

May 18, 2018

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

Re: *Investment Company Liquidity Disclosure (File No. S7-04-18)*

Dear Mr. Fields:

The Investment Company Institute¹ strongly supports the SEC's proposal to improve funds' liquidity disclosure by requiring funds to discuss the operation and effectiveness of their liquidity risk management programs in their shareholder reports.² The Commission also proposes to rescind reporting and public disclosure of aggregated liquidity classification (or "bucketing") information.

Based on extensive outreach by the Commission's staff and other input received since adoption of rule 22e-4 ("liquidity rule") and related form amendments, the Commission believes that these two actions would more effectively achieve the policy goal of promoting better investor understanding of their funds' liquidity risks, while minimizing investor confusion. We strongly agree. The Commission compellingly articulates the risks and shortcomings of publicly disclosing bucketing information. Simply put, bucketing information is inappropriate as required public disclosure because funds will generate this information using complex and widely divergent methodologies, and such information by its nature is subjective, forward-looking, and hypothetical. By contrast, funds would satisfy the new shareholder report requirement by addressing their specific liquidity risks and how they manage them

¹ The [Investment Company Institute](#) (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US\$21.7 trillion in the United States, serving more than 100 million US shareholders, and US\$7.5 trillion in assets in other jurisdictions. ICI carries out its international work through [ICI Global](#), with offices in London, Hong Kong, and Washington, DC.

² *Investment Company Liquidity Disclosure*, SEC Release No. IC-33046, 83 Fed. Reg. 11905 (Mar. 19, 2018) ("Proposing Release"), available at www.gpo.gov/fdsys/pkg/FR-2018-03-19/pdf/2018-05511.pdf.

in narrative that is clear and useful to investors. The SEC's proposed approach to liquidity disclosure is therefore vastly superior to the status quo.

I. Background and Executive Summary

The SEC adopted the liquidity rule and related reporting and disclosure requirements in 2016.³ The SEC intended to promote more effective liquidity risk management throughout the fund industry and thereby reduce the risk that funds would be unable to meet shareholder redemptions.

The liquidity rule is multi-faceted. It requires a fund⁴ to adopt and implement a written liquidity risk management program, under which the fund must assess, manage, and periodically review its liquidity risk; classify each portfolio investment into one of four liquidity "buckets" at least monthly; determine and maintain a minimum amount of its portfolio in "highly liquid investments"; and limit illiquid investments to 15 percent of net assets.

Reporting and disclosure requirements complement the liquidity rule. Under the 2016 framework, funds must report to the SEC investment-specific bucketing information and aggregated bucketing information (*i.e.*, aggregated percentages of portfolio investments in each of the four buckets) each month on Form N-PORT. The SEC would publicly disclose the aggregated bucketing information for the third month of each fiscal quarter.

Funds have been implementing the rule diligently, and this work has revealed ambiguities and difficulties. To their considerable credit, the SEC and its staff have remained sharply focused and responsive to the problems that funds have uncovered through their efforts. First, the SEC extended the compliance dates for portions of the liquidity rule.⁵ ICI had requested a one-year delay for the rule's bucketing and related requirements, and continues to believe that a delay of that duration would have been appropriate and supported by fund complexes' implementation experiences to date.⁶ Still, the six-month delay that the SEC granted was a measured response to compliance bottlenecks, providing funds additional time to establish and test the rule's novel and complex asset classification requirements.⁷ The

³ *Investment Company Liquidity Risk Management Programs*, SEC Release No. IC-32315, 81 Fed. Reg. 82142 (Nov. 18, 2016) ("Adopting Release"), available at www.gpo.gov/fdsys/pkg/FR-2016-11-18/pdf/2016-25348.pdf.

⁴ The rule applies to registered open-end funds, excluding money market funds ("funds").

⁵ *Investment Company Liquidity Risk Management Programs; Commission Guidance for In-Kind ETFs*, SEC Release No. IC-33010, 83 Fed. Reg. 8342 (Feb. 27, 2018) ("Liquidity Extension Release"), available at www.gpo.gov/fdsys/pkg/FR-2018-02-27/pdf/2018-03917.pdf.

⁶ See *infra*, note 10.

⁷ Some members have found the six-month delay sufficient. But others have expressed continued concern that the additional time may not suffice to allow for careful and diligent implementation, particularly given the concurrent push by fund complexes and service providers to comply with the upcoming enhanced fund reporting requirements. We will

SEC staff also issued Frequently Asked Questions (“Liquidity FAQs”), which address difficult aspects of the rule, including bucketing and issues unique to sub-advised funds and ETFs.⁸ The FAQs provided needed guidance to aid implementation and make compliance more workable.

ICI too has supported and engaged with members on their liquidity work. ICI created a member working group⁹ prior to the SEC’s initial liquidity proposal, and it remains active. This working group primarily serves as a forum for addressing implementation issues. It has provided ICI with an invaluable window into members’ continuing challenges and concerns, the most important of which ICI has communicated to the SEC and staff.¹⁰ A significant focus has been on the rule’s bucketing requirements, and their implications for the related public reporting of bucketing information.

Some concerns about this public reporting are long standing. As with the proposed rule, the final rule requires a fund to determine how quickly it can convert to cash (or sell) each investment, factoring in the sale’s potential impact on the investment’s value (“value impact”) and numerous other market, trading, and investment-specific considerations. This exercise is significantly different in kind from other quantitative disclosure responsibilities, such as calculating a fund’s performance and fees and expenses. Funds produce those figures using highly prescribed methodologies with objective inputs. By contrast, funds’ bucketing outputs—even for the same investment of the same size— inevitably will differ from one another, due to variances in underlying methodologies and assumptions. These differences would not be at all apparent to investors, who see only the uniform outputs from the exercise. It is foreseeable that investors, quite mistakenly, will conclude that bucketing information may be compared across funds just like performance and fee and expense information.

Other concerns about this public reporting have arisen or become more pronounced following the rule’s adoption. The SEC changed certain key bucketing requirements in the final rule (*e.g.*, the value impact and quantity elements).¹¹ These created new methodological decisions and potential points of divergence for funds and any third parties from which they may seek assistance, making fund-to-fund

continue to monitor the industry’s progress towards implementing the rule and will communicate with the staff as necessary and appropriate.

⁸ They are available at www.sec.gov/investment/investment-company-liquidity-risk-management-programs-faq.

⁹ Reflecting the reach and multi-disciplinary nature of the liquidity rule, ICI’s liquidity working group consists of personnel from senior management, risk, portfolio management, legal, compliance, operations, and fund accounting. 114 fund complexes are members of and have contributed to this group’s work to date.

¹⁰ See Letter from Paul Schott Stevens, President and CEO, ICI, to The Honorable Jay Clayton, Chairman, SEC, dated July 20, 2017 (“ICI 2017 Letter I”), available at www.ici.org/pdf/liquidity_sec_clayton_ltr.pdf; and Letter from Dorothy Donohue, Acting General Counsel, ICI, to Brent J. Fields, Secretary, SEC, dated November 3, 2017 (“ICI 2017 Letter II”), available at www.sec.gov/comments/s7-03-18/s70318-3129402-161936.pdf.

¹¹ See *infra* note 16 and accompanying text for a more detailed summary of these changes.

bucketing results even less comparable.¹² The number of methodological decisions and assumptions that a fund must make to satisfy the rule's bucketing requirements has become more fully apparent only through implementation. This is unsurprising, because the SEC's bucketing requirements are unprecedented in their makeup and complexity.

Therefore, the proposal to eliminate public disclosure of aggregated bucketing information is a necessary and welcome development. It reflects the SEC's recognition that the rule's complex bucketing requirements should not be relied upon to yield useful, understandable, comparable, and reliable public disclosure. In the Proposing Release, the Commission describes three core obstacles to investors' understanding of bucketing information: (i) its subjectivity; (ii) its lack of context; and (iii) the inappropriate focus it places on liquidity risk over other risks ("liquidity risk in isolation"). Because of its nature and the related concerns that the Commission and others have raised, this bucketing information plainly risks confusing and misleading investors, whether attempting to make sense of a particular fund's bucketing information or comparing it to that of other funds.

