NEW YORK
CITY BAR

**COMMITTEE ON
INVESTMENT MANAGEMENT REGULATION**

FRANK J. NASTA
CHAIR
270 PARK AVENUE
NEW YORK, NY 10017-2014
PHONE: (212) 648-0894
FAX: (212) 648-1978

DIANNE E. O'DONNELL
SECRETARY
787 SEVENTH AVENUE
FL 40
NEW YORK, NY 10019-6099
PHONE: (212) 728-8558
FAX: (212) 728-9558

January 13, 2016

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

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

File No. S7-16-15

Dear Mr. Fields:

This letter is submitted by the Committee on Investment Management Regulation of the New York City Bar Association (the "Committee") and responds to the request of the Securities and Exchange Commission (the "Commission") for comment in Release No. IC-31835 (Oct. 15, 2015) (the "Proposing Release"), in which the Commission proposed a new Rule 22e-4 ("Proposed Rule 22e-4" or the "Proposed Rule") under the Investment Company Act of 1940, as amended ("1940 Act"), and certain amendments to certain of the Commission's rules and forms (the "Proposal").[1] The Committee is composed of lawyers with diverse perspectives on investment management issues, including members of

[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. 62,274 (proposed Oct. 15, 2015).

law firms and counsel to financial services firms, investment company complexes and investment advisers. A list of our members is attached as Annex A.

As stated in the Proposing Release, the Proposal is intended to promote effective management of liquidity risk for registered open-end funds, including open-end exchange-traded funds ("ETFs") but not including money market funds ("Covered Funds" or "Funds"), to attempt to reduce the risk that Covered Funds will be unable to meet redemption obligations, and to try to mitigate dilution of the interests of Covered Fund shareholders, in accordance with Section 22(e) and Rule 22c-1 under the 1940 Act.[2] The Proposing Release contains a comprehensive review of the Commission's views about the management of portfolio liquidity practices for Covered Funds. The Proposing Release also seeks to provide greater clarity about the Commission's views on the complexities attendant to the practices that Covered Funds, which issue redeemable securities, should consider and follow to assure their compliance with Section 22(e) of the 1940 Act and to enable such Funds to make payment for securities tendered for redemption within seven days of their tender.

The Committee appreciates the opportunity to comment on the Commission's Proposal. The Committee strongly supports the primary goal of the Commission in issuing the Proposal: to underscore the importance of the implementation by open-end funds and their investment advisers of portfolio security liquidity risk management processes to support the ability of such Funds to comply with their obligation under Section 22(e) of the 1940 Act to meet Fund shareholders' redemption requests in a timely manner. The Committee also appreciates the difficulty of the task facing the Commission in its efforts to craft rules addressing fund liquidity risk management under the existing structure of the 1940 Act. As the Commission notes in the Proposing Release, open-end funds, including ETFs, seek a wide variety of investment objectives and use many different types of investments, many not existing or even contemplated in 1940, to seek those objectives. Indeed, the 1940 Act contains no definition of "liquidity," nor is the lack of investment portfolio liquidity one of the eight ills identified in Section 1(b) of the 1940 Act by which investors were "adversely affected" and remediation of which served as the public policy bases for the 1940 Act.

In this letter, the Committee outlines a number of concerns with aspects of the Proposal and responds to certain of the Commission's associated requests for comment. In brief, those concerns include:

(1) **Disclosure Requirements.** The Committee believes that certain proposed disclosure requirements may confuse or mislead investors about the ability of a Covered Fund's liquidity risk management program ("Program") to address liquidity risk in the securities markets.

(2) **Portfolio Holdings Liquidity Information on Proposed Form N-PORT May Become Outdated and Thus Harmful or Misleading to Investors Relying on Such Disclosures, Including During Periods of Market Stress.** As a result of changes in portfolio holdings and in portfolio holdings' liquidity classifications, especially in times of market stress, a Fund's current portfolio holdings and liquidity classifications may differ substantially from those reported on Form N-PORT. Accordingly, the Committee believes that during times of market stress, the portfolio holdings liquidity information reported on Proposed Form N-PORT may be harmful or misleading to investors.

---

[2] The Proposal also includes, among other things, proposed amendments to Rule 22c-1 to permit Covered Funds to elect to use "swing pricing," if certain requirements and conditions are met. This letter does not comment on that part of the Proposal.

(3) **The Responsibility Assigned to Fund Directors under the Proposal Does Not Align with the Appropriate Functions of Directors Under State Laws.** The responsibilities the Proposal would place upon a Covered Fund's board of directors or trustees ("Board" or "Directors") to approve a Covered Fund's initial Program and any material changes to it would in effect require Directors to exercise a functional investment managerial role in Fund operations, rather than an oversight role of the actions taken by a Fund's manager(s). The Proposal's statement that Directors could exercise that role by relying on an investment adviser's "summaries" of highly complex compliance structures for creating and implementing a Program is troublesome, given the fiduciary responsibilities of Directors. Moreover, the Proposal lacks any statement about the standard of care to which the Commission would hold such Directors in exercising those new functions.

(4) **The Proposed Rule Would Raise Enhanced Litigation Risks for Covered Funds, Investment Advisers and Directors.** By proposing to adopt the very complex liquidity risk management practices that the Commission has described in the Proposal as a rule, rather than issuing them in the form of enhanced guidance, the Commission proposes an approach that the Committee believes will increase the risk of unwarranted litigation against Covered Funds, their Directors and investment advisers. Investors might claim, in hindsight, that their reliance on the disclosures mandated by the Proposed Rule, including those on Form N-PORT and those on Form N-1A with respect to a Fund's adoption of a Program, caused the investors to experience financial losses. In addition, by not addressing the standard of care under which the Commission would expect to hold Boards of Covered Funds accountable in their actions and deliberations under the Rule, the Proposal exposes Directors to heightened litigation risk by investors claiming a breach of duty in connection with the Directors' exercise of their responsibilities under the Rule.

(5) **The Proposed Requirement that a Covered Fund Maintain a "Three-Day Liquid Asset Minimum" Is Premised Upon the Inapposite Application of the Requirements of Rule 15c6-1 under the Securities Exchange Act of 1934 to Covered Funds.** It appears that the Commission has based the proposed requirement that Covered Funds should maintain a Three-Day Liquid Asset Minimum on the following three premises: (1) most open-end fund redemption proceeds are paid through broker-dealers that are subject to the requirements of Rule 15c6-1 under the Securities Exchange Act of 1934 ("Exchange Act"), (2) as a business matter, most open-end funds have committed, in their prospectuses or otherwise, to pay redemption proceeds in less than the seven-day period required pursuant to Section 22(e) of the 1940 Act, and (3) as a result, open-end funds are, impliedly, not just as a practical matter, subject to T+3 settlement of redemptions under Rule 15c6-1. The Committee believes that the last assumption is not correct and that even if some open-end funds do attempt to pay redemption proceeds in fewer than seven calendar days, that practice does not lead to the conclusion that all open-end funds are subject to the requirements of Rule 15c6-1. The Committee believes that even if some Covered Funds seek to pay redemption proceeds in less time than is required by Section 22(e) of the 1940 Act, the requirements of Section 22(e) govern the timeliness of open-end funds' payment of redemption proceeds.

