixed income and non-U.S. indexes).[34] ETFs that track such indices, in order to satisfy the TDLA Minimum, would need to maintain cash (and/or other TDLAs) that could not be invested in index components, leading to "tracking error" (the difference between the performance of the ETF and that of its benchmark index) which could be substantial.[35]

Furthermore, as noted in the Proposing Release, the Commission has granted exemptive relief from Section 22(e) of the 1940 Act to ETFs, allowing ETFs which effect redemptions in kind to pay redemption proceeds later than seven days if necessary due to market holidays and/or delayed settlement periods outside the United States. If adopted as proposed, Rule 22e-4 could effectively undercut the exemptive relief from Section 22(e) granted to ETFs by forcing ETFs to keep a portion of their assets in positions which can be converted to cash in three or fewer days, despite the Commission recognizing (by granting the exemptive relief) that the seven-day requirement under Section 22(e) is not indispensable for ETFs which effect redemptions in kind and hold foreign securities which cannot be transferred in kind within seven days. We therefore answer in the affirmative the Commission's question in the Proposing Release about whether the requirements of proposed Rule 22e-4 should be modified on account of the ETFs' exemptive relief from Section 22(e).

E. The Role Of A Fund's Board In Liquidity Risk Management

Under proposed Rule 22e-4, a fund's board would be required to: (i) initially approve a fund's liquidity risk management program, including the TDLA Minimum;[36] (ii) approve any material

[34] *See* Proposing Release at n. 123 and 197 and accompanying text.

[35] The Proposing Release notes that the liquidity of an ETF's portfolio holdings may impact the effectiveness of the ETF's arbitrage mechanism and the ETF shares trading at a price that is at or close to the net asset value ("***NAV***") of the ETF. However, those factors also may be affected by an ETF's structural tracking error.

[36] Fund directors may satisfy their obligations regarding this initial approval by reviewing summaries of the fund's liquidity risk management program that provide information on the program's most important features and an understanding of how the program addresses the proposal's required liquidity risk assessment and of the determination of the TDLA Minimum. *See* Proposing Release at 62323-62325.

changes to a fund's liquidity risk management program, including *any* changes (material or otherwise) to the TDLA Minimum; (iii) review no less frequently than annually a written report from the Program Administrator (defined below) that reviews the adequacy and effectiveness of implementation of a fund's liquidity risk management program, including the TDLA Minimum; and (iv) approve the entity or person(s) designated by the fund as responsible for administering a fund's liquidity risk management program (the "***Program Administrator***").[37]

A fund's board plays a very important role in the fund industry and serves as an "independent check" on the fund's investment adviser.[38] However, we are concerned with the level of involvement assigned to a fund's board in certain areas, including the requirement that the board approve a fund's TDLA Minimum as well as *any* changes (material or otherwise) to the fund's TDLA Minimum. As the Commission recognizes, the amount of liquid assets that a fund maintains to satisfy foreseeable shareholder redemptions could fluctuate based on a variety of factors. To require board approval of a fund's TDLA Minimum, as well as the prior board approval of any changes to the fund's TDLA Minimum, would usurp the role typically assigned to a fund's investment adviser to manage the day-to-day operations of the fund. Moreover, the determination about a particular fund's TDLA Minimum would be a highly technical analysis that requires an intimate familiarity with the fund's investment strategies, shareholder base, then-current portfolio holdings and current and foreseeable market conditions, and this level of inquiry and expertise necessary to make these determinations would arguably take fund boards beyond an oversight role into one that concerns the day-to-day management of the fund. Accordingly, the board's role under proposed Rule 22e-4 should be limited to providing appropriate *oversight*, and not cross the line into *management* of the fund, consistent with Commission views. According to the Division of Investment Management:

> Rules that impose specific duties and responsibilities on the independent directors should not require them to "micro-manage" operational matters. To the extent possible, operational matters that do not present a conflict between

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[37] *See* proposed Rule 22e-4(b)(3). The Program Administrator must be a fund's investment adviser or officers (which may not be *solely* portfolio managers of the fund).

[38] *See* Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 112 (1940) at 109 (describing the board as an "independent check" on management); *see also Burks v. Lasker*, 441 U.S. 471, 484 (1979) (citing *Tannenbaum v. Zeller*, 552 F.2d 402, 406 (2d. Cir. 1977)) (describing independent directors as "independent watchdogs").

> the interests of advisers and the investment companies they advise should be handled primarily or exclusively by the investment adviser.[39]

We are also concerned that any delay in board approval could harm fund shareholders. For example, when market conditions stabilize and shareholder redemption requests return to historical levels, a fund may wish to capitalize on a less-liquid market opportunity. However, the fund may be unable to do so if it would violate the TLDA Minimum, despite the changed conditions. Under these circumstances, the fund would have to stand idle and hope the opportunity does not pass by while board approval is obtained. Requiring board approval in these circumstances, which may be difficult to obtain on a timely basis, appears unnecessary and could increase fund expenses. For this reason, we recommend utilizing the procedural framework of Rule 38a-1 under the 1940 Act for requiring a fund to adopt and implement any liquidity risk management policies and procedures.

F. Issues Relating To Derivatives

Proposed Rule 22e-4 would require a fund, when assessing the liquidity of a portfolio asset, to consider whether it invests in the asset because it is connected with an investment in another portfolio asset. The Proposing Release states that this may occur when a fund enters into a derivatives transaction or in a situation in which a fund uses an asset for hedging or risk mitigation purposes.[40]

Pursuant to Investment Company Act Release No. 10666 ("***Release 10666***"),[41] and subsequent no-action guidance from SEC staff, a fund generally will earmark or maintain liquid assets in a segregated account to "cover" the fund's obligations under derivatives transactions. The Proposing Release states that, while the Commission expects that assets used by a fund to cover derivatives would be liquid in isolation, when evaluating the liquidity of such assets under proposed Rule 22e-4, the fund would have to consider that the assets are being used to cover

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[39] Division of Investment Management, Securities and Exchange Commission, Protecting Investors: A Half Century of Investment Company Regulation (1992) at 266. We do not believe that there are material conflicts of interest between investment advisers and the funds they manage with respect to liquidity risk management. In fact, we believe the interests of investment advisers and the funds they manage are aligned because an adviser has every incentive to preserve sufficient liquidity to satisfy redemption obligations. To do otherwise could subject an adviser to profound reputational harm.

[40] *See* Proposing Release at 62301.

[41] Securities Trading Practices of Registered Investment Companies, 44 Fed. Reg. 25128 (Apr. 27, 1979).

other transactions and, as stated in Release 10666, that such assets are "frozen" and "unavailable for sale or other disposition."[42] According to the Proposing Release, because these assets are only available for sale to meet redemptions once the related derivatives position is disposed of or unwound, a fund should classify the liquidity of these assets using the liquidity of the derivatives they are covering.[43]

Implicit in the Commission's proposal is the view that funds identify individual liquid assets to cover specific derivatives instruments. We understand that, instead, many funds review their outstanding obligations under their derivatives positions on a portfolio basis and then, after taking into account any permitted netting, determine an aggregate value of such obligations requiring coverage. The funds then earmark or segregate a corresponding portion of their aggregate liquid assets to satisfy the cover requirement. Under the Commission's proposed approach, it appears that a fund would be required to examine and determine the liquidity classification for each asset used to cover each individual derivative instrument on an ongoing basis. This proposal would significantly alter the manner in which many funds currently determine their cover amounts, and they may need to reassess their existing operational capacities. Many funds may find this requirement under proposed Rule 22e-4 to be exceedingly difficult to satisfy from an operational perspective. As an alternative approach, the Commission could require funds to assign liquidity classifications to cover assets on an aggregate portfolio basis in amounts corresponding to the aggregate amount of derivatives exposure in each liquidity category. This approach would satisfy the Commission's need to link the liquidity of assets used for cover to the related derivatives instruments, while preserving the operational flexibility for funds to continue to cover derivatives on an aggregate portfolio basis.