We also comment on the SEC staff's plan to analyze the liquidity data that it receives through Form N-PORT filings and recommend to the Commission by June 2020 whether, and if so how, fund-specific liquidity classification information should be disseminated to the public. Specifically, we explain (i) why this analysis is highly unlikely to override the Proposing Release's conclusions regarding the shortcomings of public disclosure of bucketing information, and (ii) how the staff should approach this analysis if the SEC nevertheless decides to move forward with it.

We strongly agree with the Commission that replacing this with the new shareholder report disclosure item—requiring funds to discuss the operation and effectiveness of their liquidity risk management programs in a narrative and period-specific way—would provide liquidity information that is far more clear and useful. This is undoubtedly a more effective way to provide investors with information about the nature and extent of a fund's liquidity risks and how the fund manages them. We recommend modest revisions to this item, which would preserve the core concept while (i) mitigating risks of this disclosure distorting investors' understanding of funds' overall risk profiles, and (ii) accommodating those funds wishing to leverage annual liquidity program reporting to their boards.

ICI also supports the two other proposed amendments to Form N-PORT, which would (i) permit a fund to "split" an investment into multiple buckets in certain circumstances, and (ii) require a fund to report cash and cash equivalents not reported elsewhere on the Form. "Splitting" would allow a fund to report bucketing information in a way that might better reflect its views about the investment's liquidity. Information on funds' cash holdings would enhance the SEC's ability to monitor funds' compliance with their highly liquid investment minimums ("HLIMs").

¹² We nevertheless regard these changes as improvements because they provide funds with flexibility to better align those requirements with funds' current approach to liquidity risk management.

To provide additional background and context, we begin by providing ICI's views on the liquidity rule. We then devote a separate section to, and provide comments on, each of the proposal's elements. In addition to our strong support for narrative disclosure rather than the public bucketing information, we also (i) strongly recommend that the SEC adopt a safe harbor within its liquidity framework; (ii) address the Proposing Release's questions about the Department of the Treasury's recommendation that the SEC embrace a principles-based approach to bucketing; and (iii) comment on the proposed compliance dates.

II. ICI's Views on the Liquidity Rule

The liquidity rule and related requirements have several sound elements, including the:

- Written program requirement, which will enhance the formality, discipline, and rigor of the industry's current liquidity risk management practices;
- Definition of "liquidity risk" and the rule's broad and practical set of related factors and guidance for assessing, managing, and reviewing liquidity risk, which serve as the rule's foundation and create a strong analytical framework;
- 15 percent limit on illiquid investments and a fund's reporting requirements to its board and the SEC when it exceeds this limit;
- General board oversight requirements, including annual reporting to the board;
- Redemption-in-kind policies and procedures requirement;
- Related recordkeeping requirements; and
- New prospectus disclosure and the liquidity-related items on Form N-CEN.

We understand that the SEC is not actively considering amending the rule's bucketing requirements, or the reporting of bucketing information to the SEC (beyond the proposed removal of the aggregated bucketing item). Therefore, this comment letter does not focus on those elements of the SEC's liquidity framework. But to explain why we support the SEC's proposal to eliminate public reporting of bucketing information—and to address the Proposing Release's questions about the Department of the Treasury's recommendation that the SEC embrace a principles-based approach to bucketing in Section VII.B—we briefly summarize our views on bucketing.

ICI has expressed concerns with the rule's bucketing and related reporting requirements since the proposal stage¹³ and following adoption of the rule.¹⁴ Our views have become more deeply informed and substantiated through our implementation work with members over the past 18 months.

In sum, these requirements are, and will be, complicated and costly to implement and administer going forward; will generate information of limited value to the SEC, because of its subjective, forward-looking, and hypothetical nature; and could foster regulatory overreliance on that information. Further, this information will confuse and potentially mislead investors and others (including third parties and intermediaries), who will not appreciate its limitations or the disconnect between the uniform reporting outputs that Form N-PORT requires and the necessary discretion that the rule grants funds in generating those outputs.

More fundamentally, we believe that bucketing has outsized significance within the SEC's liquidity framework, and that within this framework it is designed to achieve two objectives that are in irreconcilable tension: (i) serving as an integral part of a fund's internal liquidity risk management program, and (ii) providing comparable industry-wide data to the SEC and the public. But in practice *no* single set of bucketing requirements can do both effectively.¹⁵

To illustrate, the final liquidity rule contained several bucketing-related changes from the proposal that we regard as improvements, particularly its permissive provisions for asset class bucketing, its streamlined and less prescriptive rule text, its revised value impact standard, and its revised standard for assessing quantity.¹⁶ Two things stand out, and are simultaneously true: (i) within the liquidity rule

¹³ See, e.g., Letter from David W. Blass, General Counsel, ICI, to Brent J. Fields, Secretary, SEC, dated May 17, 2016 ("ICI 2016 Letter II"), at 3-7, available at www.sec.gov/comments/s7-16-15/s71615-141.pdf; Letter from David W. Blass, General Counsel, ICI, to Brent J. Fields, Secretary, SEC, dated January 13, 2016 ("ICI 2016 Letter I"), at 18-36, available at www.sec.gov/comments/s7-16-15/s71615-54.pdf; and Letter from Brian K. Reid, Chief Economist, ICI, to Brent J. Fields, Secretary, SEC, dated January 13, 2016 ("ICI Research Letter"), at 43-56, available at www.sec.gov/comments/s7-16-15/s71615-56.pdf.

¹⁴ See, e.g., ICI 2017 Letter I at 2-5.

¹⁵ Theoretically, a flexible, principles-based regulatory approach to bucketing would be highly desirable with respect to the first objective (it would lower costs and respect the diversity of sound liquidity risk management practices that funds currently employ, or could employ in the future), but highly problematic with respect to the second (it would be nearly impossible for the SEC or the public to compare funds' reporting in an apples-to-apples way). Conversely (and theoretically), a highly prescriptive regulatory approach to bucketing would yield much more comparable data (fund fee and expense and performance data are good examples of information that is useful precisely because the methodologies for calculating them are highly prescribed), but would be costly to generate and in most cases, pull funds away from the liquidity risk management practices that they would otherwise employ.

¹⁶ More specifically, the final rule permits classification by asset class (rather than by individual holding); replaces the nine prescribed factors for evaluating the liquidity of an investment with general guidance in the Adopting Release; includes a revised value impact standard (the proposal would have required consideration of whether a sale would "materially affect the value" of the investment; the final rule requires consideration of whether the sale would "significantly chang[e] the

itself, these represent improvement, because they increase fund discretion, thereby enhancing bucketing's value to funds and advisers as a means of assessing and managing liquidity risk; and (ii) these changes raise new concerns regarding public reporting, because they make the bucketing process more subjective, rendering data less comparable.¹⁷ The Commission, too, has recognized that the methodologies that funds adopt have disparate assumptions and will result in variability in the classifications.

As discussed below in the section about the Treasury's recommendation, we believe that further amendment to the liquidity rule itself is justified and worthy of the SEC's attention. We also believe, however, that this proposal, together with adoption of a safe harbor,¹⁸ would address some of the most acute and persistent concerns about the SEC's liquidity framework that our members have voiced over the past few years and that the Commission also acknowledges in this proposal.

III. Support for Eliminating Public Bucketing Information

Under the proposal, the SEC would no longer require a fund to report and publicly disclose its aggregate bucketing information (*i.e.*, aggregated percentages of portfolio investments in each of the four buckets). We strongly support the SEC eliminating public bucketing information and the Commission's policy rationale for this decision. We also provide additional grounds for adopting this important proposal and address the Commission's request that, in 2020, the SEC staff re-evaluate the need for public reporting of bucketing information.

A. Evaluation of SEC's Policy Rationale and Additional Support

We strongly support the SEC's proposal to eliminate public reporting of bucketing information for several reasons. Stemming from our concerns with the nature of bucketing information generally and the heightened risks of it being confusing or misleading to the public, we have opposed public reporting of bucketing information when first proposed¹⁹ and following adoption of the liquidity-related Form N-PORT items.²⁰ As discussed above, several of the SEC's bucketing-related changes at adoption were

[investment's] market value"); and sets a different standard for assessing quantity (the proposal would have required a fund to assume liquidation of an entire position; the final rule requires a fund to consider sizes it would "reasonably anticipate trading").