Responses to Certain Questions Raised in the Proposing Release. The Proposing Release includes a number of requests for comment on particular aspects of the Proposal. The Commission asks whether the general elements of the Proposal would enhance Funds' ability to assess and manage liquidity risk. As an initial matter, we urge the Commission to reconsider whether the adoption of Proposed Rule 22e-4, requiring the assignment of a Covered Fund's portfolio securities to highly specific liquidity classifications, which are based, most typically, upon estimates using past market activity, is necessary to achieve the Commission's objectives. Instead, we propose that the Commission take a different

approach, either (1) by providing updated formal guidance to Covered Funds, rather than adopting a rule, about the types of considerations a Covered Fund should analyze on a regular basis to determine the liquidity of its portfolio investments, and stating that such Funds should adopt appropriate liquidity management programs that would consider the types of factors the Commission identified in the Proposal, or (2) if the Commission determines to take a rules-based approach to liquidity management by Covered Funds, to use a "principles-based" approach similar to that allowed under 1940 Act Rule 38a-1 and Rule 206(4)-7 under the Investment Advisers Act of 1940, as amended ("Advisers Act"), and require Covered Funds or their advisers to adopt portfolio liquidity management oversight programs appropriate for the particular Fund consistent with the requirements of Section 22(e) and Rule 22c-1 under the 1940 Act.

The Commission also requests comment on whether the proposed liquidity classification disclosure on proposed Form N-PORT would meet the Commission's objective of assisting investors. For the reasons set forth below, the Committee believes that the proposed liquidity classification disclosure on proposed Form N-PORT would not provide meaningful, current information about portfolio security liquidity in a manner that would assist investors in understanding and dealing with market-based risks of investing in a Covered Fund.

The Commission also requests comment on whether the Commission should require that the proposed liquidity classification information on proposed Form N-PORT be reported only to the Commission and not be publicly disclosed. We believe the reasons set forth below demonstrate that the proposed liquidity classification information on proposed Form N-PORT should be reported only to the Commission and should not be publicly disclosed.

The Commission also asks whether the proposed amendments to Form N-1A regarding payment of redemption proceeds would be helpful to Fund shareholders and whether there are any challenges associated with Funds disclosing whether methods of meeting redemption requests are used regularly or only in stressed market conditions. For the reasons set forth below, we believe the proposed amendments to Form N-1A concerning disclosure of the number of days in which a Fund will pay redemption proceeds would not be helpful to Fund shareholders. We also set forth below certain concerns with requiring Funds to disclose whether methods of meeting redemption requests are used regularly or only in stressed market conditions.

Proposed Rule 22e-4(b)(2)(i) sets out the requirements for classifying the relative liquidity of a Fund's portfolio positions. It would require each Covered Fund to classify and "engage in an ongoing review" of each portfolio position based on listed categories of the number of days in which it is determined, using information obtained after reasonable inquiry, that the Fund's position in the asset (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." The Proposal asks whether that quoted language is "sufficiently clear."[3] As discussed below, although the Proposal clarifies what that quoted language intends, the Committee believes that the language is not sufficiently clear and should be revised.

1. As an Alternative to Adopting the Proposed Rule, the Commission Could Use a Principles-Based Approach by Issuing Formal Guidance on Liquidity Risk Management by Covered Funds or by Adopting a Rule Allowing Funds to Tailor Their Risk Management Process.

[3] Proposing Release, 80 Fed. Reg. at 62,296.

While the Committee strongly supports the Commission's efforts to emphasize Covered Funds' obligations under Section 22(e) of the 1940 Act, the Proposal seeks to impose a prescriptive, rules-based approach to monitoring and managing liquidity by Covered Funds. In this regard, although the Proposal provides some flexibility to the Board of the Covered Fund when adopting a Program, the Proposal is highly restrictive and, as discussed herein, might impose a measure of liquidity risk management that could misalign incentives by encouraging investment advisers to place too much emphasis on investors' liquidity "perceptions" of a Fund based upon data that the Fund must publicly file and the misleading impressions that data could create.

The Commission asks whether the general elements of the Proposal would enhance Funds' ability to assess and manage liquidity risk.[4] As an alternative approach, we recommend that the Commission consider taking a principles-based approach, either by issuing the principles outlined in the Proposal as formal guidance, updating and replacing prior guidance by the Commission with respect to liquidity and illiquid securities, or by adopting a rule whereby each Covered Fund and its investment adviser can tailor that Fund's specific liquidity management requirements based upon the facts and circumstances applicable to that Fund, its investment portfolio and shareholders. In this respect, the Committee recommends that the Commission use the Rule 38a-1/Rule 206(4)-7 framework as a model for that approach, requiring each Covered Fund or, as we recommend, its investment adviser to adopt and implement written policies and procedures reasonably designed to ensure that the Covered Fund is reasonably capable of satisfying the requirements of Section 22(e) of the 1940 Act.

We believe that a principles-based approach would fulfill the policy objectives of the Commission of seeking to ensure that Covered Funds are able to meet their redemption obligations to their shareholders while at the same time permitting Covered Funds to create a flexible framework which balances anticipated liquidity needs with the Fund's investment objectives and strategies. Additionally, even under a flexible rule, the staff of OCIE could examine the books and records of each Covered Fund and evaluate and test the reasonableness of the policies and procedures of the Covered Fund.

Moreover, the Proposal could result in substantial additional compliance costs for Covered Funds and, as discussed below, the risk of litigation-related costs for Covered Funds. Such compliance costs may be prohibitive for smaller Covered Funds. The principles-based approach that we propose would mitigate certain of these costs, as smaller Covered Funds could better tailor Programs to their specific circumstances and resources.

2. Proposed Amendments to Proposed Form N-PORT

a. Item C.13: Liquidity Classifications of Fund Positions

Delayed Disclosure. Frequent changes by a Covered Fund to the liquidity classifications of its portfolio investments would most likely be made during periods of market stress, precisely when investors are most likely to seek information concerning the liquidity of the Covered Fund's portfolio positions, and to rely on that information, if available, in deciding whether to redeem or maintain an investment in the Fund's shares. However, under the Proposal, only liquidity classification information reported for the third month of a Covered Fund's fiscal quarter would be made publicly available on Form N-PORT, and

---

[4] *See id.* at 62,302.

would only be made available on a sixty-day lag.[5] The Committee questions whether such potentially outdated information could be harmful or misleading to investors, especially during periods of market stress. Unforeseen market events could completely change the liquidity profile of a Covered Fund in a short period of time and lead investors to believe that the Fund's investments are "safer" than the investments actually are, based on more current market environment and liquidity evaluations.

The Proposal requires Funds to review liquidity classifications on an ongoing basis and to revise such liquidity classifications as appropriate. Certain factors on which liquidity classifications are to be based may vary substantially under stressed market conditions.[6] Moreover, the Proposal contemplates daily, or even hourly, review of liquidity classifications in certain circumstances, such as where portfolio asset liquidity may depend significantly on current market conditions. Such frequent reviews would be necessary to, among other things, ensure compliance with the three-day liquid asset minimum ("TDLA Minimum"), and at a minimum, monthly review of liquidity classifications would be required for accurate Form N-PORT reporting.[7]

The quarter-end snapshot of Fund portfolio holdings' liquidity classification information to be included on a Fund's Form N-PORT would be made publicly available with a sixty-day lag. That delayed snapshot would be the only liquidity classification information publicly disclosed for approximately ninety days, until the next quarter's delayed snapshot becomes publicly available.[8] The timing of that public disclosure of a Fund's liquidity classifications under the Proposal would not necessarily be concurrent with the frequency of the review and the Fund's investment adviser's reclassification of the liquidity of a Fund's portfolio positions. It is not clear how such a disclosure regime would benefit investors, particularly during periods of market stress, or serve to reduce the risk that Funds would be unable to meet redemption obligations. More frequent reporting is not a viable alternative; among other issues, such a requirement would create additional burdensome costs and the potential for front-running.

Particularly during or following periods of market stress, certain previously-disclosed liquidity classifications likely may have changed but such updated classifications would not yet have been made publicly available. Accordingly, Covered Funds that properly review and update liquidity classifications and that publicly disclose liquidity classifications on the schedule required under the Proposal could face, along with their Directors, claims from litigants purporting to have relied upon publicly-available liquidity classification data not representative of the Covered Fund's actual portfolio holdings at the time. Even if a Covered Fund and its Directors prevailed in such litigation, the Fund could face substantial litigation expenses, including expenses related to discovery of data classification analysis, as a result of

---

5 *See id.* at 62,345 n.561.