The Proposing Release also states that a fund may purchase an asset in connection with its holding of another asset for reasons such as hedging. The Proposing Release cites an example in which a fund purchases a debt security denominated in a foreign currency and hedges the foreign exchange risk with a currency future.[44] The Commission would require that a fund, when evaluating the liquidity of the currency future, consider the way in which the currency future is being used in the fund's portfolio. If the fund purchases a more liquid asset in connection with a less liquid asset, and the fund intends to transact in the more liquid asset only in connection with the less liquid asset, the Commission would require that the liquidity of the two assets be linked

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[42] Proposing Release at 62302. *See also* Release 10666.

[43] *See* Proposing Release at 62302.

[44] *See id*.

by the fund. In the example in the Proposing Release, the liquidity of the currency future would be determined by the liquidity classification of the foreign debt.[45]

We note that the Commission's requirement would likely be difficult to satisfy from both an operational and portfolio management perspective. Hedging transactions and other types of risk management activities are typically evaluated and executed on an aggregate portfolio basis. Many funds may be unable to attribute overall currency, interest rate and other risks in a portfolio to specific, individual positions or portfolio assets. With currency hedging, for example, a combination of portfolio exposures to various currencies could have a net effect such that the overall portfolio currency exposure would be less than the currency exposure arising from each of the fund's individual investments in foreign debt securities. To adopt the Commission's approach, a fund may need to disregard any such netting[46] or risk-reducing benefits and engage in costlier, more burdensome security-by-security analyses for hedging transactions. Further, a fund may need to overhaul its operational and portfolio management systems to attribute each hedge position to a specific underlying security. We are concerned with any rule that ultimately may discourage funds from engaging in hedging transactions and other risk management activities.

II. SWING PRICING

Under proposed amendments to Rule 22c-1 of the 1940 Act, funds (excluding Money Funds and ETFs) would be permitted, but not required, to use "swing pricing" to mitigate the risk that shareholder purchase and redemption activities could dilute the value of fund shares. As explained in the Proposing Release, swing pricing generally refers to a mechanism that would adjust the NAV of a fund's shares to effectively pass on the trading and other costs associated with purchases or redemptions of fund shares to the purchasing or redeeming shareholder.

Before a fund could employ swing pricing, it would be required to establish policies and procedures that designate an amount (the "***swing factor***") by which the fund will adjust its NAV if the level of net purchases into or net redemptions from the fund has exceeded a specified percentage of the fund's NAV (the "***swing threshold***"). In addition, the policies and procedures would be required to: (i) provide for the periodic review (at least annually) of the fund's swing threshold; (ii) specify how the fund calculates the swing factor in the event the

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[45] *See id.*

[46] Under the recently proposed rule on derivatives, a fund may calculate on a *net basis* both the mark-to-market coverage amount and the risk-based coverage amount for all derivatives transactions covered by a netting agreement that allows the fund to net its payment obligations in connection with multiple derivatives transactions. *See* Use of Derivatives by Registered Investment Companies and Business Development Companies, 80 Fed. Reg. 80884, 80926-80932 (December 28, 2015).

fund's swing threshold is breached; and (iii) be approved by the fund's board, including a majority of the independent board members.

A. The Implementation Of Swing Pricing Currently Presents Significant Operational Challenges

We appreciate the Commission's efforts to seek to provide funds with an effective tool to mitigate potential shareholder dilution resulting from shareholder purchase and redemption activity. However, we have concerns similar to those expressed by a number of participants in the fund industry that swing pricing raises operational challenges regarding its implementation under the current market structure in the United States. In particular, we believe that omnibus account and sub-accounting arrangements and the increasing role of fund intermediaries would make it exceedingly difficult, costly and burdensome (if not impossible) for funds to be able to employ swing pricing consistently to all shareholders.[47]

Significantly, a fund using swing pricing likely would need to be able to monitor intra-day shareholder trades or flows of money into and out of the fund for purposes of determining (i) whether the fund's net purchases or net redemptions would cross the fund's swing threshold, thereby triggering the swing factor and (ii) the swing factor that the fund will use to adjust its NAV, to the extent the fund's swing factor varies depending on its net flows. We understand, however, that funds and intermediaries believe there are severe challenges that must be addressed before funds would have the ability to monitor daily fund flows in the manner contemplated under the swing pricing proposal.

We understand that information regarding net flows typically is not received by a fund until after the time at which the fund is required to strike its NAV (generally 4:00 p.m. Eastern time), including, in some cases, the following morning. In the case of intermediaries, which are increasingly relied upon for the distribution of fund shares and the transmission of order flow information,[48] aggregated trade orders may not be delivered to a fund until well after the fund's valuation time. Similar challenges are present in the case of omnibus arrangements, where intermediaries may not be able to process transactions on their systems until each of the funds

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[47] Under omnibus arrangements, the positions of multiple beneficial owner customers of an intermediary are aggregated into a single or a few "omnibus" accounts, which are held by and registered in the name of a single intermediary acting on behalf of its customers.

[48] The Commission has acknowledged that most investors buy shares through intermediaries. *See e.g.*, *Transfer Agent Regulations*, Securities Exchange Act Rel. No. 76743 (Dec. 22, 2015), at n. 454 ("[T]he 2015 ICI Factbook notes that among households owning mutual fund shares outside employer-sponsored retirement plans, 80 percent own fund shares through investment professionals.").

offered on the platform transmits its final NAV to, and the final NAVs are received by, the intermediaries. Given that the successful implementation of swing pricing depends heavily on a fund's receipt of timely and reasonably accurate cash flow estimates, to the extent that current trade processing systems and practices limit the ability of funds to receive intraday order flow information, it will be very difficult to develop a workable swing pricing regime.

In the Proposing Release, the Commission recommends that funds attempt to address these concerns by arranging for interim feeds of fund flows from a fund's transfer agent or distributor or facilitating effective communication between the various personnel charged with implementing the fund's swing pricing, portfolio management and daily pricing.[49] Even if these measures were deemed to be sufficient to address these issues, due to the operational limitations described above, we believe that intermediaries currently may not have systems in place to be able to transmit intra-day order flow information to the degree that is required under the swing pricing proposal. Without significant (and probably very costly) changes to the process by which funds consolidate shareholder purchase and redemption activity, these issues regarding processing and transmitting fund flow information could, among other things, limit the ability of a fund to determine with any confidence whether to "swing" its NAV and by how much, cause the possible misapplication of a fund's swing pricing policies and procedures, delay the completion of a fund's pricing process and result in a general unwillingness of funds to adopt swing pricing.