¹⁷ This explains why it is entirely consistent for commenters to maintain that the rule's bucketing requirements are at once too prescriptive (when addressing their function within the liquidity risk management program) and too subjective (when addressing their function in generating data for the SEC and public).

¹⁸ See *infra*, Section VII.A.

¹⁹ See, e.g., ICI 2016 Letter I at 26-29; ICI Research Letter at 11-12 and 48-51; and ICI 2016 Letter II at 6-7.

²⁰ See, e.g., ICI 2017 Letter I at 3; and ICI 2017 Letter II at n.3.

welcome, but the potential for increased points of divergence among funds' bucketing methodologies deepened our concerns with public reporting of bucketing output.

The Commission has set forth a strong and compelling rationale for eliminating public reporting of bucketing information, citing many of the objections that ICI and others have raised—particularly concerns about the information's subjectivity; its lack of context and connection to the fund's liquidity risk and liquidity risk management generally; its heightened focus on liquidity risk compared to other risks that could be more relevant to a fund; and its potential to create more coordinated investor behavior and more correlated portfolios. We strongly concur with the SEC's rationale and provide additional support below for the elimination of public reporting.

The bucketing exercise and its resulting output are highly subjective and variable. The SEC is entirely correct in observing that variations in underlying data, measurement periods, methodologies, and assumptions that funds will use to bucket investments can significantly affect reported information in ways that investors may not understand; that presenting this information in the required standardized format may inaccurately imply a degree of methodological consistency across funds that does not exist; and that any resulting comparisons across funds could be misleading. Much more can be said, however. Aside from variation, the *number* of methodological choices and assumptions that a fund must make to bucket all of its portfolio investments is legion.²¹ Further, output will be highly sensitive to certain inputs and assumptions that funds choose.²²

European regulators' recent transaction cost disclosure efforts provide an unambiguous lesson in the need for caution when requiring investor disclosure based upon complex methodologies with subjective inputs.²³ We describe these regulations and their resulting disclosures in Appendix A. Similar to US funds' bucketing requirements, these regulations provide for different ways of evaluating and

²¹ To take just one bucketing element, "reasonably anticipated trading size" requires a fund to make multiple judgements to arrive at a single number for each investment. Based on ICI member surveying, funds will consider some or all of the following: which liquidity risk factors will inform this number, and to what extent; the extent to which factors should be quantitative and/or qualitative; how far back to assess historical fund cash flows (*e.g.*, number of months or years); relevant time increments for assessing potential outflows (*e.g.*, number of days or weeks); whether and to what extent to factor in stressed conditions; manner and extent to which backward-looking flow history should be adjusted to arrive at forward-looking projections; for newer funds, how to project cash flows in the absence of fund-specific data; how to allocate a fund-level outflow to investments to arrive at a "reasonably anticipated trading size" number for each investment, and which simplifying assumptions (if any) may be appropriate (*e.g.*, assuming *pro rata* selling of investments); and how to treat cash.

²² See ICI 2017 Comment Letter II at 6-7 (describing an exercise in which five vendors bucketing the same high yield bond portfolio and using the same "reasonably anticipated trading size" assumptions nevertheless estimated percentages in the "highly liquid" bucket ranging from 7 to 95 percent).

²³ Both the European Union's Regulation on Packaged Retail and Insurance-Based Investment Products ("PRIIPs") and the recast Markets in Financial Instruments Directive and the Markets in Financial Instruments Regulation (collectively, "MiFID II") mandate that funds disclose "actual transaction costs," including implicit or indirect costs, to investors.

calculating a fund's transaction costs. While the intent of European regulators was to provide investors with objective and comparable numbers, it has become clear that this regulatory approach has led to varying and counterintuitive results and thus confusing and misleading information for investors. Indeed, some funds have reported transaction costs of zero, or even *negative* numbers. Disclosure of US funds' bucketing information would be no different, and this European experience is further proof that the Commission's narrative-oriented disclosure proposal is the correct approach.

Bucketing output is forward-looking and hypothetical. Bucketing determinations are inherently forward-looking and hypothetical. For each investment, a fund must ask: based on current market conditions and taking into account relevant market, trading, and investment-specific considerations, how quickly could the fund convert to cash (or sell, depending on the category) an amount of the investment that the fund would reasonably anticipate trading without significantly changing its market value? (The number of key terms within this query that a fund must interpret and operationalize further underscores the highly subjective nature of this exercise.) The definitions for each of the four liquidity categories make clear that these are "reasonable expectations"—in other words, a fund has no way of knowing with certainty in advance if it could execute a trade of the requisite size without "significantly affecting its value" within a given time frame. Funds may use backward-looking data to assist with making these determinations, but the data are often limited and incomplete.

That bucketing output is subjective and forward-looking is not itself inherently problematic. Indeed, much of portfolio and risk management *is* subjective and forward-looking. Macroeconomic, industry, and security analysis, interest rate forecasts, credit risk assessments, and short- and long-term price targets for investments are commonplace in asset management. Although these kinds of proprietary and subjective analyses may help advisers manage fund assets, and although funds might judiciously summarize elements of their analyses in certain shareholder communications, they do not make unqualified and highly specific predictions about future market and fund events. Similarly, while model-driven predictions of an investment's or a portfolio's liquidity may be a useful internal risk management tool, those predictions have never been subject matter for required public disclosure, nor should they be now.²⁴

Bucketing output is an overly-simplistic measure of a fund's liquidity risk profile. This aggregated bucketing information greatly risks misleading investors because it provides too simplistic and reductive

²⁴ We also have concerns with the SEC staff's plan to publish aggregated and anonymized information about the fund industry's liquidity. We assume that this would include industry-wide aggregated bucketing information, as reported under Item C.7 of Form N-PORT. While aggregating and anonymizing this information is helpful and would eliminate certain concerns related to public disclosure of bucketing information (*e.g.*, misleading fund-to-fund comparisons), the report's contents still would represent an aggregation of subjective information generated using disparate data, methodologies, and assumptions. We believe that this type of reporting would have limited value to the SEC, the public, and other regulators. At a minimum, any reports that the staff publishes should make clear that the information is: generated by funds using disparate practices, as permitted by the liquidity rule; subjective; specific as of a particular point in time (and thus subject to change); and forward-looking and hypothetical.

a measure of a fund's liquidity risk profile. Funds may assess some risks using a single metric, but liquidity risk certainly cannot be so simply assessed using the aggregated bucketing information (or any other single metric, for that matter). Liquidity is notoriously multi-faceted and hard to measure, particularly for instruments that trade over-the-counter. The SEC staff's recent report to Congress on market liquidity recognizes the lack of any single reliable metric, in its lengthy discussion and analysis of market liquidity for Treasuries and corporate bonds.²⁵ The DERA Report states:

“[S]ome studies suggest composite measures that would present a single number to summarize multiple facets of liquidity. These composite measures typically rely on weighted averages or principal component analysis of several liquidity measures that quantify different dimensions of liquidity. However, such index measures may be difficult to interpret, and there is little consensus in academic and practitioner research on the use of aggregate liquidity metrics.”²⁶

IOSCO's recent report on the liquidity of secondary corporate bond markets recognizes this as well.²⁷

We believe these important insights apply with equal force to the rule's bucketing requirements and the resulting reporting output. In bucketing each investment, the rule requires a fund to account for “relevant market, trading, and investment-specific considerations,” and the Adopting Release provides guidance about the related factors that may be relevant in doing so.²⁸ For each investment, a fund must distill all this relevant information to a single “days-to-cash/sale” number and place the investment into one of four liquidity buckets. The aggregated bucketing information is a further distillation, resulting in four (or fewer) numbers meant to capture the liquidity profile of the entire portfolio.