6 For example, the Proposal requires Funds to consider each of the following, among other factors, when determining portfolio positions' liquidity classifications: the existence of an active market for the asset; the frequency of trades or quotes for the asset and average daily trading volume of the asset; the volatility of trading prices for the asset; bid-ask spreads for the asset; and the size of the Fund's position in the asset relative to the asset's average daily trading volume. Under stressed market conditions, it may be impractical to reach stable conclusions for one or more of these factors, and, as a result of timing differences and different information sourcing, conclusions may vary substantially among different Covered Funds.

7 *See id.* at 62,303 n.253 and accompanying text.

8 *See id.* at 62,345 n.561.

the Fund's compliance with the disclosure regime the Proposal would mandate, without any resulting benefit to investors.

Additionally, the Committee is concerned that third-party service providers that gather, analyze and publish information about Covered Funds may utilize a Covered Fund's disclosures on Form N-PORT, but that, for the reasons discussed above, such information may not be reflective of a Covered Fund's actual portfolio holdings. This concern is particularly relevant in times of market stress. For example, a Covered Fund's particular portfolio holding may be classified in a relatively liquid category (such as the 2-3 business day bucket), and that classification may be made publicly available on Form N-PORT. However, as a result of issuer-related concerns or market movements, the Covered Fund may reclassify the position into a relatively less liquid category (such as the 8-15 calendar day category). Third-party service providers analyzing available data on Form N-PORT may criticize the Covered Fund for the apparent more-liquid classification of the position in question (which could call into question the safety the Fund's TDLA Minimum afforded), but such criticism would be unwarranted in light of the Fund's reclassification of the position. Such criticism, although not warranted, could result in outflows from the Covered Fund, exacerbating the very concerns the Commission seeks to address in the Proposal.

If the Commission believes that it needs the data it is seeking in the Proposal in order to monitor effectively the liquidity practices of Funds, we would urge the Commission to seek that information via ***non-public reporting*** by a Covered Fund (as is done under Form PF); such reporting should take into account specific, fact-based objective reporting that can be compiled and filed with the Commission on a systematic basis. To the extent that the Commission expects Covered Funds to make liquidity classification determinations with respect to portfolio holdings on a daily or even hourly basis in times of market stress, the Committee believes that the Commission should not make the periodic reports of a Fund's liquidity classification determinations publicly available. As stated, there is a substantial risk that the liquidity classification information filed with the Commission would not be helpful to investors and could give rise to greater litigation risks for such Funds if investors claim to have relied on such liquidity classification information when making a decision to purchase or sell shares of a Covered Fund during times of market stress, and that at the time of such purchase/sale decision the Fund's actual liquidity risk classifications had changed materially from the classifications in the reports filed with the Commission.

Market and Regulatory Pressures for Uniformity. The Commission expects that publicly-available liquidity classification data on Form N-PORT may lead to certain positions being more consistently classified across the Fund industry.[9] The Commission also specifically contemplates further inquiry by the Commission's staff where a Fund's liquidity classifications disclosed on Form N-PORT are considered an "outlier."[10] For each of these reasons, Funds could face pressure to classify portfolio positions consistently with other Funds' publicly-disclosed classifications, a result that calls into question the value of such classifications, so that, rather than reflecting proprietary evaluations, classification measurements may ultimately be obtained from a small number of third party evaluators.[11]

---

9 *See id.* at 62,346.

10 *See id.* at 62,294 ("[W]e note that if a fund is an outlier with respect to its liquidity classifications, Commission staff would be able to identify such outlier classifications based on the fund's position-level liquidity disclosure on Form N-PORT and determine whether further inquiry is appropriate.").

11 We note that funds' public disclosures of 15% standard assets on proposed Item C.7 would be susceptible to similar market pressures as funds' public disclosures of liquidity classifications. For example, if the

Need for Clarity in Guidance Concerning Liquidity Classifications. Proposed Rule 24e-4(b)(2)(i) sets out the requirements for classifying the relative liquidity of a Fund's portfolio positions. Proposed Rule 22e-4(b)(2)(i) would require each Covered Fund to classify and engage in an ongoing review of each of the Fund's portfolio positions, "based on . . . categories of [the] number of days in which it is determined, using information obtained after reasonable inquiry, that the fund's position in [each portfolio] asset (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." The Proposal explains that with respect to such determination, the term "immediately prior to sale" is meant to reflect that the Fund must determine whether the sales price the Fund would receive for a security that is sold is "reasonably expected to move the price of the asset in the market, independent of other market forces affecting the asset's value." According to the Proposal, this provision is not meant to require a Fund to anticipate and determine in advance the precise current market price or fair value of an asset at the moment before the Fund would sell the asset.[12]

A portfolio asset's liquidity determination could, however, result in portions of the asset being assigned to different liquidity classifications under the Proposed Rule. Thus, if the Fund believes that a portion of the Fund's holding of an asset could be sold within three business days without moving the market price, but that the sale of the remainder of the position would require a longer period to complete without moving the market price, the Committee does not believe that the quoted phrase is clear as to how a determination should be made as to the effect of the sale of the second tranche of such asset: if the price of the asset is lower after the sale of the "liquid" portion of the Fund's holdings, is that the "asset's value" that should be used as the basis of such determination, rather than the value before the initial sale? Against which "value" is such "materiality" test supposed to be made? The language in the Proposed Rule is not clear on that point.

Additionally, if the purpose of the Proposed Rule is to assure that a Fund can meet its redemption demands within seven calendar days as required by Section 22(e) of the 1940 Act, it is not clear why a shift from a so-called "binary" determination of the "liquidity" of a Fund's portfolio assets is a necessary standard. That "binary" approach was adopted by the Commission in prior guidance and rulemaking and entailed a determination whether a Fund could sell a security within seven calendar days in the ordinary course of business at approximately the amount at which the Fund had valued the security.[13] In the Proposing Release, the Commission has changed the focus for determining liquidity of assets for Section 22(e) compliance purposes to estimating whether the sale of some or all of a position in a security in the future might "move the market" in a manner that would *materially* affect the value at which the asset was held immediately prior to sale, without considering other market conditions. This construct, incorporating the phrase "that does not materially affect the value of that asset immediately prior to sale," differs substantially from prior Commission guidance and, indeed, its prior definitions of "illiquidity" that focused on a Fund's estimation whether the Fund could sell a security within seven days at *approximately* the value at which the Fund had been carrying the security. "Approximately" and "materially affect" connote the application of very different levels of judgment. While the Proposing Release states that the

---

market generally is not treating a particular type of asset as a 15% standard asset, a fund would face pressure to follow suit.

12 *Id.* at 62,292.

13 *See* Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Investment Company Act Release No. 17452 (Apr. 30, 1990) [55 FR 17933, 17940 (Apr. 30, 1990)], citing Investment Company Act Release No. 14983 (Mar. 12, 1986) [51 FR 9773 (Mar. 21, 1986)] (adopting amendments to Rule 2a-7).

new construct for determining liquidity is not meant to require a Fund to anticipate and determine in advance the precise current market price or fair value of an asset at the moment before the Fund would sell the asset, but rather is meant to establish factors for a Fund to consider in classifying the liquidity of an asset, the proposed language of the Rule does not say that. It is unclear whether a Fund could be held liable under the strict language of the Proposed Rule for misjudging the degree of effect a sale of a particular asset would have on the Fund's future valuation of the asset after sale of some of the position, or the amount the Fund received on sale of the entire position.

b. Item B.7: Three-Day Liquid Asset Minimum

Delayed Disclosure. The Proposal would require a Fund to disclose its TDLA Minimum on Form N-PORT and, like the liquidity classifications discussed above, a quarter-end snapshot of a Fund's TDLA Minimum would be made publicly available on a sixty-day lag. However, a Fund's TDLA Minimum "could become outdated for multiple reasons . . . [including] market events," and the Commission encourages Funds to adopt procedures specifying triggers for and governing ad-hoc reviews of the TDLA Minimum in addition to the semi-annual review required under the Proposal.[14] Once again, the timing of public disclosure of the TDLA Minimum under the Proposal would not comport with more frequent or ad-hoc reviews and revisions necessary in certain circumstances. Thus, again, investors may have access only to outdated information concerning a Fund's TDLA Minimum at the precise time that reliance upon such information is greatest.