Moreover, we respectfully note that all funds would not be able to implement swing pricing on equal terms. For example, smaller fund complexes are less likely than larger fund complexes to have adequate resources or internal processes in place to be able to support the use of swing pricing. In addition, as the timeliness and accuracy of intraday flow information to a fund depends on the intermediaries through which the fund distributes its shares, certain funds may benefit more than others to the extent they use intermediaries that have developed systems to address the operational concerns associated with swing pricing or have large numbers of direct shareholders.

For these reasons, we believe that any final rule amendments adopted by the Commission should be preceded by operational improvements, corresponding cost-benefit analysis of the actions that are necessary to adequately support the implementation of swing pricing in today's market structure and possibly rules directly applicable to market intermediaries to make their operations easier with funds.[50]

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[49] *See* Proposing Release at 62328-62331.

[50] The Commission recently issued a concept release seeking public comment on possible updates and improvements to the regulatory framework for transfer agents. *Transfer Agent Regulations*, Securities Exchange Act Rel. No. 76743 (Dec. 22, 2015). Given the importance of transfer agents

Given that many funds successfully use swing pricing in certain foreign jurisdictions, we also encourage the Commission to study areas in these jurisdictions where conditions or practices appear to facilitate the timely processing and transmission of daily fund flows for purposes of swing pricing, including timing considerations with respect to the receipt of trade orders and the valuation and pricing of fund shares.[51]

We understand, however, that addressing these types of operational matters may involve a substantial undertaking by the Commission and/or various industry participants, which could potentially delay any final rulemaking on the swing pricing proposal. Given the importance of swing pricing to the success of the overall set of reforms proposed by the Commission, we believe that any delay in the swing pricing proposal should be accompanied by a corresponding delay in the liquidity risk management program and disclosure-based requirements.

B. Funds Should Have More Flexibility To Address Shareholder Dilution

As proposed, a fund's use of swing pricing would be optional. In this regard, swing pricing is more permissive than other components of the proposed rulemaking, such as the mandatory requirements pertaining to the liquidity risk management program under proposed Rule 22e-4. We agree with the Commission that swing pricing should be discretionary because funds should be able to weigh the potential advantages and disadvantages of swing pricing in relation to a fund's particular circumstances and risks. However, the proposal is limiting in other respects in that swing pricing is the only tool available to funds under the proposal to counter potential dilution of fund shareholders. We recommend that the Commission provide greater flexibility than is currently proposed to enable a fund to choose from among various dilution recovery methods the approach that best suits the individual circumstances of the fund.

The Proposing Release discusses and requests comment on whether funds should be able to utilize a number of other pricing mechanisms that the Commission believes "could mitigate

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and intermediaries to the operational feasibility of swing pricing, the Commission should use this opportunity to more fully understand the ways in which current market practices could be enhanced in order to operationalize the use of swing pricing.

[51] We understand that the Commission's consideration of the swing pricing proposal was influenced by swing pricing *rules and guidelines* adopted in certain European jurisdictions. *See* Proposing Release at n. 473 ("These factors [in proposed rule 22c-1(a)(3)(i)(B)] overlap significantly with factors that we understand are commonly considered by funds that use swing pricing in other jurisdictions, in order to determine a fund's swing threshold. For example, the Luxembourg Swing Pricing Survey, Reports & Guidelines provides [similar] factors influencing the determination of the swing threshold …"). The Commission should also seek to better understand the *operational* practices in these jurisdictions that permit the successful use of swing pricing.

dilution arising from shareholder transaction activity," but which would not be permitted under the proposed amendments to Rule 22c-1.[52] For example, an additional dilution recovery tool is the use of purchase and redemption fees or liquidity fees, a practice that has already been sanctioned in the context of Money Funds.[53] Purchase and redemption fees or liquidity fees are advantageous in that they are an easy concept for investors to understand and would likely not produce the same volatility and tracking concerns as swing pricing. However, the Commission did not focus on this option as a way to counter shareholder dilution because it believes that, on balance, the operational costs and difficulty of imposing a fee would be significantly higher than those associated with swing pricing.

We believe choices should be left to the funds and their boards, which are in a better position to determine the appropriate means to counter dilution effectively under the particular circumstances of a fund.[54] For example, smaller fund complexes that do not have the capability to support swing pricing may determine that another approach is more appropriate or cost-effective. Particularly in times of market stress or crisis, investors will tend to redeem from funds that have not implemented swing pricing. Since these will likely be disproportionately smaller funds, swing pricing will create incentives for investors to redeem from the funds least likely to be able to handle the stress from large amounts of redemptions. This result is both anti-competitive and – to the extent that the SEC is concerned about redemptions leading to "fire sales" – counterproductive. At a minimum, the SEC should provide smaller funds with other tools to manage dilution risk. In response to concerns that a choice of dilution recovery mechanisms may increase investor confusion, we believe this risk could be successfully mitigated through appropriate disclosure requirements.

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[52] Proposing Release at 62345.

[53] *See* Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. 47736 (Aug. 14, 2014), at n. 139 and accompanying text. In addition, according to the Proposing Release, the Commission "has previously recognized that excessive trading of mutual fund shares could dilute the value of long-term investors' shares … and in response to this … adopted rule 22c-2 under the [1940] Act." Proposing Release at 62327. Rule 22c-2 permits funds to impose a redemption fee of up to two percent and even requires funds boards to consider imposing redemption fees under certain circumstances. *See* Rule 22c-2(a). The prior codification of the use of redemption fees to counter the risk of shareholder dilution supports (i) the general argument that multiple tools could be made available to funds to mitigate potential dilution and (ii) that the Commission has specifically recognized the use of redemption fees as a workable option.

[54] We note that certain foreign jurisdictions provide for this type of flexibility, which supports the argument that this is a workable regime. Indeed, as the Commission points out in the Proposing Release, liquidity fees (including "dilution levies" used by certain UCITS) are presently used in some foreign jurisdictions as a distinct liquidity risk management tool separate from swing pricing. *See* Proposing Release at n. 443.

Additionally, we believe that swing pricing as proposed by the Commission could potentially benefit from greater flexibility. We acknowledge that the proposal is permissive in regards to the initial decision to adopt swing pricing, but it may be more restrictive in other respects when compared to the swing pricing practices used in certain foreign jurisdictions. For example, a fund should be permitted to apply swing pricing to net *redemptions* only, as opposed to applying it equally to net redemptions and net purchases, which would be the case under the proposed rule amendments. As the Commission points out in the Proposing Release, "there may be more significant issues regarding potential dilution for non-redeeming shareholders in connection with shareholder redemptions, because funds are obligated to satisfy redemption requests pursuant to section 22(e) of the [1940] Act."[55] Certain funds may also decide that full swing pricing is appropriate in their case (not just partial swing pricing).

Generally, we believe that requiring funds to consider specific factors as part of the swing threshold and swing factor determinations is too rigid and prescriptive. Certain of these factors require subjective judgments about complex information that may not necessarily be known with reasonable certainty (*e.g.*, market impact costs). As such, a fund may not be able to obtain sufficient information on which to base these considerations. This could create a disincentive for funds to adopt swing pricing due to the risk of not being able to satisfy the requirements prescribed by the rule amendments. Instead, we believe a better approach would be to outline in conceptual guidance the appropriate principles and factors a fund could consider in making the swing factor determinations.