²⁵ *Access to Capital and Market Liquidity*, Staff of the Division of Economic and Risk Analysis of the SEC (August 2017) (“DERA Report”), available at www.sec.gov/files/access-to-capital-and-market-liquidity-study-dera-2017.pdf. “A vast academic literature on market microstructure formulates different measures reflecting various dimensions of liquidity. Existing measures of liquidity can be grouped roughly into three categories: trading activity measures (e.g., trading volume, turnover, average trade size), transaction cost measures (e.g., bid-ask spread, price impact), and measures of liquidity supply (e.g., dealer inventory, order book depth).” DERA Report at 70.

²⁶ DERA Report at 73.

²⁷ *Examination of Liquidity of the Secondary Corporate Bond Markets* (February 2017) (“IOSCO Report”), available at www.iosco.org/library/pubdocs/pdf/IOSCOPD537.pdf. “IOSCO recognizes that no single metric can act as a reliable measure of liquidity and that an examination of many different metrics is needed to see a more complete picture of corporate bond market liquidity.” IOSCO Report at 1. Further, “there could be some aspects of liquidity (for example, immediacy) that may not be fully taken into account by the metrics closely examined in this report.” IOSCO Report at 21. Immediacy (e.g., days-to-cash/sale) is the very thing that funds must calculate and report on Form N-PORT.

²⁸ Adopting Release at 82186-82191. General categories of factors include: existence of active market for an asset class or investment; exchange-traded nature of an asset class or investment; other trading mechanism considerations; diversity and quality of market participants; frequency of trades or quotes; average daily trading volume; volatility of trading prices; bid-ask spreads; standardization and simplicity of asset class's or investment's structure; maturity and date of issue of fixed income securities; restrictions on trading; and limitations on transfer.

This process also would obscure key differences between investments that may be placed in the same bucket. For instance, an investment could be classified as “illiquid” because of certain innate qualities (e.g., limitations on transfer), or because of the position’s size. In the case of a classification motivated primarily by size, the fund can sell the investment—but it may take longer than seven days to do so without generating a significant value impact. This would not be apparent to investors, who would see only one aggregated “illiquid investments” figure, and based on the name, likely assume severe restraints on the ability to sell that may not exist.

The complexity and variety of inputs, together with the process of analyzing and reducing them to a few standardized outputs, must give serious pause concerning the reliability and comparability of those outputs. Aggregated bucketing percentages may have a superficial appeal as a source of liquidity risk information for investors, but that appeal is belied by the complex and subjective processes that generate them. These outputs are anything but simple or basic. If it were otherwise, then approximately 91 percent of our survey respondents—fund complexes, large and small, with decades of experience with assessing and managing liquidity—would not be seeking the assistance of vendors, at significant ongoing cost.²⁹

Eliminating bucketing output as a disclosure item is consistent with SEC precedent. The SEC’s requiring funds to publicly disclose such subjective and forward-looking information would be unprecedented. We are aware of no other public disclosure requirements—in Form N-1A, Form N-CSR, Form N-PORT, or Form N-CEN—that are similarly subjective and forward-looking. The SEC generally does not require, and in fact often proscribes, such public disclosure for funds.³⁰ The SEC’s policy rationale is clear: “Forward-looking information of mutual funds is not covered by rule 175 [under the Securities Act of 1933], the safe harbor for projections, because forecasts of the securities markets may pose a significant risk of misleading investors and can quickly become stale.”³¹ Other regulators also restrict forward-looking and hypothetical disclosure.³² Understood within this wider context, it is the Adopting Release’s insistence on public bucketing disclosure—not this proposal—that represents a break from the SEC’s long-standing fund disclosure philosophy.

²⁹ See *infra*, note 65.

³⁰ For instance, Rule 156 (Investment Company Sales Literature) under the Securities Act of 1933 provides that representations about future investment performance could be misleading. The rule also cautions against “[u]nwarranted or incompletely explained comparisons to other investment vehicles or to indexes.” While the funds themselves would not be making these comparisons on Form N-PORT, the policy concern is nevertheless valid with respect to reporting of liquidity information, because others will make the comparisons.

³¹ *Disclosure and Analysis of Mutual Fund Performance Information; Portfolio Manager Disclosure*, SEC Release IC-17294, 55 Fed. Reg. 1460, at n.13 (Jan. 16, 1990), available at <https://cdn.loc.gov/service/ll/fedreg/fr055/fr055010/fr055010.pdf>.

³² For instance, FINRA Rule 2210(d)(1)(F) generally prohibits communications that make unwarranted forecasts.

Further, the SEC has ample precedent within its own practices for collecting information from funds and other registrants and keeping it non-public. Other financial regulators do the same. Most notably:

- Several of the new liquidity-related reporting requirements already will be non-public (*i.e.*, investment-specific bucketing information and HLIM information on Form N-PORT, and Form N-LIQUID filings that funds will make if they fall below their HLIMs (if applicable) or exceed the 15 percent illiquid investments limit).
- Most Form N-PORT filings will be non-public in their entirety (all but quarterly filings), along with certain subjective and sensitive items on those otherwise publicly available quarterly filings (*i.e.*, miscellaneous securities, position-level risk metrics (delta), country of risk and economic exposure metrics, and explanatory notes related to these non-public items).
- The private fund information that registered investment advisers file with the SEC on Form PF is entirely non-public.
- Institutional investment managers exercising discretion over accounts holding certain equity securities having an aggregate fair market value of \$100 million or more file quarterly holdings reports with the SEC on Form 13F, but this filing requirement also provides for confidential treatment of information that would reveal an investment manager's investment strategy (*e.g.*, a program of acquisition or disposition that is ongoing).
- Three regulatory regimes that have aggregated "days to liquidate" bucketing reporting similar to Form N-PORT's—US private fund information on Form PF, US commodity pool information on Form CPO-PQR, and information that European Alternative Investment Funds (AIFs) provide to their competent authorities—all provide for non-public reporting.

We summarize these and other germane examples in Appendix B.

B. SEC Staff's Planned Re-Examination of Public Bucketing Information

In the Proposing Release, the Commission requests that the staff provide an analysis of the liquidity data to the Commission by June 2020 and a recommendation addressing whether and, if so, how fund-specific liquidity classification information should be disseminated to the public.³³ The intent is to further inform the staff about whether the bucketing information would be helpful to investors, or would instead confuse and mislead them.

³³ Proposing Release at 11911.

We are highly skeptical about whether any findings could be strong enough to override the SEC's findings set forth in the Proposing Release and the SEC's general philosophy with respect to fund disclosure.³⁴ Funds will operationalize the rule's bucketing requirements in varying ways that will produce varying outputs—in 2019, 2020, and beyond. The Commission's observed concerns—subjectivity, lack of context, and liquidity in isolation—still will be present. The Commission and others have acknowledged there is no single, reliable metric for assessing liquidity. And as explained above, the nature of this bucketing information is incompatible with required public disclosure.

If the Commission nevertheless wishes to move forward with this review, we strongly believe that any staff examination of this information must be sufficiently thorough to draw meaningful conclusions, particularly for a policy matter of this importance. Accordingly, we believe that a June 2020 deadline is far too compressed to conduct such a study, and that June 2022 would be a much more realistic target.

The SEC will not receive *any* bucketing data until June 2019. This means that with a June 2020 deadline, the staff would have no more than a year of data to study for purposes of making its recommendation. Furthermore, SEC experience with Form N-MFP reporting suggests that it easily could take several months to iron out the technical and interpretive issues related to this new filing requirement, during which time the data collected could be of questionable value.

The SEC recognized this possibility when it adopted Form N-PORT and stated that all reports filed for the first six months would be kept non-public. The SEC explained that it wished to allow funds and the SEC “to make adjustments to fine-tune the technical specifications and data validation processes,” in order to “ultimately improve the data that is reported to the Commission and, as required disclosed to the public.”³⁵ We believe that the bucketing reporting on Form N-PORT could be similarly unsettled in the early months. Thus, the staff could have at its disposal considerably less than a year of useful data.