Market Pressure for Uniformity. The Commission acknowledges that public disclosure of the TDLA Minimum on Form N-PORT would facilitate comparisons between Funds and observations of changes over time in the TDLA Minimum.[15] As with public disclosure of liquidity classifications, comparisons of TDLA Minimums across Funds would likely result in competitive pressures for relatively uniform TDLA Minimums among Funds with similar investment strategies.

Need for Clarity in Defining "Liquidity Risk" Under Proposed Rule 22e-4. The Commission proposes to define "liquidity risk" in the Proposed Rule 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."[16] Through the use of "expected" and "reasonably foreseeable under stressed conditions," the Commission has introduced indefinite regulatory requirements that could subject Covered Funds, their Boards and their investment advisers to much second-guessing, whether by legal counsel for investors or by the Commission's staff. The phrase "without materially affecting the fund's net asset value" could become an impediment to a Fund's attempt to sell liquid securities in a market in which prices are falling overall, because of the risk of becoming subject to after-the-fact challenges as to the effectiveness of the Fund's Program.

---

14 *See* Proposing Release, 80 Fed. Reg. at 62,315-16.

15 *Id.* at 62,347 ("Requiring reporting of [the TDLA Minimum] on Form N-PORT would allow our staff and other interested parties to easily assess the [TDLA Minimum] across funds . . . . This should facilitate comparisons between funds as well as the observation of trends over time in this indicator of fund liquidity.").

16 *Id.* at 62,303.

Finally, in defining "three-day liquid assets" as cash or any asset or position in an asset that the "fund believes is convertible into cash within three business days at a price that does not materially affect the value of that asset immediately prior to sale,"[17] the Commission has moved away from the definition of illiquid securities that it has used as the basis of prior guidance, widely relied upon by the Fund industry: "[g]enerally, an 'illiquid security' is any security that cannot be disposed of within seven days in the ordinary course of business at approximately the amount at which the company has valued the instrument."[18]

The Proposing Release notes, as discussed above, that the term "immediately prior to sale" is intended to require a Fund to determine whether the price the Fund would receive on the sale of an asset is "reasonably expected to move the price of the asset in the market."[19] That definitional change introduces a risk that Funds, their Boards and investment advisers will be second-guessed about decisions to sell particular portfolio assets in a downward-moving market at prices less than that at which the Fund has historically valued the assets on its books.

That change also raises significant concerns about the effect of such determination of the projected price of a block sale of a particular asset on the determination of the current value assigned to that asset for purposes of compliance with Section 2(a)(41) of the 1940 Act, in light of past Commission staff guidance that in valuing a particular asset, a Fund need not consider the price it would receive in a sale of its entire position.[20] The interplay between the concepts of liquidity, as set forth in the Proposal, and valuation for purposes of compliance with the 1940 Act have not, in the Committee's view, been sufficiently addressed in the Proposal. The Committee urges the Commission to reaffirm that valuation for Section 2(a)(41) purposes is independent of, and not affected by, separate judgments as to the liquidity of large positions or of possible future market stresses not reflected in currently evaluated prices.

3. Proposed Amendments to Form N-1A Item 11

Although all Funds are required to honor redemption requests within seven days pursuant to 1940 Act Section 22(e), the Proposal would require Funds to disclose in their registration statements the number of days in which redemption proceeds will be paid to redeeming shareholders. Funds disclosing shorter periods for payment of redemption proceeds (such as within three days, consistent with the requirements applicable to broker-dealers under Rule 15c6-1 under the Exchange Act) may be viewed more favorably by investors, thus increasing market pressure for all Funds to adopt and disclose such shorter redemption

---

[17] *Id.*

[18] Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Investment Company Act Release No. 17452 (Apr. 30, 1990) [55 FR 17933, at 17940 (Apr. 30, 1990)], citing Investment Company Act Release No. 14983 (Mar. 12, 1986) [51 FR 9773 (Mar. 21, 1986)].

[19] Proposing Release, 80 Fed. Reg. at 62,292.

[20] *See* Annual Industry Comment Letter, Chief Accountant, Div. of Inv. Mgmt, SEC (Feb. 14, 2001) ("We recently received a question about whether it is appropriate for a registered investment company to value an unrestricted security at a discount or premium from a readily available market quotation based solely on the size of the investment company's holding. . . . [W]e do not believe it is appropriate to discount or mark-up a readily available market price for an unrestricted security solely because an investment company holds a large quantity of the outstanding shares of an issuer or holds an amount that is a significant portion of the security's average daily trading volume.").

periods. For certain Funds, particularly those with relatively less liquid portfolios, such shorter redemption periods may not be appropriate. In certain cases, investors relying on such disclosures could face longer than expected redemption periods. The Committee believes that reliance upon the existing statutory requirement of Section 22(e), together with the flexibility to disclose the timing of redemption proceeds if a Fund determines to do so, better serves Funds and investors than a *requirement* to disclose the number of days in which redemption proceeds will be paid. The Committee believes that the 1940 Act's framework for the timing of meeting redemption requests should be maintained and should not be, in effect, narrowed for consistency with Exchange Act Rule 15c6-1.

The Proposal would also require Funds to disclose in their registration statements the methods used to meet redemption requests and whether such methods are used regularly or only in stressed market conditions. The Committee believes that this requirement would inappropriately limit Funds' flexibility with respect to meeting redemption requests. For example, if a Fund discloses that it would use a particular method of meeting redemption requests only under stressed conditions, there is a risk that unexpected circumstances may arise that necessitate the use of that method of meeting redemption requests (or where use of that method is in the Fund's best interests) even though the market is not facing stressed conditions. The Committee also believes that such a disclosure requirement will result in primarily boilerplate disclosures, as Covered Funds seek to retain operational flexibility in meeting redemption requests while also satisfying new disclosure requirements. Another unintended consequence of the reporting requirements would be the added pressure on smaller Fund groups to seek external means to enhance liquidity in Funds investing in securities that have lengthier settlement practices, such as loan Funds. For example, some larger Funds may be able to "access" liquidity from third parties in a relatively less-expensive manner than smaller Funds.

4. The Responsibilities of a Covered Fund's Board with Respect to Adoption and Oversight of the Fund's Program.

Under Proposed Rule 22e-4(b)(3), a Covered Fund's Board would be assigned approval and oversight responsibilities with respect to the Fund's Program. The Board, including a majority of the disinterested Directors, would be required to approve the initial Program, including the Fund's TDLA Minimum, as well as any material changes to the Program (including a change to the TDLA Minimum). Additionally, the Board, including a majority of the disinterested Directors, would be required to review, at least annually, a written report prepared by the Fund's investment adviser or officers administering the Program, that describes the adequacy of the Program, including the TDLA Minimum, and the effectiveness of its implementation. The Board also would have the responsibility to approve the designation of the Fund's investment adviser or officers (which may not be solely portfolio managers of the Fund) responsible for administering the Program.