Although the Commission cites operational difficulties as a reason to not permit funds to build their own swing pricing methodologies as described above, we respectfully believe these are decisions that should be made by the funds themselves after carefully weighing the benefits and drawbacks of adopting a particular swing pricing approach given the factors they believe are appropriate under the circumstances and subject to applicable fiduciary duties.

C. The Commission Should Provide Additional Guidance On Swing Pricing As A New Potential Source Of Pricing Errors

As proposed, swing pricing would require determining on a daily basis whether a fund's net purchases or net redemptions cross the fund's swing threshold, thereby triggering the swing factor. In making these determinations, the Commission observes that persons administering a fund's swing pricing policies and procedures typically would have limited time in which to process shareholder purchase and redemption orders and ultimately determine a fund's net cash flows. In addition, it seems that the "information obtained after reasonable inquiry" upon which the administrator could estimate net cash flows often times could be limited and/or

[55] *Id.* at 62369-62370.

incomplete. Once it is determined that the swing threshold has been reached, the swing pricing administrator would be required to calculate the swing factor, again under limited time constraints using estimates.

Due to these and other factors, the process by which swing pricing determinations are made is likely to introduce a number of possibilities for errors in the computation of a fund's NAV. Such errors could, for example, result from: (i) the application of an incorrect swing factor to a fund's NAV; (ii) adjusting the fund's NAV in the wrong direction; and (iii) the failure to adjust the fund's NAV when the swing threshold has been reached. Any number of factors may contribute to each of these errors.

Because there would be limited time within which an error of this nature could be identified and subsequently corrected, swing pricing errors generally would not be discovered until after the fund strikes its NAV. Given that swing pricing results in a NAV adjustment for *all* transacting shareholders, a NAV error due to inaccurate fund flow information could require reprocessing on a large scale to correct the misstated NAV for all shareholders transacting on the day in which the swing pricing error occurred.

The Commission has requested comment on whether it should provide guidance as to the circumstances in which a possible misapplication of a fund's swing pricing policy could result in a material NAV error. Given the heightened risk of pricing errors, in the absence of adopted and protective regulatory guidance, we believe a fund's use of swing pricing would be unfairly subject to second-guessing by parties who would have the benefit of hindsight in the event that there is a swing pricing error, despite the absence of negligence when the error occurred. Accordingly, we believe the Commission should address these issues.

Specifically, the Commission should consider providing guidance on the steps one might take to satisfy the "reasonable inquiry" standard as well as the manner in which funds could successfully navigate through potential pricing errors. One way to reduce legal uncertainty could be to provide that, under limited circumstances where, for example, the swing pricing error is solely the result of limited or inaccurate fund flow information, NAV errors due to the misapplication of swing pricing would not require the reprocessing of all affected transactions. In addition, the Commission could expressly provide that the relevant parties, including the fund, the swing pricing administrator and the fund board, would not be exposed to liability for NAV errors of this type if there were adequate guardrails in place and reasonable measures were taken to implement swing pricing.

In any case, we believe it would not be prudent for the Commission to attempt to prescribe a definitive list of scenarios under which the misapplication of a fund's swing pricing policies would result in a material NAV error or the specific steps that a fund should take to rectify any

such error. Instead, we believe the Commission should defer to funds to oversee swing pricing misapplications and determine appropriate corrective actions.

To facilitate the foregoing, we believe funds should be able to adopt error correction procedures specifically relating to swing pricing or update existing procedures to the extent necessary and appropriate. As noted above, however, any final rule amendments that require funds to adopt NAV correction policies specifically for swing pricing should be flexible enough to allow a fund to adopt procedures tailored to its specific circumstances. Given the significant liability risks, we would strongly encourage the Commission to work with the industry and other interested parties prior to issuing guidance.

D. A Fund's Board Should Be Limited To An Oversight Role

With respect to the duties and responsibilities of fund boards under the proposed amendments to Rule 22c-1, we support the Commission's recognition that a board should not be required to *manage* the administration of a fund's swing pricing policies and procedures. Fund directors are usually not able to evaluate fund flows and do not have the technical resources necessary to administer swing pricing on a daily basis. Accordingly, similar to proposed Rule 22e-4, the board's role under the swing pricing proposal should be limited to providing appropriate *oversight*, and not cross the line into *management* of the fund, consistent with Commission views.[56]

Although the proposed amendments to Rule 22c-1 provide that a fund's board is required to designate the fund's investment adviser or officers responsible for administering the fund's swing pricing policies and procedures, we believe that there are certain provisions of the proposed rule amendments that would require boards to be involved on a level of granularity that approaches *management* of the fund, and thus would likely be inappropriate for a board.

For example, we believe that the proposed amendment requiring a board to approve the swing threshold amount (and any changes to the swing threshold amount) should instead be a management function, subject to board oversight. The determination about a particular fund's swing threshold amount would indeed be a highly technical analysis with reference to specific factors that requires an intimate familiarity with the fund's daily operations.[57] The level of

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[56] *See supra* note 39 and accompanying text.

[57] A fund board would be required to consider: (i) the size, frequency, and volatility of historical net purchases or net redemptions of fund shares during the normal and stressed periods; (ii) the fund's investment strategy and the liquidity of the fund's portfolio assets; (iii) the fund's holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources; and (iv) the costs associated with transactions in the markets in which the fund invests. *See* proposed Rule 22c-1(a)(3)(i)(B).

inquiry and expertise necessary to make these determinations would arguably take fund boards beyond an oversight role into one that concerns the operational matters of the fund. We believe the board's oversight role in this manner would not diminish in any way the board's ability to "help ensure that a fund establishes and implements swing pricing policies and procedures that are in the best interests of all the fund's shareholders."[58]

We also question whether some of the duties placed on fund directors under the proposed rule amendments would be so burdensome as to affect the fund directors' ability to continue to carry out their oversight responsibilities in other areas. The proposed board requirements, which include, for example, determining whether to implement swing pricing and approving a fund's swing pricing policies and procedures, would require fund directors to develop skills and expertise necessary to evaluate and continually monitor portfolio characteristics on a very granular level. These additional board responsibilities, which at times call for complicated calculations and subjective judgments (*e.g.*, the determination of the swing threshold), would likely detract from the ability of the board to continue to oversee other areas. Again, we believe that directors may be as effective in overseeing swing pricing programs with less granular responsibilities. Directors, guided by their fiduciary duties, are better situated to decide themselves how best to exercise their oversight role.[59]

More broadly, when considered in the context of the Commission's other recent and expected future proposed rulemaking for funds, we anticipate there to be a significant growth in the responsibilities of fund directors over the next several years.[60] If these rule proposals are adopted, it could raise important questions about the ability of directors to be able to effectively participate in the full range of the board's responsibilities to the funds that they oversee. This type of regulatory environment, in which fund boards would be held responsible for increasingly complex and highly technical matters fraught with subjective decision-making, could discourage qualified individuals from serving on boards and potentially cause boards to

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[58] *See* Proposing Release at 62339.