Beyond these practical matters, that one-year period may not capture any significant market events, or periods when funds are more likely to experience outflows. The Commission will need such data to adequately assess how this bucketing information performs before, during, and after periods of heightened fund outflows, the types of periods the Commission had in mind when it adopted the liquidity rule.³⁶ Given that market events are unlikely to be aligned across the wide array of asset types

³⁴ See *supra*, notes 30 through 32 and accompanying text, for a discussion of how this disclosure item would be out of step with the SEC's existing fund disclosure philosophy.

³⁵ *Investment Company Reporting Modernization*, SEC Release No. IC-32314, 81 Fed. Reg. 81870 (Nov. 18, 2016) (“Reporting Modernization Release”), at 81966, available at www.federalregister.gov/documents/2016/11/18/2016-25349/investment-company-reporting-modernization.

³⁶ See, e.g., Adopting Release at 82150-82151. (“There can be significant adverse consequences to remaining investors in a fund that does not adequately manage liquidity. As noted above, the proportion of illiquid assets held by a fund can increase

(*e.g.*, equities, bonds, international securities, and sub-classifications of each) in which funds invest, it could be several years before the staff has sufficient data to assess how bucketing information behaves during periods of market stress or fund outflows.

Finally, in our view, any review must evaluate comprehensively *all* liquidity-related disclosures, both new (*i.e.*, the new prospectus disclosure on meeting redemptions, the new shareholder report disclosure (if adopted), and the relevant Forms N-PORT and N-CEN items) and existing (*e.g.*, liquidity risk disclosure in prospectuses). These all work together in a complementary manner and must be evaluated accordingly.

IV. Support for New Shareholder Report Disclosure

As an improved and alternative approach to public disclosure of bucketing information, the SEC proposes that funds, as part of Management's Discussion of Fund Performance (MDFP), "[b]riefly discuss the operation and effectiveness of the Fund's liquidity risk management program during the most recently completed fiscal year." The SEC explains that such disclosure would be a more accessible and useful way to assist investor understanding of fund liquidity than the currently required aggregated bucketing information. We agree that shareholder report disclosure would far better serve investors, and we strongly support it for the following reasons.

More Effective Disclosure. This new narrative disclosure item would allow funds to discuss liquidity risk and its management in a flexible way, focusing on the most relevant information each period, and it would be much easier for investors to understand. By contrast, the aggregated bucketing numbers are much more limited in scope (relevant at best to only one of the rule's several liquidity risk factors)³⁷ and thus present a highly incomplete—and potentially misleading—picture of the fund's overall liquidity risk.

Narrative disclosure undoubtedly provides both better and clearer information to investors. It allows a fund to highlight, based on its actual experience, only those factors that were particularly relevant during the period. Fund-to-fund and year-to-year, the most relevant factors, and the narrative, will vary. The proposal recognizes this and grants funds the necessary broad discretion to provide investors with meaningful and understandable disclosure.

Complementary Disclosure. The proposal recognizes the complementary nature of, and properly uses, the various channels through which the SEC and investors receive information about funds, *i.e.*, prospectuses and SAIs, Form N-PORT filings, and shareholder reports. Because liquidity risk is multi-

if the fund sells its more liquid portfolio assets to meet redemptions. This in turn could adversely affect the fund's risk profile and cause the fund to have difficulty meeting future shareholder redemptions.")

³⁷ See Rule 22e-4(b)(1)(i).

faceted and fluid, it is eminently sensible for the SEC to approach liquidity-related reporting and disclosure in a similar manner.³⁸ The prospectus and SAI are well-suited for more comprehensive liquidity risk disclosure and other information about how the fund meets redemptions;³⁹ Form N-PORT is well-suited for more granular and objective “snapshot-oriented” information about the fund, principally for the SEC’s benefit;⁴⁰ and the shareholder report is well-suited for accessible, timely, and topical “plain English” narrative assessments of a fund’s liquidity during the relevant period.

More Accurate Disclosure. This proposed shareholder report disclosure item would be a backward-looking description of a discrete and well-defined period, and therefore simply does not raise the same concerns as the forward-looking projections that are intrinsic to the bucketing exercise. A backward-looking analysis clearly demonstrates to investors that the conditions discussed are unique to that period, and should not be counted on to persist.

While we support this proposed addition to shareholder reports, we recommend three changes to the proposed form requirements and urge that the SEC highlight one key point in any adopting release, as described below.

Relocating the Disclosure within the Shareholder Report. For all its strengths, we believe this proposed disclosure item would be misplaced in the shareholder report’s aptly-named Management’s Discussion of Fund Performance section, which currently requires a fund to:

- discuss its performance during the most recently completed fiscal year, and those factors (including the relevant market conditions and the fund’s investment strategies and techniques) that materially affected it; and

³⁸ The SEC staff previously has recognized the complementary nature of various forms of communication for conveying investment risk, and this proposal is very much consistent with this principle. See Division of Investment Management Guidance Update No. 2016-02, *Fund Disclosure Reflecting Risks Related To Current Market Conditions* (March 2016), available at www.sec.gov/investment/im-guidance-2016-02.pdf. (“If a fund determines that its risk disclosure is not adequate, the staff believes that the fund should consider the appropriate manner of communicating changed risks to existing and potential investors, for example, in the prospectus, shareholder reports, fund website, and/or marketing materials.”)

³⁹ See *infra*, note 69.

⁴⁰ See *infra*, note 68. Some, in support of making public aggregated bucketing information on Form N-PORT, have analogized it to the disclosure of ingredients on a food label. Analogizing Form N-PORT to a food label makes sense. But the “ingredients” in this case are best understood as the fund’s portfolio holdings, and perhaps other objectively determinable characteristics of those holdings and the portfolio. Just as the food industry might object to the mandatory inclusion of complex, agency-created, subjective scores for “tastiness” or “healthiness” on a food label, we object to public disclosure of subjective bucketing information on Form N-PORT.

- provide additional quantitative fund performance information as far back as 10 years.⁴¹

Adding a third liquidity-specific disclosure item to this part of the shareholder report as proposed would elevate liquidity to a unique and important status in this section that would not be appropriate. Liquidity risk is one among many that funds encounter and manage; for many funds, it is not a principal risk, or one that materially affects fund performance during most periods.⁴² Other risks (*e.g.*, for bond funds, interest rate risk, credit risk, prepayment risk, currency risk, *etc.*) may much more frequently and significantly affect fund performance, yet these risks could get overshadowed by a far less material risk, leaving investors with a distorted picture of the fund's overall risk profile. The "liquidity risk in isolation" concern that the SEC rightly identifies with respect to public bucketing information would be present here as well.

We believe that this concern largely could be mitigated by placing this disclosure elsewhere in the shareholder report. Liquidity risk is not unique (or in most cases material) as a *performance-related* risk factor, and therefore should not be linked so closely to the existing MDFP items, given their focus on performance (and for the narrative item, materiality). To account for the very few cases where liquidity *was* a material factor affecting a fund's performance during a period, the SEC could clarify that it expects such a fund to discuss liquidity in the narrative portion of the MDFP.

Accommodating Synchronization of Shareholder Report Disclosure with Liquidity Reporting to the Board.

The proposed disclosure item would relate to the fund's "most recently completed fiscal year." The proposal also contemplates a connection between this new disclosure requirement and a fund's obligation to report to its board at least annually on the operation of its liquidity program and its adequacy and effectiveness.⁴³ The similarities between these requirements are unmistakable, and the SEC's decision to base this new disclosure requirement on an existing rule requirement is wise.

⁴¹ Item 27(b)(7) of Form N-1A.

⁴² The SEC staff previously has highlighted the importance of tailored disclosure and consistency between a fund's principle investment strategy and risk disclosure (in the prospectus) and its MDFP disclosure (in the shareholder report). See Letter from Barry Miller, Associate Director, SEC Division of Investment Management, to Karrie McMillan, General Counsel, ICI, dated July 30, 2010, available at www.sec.gov/divisions/investment/guidance/ici073010.pdf. ("[T]he comprehensive nature of lengthy, often highly technical, derivatives-related disclosures [in registration statements] could lead some investors to believe that a fund with such disclosure would have substantial exposure to derivative transactions, yet we have observed that some funds providing this disclosure actually appear to have relatively small exposure to derivatives. ... Where appropriate, we will query whether the strategies listed are, in fact, principal investment strategies and whether the risk disclosure is tailored to those strategies. We also will continue to compare a fund's investment objectives, strategies and risks in its registration statement to its shareholder reports to assess whether the disclosures regarding the fund's operations appear to be consistent with its registration statement disclosures.")