The Commission asks whether it should require Boards to approve the initial Program, including the TDLA Minimum, and whether Boards should be required to approve material changes to such Programs and a Fund's TDLA Minimum, or whether, similar to Rule 38a-1 under the 1940 Act, there should be no requirement for Board approval of changes to Programs.[21]

a. Concerns About the Nature of Responsibilities to be Imposed on Boards of Covered Funds Under the Proposed Rule.

---

[21] Proposing Release, 80 Fed. Reg. at 62,325.

The Committee is concerned that the Proposal would place on Covered Fund Boards responsibility for complex operational decisions involving investment-, market- and portfolio security-based factors, an obligation that is inconsistent with the typical oversight matters for which Boards are generally responsible. This proposed requirement is based, at least in part, on the notion that conflicts of interest between the investment adviser or officers tasked with implementing the Covered Fund's Program and the Covered Fund necessitate the proposed level of Board involvement.[22] However, unlike certain other areas where the Commission has determined that conflicts of interest necessitate direct involvement by the Board,[23] the conflicts the Commission cites in explaining its decision to propose direct Board responsibility for approval and oversight of a Covered Fund's Program differ little from the conflicts addressed by other policies typically adopted under 1940 Act Rule 38a-1. That is, the conflicts cited by the Commission – for example, "an adviser might have an incentive to set a low [TDLA Minimum] in order to permit the fund to invest in additional less liquid assets (because such assets may result in higher total returns for a fund), even though a low [TDLA Minimum] may not reflect an appropriate alignment between the fund's portfolio liquidity profile and the fund's liquidity needs"[24] – are qualitatively different from the potential abuses that necessitate more direct Board oversight in certain other contexts, such as cross-trades under Rule 17a-7.

Moreover, the Commission fails to explain why a Board and an investment adviser would necessarily have conflicting views on this issue, given their shared focus on Fund performance. In fact, this issue appears to be not so much a conflict of interest as a tension in competing objectives – tensions that an investment adviser must deal with managing any Fund on a day-to-day basis in assessing whether a particular investment is consistent with achieving the Fund's investment objectives. Liquidity does not present the classic type of conflict of interest where a Board's role as "independent watchdog"[25] would be implicated, as in the case of approving the Fund's investment management contract, reviewing the use of an affiliated broker (or other transactions between a Fund and its affiliated persons) or the use of Fund assets to finance Fund distribution.

The Commission has determined that a Covered Fund's investment adviser or officers, and not its chief compliance officer, must be designated as responsible for administering the Program (as this is the way the Commission understands most Funds currently manage liquidity) and that it would task persons in a position to manage a Covered Fund's liquidity risks on a real-time basis with responsibility for

---

22 *Id.* at 62,323-24 ("This requirement is designed to facilitate independent scrutiny by the board of directors of the liquidity risk management program – an area where there may be a conflict of interest between the investment adviser and the fund. . . . Given that the fund's liquidity risk management program will be administered by a fund's investment adviser or officers (rather than a chief compliance officer), we believe that board approval of material changes in this context will provide an important independent check on such administration.").

23 *See, e.g.*, Exemption of Certain Purchase or Sale Transactions Between a Registered Investment Company and Certain Affiliated Persons Thereof, 45 Fed. Reg. 29,067 (May 1, 1980) (proposing amendments to Rule 17a-7) (explaining that "an unscrupulous investment adviser might 'dump' undesirable securities on a registered investment company" and that, "the first line of responsibility for determining compliance with the proposed amendment" to Rule 17a-7 "should be with each investment company's directors").

24 Proposing Release, 80 Fed. Reg. at 62,323.

25 *See Burks v. Lasker*, 441 U.S. 471, 484 (1979) (quoting *Tannenbaum v. Zeller*, 552 F.2d 402, 406 (2d Cir. 1977)).

administration of the Program[26]. Although the Commission acknowledges "that [its] proposal to require directors to approve material changes to [Programs] differs from the requirements under" 1940 Act Rule 38a-1, and explains that because "the fund's [Program] will be administered by a fund's investment adviser or officers (rather than a chief compliance officer), [the Commission] believe[s] that board approval of material changes in this context will provide an important independent check on such administration," the Commission provides no clear process for the administration of the Program. The Committee submits that using the framework of Rule 38a-1 as a model for the Program administered by the investment adviser or officers, as outlined below in response to the Commission's questions, and overseen by the Board will more appropriately align operational and oversight responsibilities between the Covered Fund's officers and the Board and enable the independent members of the Board to rely on the same standard of oversight for their supervisory roles over matters not affected by direct conflicts with the adviser.

The Proposing Release suggests that the prescribed level of Board engagement set forth in the Proposal is required because "[d]irectors, and particularly independent directors, play a critical role in overseeing fund operations, although they may delegate day-to-day management to a fund's adviser. Given the board's historical oversight role, we believe it is appropriate to require a fund's board to approve the fund's liquidity risk management program." However, this assertion is inconsistent with the historical view of the Commission and its staff, which has appropriately emphasized that Fund Boards, particularly independent Directors, should not be required to micro-manage a Fund's operations. As the Division of Investment Management noted in its 1992 study of mutual fund regulation:

> We believe that independent directors are unnecessarily burdened, however, when required to make determinations that call for a high level of involvement in day-to-day activities. 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 the interests of advisers and the investment companies they advise should be handled primarily or exclusively by the investment adviser.[27]

Consistent with this view, the Committee believes that the Proposed Rule should be premised on the assumption that the Board's oversight of Fund liquidity programs should be the same as that applicable to other areas of Fund operations. It is inconsistent with appropriate Fund governance practices to premise the Proposed Rule on the assumption that Fund Boards should exercise independent judgment over technical day-to-day matters, many of which must be dealt with on very short notice.

In response to the Commission's questions, the Committee believes that a more appropriate role for Fund Boards would be:

(1) as stated in the Proposal, to require the Board to designate the Fund's investment adviser or other risk officer responsible for the development and implementation of a Program for the Fund,

---

26 Proposing Release, 80 Fed. Reg. at 62,324.

27 Div. of Inv. Mgmt., SEC, Protecting Investors: A Half Century of Investment Company Regulation (May 1992), at 266.

(2) to require that the Fund's investment adviser or such other risk officer develop, adopt and implement a Program appropriate for the Fund under the standards set forth either in a rule adopted by, or formal guidance issued by, the Commission on Fund liquidity risk management practices,

(3) to require the investment adviser (or other liquidity risk officer designated by the Board) to provide a summary report to the Board on the initial provisions of that Program, including the TDLA Minimum for the Fund, and any amendments to the Program or material changes to the TDLA Minimum, and

(4) to require that the Board receive reports, at least annually, from the investment adviser or chief risk officer, as appropriate, as well as from any consultant or third-party service provider or consultant that the Board may, in the exercise of its reasonable business judgment, choose to engage to assist it in such review, on the operation and implementation of the Program and any material proposed changes thereto or violations thereof. The Committee believes, further, that the Board may wish to seek a report from the Fund's Chief Compliance Officer pursuant to the existing requirements of Rule 38a-1 under the 1940 Act, to assure that the investment adviser or chief risk officer has adopted and implemented policies and procedures reasonably designed to assure that the investment adviser or chief risk officer has adopted and implemented a Program that complies with Rule 22e-4 and other applicable federal securities laws and rules.

The Committee is concerned with the statement in the Proposal that the adoption and implementation of a Program "differs from the requirements under rule 38a-1under the [1940] Act, which does not require a fund board to approve changes to a fund's compliance policies and procedures."[28] However, policies and procedures for compliance with Rule 17a-7 inter-fund transactions,[29] for example, are undeniably "compliance policies and procedures" under the 1940 Act, and pursuant to Rule 17a-7(e), a Fund's Board must approve such policies and procedures, including any amendments thereto. Similarly, policies and procedures adopted by a Fund pursuant to Rule 12b-1 implicate "policies and procedures" under the 1940 Act and similarly require Board approval for their adoption and amendment.