[59] The Commission notes in the Proposing Release that the proposed oversight requirements for a fund's board and its independent directors "reflect the historical role that a fund's board and independent directors have held with respect to issues involving valuation." *Id.* at 62239. As the role of fund boards with respect to valuation derives from specific, *statutory* responsibilities, we do not believe it would be appropriate to impose a similarly expansive role on fund boards in the case of swing pricing, which is not mandated by statute. *See, e.g.*, Section 2(a)(41)(B) of the 1940 Act and Rule 2a-4 thereunder (when market quotations are not readily available for a fund's portfolio securities, the 1940 Act requires a fund's board to determine, in good faith, the fair value of the securities).

[60] *See also* Greg Saitz, The Future Issue: More Rules, More Board Duties by 2020 New Director Duties, *Board IQ* (Dec. 15, 2015).

become larger by recruiting additional members with technical expertise, rely more heavily on third party experts and generate new costs, all of which could be detrimental to the interests of fund shareholders. Accordingly, we believe any final rulemaking on swing pricing should carefully limit the board's role to an oversight capacity and consider the impact of any rule amendments on fund boards.

E. A Two Percent Limit On Redemption Transaction Fees Should Not Be Applicable to ETFs

1. The Commission's Rationale For Not Imposing A Swing Factor Upper Limit Should Similarly Apply To ETF Redemption Transaction Fees

The Commission is proposing to exclude ETFs from the scope of the proposed amendments to Rule 22c-1 in part because they currently are permitted to impose transaction fees on APs that purchase or redeem creation units. These transaction fees obviate the need for swing pricing because, like swing pricing, they serve to mitigate the dilution of existing shareholders by effectively passing on the costs stemming from purchase or redemption activity to the shareholders associated with that activity.

Proposed amendments to Rule 22c-1 notably would not set an upper limit on the swing factor that a fund would be permitted to use in adjusting its NAV. In contrast, with respect to ETFs, the Commission has included in ETF exemptive relief a provision limiting ETF redemption transaction fees to the Commission's limits applicable to management investment companies offering redeemable securities – which, under current Rule 22c-2, is two percent. Under proposed amendments to Rule 22c-1, this effective two percent limit under Rule 22c-2 would continue to apply to ETFs, without granting ETFs the ability to utilize swing pricing to accommodate costs of redemption activity which exceed that two percent limit. However, the Commission's rationale expressed in the Proposing Release for not requiring an upper limit on the swing factor supports the argument that the existing two percent limit on ETF redemption transaction fees should be lifted. Specifically, the Proposing Release provides in relevant part:

> We are not proposing to require an upper limit on the swing factor that a fund would be permitted to use, on account of the difficulty of establishing an appropriate across-the-board limit that would permit funds with different investment strategies, under all market conditions, to determine a swing factor that reflects the costs associated with the potential shareholder purchase or redemption activity. These costs could vary widely across funds and under

> different market conditions, and we do not wish to limit the extent to which swing pricing could mitigate the dilution of existing shareholders.[61]

We see no legitimate reason why this rationale for not setting a maximum swing factor limit should not be applied equally to ETF redemption transaction fees. Certain ETFs which effect redemptions in cash may incur varying levels of shareholder dilution from redemptions, especially in markets that are experiencing substantial volatility. In such event, an ETF could incur redemption transaction costs in excess of two percent that cannot be passed onto the AP under the ETFs' exemptive relief. Accordingly, we believe the current two percent limit on ETF redemption transaction fees unduly limits the extent to which such transaction fees could mitigate the potentially dilutive effects of shareholder purchase and redemption activity.

Under proposed amendments to Rule 22c-1, open-end mutual funds would be permitted to utilize swing pricing to mitigate the dilution of existing shareholders, but an ETF would have no such option. We believe that, for the reasons set forth in the Proposing Release with respect to not capping the swing factor,[62] a better approach for ETFs would be to permit, but not require, an ETF to set a maximum limit on ETF transaction fees. As in the case of the swing factor under proposed amendments to Rule 22c-1, the Commission could impose certain safeguards to ensure that ETF transaction fees would not be set inappropriately high, such as by requiring the fee level to be determined with reference to specific factors and/or by requiring approval of the fee level by the fund board, which has an obligation to act in the best interests of the fund and its shareholders.

2. Elimination Of The Two Percent Cap On ETF Redemption Transaction Fees Is Consistent With The Purposes Of Rule 22c-2

Elimination of the two percent cap would also be entirely consistent with the policies underlying Rule 22c-2. The purpose of Rule 22c-2 is to reimburse mutual funds for the costs of short-term trading and to discourage short-term trading of fund shares by reducing the profitability of the trades.[63] The two percent limit is designed to strike a balance between

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61 Proposing Release at 62337.

62 To the extent the Commission believes that a swing factor in excess of two percent applied by an open-end fund pursuant to proposed Rule 22c-1 is not inconsistent with the open-end fund's issuance of redeemable securities, there is no reason in our view for the Commission to be concerned that an ETF which applies redemption transaction fees in excess of two percent is compromising the redeemable character of an ETF's securities – especially because ETFs obtain exemptive relief from the Commission to issue shares that are only redeemable in large aggregations.

63 *See* Mutual Fund Redemption Fees, 70 Fed. Reg. 13328 (Mar. 18, 2005).

competing goals – preserving the redeemability of mutual fund shares while reducing the ability of shareholders who regularly trade their shares for profit at the expense of the remaining shareholders.[64] It is clear that Rule 22c-2 did not contemplate the unique structure of ETFs and the role of transaction fees in protecting shareholders against the costs of cash redemptions. ETFs issue and redeem their shares in creation units to APs only. APs are sophisticated market participants. The transaction fees in question are borne by APs and are tied specifically to the incremental costs incurred by the ETF as a result of the cash redemptions. Thus, the variable transaction fee does not apply to the extent redemptions are effected in kind. In contrast to the redemption fees which are the focus of Rule 22c-2, the redemption transaction fees charged by an ETF are not intended to inhibit frequent trading. In fact, the unfettered ability of an AP to redeem is critical to the efficiency and effectiveness of the arbitrage process which tends to ensure that shares trade at market prices of or close to NAV. Therefore, an ETF has an incentive to ensure that transaction fees are not regarded by APs as excessive or would otherwise impede redemptions. Furthermore, the concerns reflected in the Rule 22c-2 adopting release about high redemption fees unduly burdening shareholders do not apply to ETFs. To the contrary, the transaction fees charged by ETFs are designed to protect shareholders against the costs of cash redemptions and to put the ETF essentially in the same economic position as would have been the case had redemptions been in kind. The transaction fees in no way impact an "ordinary shareholder's" ability to promptly effect purchases or sales of ETF shares in the secondary market.

Rule 22c-2 is intended to protect the "ordinary shareholder" from the harmful effects of short-term trading.[65] To the extent an ETF is unable to pass through the incremental costs of a cash redemption to an AP by virtue of a two percent cap, these costs are shifted to the remaining shareholders of the ETF. This result would be inconsistent with the underlying purpose of Rule 22c-2, which is to prevent the dilution of shareholder value, and with the concerns expressed in the Proposing Release motivating proposed Rule 22c-1.

In view of the foregoing, we believe the Commission should eliminate for ETFs the two percent cap on redemption transaction fees.

III. COST-BENEFIT ANALYSIS

Section IV of the Proposing Release contains an economic analysis section. The proposal requests comments on the economic analysis, including on whether the analysis has: (i) identified all benefits and costs, including all effects on efficiency, competition, and capital formation; and

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[64] *Id.* at 13331.