⁴³ See Proposing Release at n.39. ("Because funds will already need to prepare a [board] report on the program for these purposes, we expect that the disclosure requirement we are proposing today would be unlikely to create significant

Unfortunately, fund complexes offering multiple funds with fiscal year-ends spread throughout the year will be frustrated in their ability to leverage their board reporting for this shareholder report requirement. According to an October 2017 ICI member survey, a substantial share of fund complexes—over 83 percent—intend to provide their boards with a single liquidity report each year, covering all funds for which the board has responsibility.⁴⁴ For a complex with funds with differing fiscal year-ends, the period covered by the single board report would not coincide with the shareholder report periods for all funds.

To remedy this, we propose revising this form requirement to state: “Briefly discuss the operation and effectiveness of the Fund’s liquidity risk management program, as assessed during the period.” Stated in this slightly more general way, funds would have the flexibility to conduct this assessment as part of the annual shareholder report disclosure process, or in reliance upon their annual board reporting. This would greatly reduce the costs and burdens of preparing this new disclosure for all fund complexes.

The SEC could stipulate in instructions to this new item that (i) a fund must include the disclosure in at least one shareholder report (annual or semi-annual) each year, and (ii) the disclosure must be included in the shareholder report covering the period that includes the period-end of the liquidity assessment.⁴⁵ Further, the instructions could stipulate that a fund also must discuss any material changes related to this disclosure subject occurring in any period between the end of the assessment and the shareholder report’s period-end date. Together, these instructions would ensure timely liquidity disclosure to investors, in a cost-effective way.

Creating an Exemption for Certain Funds. Third, the SEC should include an instruction that exempts “primarily highly liquid funds” and In-Kind ETFs from this new disclosure requirement.⁴⁶ In the

additional burdens as the conclusions in this report may be largely consistent with the overall conclusions disclosed to investors in the annual report.”)

⁴⁴ In October 2017, ICI surveyed its members to better understand how they intended to fulfill certain rule requirements, including the annual reporting to boards required by Rule 22e-4(b)(2)(iii). 61 ICI member firms responded, representing 73 percent of US registered open-end long-term fund assets as of March 2018. This ICI survey indicated that over 83 percent of respondents with a view anticipated preparing a single written annual report to their fund boards, covering all funds for which the boards are responsible.

⁴⁵ To illustrate, suppose a fund complex provides its board with a single liquidity report (including all funds) covering the calendar year (*i.e.*, January 1 to December 31). A fund with a fiscal year-end of October 31 would include the necessary liquidity disclosure in its semi-annual shareholder report for the period-ended April 30. This would be similar to the form requirement relating to disclosure about the board’s approval of an investment advisory contract in a shareholder report.

⁴⁶ See Rule 22e-4(a)(9) for the definition of “In-Kind ETF.” The rule and Adopting Release do not expressly define “primarily high liquid fund,” but the rule exempts such funds from the HLIM requirements. See also Adopting Release at n.726. (“In our view, if a fund held less than 50% of its assets in highly liquid investments it would be unlikely to qualify as “primarily” holding assets that are highly liquid investments.”)

overwhelming majority of cases, these fund types would have only perfunctory information to report to investors about their liquidity. In fact, the liquidity rule distinctly recognizes that this subset of funds has lower liquidity risk, by exempting them from the HLIM requirements. The rule likewise wisely exempts In-Kind ETFs from the rule's bucketing requirements. (Because In-Kind ETFs would not report bucketing information of any kind on Form N-PORT, this proposal would not eliminate any of the liquidity information that their shareholders would receive.) Requiring them to provide narrative disclosure in their annual reports would be imprudent because it simply would give liquidity risk much more prominence than it warrants (particularly relative to other risks and factors affecting their investment performance during the period). It is these funds for which the "liquidity risk in isolation" concerns are most acute, and we believe *any* required liquidity risk disclosure in the shareholder report could be misleading.⁴⁷

Providing for Proportionate Disclosure. We also recommend that the SEC explicitly state that funds should consider the materiality of the disclosure and provide appropriately proportionate disclosure.⁴⁸ In the Proposing Release, the SEC highlights items that would not be required, or those that a fund "might opt" to include. To further clarify its expectations, the SEC should state that these permissible items are not meant to become a mandatory laundry list of items that a fund should address in its disclosure. Rather, the length of the disclosure generally should be commensurate with the degree of liquidity risk and significance of any liquidity-related challenges faced during the period. Keeping this disclosure suitably concise is sensible, better serves investors, and will help prevent this new item from taking on outsized importance within the shareholder report.⁴⁹

V. Support for Bucketing an Investment in Multiple Categories

Form N-PORT currently requires a fund to assign each investment to a single liquidity bucket. Under the proposed amendments, a fund would be permitted but not required to "split" an investment into multiple buckets in three specified circumstances: (i) if the fund has multiple sub-advisers with differing liquidity views; (ii) if portions of the position have differing liquidity features that justify treating the

⁴⁷ Again, to account for the very few cases where such a fund's liquidity *was* a material performance factor during a period, the SEC could clarify that these funds would be subject to the existing MDFP requirement to discuss the factors (including liquidity) that materially affected the fund's performance during the period.

⁴⁸ See *Recommendations for Liquidity Risk Management for Collective Investment Schemes*, IOSCO (February 2018) ("IOSCO Recommendations"), available at www.iosco.org/library/pubdocs/pdf/IOSCOPD590.pdf. Recommendation 7 emphasizes the need for "a proportionate and appropriate explanation of liquidity risk..."

⁴⁹ Moreover, the SEC should make clear that there is no explicit requirement to attribute the fund's investment returns to liquidity factors during the period. For a fund with low liquidity risk operating in normal market conditions, liquidity factors generally will not have a material effect on the fund's investment returns, nor an effect that can be easily quantified as such.

portions separately;⁵⁰ or (iii) if the fund chooses to classify the position through evaluation of how long it would take to liquidate the entire position (rather than basing it on the sizes it would reasonably anticipate trading).⁵¹

We support this proposed splitting provision as a *permissible option* that would allow a fund to report bucketing information in a way that might better reflect its views about the investment's liquidity.⁵² Funds sometimes sell an investment in pieces over time to manage liquidity and minimize dilution; splitting therefore may better capture this aspect of an investment's liquidity. This additional flexibility in turn could increase bucketing's utility to funds and advisers as a means of assessing and managing liquidity risk.⁵³ Splitting may be particularly beneficial for sub-advised funds.⁵⁴

In addition, we recommend expanding these proposed provisions, as discussed below.

By way of background, the initial 2015 liquidity proposal would have required a fund, as part of its bucketing requirements, to (i) assume complete liquidation of each investment in its portfolio, and (ii) if necessary, split a position across buckets. These were two distinct features of the proposal, and in commenting on it, we strongly objected to assuming complete liquidation,⁵⁵ but took no position on splitting. The final rule changed both, substituting the "complete liquidation" assumption with a new "reasonably anticipated trading size" quantity assumption, and stipulating that a fund must assign each investment in its entirety to a single bucket (*i.e.*, the least liquid one). We regard the SEC's adoption of

⁵⁰ We understand this circumstance to be rather narrow, based on the two examples (*i.e.*, a portion of a holding with a put feature, and a holding that is only partially subject to a restriction) that the SEC gives in the Proposing Release.

⁵¹ See proposed Item C.7 of Form N-PORT. The impact any such Form N-PORT changes would have on funds' bucketing and related compliance obligations under the liquidity rule under the second and third proposed circumstances is unclear. In any adopting release, the SEC should clearly state that these means of reporting bucketing information also would be permissible for fulfilling all bucketing and compliance obligations under the rule. This would be consistent with Liquidity FAQ #7, which permits a fund with multiple sub-advisers with differing liquidity views to classify portions of the same investment differently for purposes of complying with the rule. And the SEC staff also should rescind Liquidity FAQ #8, which these Form N-PORT amendments would supersede.