The Proposal seems to imply that in overseeing a Fund's Program, the Fund's Board would be subject to a higher standard of duty than that which applies under Rule 38a-1. The Proposal states in numerous places that the intent of the Commission in proposing Rule 22e-4 and the other amendments in the Proposal is to "promote effective liquidity risk management practices throughout the open-end fund industry and thereby reduce the risk that funds will not be able to meet redemption obligations and mitigate potential dilution of the interests of fund shareholders in accordance with section 22(e) of, and rule 22c-1 under, the Investment Company Act."[30] Those are clearly regulatory requirements within the ambit of a Fund's Rule 38a-1 process.

---

28 Proposing Release, 80 Fed. Reg. at 62,324.

29 Exemption of Certain Purchase or Sale Transactions Between an Investment Company and Certain Affiliated Persons Thereof, 17 C.F.R. § 270.17a-7 (2015) ("The board of directors of the investment company, including a majority of the directors who are not interested persons of such investment company, (1) Adopts procedures pursuant to which such purchase or sale transactions may be effected for the company, which are reasonably designed to provide that all of the conditions of this section in paragraphs (a) through (d) have been complied with; (2) Makes and approves such changes as the board deems necessary, (3) Determines no less frequently than quarterly that all such purchases or sales made during the preceding quarter were effected in compliance with such procedures . . .").

30 Proposing Release, 80 Fed. Reg. at 62,286.

The Committee believes that policies and procedures required under Proposed Rule 22e-4 would also be "policies and procedures reasonably designed to prevent violation of the Federal Securities Laws by [a] fund, including policies and procedures that provide for the oversight of compliance by each investment adviser . . . of the fund."[31] However, because of the complexity of the policies and procedures attendant to the creation of a Program and because the characteristics and requirements of such Program entail day-to-day investment management functions, which are not the types of responsibilities appropriate to assign to a Board or within a Board's expertise or statutory purpose, the Committee believes that the development and implementation of a Program should be the compliance responsibility of the Fund's investment adviser or chief risk officer, not that of the Board.

The Committee believes that requiring the Fund's investment adviser to adopt and implement such liquidity management procedures, with oversight by the Fund Board, is an approach that more appropriately assigns oversight responsibilities, not managerial and operational responsibilities, to Fund Boards in connection with the adoption and implementation of Programs, and would be consonant with the statutory responsibilities of Directors.

b. There Is a Need for the Proposed Rule to Recognize Affirmatively the Applicability of a Reasonableness Standard to the Actions and Determinations by the Boards of Covered Funds under the Rule.

The Committee is also concerned that the Proposal does not address the standard of care to which the Commission would expect to hold a Board accountable, whatever the Commission decides the Board's assigned role should be in connection with the adoption and implementation of a Fund's Program.

The Proposed Rule sets forth the aforementioned responsibilities for Boards of Covered Funds with respect to oversight of a Fund's adoption and implementation of a Program. As in the case of the Committee's 2011 Comment Letter on Money Market Fund Reforms[32], and in its 2014 Comment Letter on the removal of NSRO ratings requirements from Rule 2a-7[33], the Committee is concerned about the approach the Proposed Rule takes to the assignment of responsibilities to a Covered Fund's Board, particularly (in the absence of stated, objective legal standards in the 1940 Act for measurement of a Fund's liquidity) with respect to a Board's responsibility for, and involvement in, determinations that a portfolio security is liquid. The Committee therefore urges that the Adopting Release for the Rule should include a statement by the Commission recognizing that the Commission will assess a Board's exercise of whatever responsibilities are assigned to the Board under the Rule in light of the Board's good faith application of its reasonable business judgment.

That recognition, and explicit statement, would be consonant with prior approaches taken by the Commission with respect to Board responsibilities arising under Rule 2a-7. In its adopting release for

---

31 *See* 17 C.F.R. § 270-38a-1 (2015).

32 *See* Comment Letter of the Committee on Investment Management Regulation of the New York City Bar (Apr. 29, 2011), *available at* http://www.sec.gov/comments/s7-07-11/s70711.shtml.

33 *See* Comment Letter of the Committee on Investment Management Regulation of the New York City Bar (Oct. 14, 2014), *available at* http://www.sec.gov/comments/s7-07-11/s70711.shtml.

Rule 2a-7 in 1983,[34] the Commission addressed the nature and extent of Board responsibilities with respect to compliance with the various requirements of that rule. In particular, the Commission addressed the concerns expressed by some commenters that the proposed version of Rule 2a-7 would imperil the Board's ability to delegate responsibility for day-to-day portfolio management oversight:

> In meeting the rule's requirement that the fund invest only in those securities which the board determines to meet certain quality standards, the board may delegate to the investment adviser the responsibility for investigating and judging the creditworthiness of particular instruments. However, like the procedures discussed above, the board must exercise sufficient oversight if it wishes to delegate this function to the investment adviser. Again, sufficient oversight would involve the board setting guidelines, its approval of the adviser's methods in advance and routine surveillance of the adviser's performance.[35]

Furthermore, in adopting Rule 2a-7 in 1983, the Commission commented on the nature and extent of a Board's fulfillment of the responsibilities set forth in that rule. In response to concerns raised by some commenters that a Fund's failure to maintain a stable net asset value should not give rise to a presumption that the Fund's Board had failed to fulfill its responsibilities, the Commission stated:

> [T]he Commission does not expect the board of directors to be insurers of the activities of the investment adviser or the fund. *The Commission has evaluated in the past, and would similarly evaluate in the future, the actions of the board of directors based upon a reasonable business standard* . . . . The mere adoption of those specific procedures required by the rule and exemptive orders will not, *per se*, fulfill the board's responsibilities. On the other hand, if a board adopts procedures which are reasonably designed to assure stability and the board acts in a reasonable fashion to assure that those procedures are followed, the Commission would not hold the board responsible for any failure to maintain a stable net asset value per share.[36]

In light of the statements the Commission made in the 1983 Adopting Release with respect to the application of a reasonable business standard to a money market Fund Board's exercise of its Rule 2a-7 responsibilities, and given the arguably more complex responsibilities that the Commission proposes to assign to all Covered Fund Boards under the Proposed Rule, it is especially appropriate for the Commission to state, in adopting the Proposed Rule, that in evaluating the actions a Covered Fund's Board takes in exercising its responsibilities under the Rule, the Commission would do so based upon the reasonable business standard applicable to the Fund's Board. The Committee believes that position is consonant with the Commission's earlier statements about the responsibilities of money market Fund Boards.

---

34 Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds), Investment Company Act Release No. 13380 (Jul. 11, 1983) [48 FR 32,555 (Jul. 18, 1983)] (the "1983 Adopting Release").

35 *Id.* at 32,561.

36 *Id.* at 32,562 n.42 (emphasis added).

5. The TDLA Minimum Should Be Determined Based on Normal Market Conditions with Flexibility to Adjust to Address Changing Market Conditions.

Under the Proposal, a Covered Fund determining its TDLA Minimum would be required to consider the same factors that it would be required to consider in assessing its liquidity risk[37]; the Proposal's definition of "liquidity risk" "contemplates that the fund consider both expected requests to redeem . . . as well as requests to redeem that may not be expected, but are reasonably foreseeable under stressed conditions."[38] Indeed, in formulating its cash flow projections (a factor required to be considered in assessing liquidity risk), "[i]t would be essential that the fund formulate its cash flow projections after considering the factors in both normal and stressed periods."[39] Thus, under the Proposal, a Covered Fund's TDLA Minimum must be appropriate for both normal and reasonably foreseeable stressed conditions.