[65] *Id.*

(ii) given due consideration to each benefit and cost, including each effect on efficiency, competition and capital formation.[66]

We have concerns that the benefits of the proposal may not be sufficiently developed or quantified to justify the potential cost of the compliance burden that the proposal would generate. In addition, the discussion of the cost estimate in the proposal does not appear to provide any detail, other than a general description, as to the basis for the estimates, and it is possible that the SEC staff estimate falls short of actual costs that would be incurred to comply with the proposal if adopted as proposed. Our comments are directed at the portion of the initial economic analysis section that discusses the costs, benefits, and effect on efficiency, competition and capital formation of proposed Rule 22e-4 (the "***Cost-Benefit Analysis***" or "***CBA***")).[67]

A. The CBA Is Premised On Benefits That Are Not Established Or Empirically Validated in the Proposing Release

The CBA takes the position that funds are currently threatened by the possibility of a first-mover advantage or incentive whereby shareholders will engage in rapid destabilizing requests for redemption of fund shares because of a concern that a fund will find itself in a compromised liquidity position.[68] Based upon this foundation, the CBA argues that a fund that is subjected to a first mover incentive episode could experience two problems. First, it might be unable to meet its redemption obligations.[69] Second, it would meet its redemption obligations only by materially affecting the fund's NAV or through methods that would have other adverse impacts on non-redeeming investors such as increased risk exposure and decreased liquidity.[70] The CBA maintains that investors will benefit because the impact of proposed Rule 22e-4 would be to decrease the possibility of such a first mover incentive event and the purported negative effects related thereto.

The Commission's primary source for the notion of a first-mover advantage in funds appears to be an academic paper and some comment letters.[71] None of these sources provides actual evidence of investor behavior that shows redemptions motivated by incentives of moving first,

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[66] Proposing Release at 62373.

[67] *Id*. at 62357-62366.

[68] *Id*. at 62350, 62351, 62358.

[69] *Id*. at 62357.

[70] *Id*.

[71] *Id.* at n. 49-50.

nor do they provide an estimate of cost or loss to a fund. Further, the proposal does not cite to estimates from the Commission's economists on the potential costs to funds and their remaining shareholders from potential redemptions by *first movers.* Accordingly, we respectfully note that there appears to be an inadequate empirical basis for the need for the significant cost that the proposal would impose.

The CBA and the Commission's prior statements do not support the first mover incentive as a valid material threat to open-end funds. The CBA acknowledges that the Commission has no evidence of the existence of the first-mover advantage in regard to open-end funds other than money market funds:

> While we understand that fund investors may not have historically been motivated to redeem on account of a perceived (or actual) first-mover advantage during previous periods of stress . . .[72]

The CBA acknowledges that the first-mover advantage is in fact "more commonly referenced with respect to [Money Funds]."[73] The notion of a first-mover advantage harming funds other than Money Funds appears to be inconsistent with views expressed by the Commission in the context of money market fund reform. The Commission's rationale for the money market fund reform adopted in 2014 – namely, to implement a floating NAV for non-"retail" and non-"government" Money Funds – was to eliminate the "first-mover advantage" that was attributable to Money Funds using the amortized cost method of valuation to maintain a stable price per share.

The Commission in its 2013 money market reform proposal effectively concluded that a shift from a stable NAV to a floating NAV for Money Funds would largely eliminate the threat of redemption runs on Money Funds that the Commission believed was posed by the first-mover advantage. The Commission expressed the following view:

> Our floating NAV proposal is designed to increase the transparency of risks present in [Money Funds]. By making gains and loses a more regular and observable occurrence in [Money Funds], a floating NAV could alter investor expectations by making clear that [Money Funds] are not risk free and that the funds' share price will fluctuate based on the value of the funds' assets. *Investors in* [Money Funds] *with floating NAVs should become more accustomed*

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72 *Id.* at 62358.

73 *Id*.

> *to, and tolerant of, fluctuations in* [Money Funds'] *NAVs and thus may become less likely to redeem shares in times of stress*.[74]

Thus, in 2013, the Commission maintained that a floating NAV would provide a solution to address the threat it asserted that the first-mover advantage posed to Money Funds. It is inconsistent to assert now, one year after adopting the money market fund reforms, that the first-mover advantage, in fact, poses a serious threat to other open-end funds that have always operated with a floating NAV. These contradictory positions of the Commission appear to undermine the validity of the argument made in the proposal that the first-mover advantage poses an actual threat to all open-end funds and, makes it all the more important that the Commission be able to show with empirical evidence that the potential for a first-mover advantage could be harmful to funds. In light of the significant costs that the proposals will impose on the fund industry, a foundation of empirical evidence showing the potential for meaningful harm to investors is needed for measures whose rationale is to combat a purported first-mover advantage.

In lieu of empirical evidence, the Commission asserted that even though it cannot argue that the first-mover advantage was observed, even during dramatic circumstances associated with the financial crisis of 2008, it is still possible that it might arise at some point in future, saying "we cannot predict how investors may behave in the future."[75] This assertion seems speculative under the circumstances of the Commission's inconsistent positions on the risks of a first-mover advantage and does not provide the type of sound empirical basis that are warranted to justify the significant costs that would be imposed by the proposal.

Accordingly, we believe that the CBA does not adequately support the potential advantage of proposed Rule 22e-4. In this regard, we note that Commission stated that it cannot quantify the total benefits to fund operations and investor protection.[76]

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[74] Money Market Fund Reform; Amendments to Form PF, 78 Fed. Reg. 36834, 36851 (June 19, 2013) (emphasis added) (footnote omitted).

[75] Proposing Release at 62358.

[76] *Id*. at 62359.

B. The CBA Does Not Support Its Assertions That The First-Mover Advantage Could Trigger Fire Sales of Assets

The CBA also posits certain benefits to funds and fund shareholders that would flow from addressing the threat the first-mover advantage purportedly poses, notably from proposed Rule 22e-4.

The Commission argues that the first-mover advantage could cause a fund to sell portfolio assets in unfavorable market conditions to meet redemptions, and that proposed Rule 22e-4 could decrease the risk that asset sales by such a fund could create significant negative price pressure on those assets (often referred to as "fire sales").[77] The CBA asserts that proposed Rule 22e-4 could decrease the risk that the fund might indirectly transmit stress to other market sectors and participants.[78]

Consistent with the absence of empirical evidence to show deleterious effects of a first-mover advantage, the proposal does not provide evidence for its fire sale hypothesis. To the contrary, the CBA refers to situations where purported spillover market effects did not occur.[79]

The CBA does not set forth any type of empirical analysis of the circumstances under which the fire sale hypothesis might actually arise. The hypothesis seems to suggest that sales of assets by a single fund could be so significant that it would cause a destabilization of one or more categories of assets. This would appear to raise a range of issues as to hypothetical volume and timing of such sales, the nature of the assets involved, the types of markets in which the assets trades and likely incentives and reactions of market participants.

Investors seek to sell assets for a range of reasons on an ongoing basis. They also seek to buy assets for a range of reasons on an ongoing basis. At any given time innumerable factors may result in an increase or decrease in the value of a particular asset. The CBA does not provide any basis to show that out of all the various purchase and sale transactions there should be an assumption that sales by a fund in response to redemption requests will have a disruptive effect that can transmit "stress" to other market participants.