⁵² Because funds already have expended considerable time and resources implementing the existing bucketing requirements, including the "one bucket per investment" requirement, we would strongly oppose making splitting a *required* bucketing element.

⁵³ Of course, this also would lessen the degree of comparability of this reported information, which again underscores the importance of keeping bucketing information non-public.

⁵⁴ Implementation of the rule and reporting requirements has been particularly challenging for sub-advised funds, which have more service providers whose activities must be coordinated to ensure compliance with the rule. The Liquidity FAQs were helpful in this regard, and we appreciate the SEC's consideration of these issues in the proposal.

⁵⁵ ICI 2016 Comment Letter I at 20-21.

the “reasonably anticipated trading size” quantity assumption as an improvement, insofar as it much more realistically reflects the magnitude of a fund’s potential portfolio sales activity to meet redemptions. But some were disappointed that the final rule and Form N-PORT did not permit splitting.

We recommend that the SEC permit funds to couple “reasonably anticipated trading size” (beyond the first two circumstances) with splitting. We believe this is sensible, as illustrated by the SEC’s example in the Proposing Release.⁵⁶ Currently, a fund would place the entire position (\$100 million) in the “moderately liquid” bucket. But we see no valid reason why the fund should not be permitted to place at least \$4 million in the “highly liquid” bucket, if the fund reasonably believes it could convert that much to cash in less than 3 business days without a significant value impact. We therefore recommend that the SEC permit this type of splitting together with “reasonably anticipated trading size,” provided that any amounts exceeding the “reasonably anticipated trading size” would be placed in the same bucket that the rule currently would require.⁵⁷

Without this type of additional flexibility, the current general prohibition on splitting under the liquidity rule and Form N-PORT may result in some odd “cliff effects” in bucketing output. Continuing with this example, if a fund instead sets its “reasonably anticipated trading size” at \$4 million or less, the entire \$100 million moves to the “highly liquid” bucket. But a “reasonably anticipated trading size” of just \$1 more (\$4,000,001) would push the entire \$100 million position into the “moderately liquid” bucket. Funds should have the ability to avoid these types of extreme and counterintuitive outcomes to the extent possible.

And finally, the SEC should state plainly that a fund’s option to split is investment-specific rather than portfolio-specific.

VI. Support for Disclosure About Cash and Cash Equivalents

The proposal would amend Form N-PORT to require funds to report cash and cash equivalents not reported elsewhere on the Form. Currently, cash may not be considered an investment for purposes of the Form and accordingly would not be reported.⁵⁸ But cash held by a fund is a highly liquid investment

⁵⁶ Proposing Release at n.61: “[U]nder this alternate approach, a fund with a \$100 million position in a security with a reasonably anticipated trading size of \$10 million might determine that it could convert \$4 million to cash in 1-3 days and \$6 million in 4-7 days.”

⁵⁷ To illustrate this method using the footnote 61 example, a fund would (i) assign \$4 million to the “highly liquid” bucket, because it has determined that it could convert \$4 million to cash in 1-3 days, and (ii) because the next \$6 million (*i.e.*, the remainder of the “reasonably anticipated trading size”) would be “moderately liquid,” assign the remaining \$96 million to the “moderately liquid” bucket.

⁵⁸ Item C.4.a. of the Form requires funds to classify each investment by type (*e.g.*, equity, preferred, debt, repurchase agreement, derivative, *etc.*). Item C.4.a., however, does not include “cash” as an investment type. Accordingly, we believe the Commission does not intend that funds report cash at Part C of the Form.

under the liquidity rule and would have been included in the Item B.8 aggregated bucketing information that the SEC has proposed to eliminate. The Proposing Release notes that, without the aggregate information, the SEC may not be able to effectively monitor whether a fund is compliant with its HLIM unless it knows the amount of cash held by the fund.

We agree with this narrowly-stated rationale and therefore support the proposed change.⁵⁹ We also support the Proposing Release's reference to US Generally Accepted Accounting Principles for purposes of defining cash equivalents. We believe in almost all instances investments in cash equivalents (*e.g.*, Treasury bills, commercial paper, money market funds) will be included in Part C of the Form and therefore recommend that the SEC not require cash and cash equivalents to be reported as two distinct items in Part B of the Form.

VII. Miscellaneous Issues

This section (i) provides the rationale for why the SEC should add a safe harbor relating to bucketing to the liquidity framework; (ii) addresses the Proposing Release's questions about the Treasury's liquidity rule recommendation; and (iii) recommends refining the proposed compliance dates.

A. Creation of a Safe Harbor

While eliminating public reporting will address important industry concerns, we strongly urge the Commission to provide a safe harbor to protect funds from being penalized unfairly for generating, relying on, and reporting subjective, forward-looking, and hypothetical information.⁶⁰

The fund industry remains seriously concerned that bucketing decisions—and all acts and omissions that follow from those decisions—will be improperly second-guessed, calling into question compliance with the rule and related reporting requirements and subjecting parties to potential liability under the federal securities laws. Unfortunately, such concerns will create incentives for fund complexes to seek

⁵⁹ While reporting of cash and cash equivalents in new Item B.2.f. as proposed will better enable the Commission to monitor compliance with a fund's HLIM, it may not be able to precisely monitor compliance without the detail afforded in a statement of assets and liabilities. The SEC also may monitor compliance with a fund's HLIM through Item B.7, which requires the fund to provide the number of days that it fell below its HLIM during the reporting period.

Even though we support this proposed change, we caution the SEC and the public against placing too much emphasis on this one new and highly limited data point. It will be an incomplete measure of a portfolio's "cash" (as broadly and commonly understood), because reporting of cash equivalents may appear separately under Item C. Furthermore, even if the reporting of "cash" were not splintered in this way, "cash" is an incomplete measure of a fund's highly liquid investments, and a poor proxy for "liquidity" generally.

⁶⁰ After generating bucketing information, funds then will rely on it to ensure compliance with their HLIMs (if applicable) and the 15 percent limitation on illiquid investments, and it will be central to funds' reporting to the SEC on Forms N-PORT and N-LIQUID.

the perceived safety of relying upon a vendor that provides bucketing information for other funds. This “safety in numbers” approach has the potential to undermine the quality and usefulness of the data reported to the SEC.

Recent SEC precedent supports extending this type of protection to funds in this context. In its 2017 interpretive guidance on pay ratio disclosures, the SEC stated:

“In light of the use of estimates, assumptions, adjustments, and statistical sampling permitted by the rule, pay ratio disclosures may involve a degree of imprecision. This has led some commenters to express concerns about compliance uncertainty and potential liability. In our view, if a registrant uses reasonable estimates, assumptions or methodologies, the pay ratio and related disclosure that results from such use would not provide the basis for Commission enforcement action unless the disclosure was made or reaffirmed without a reasonable basis or was provided other than in good faith.”⁶¹

This rationale underlying the Commission’s guidance on pay ratio disclosures applies to the liquidity rule’s bucketing requirements to a striking degree.

The optimal approach would be to add an explicit safe harbor to the liquidity rule itself.⁶² This safe harbor only would be available to persons who have a “reasonable basis” for actions or omissions in connection with efforts to comply with the liquidity rule and with disclosure and filing obligations required by, or in connection with the requirements of, the rule. For purposes of this proposed safe

⁶¹ *Commission Guidance on Pay Ratio Disclosure*, SEC Release No. 33-10415, 82 Fed. Reg. 44917 (Sept. 27, 2017), available at www.gpo.gov/fdsys/pkg/FR-2017-09-27/pdf/2017-20632.pdf.