The Committee submits that requiring Covered Funds to determine their TDLA Minimums based on liquidity risk under both normal and reasonably foreseeable stressed conditions would result in artificially high TDLA Minimums. TDLA Minimums set at artificially high levels may be detrimental to Covered Funds and their shareholders, as assets may not be deployed in the most efficient or profitable manner permitted under applicable investment restrictions. Instead, the Commission should require Covered Funds to determine their TDLA Minimums based solely on normal market conditions but permit Covered Funds, by action of the person or entity administering the Program, to adjust the TDLA Minimum to address changing market conditions. The Board may be notified if the adviser's adjustment of a Fund's TDLA Minimum is not contemplated by the framework previously identified to the Board. Such an approach would permit a more efficient deployment of Fund assets while maintaining the flexibility needed to protect shareholders through maintenance of an appropriate TDLA Minimum.

6. Minimal Dilution

In discussing Funds' liquidity management practices, the Commission notes that

> [s]everal factors influence how liquidity management by open-end funds affects the equitable treatment of investors. . . . When a fund receives redemption requests from shareholders, and the fund does not have cash on hand to meet those redemptions, the fund has discretion to determine whether to sell portfolio assets . . . *and which assets will be sold . . . . A fund may choose to sell its most liquid assets first*."[40]

Subsequently, in discussing the factors to consider when setting the TDLA Minimum, the Commission states that, "minimum liquidity would not likely advance the Commission's goal of reducing the risk that funds will be unable to meet redemptions and mitigating dilution if funds can only meet redemptions in stressed conditions *through sales of portfolio assets that create dilution* and significantly increase the fund's liquidity risk."[41]

---

[37] Proposing Release, 80 Fed. Reg. at 62,311.

[38] *Id.* at 62,303-04.

[39] *Id.* at 62,312.

[40] *Id.* at 62,278-79 (emphasis added).

[41] *Id.* at 62,312 (emphasis added).

The Committee is concerned that the Commission intends for Funds to be required to sell three-day liquid assets first in meeting redemption requests (*i.e.*, that assets not classified as three-day liquid assets may not be sold or otherwise disposed of to meet redemption requests unless and until all three-day liquid assets are sold or otherwise disposed of). Such an approach would eliminate the inherent judgment vested in the Fund's portfolio management team concerning the timing and nature of portfolio transactions. Instead, even if the Commission determines to adopt the TDLA Minimum requirement substantially as proposed, the Committee submits that Fund portfolio management should retain discretion to manage Fund liquidity and dispose of such Fund assets as portfolio management deems necessary to meet redemption requests. The Committee urges the staff to clarify this point in light of the ambiguity in the Proposing Release.

7. Open-End Funds Are Not Subject to the Requirements of Rule 15c6-1 under the Exchange Act and if the Commission Proposes to Adopt a Liquid Asset Minimum Based on a Time Period, It Should Use the Seven-Day Period Specified in Section 22(e) of the 1940 Act.

In the Proposing Release, the Commission notes 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, and are required by Section 22(e) of the Investment Company Act to make payment to shareholders for securities tendered for redemption within seven days of their tender."[42] The Commission then asserts that many investors expect to receive their redemption proceeds in less than seven days where the Fund prospectus states that the Fund seeks to pay proceeds sooner than the seven-day period, and that Funds that are redeemed "through" broker-dealers "must" meet redemption requests within three days because the broker-dealers are subject to Rule 15c6-1 under the Exchange Act. It appears to the Committee that those assertions formed the basis of the Commission's selection of three days as the basis of the TDLA Minimum a Covered Fund must maintain pursuant to the Proposed Rule. For the reasons set forth below, the Committee disagrees with the Commission's application of Rule 15c6-1 to open-end investment companies and urges the Commission to reconsider the basis of any liquid asset minimum standard it may adopt so that the standard is consistent with the seven-day requirement under Section 22(e) of the 1940 Act, which, unlike Rule 15c6-1 under the Exchange Act, is clearly applicable to Funds.

The Commission's approach in this section of the Proposing Release appears to conflate business practices with regulatory requirements, by purportedly subjecting investment companies to an Exchange Act regulation that applies only to broker-dealers. Rule 15c6-1 states, in pertinent part,

> (a) [A] broker or dealer shall not effect or enter into a contract for the purchase or sale of a security (other than an exempted security, government security, municipal security, commercial paper, bankers' acceptances, or commercial bills) that provides for payment of funds and delivery of securities later than the third business day after the date of the *contract unless otherwise expressly agreed to by the parties at the time of the transaction* (emphasis added).[43]

---

42 *Id.* at 62,277.

43 Settlement Cycle, 17 C.F.R. § 240.15c6-1 (2015).

Assuming that a broker-dealer holds Fund shares in an omnibus account for the benefit of its customers, or even in a proprietary account for its own investment, and further assuming that purchasing and holding Fund shares for its customers or its own account constitutes "entering into a contract for the purchase" of a security,[44] such a transaction is subject to the terms of the security described in the Fund's prospectus setting forth how to tender shares for redemption. Thus, if a Fund's prospectus states that redemption proceeds will be paid within seven calendar days, the maximum period permitted under Section 22(e) of the1940 Act, or that the Fund may seek to pay such proceeds sooner than such seven-day maximum period, the broker-dealer has, by purchasing such shares for its client's account or its own, "expressly agreed" to the terms for payment of redemption proceeds set forth in the prospectus. While, as a practical or business matter, Funds may seek to accommodate broker-dealers redeeming shares held in their omnibus or proprietary accounts by making such redemption payments sooner than the maximum seven-day period, that does not raise the Fund's business practice to one requiring the Fund to comply with Rule 15c6-1, an inapplicable regulation.

Moreover, if the broker-dealer is merely acting as agent in forwarding to a Fund's transfer agent a redemption request submitted by its customer who holds mutual fund shares in the customer's own name, the broker-dealer is itself not entering into a "contract" with the Fund for such redemption, and processing the redemption tender should not be subject to the requirements of Rule 15c6-1.

In the Proposing Release, the Commission notes that, in a 1995 no-action letter analyzing the implications of the adoption of Rule 15c6-1 on a mutual fund's determination of the liquidity of its portfolio assets, the staff stated: "[b]ecause Rule 15c6-1 applies to brokers and dealers, and does not apply directly to funds, it is the view of the Division [of Investment Management] that the implementation of T+3 does not change the standard for determining liquidity, which is based on the requirements of Section 22(e)."[45] That letter notes that as a practical matter, some Funds will seek to meet the T+3 period set forth in Rule 15c6-1 if a broker-dealer is "involved in the process." The Commission now seeks to codify in the Proposed Rule, by adopting a TDLA Minimum, what has been a business practice of some Funds into a mandatory requirement for all open-end Funds to establish what is essentially a reserve requirement. That determination apparently is on the Commission's theory that a Fund's practical acquiescence to the needs of its broker-dealer counterparties constitutes the contractual agreement by such Funds that they are subject to and must comply with Rule 15c6-1.

Congress presumably adopted the seven-day limit applicable to Funds issuing redeemable securities in recognition of the liquidity management requirements facing Funds holding various types of portfolio assets. The Committee does not see the regulatory basis for taking action inconsistent with Congress's decision to adopt a seven calendar-day settlement period for Fund redemptions by imposing a three-day liquidity minimum based on the questionable premise that Covered Funds are subject to a rule directed at the conduct of broker-dealers.

---

[44] The Committee posits that there is a legal distinction between a redemption and a purchase/sale transaction, such that tender of a Fund's shares for redemption, whether they were originally purchased through a Fund's distributor or directly from the Fund, arguably does not constitute "entering into a contract" with the Fund to "sell" the Fund's shares back to the Fund.