Further, ETFs are usually able to pay for redemption of creation units *in kind* rather than in cash. This warrants analysis of whether the fire sale hypothesis is even relevant for ETFs, and further illustrates the need for empirical study of these risks.

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77 *Id.*

78 *Id.*

79 *Id.*

Accordingly, we do not believe that the CBA provides empirical support for purported benefit of Rule 22e-4 with respect to reducing the likelihood of a fire sale triggered by the first-mover advantage. In this regard, we note that Commission stated that it is unable to quantify the potential benefits with respect to purported fire sales.[80]

C. The Cost Estimates In The CBA Are Based On Improper Assumptions

The CBA estimates aggregate one-time costs to fund complexes to establish and implement a liquidity risk management program of approximately $1.4 billion and aggregate annual on-going program-related costs of approximately $240 million.[81]

The Commission discloses that the cost assumptions for many aspects of the proposal are based on the Commission staff's recent estimates of the costs associated with implementing the liquidity fees and redemption gates provisions of the 2014 amendments to Rule 2a-7 under the 1940 Act.[82] Namely, the staff looked to the one-time costs associated with drafting relevant procedures, testing and implementing the procedures, and related matters. However, the cost that a Money Fund could incur in connection with implementation of fees and gates is not relevant to the cost a fund complex would incur in connection with the liquidity classifications and other requirements set forth in proposed Rule 22e-4. Rather, most of the expenses associated with fees and gates are the costs associated with the platforms on which Money Funds can be purchased and redeemed, which would need to be able to cope with the fees and gates (which is a significant reason that many Money Funds have chosen to convert to "government" Money Funds). While these costs may be relevant to the implementation of swing-pricing pursuant to the proposed amendments to Rule 22c-1, proposed Rule 22e-4, on the other hand, would require the development of an internal infrastructure to analyze and test for liquidity conditions of a fund's assets, and would be unlikely to touch on the interaction with the platforms on which funds are traded. These are very different costs in type and amount. Indeed, a better proxy for the costs associated with proposed Rule 22e-4 may be a fund or management's costs of analyzing the value of the fund's assets, particularly those assets that are fair valued. We submit that the Commission should have tried to analyze those costs and then adjusted since fair value is typically used on a small portion of the assets held in most funds, whereas proposed Rule 22e-4 would require on-going liquidity analysis of all fund portfolio positions (and portions thereof).

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80 *Id.*

81 *Id*. at 62361.

82 *Id.* at n. 702, 707 and 759.

In addition, the discussion of the cost estimate in the proposal does not provide any detail, other than a general description, as to the basis for the estimates, and it is possible that the SEC staff estimate falls short of actual costs that would be incurred to comply with the proposal if adopted as proposed. In this regard, proposed Rule 22e-4 would require that the Liquidity Classification Factors be applied on an on-going basis to the liquidity assessment of each portfolio holding of a fund (and portions thereof). Those factors intuitively seem to be information that should be reviewed by an adviser in making a buy or sell decision for a fund, but it could be that the analysis of these factors at the depth contemplated by the proposal is not part of the on-going regimen of an investment adviser in the absence of a buy/sell decision for an instrument. Thus, the proposal could mandate significant micro-level analysis of portfolio instruments that is not currently conducted by a fund adviser. This type of analysis would likely require input from key investment personnel with a fund adviser, including portfolio management personnel and traders. It is not at all clear from the proposal whether the SEC staff's cost estimate has fairly considered the cost implications of compliance with this part of the rule.

D. Other Alternatives Do Not Appear To Have Been Considered by the Commission

With the very significant cost burden that the proposal would entail, even under the Commission staff's estimates, there are many other alternatives that should have been considered by the Commission. These include, among others, the following:

(i) Using a principles-based approach rather than the prescriptive, rigid approach that would be required under proposed Rule 22e-4. This is a particularly compelling alternative given that the Commission staff has found that many fund complexes already have "comprehensive" liquidity management programs, among the other reasons set forth in this letter;

(ii) Placing the primary responsibility for the liquidity management program on fund management rather than on a fund's board, which may simplify documentation and reporting burdens and costs;

(iii) Assessing the potential cost of obtaining the inputs that seem appropriate to an assessment of liquidity of portfolio securities, and particularly debt securities. In this regard, we note that valuation estimates for many fixed income securities may be provided by broker-dealers as a courtesy to a fund group or a fund manager. With the rigor of the liquidity management program in the proposal, it is conceivable that fund groups will seek liquidity information from broker-dealers, but that broker-dealers and others may be reticent to provide liquidity information on a regular basis as a courtesy,

and may begin charging for it. This type of foreseeable expense should be estimated as a potential cost of the proposal; and

(iv) Assessing the relative cost of using fewer than six categories of liquidity versus the six that have been proposed, and whether a management program with fewer categories would be less expensive.[83]

E. The CBA Does Not Provide An Appropriate Quantification Of The Costs And Adverse Impacts On Efficiency, Competition And Capital Formation In Regard To The Impact On Issuers Of Less Liquid Assets

In its discussion of costs, the CBA acknowledges that the proposed rule could result in certain funds increasing their investment in relatively more liquid assets and thereby decreasing their investments in relatively less liquid assets. The CBA observes that if funds decrease their investments in less liquid assets the market for those assets could become even less liquid.[84] The CBA then makes a critical acknowledgement of proposed Rule 22e-4's potential impact on the capital markets:

> This could discourage new issuances of similar [less liquid] assets and decrease the liquidity of less liquid assets that are still outstanding.[85]

Moreover, the CBA notes that if the program requirement were to significantly reduce the number of buyers and sellers the proposal could affect capital formation among issuers of less liquid assets. The CBA recognizes that some firms could be discouraged from issuing new securities in particular asset classes due to price discounts associated with lower liquidity. It further suggests that issuers might have to respond to reduced liquidity by shifting their capital structure or by changing the terms of the securities they issue in order to seek to increase their liquidity.[86]

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[83] In this regard, the Financial Accounting Standards Board ("***FASB***") devised a disclosure regimen for generally accepted accounting principles ("***GAAP***") accounting that is intended to show the basis for considering market participant assumptions in measurements of the value of assets for companies that use GAAP accounting, and the regimen used three categories to measure market inputs for value measurements for all assets. *See* FASB, Summary of Statement No. 157, at http://www.fasb.org/summary/stsum157.shtml.

[84] Proposing Release at 62362.

[85] *Id*.

[86] *Id*. at 62363.

The CBA states that due to certain data limitations:

> it is difficult to predict the extent to which the proposed rule could lead funds to modify their portfolios, or whether such modifications would discourage the issuance of certain assets. As a result, we cannot quantify the potential costs discussed in this section.[87]

The CBA clearly recognizes that proposed Rule 22e-4 may have the impact of decreasing issuers' access to the capital markets. The adverse economic impact on such issuers and the broader economy of decreased access to the capital markets has the potential to dwarf expenses that the CBA suggests would be incurred by fund complexes in implementing and complying with proposed Rule 22e-4.

A critical purpose of the CBA requirement under the 1940 Act is to ensure that the Commission conducts a rigorous evaluation of the benefits and costs, including an adverse impact on capital formation arising from reduced access to the capital markets of its regulatory actions. Given the overall size of the mutual fund sector, regulatory action that could make harder for emerging and mid-sized businesses to access funding that they need to compete and grow should be a matter of great consequence to the Commission.

A determination that the Commission cannot quantify the potential costs or impact on capital formation associated with decreased access to the capital markets, as set forth in the CBA, cannot be viewed as an adequate discharge of the Commission's obligations. The CBA's approach is not consistent with the guidance provided by the Commission's Office of General Counsel and Division of Risk, Strategy, and Financial Innovation ("***RSFI***")[88] in a memorandum regarding economic analysis in Commission rulemaking ("***Memorandum***").[89]

The Memorandum directs that the Commission's rulemaking staff should work with economists to, among other things, quantify expected benefits of costs to the extent possible.[90] The Memorandum notes that even without hard data, quantification may be possible by making and

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87 *Id*. at 62362.

88 RSFI is now the Division of Economic and Risk Analysis.

89 *See* Memorandum to Staff of the Rulemaking Divisions and Offices from the Office of General Counsel and RSFI regarding Current Guidance on Economic Analysis in SEC Rulemakings (Mar. 16, 2012).

90 Memorandum at 9.

explaining certain assumptions.[91] The CBA does not follow this directive. It does not seek to quantify the amount of outstanding less liquid instruments or the prospective market for future issuances of such instruments. It does not discuss the relative participation of various participants in these markets. It does not seek to make assumptions regarding the range of potential impacts on these markets that could arise from varying levels of reduced participation of mutual funds in the markets. The Memorandum further notes that:

> Court decisions addressing the economic analysis in Commission rules have likewise stressed the need to attempt to quantify anticipated costs and benefits, *even where the available data is imperfect and where doing so may require using estimates (including ranges of potential impact) and extrapolating from analogous situations*.[92]

F. Summary Of CBA Considerations

We believe that the CBA raises significant issues under Section 2(c) of the 1940 Act. As discussed above, there are major questions as to the existence of the benefits that are asserted in regard to proposed Rule 22e-4. Moreover, the Commission indicates that it is unable to quantify the benefits of the proposal. The CBA does identify an initial cost of approximately $1.4 billion with significant additional annual compliance costs. However, this cost estimate is based on faulty assumptions that undermine the credibility of the estimates, and the proposal does not provide sufficient detail to ascertain the accuracy of the SEC staff's estimates to comply with the proposal, particularly the on-going analysis of the liquidity factors mandated by the proposal for each portfolio instrument of a fund. Other alternative approaches should have been considered by the Commission, which could be less costly to fund complexes. Further, the CBA does not seek to provide a quantification or range of quantifications of the potential far larger impact of impairing the liquidity of outstanding less liquid instruments or decreasing the ability or willingness of issuers to participate in the capital markets through future issuances of less liquid instruments.

IV. THE PROPOSING RELEASE RAISES SIGNIFICANT ADMINISTRATIVE LAW ISSUES

In its current form the proposal could be subject to substantial challenge under administrative law precedent. Of particular note in that regard is a U.S. Supreme Court decision issued in June 2015, *Michigan v. Environmental Protection Agency*, 135 S. Ct. 2699 (U.S. 2015).

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[91] *Id*. at 12.

[92] *Id*. at 13 (emphasis added).

In that case the Supreme Court considered a challenge to an Environmental Protection Agency ("***EPA***") final rule regarding the regulation of air pollutants emitted by power plants. The EPA was authorized to regulate power plants under a particular program only if it considers that the regulation is "appropriate and necessary" after studying hazards to public health posed by power plant emissions. The EPA argued that it did not have to consider the costs of the regulation in determining whether it was appropriate. The Court disagreed with the EPA and remanded for further consideration.

The Court provided important guidance in regard to the role of costs and benefits in considering the validity of an agency rulemaking.

> Read naturally in the present context, the phrase "appropriate and necessary" requires at least some attention to cost. One would not say that it is even rational, never mind "appropriate," to impose billions of dollars in economic costs in return for a few dollars in health or environmental benefits. In addition, "cost" includes more than expense of complying with regulations; any disadvantage could be termed a cost. EPA's interpretation precludes the Agency from considering *any* type of cost – including, for instance, harms that regulation might do to human health or the environment. The Government concedes that if the Agency were to find that emissions from power plants do damage to human health, but that the technologies needed to eliminate these emissions do even more damage to human health, it would still deem regulation appropriate. . . . No regulation is "appropriate" if it does significantly more harm than good.[93]

The principles set forth in *Michigan v E.P.A.* would be relevant to any judicial consideration of the proposal if it were to be adopted in its current form. The 1940 Act limits the Commission's rulemaking authority to rules that are necessary or appropriate to the exercise of the powers conferred on the Commission in the 1940 Act.[94]

As discussed above, there are significant issues, acknowledged by the Commission, as to whether the basis for the CBA's argument of benefits – the early-mover advantage – actually exists with respect to mutual funds. A finding, among other things, that there was no valid rationale supporting the purported benefits of a rule where an agency acknowledged that the rule would have substantial initial and ongoing costs would fall squarely in the Supreme Court's observation that no regulation is appropriate if it does significantly more harm than good.

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[93] *Michigan v. E.P.A.* 135 S.Ct. 2699, 2707 (2015).

[94] 15 U.S.C. § 80a-37(a).

V. COMPLIANCE DATES

Based on a fund's asset size, the proposal sets forth a scaled compliance period. If the proposal is adopted, fund complexes that have net assets of $1 billion or more as of the most recent fiscal year would have 18 months to comply with the new liquidity risk management rule. Fund complexes that have net assets below $1 billion would have an additional 12 months (*i.e.,* 30 months) to comply with proposed Rule 22e-4. We are generally supportive of staggered compliance dates for smaller fund complexes. However, we are concerned that this proposal, together with the other proposals the Commission will adopt, will require significant time and resources to implement. This proposal is the second part of a five-part plan "to enhance the regulation of the risks arising from the portfolio composition and operations of funds and investment advisers."[95] The Commission recently proposed the first three parts of this five-part plan. The remaining parts will include measures to "plan for the transition of client assets and to stress test funds and advisers." Based on the significant costs and resources that we would expect fund groups to incur in connection with implementing these proposals, we strongly recommend that the Commission consider how best to efficiently implement these proposals and provide lengthier compliance dates. In addition, because these proposals are interconnected, we recommend that the Commission not finalize a proposal in isolation or at a minimum without understanding how changes made to one proposal could impact the other proposals. We would also recommend that the SEC consider the costs and anticipated benefits of not only this proposal, but also the aggregate costs and anticipated benefits of all of the proposals together.

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We appreciate the opportunity to comment on the Proposing Release. Please feel free to contact Julien Bourgeois at (202) 261-3451, Brendan C. Fox at (202) 261-3381, Jeffrey S. Puretz at (202) 261-3358, Jack W. Murphy at (202) 261-3303, Robert H. Ledig at (202) 261-3454 or Brenden P. Carroll at (202) 261-3458 with any questions about this submission.

Very truly yours,

/s/ Dechert LLP

Dechert LLP

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95 Mary Jo White, Chair, Statement on Open-End Fund Liquidity Risk Management Programs and Swing Pricing, Securities and Exchange Commission (Sept. 22, 2015).