[45] Letter from Jack W. Murphy, Associate Director and Chief Counsel, Div. of Inv. Mgmt., SEC, to Paul Schott Stevens, General Counsel, Investment Company Institute (May 26, 1995), *available at* http://www.sec.gov/divisions/investment/noaction/1995/ici052695.pdf.

Conclusions. The Proposal's liquidity risk management goals are made even more difficult to attain because the liquidity of a security can be determined with certainty only in hindsight, after an attempt is made to sell the security. In addition, market conditions, the state of the economy (in the U.S. and foreign nations), government actions and initiatives, issuer-specific factors, the actions of other investors (including other investment companies, whether or not in the same family of Funds as a Covered Fund) and securities dealers are but a few of the principal, often quickly-shifting factors that can affect the ability of a Fund to sell a security to meet redemption demands by its shareholders. Effectively, the "liquidity" of portfolio securities is a factor exogenous to an investment company's operations, structure and ability to control.

To the Committee's knowledge, there is nothing in the 1940 Act or its legislative history to indicate that the 1940 Act was intended to remove all risks that a Fund could not, under every conceivable market circumstance, meet its redemption obligations under Section 22(e) of the 1940 Act. If the framers of the 1940 Act had intended to remove all such risks, they would not have permitted a Fund to invest in any security other than short-term, highly-liquid securities, such as U.S. Government bills or notes (which, although they are considered generally to be among the safest investments, nonetheless can also be subject to market illiquidity, as was seen in the 2008-2009 financial crisis). In effect, the TDLA Minimum would effectively impose a reserve requirement on Covered Funds that, together with the requirement to classify assets by projected liquidity risk, may pose challenges to Funds seeking to offer an investment objective based on investing in high yield bonds, bank loans, municipal bonds or alternative investments, which are some of the asset classes that have experienced market liquidity challenges from time to time.

The Committee is not alone in having concerns about the potential misuse of or inappropriate reliance by investors on a Fund's portfolio asset liquidity risk classification data as a reliable measure of a Fund's future ability to meet redemption requirements in all market scenarios. In commenting on proposals to improve the capability of the financial system to absorb and deal with liquidity risks in 2007, then-President of the Federal Reserve Bank of New York Timothy Geithner presciently noted the following:

> In the case of liquidity, the shortcomings of our analytical tools are magnified by the difficulty of measuring leverage or identifying potential concentrations in the financial system. This has always been challenging, but the growth in the overall size of private pools of capital and the degree of embedded leverage that exists in many derivative instruments makes this more challenging today.
>
> When market liquidity and funding seem abundant, this is likely to be observable in things we can measure, like interest rates and credit spreads. And when liquidity ebbs, the effect is conspicuous in a range of observable market prices and volumes. But we do not have, and probably never will have, a set of indicators that offers the promise of predicting when liquidity conditions will reverse, or when markets are particularly vulnerable to a more acute decline in liquidity. . . .
>
> This knowledge gap has led many to advocate the provision of information on actual positions of the major [hedge] funds, perhaps aggregated by a third party. According to the proponents, this would help market participants and regulators to identify potential concentrations or crowded trades, and that knowledge would help diffuse them before they became a problem.

> This type of transparency has understandable and enduring appeal, but it is unachievable. There is no feasible way to try to capture in real time the rapidly changing exposures of different institutions to different risks in any meaningful fashion. No one with access to that information could make sensible judgments about the level and nature of actual concentrations and whether the risks are excessive.[46]

The Proposal suggests that, by adopting the Proposed Rule and requiring Covered Funds to design and implement Programs, investors may come to believe that there can be a high degree of certitude about the ability of Funds to redeem their shares at all times and in all market and issuer-related conditions. That suggestion is the source of the Committee's overriding concern about the Proposal. Because of the exogenous nature of liquidity risk for Funds, it is unlikely that any regulation requiring Funds to estimate and exactly categorize the liquidity risk of their portfolio assets using lagging information can succeed in making Funds completely liquidity risk-free and may ultimately mislead investors about the predictive value of such data and the resulting liquidity risk calculations based on it. The Committee believes that the ever-present risk of a liquidity "melt-down" and its possible effects on the ability of a shareholder to redeem her or his Fund shares can and should be addressed through clear risk disclosure in Fund prospectuses, as an appropriate course of action with respect to Funds, which are investments in securities, not bank deposits insured by the FDIC.

The Committee strongly agrees with the Commission's underlying purpose in issuing the Proposal to urge Funds to enhance their review of liquidity risk and to be vigilant about changing issuer and market conditions that can affect a Fund's ability to sell investments to meet redemption demands. The Committee believes, however, that this regulatory goal can best be accomplished by the Commission in one of two ways:

(i) the Commission could issue updated guidance (instead of adopting a highly prescriptive rule meant to cover *all* funds) on liquidity risk management considerations for Funds to consider implementing, based upon the nature of the Fund's investment policies, portfolio holdings and shareholder base; that guidance could address the principal risk management topics discussed by the Commission in the Proposal, including: possible methods Funds could use to identify and measure liquidity risks, the need for a Fund to gather such information as is reasonably available about the estimated liquidity of investment assets that the Fund holds, and to make projections (using stress tests and other means) of the Fund's ability to sell some or all of those portfolio positions in various market and issuer-centric scenarios to enable the Fund to meet its obligations under Section 22(e) of the 1940 Act; or

(ii) if the Commission believes that it is necessary to seek its goals through the adoption of a rule, the Commission could adopt a rule requiring Covered Funds to implement Programs that would allow each Covered Fund and its investment adviser to tailor that Fund's specific liquidity management program, after considering the facts and circumstances applicable to that Fund, such as its investment objective, its investment portfolio and the nature and redemption history of its shareholders.

For the reasons set forth in this letter we believe that either approach would enhance the ability of Covered Funds to redeem their shares in a timely manner in all market conditions pursuant to the requirements of Section 22(e) of the 1940 Act.

---

[46] Timothy F. Geithner, President, Fed. Reserve Bank of N.Y., Liquidity and Financial Markets, Remarks Before the Eighth Annual Risk Convention and Exhibition, Global Association of Risk Professionals (Feb. 28, 2007).

*   *   *

The Committee appreciates the opportunity to comment on the Proposal. If we can be of any further assistance in this regard, please call me at (212) 648-0894.

Respectfully,

Frank J. Nasta, Chair
Committee on Investment Management Regulation

Drafting Committee:

Kenneth J. Berman
Ronald M. Feiman
Allison M. Fumai
Paul B. Goucher
Frank J. Nasta
Dianne E. O'Donnell
Kathryn L. Quirk
Robert G. Zack

cc: The Honorable Mary Jo White
The Honorable Kara M. Stein
The Honorable Michael Piwowar

David Grim, Director
Division of Investment Management

Annex A

Jennifer Avicolli
Barry Barbash
Erik G. Barrios
John E. Baumgardner, Jr.
Kenneth J. Berman
Peter V. Bonnano
Gregory Neal Bressler
Rajib Chanda
Stuart H. Coleman
Clifford R. Cone
Laura Anne Corsell
James Curtis
Amy R. Doberman
Ronald M. Feiman
Maureen Baker Fialcowitz
John Fitzgerald
Allison M. Fumai
Paul B. Goucher
Mary Joan Hoene
Mark Holland
Brian M. Kaplowitz
Beth R. Kramer
Hal Liebes
Catherine E. Marshall
Karrie McMillan
Kathleen Hill Moriarty
Richard F. Morris
Sean Murphy
Gariel Nahoum
Frank J. Nasta
Dianne E. O'Donnell
Patrick M. Patalino
Domenick Pugliese
Kathryn L. Quirk
Richard A. Rosen
Gregory S. Rowland
Seth Ruderman
Jeremy C. Smith
Daniel T. Steiner
Patrick D. Sweeney
Keith A. Weller
Emilie D. Wrapp
Robert G. Zack