⁶² The liquidity rule safe harbor should read as follows: “(d) No person shall be deemed to have violated any Anti-Fraud Provision of the Federal Securities Laws; or to have caused, aided, abetted, counseled, commanded, induced, procured or provided substantial assistance to another person in a violation of any Anti-Fraud Provision of the Federal Securities Laws, solely by reason of any act or omission by such person, or causing or effecting (or participating in the causing or effecting of) an act or omission by a fund or In-Kind ETF, in an effort to comply with any portion of this section or with any disclosure or filing obligation required by this section or that is in connection with the requirements of this section; provided that there is a reasonable basis for such act or omission.”

The SEC should define “Anti-Fraud Provision of the Federal Securities Laws” in the liquidity rule to mean “any provision of the federal securities laws or rules adopted thereunder that prohibits or otherwise makes it illegal to, directly or indirectly, employ any device, scheme, or artifice to defraud; make, or obtain money or property by means of, any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or engage in any act, practice, or course of business which operates or would operate as a fraud or deceit or which is fraudulent, deceptive, or manipulative. The term Anti-Fraud Provision of the Federal Securities Laws shall include, without limitation, Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, Section 206 of the Investment Advisers Act of 1940, and Section 34(b) of this title, and any rules adopted under any such provision.”

harbor, a “reasonable basis” for an act or omission would be presumed where specified requirements are satisfied, as would be set forth in SEC guidance.⁶³

Alternatively, and at a minimum, the SEC should provide assurances in guidance to funds in connection with their liquidity rule and reporting obligations similar to those provided to operating companies with respect to their pay ratio disclosure obligations. If the SEC deemed it important and appropriate to provide this guidance to operating companies in that context, there is no reason why it should not provide similar assurances to funds in connection with their liquidity rule and reporting obligations.

B. Treasury’s Liquidity Rule Recommendation

The Proposing Release notes that the Treasury recommended that the SEC embrace a “principles-based approach to liquidity risk management rulemaking and any associated bucketing requirements” and asks whether there are advantages to the Treasury’s proposed approach.⁶⁴

We firmly believe that the advantages to the Treasury’s approach would be considerable. Under such an approach, each fund complex would design and implement an asset classification approach that it determines would be most useful in assessing and managing liquidity risk. This would promote diverse liquidity risk management practices; limit the possibility of unintentionally impeding further evolution and experimentation with liquidity risk management practices; reduce the likelihood of herding and correlation that may follow from more prescriptive bucketing and reporting requirements; and

⁶³ To give form and substance to the “reasonable basis” requirement of the safe harbor, we recommend that the SEC set forth guidance creating a presumption of a “reasonable basis” where: (i) all material aspects of and material decisions related to the fund’s liquidity risk management program are overseen by a program administrator; (ii) the program utilizes such information as the program administrator considers reasonably necessary and appropriate to comply with the rule requirements; (iii) the program administrator considers factors reasonably necessary and appropriate for the fund’s or In-Kind ETF’s compliance with the rule; (iv) the act or omission is consistent with the program; (v) the act or omission is consistent with written recommendations of the administrator, if any, made in connection with any liquidity risk assessment undertaken under the rule; (vi) the administrator reasonably monitors the implementation of the program and brings material deficiencies in the program or its implementation to the attention of responsible persons; and (vii) the administrator maintains such records as are reasonably necessary and appropriate to reasonably document satisfaction of these items.

⁶⁴ *A Financial System That Creates Economic Opportunities: Asset Management and Insurance*, available at www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-That-Creates-Economic-Opportunities-Asset-Management-Insurance.pdf. With respect to the liquidity rule, the report states, “Treasury supports robust liquidity risk management programs and believes they are imperative to effective fund management and the health of the financial markets. For this reason, Treasury supports the 15 percent limitation on illiquid assets. However, Treasury rejects any highly prescriptive regulatory approach to liquidity risk management, such as the bucketing requirement. Instead, Treasury supports the SEC adopting a principles-based approach to liquidity risk management rulemaking and any associated bucketing requirements.”

significantly reduce costs.⁶⁵ We also believe fund investors would be better served by such an approach, by both reducing costs and allowing funds to optimize liquidity risk management practices without regard for how any required reportable outputs might “look” to the SEC or the public.

The Proposing Release also asks “what additional steps, if any, should [the Commission] consider to shift toward a principles-based approach.” The SEC could fully incorporate the Treasury’s recommendation by making modest edits to the existing rule.⁶⁶ Bucketing-related work undertaken to date by fund complexes and vendors would not necessarily be in vain: the SEC could make clear that the current rule’s bucketing requirements would be a reasonable means of satisfying any new principles-based asset classification requirements, and fund complexes and vendors could continue with their current implementation work if they wished to do so. Instead of “building to the rule,” vendors would be given more latitude to design offerings that they believe would help funds assess, manage, and review liquidity risk, and funds would be free to evaluate a broader array of offerings and acquire them (if deemed useful and cost-effective) on more of a limited and/or *a la carte* basis, which should lower costs while providing more tailored and useful information to funds. And finally, we would note that even with these changes, this type of modified liquidity rule, together with Form N-PORT and funds’ existing and proposed disclosure practices, would constitute a regulatory framework for US open-end funds that would exceed those of other jurisdictions and international standards worldwide.⁶⁷

⁶⁵ See Appendix B (slides 6 and 13-19) of ICI 2017 Letter II. Specifically, this September 2017 ICI member survey shows that: (i) for most firms, bucketing and related reporting requirements are expected to account for more than half of initial compliance costs; (ii) 35 percent of respondents expect to spend more than \$1 million in initial costs to comply with bucketing and related reporting requirements; (iii) most firms expect bucketing and related reporting requirements to account for more than half of annual ongoing compliance costs; (iv) 56 percent of firms expect to spend more than \$500,000 annually to comply with bucketing and reporting requirements; and (v) beyond external costs, two-thirds of respondents expect to add staff to implement and administer liquidity programs.

⁶⁶ In this regard, we note that even if the SEC removed (b)(1)(ii) (the bucketing provisions) from the rule, the rule’s liquidity risk assessment, management, and review provisions ((b)(1)(i)) still would require a fund to consider its “investment strategy and liquidity of portfolio investments during both normal and reasonably foreseeable stressed conditions, including whether the investment strategy is appropriate for an open-end fund... .” The SEC could provide enhanced guidance around this provision and stipulate that it expects funds to address in their policies and procedures how they would carry out these responsibilities (which could include a principles-based asset classification requirement). With respect to the rule’s HLIM requirements, the SEC could keep the rule’s basic framework, and permit funds to specify in their policies and procedures how they would identify “highly liquid investments” for this purpose. And with respect to the 15 percent limitation on illiquid investments, the SEC already has provided a means for complying with this new enhanced standard without engaging in full asset classification. See Liquidity Extension Release at 8348-8349. Subject to these revisions, the SEC could maintain its new Form N-LIQUID reporting regime, which would alert it to potential deterioration in fund liquidity.

⁶⁷ Cf. IOSCO Recommendations.

Moreover, the SEC still would be fully capable of adequately monitoring fund liquidity with fulsome information, including extensive portfolio information reported monthly on Form N-PORT;⁶⁸ narrative information about liquidity risk management in shareholder reports (as proposed); information about liquidity risk and redemption practices in prospectuses and SAIs;⁶⁹ and information about a fund's liquidity tools (and use of them) on Form N-CEN.⁷⁰

Further, the SEC is well-equipped through its examination powers to attain complete visibility into funds' liquidity risk management programs and practices. Importantly, Form N-LIQUID filings would provide prompt notice of potential deterioration of liquidity for a reporting fund. And the SEC could conduct its own days-to-cash/sale bucketing exercises for a fund, using the objective Form N-PORT portfolio information.⁷¹

If the SEC still wanted to receive classification-related information on Form N-PORT, a fund could report the aggregated percentages in each of the categories that it establishes and provide a description of those categories in the Form's Explanatory Notes section. This would provide the SEC with a monthly window into the fund's views about its portfolio liquidity, and the SEC could use such data for

⁶⁸ The SEC will receive a wealth of objective information from funds through Form N-PORT filings, which will require funds to report portfolio holdings and other information (*e.g.*, information about fund flows and investment returns). With this information, the SEC will be well-positioned to monitor developments at the macro level (*e.g.*, deterioration of the performance or liquidity of a particular asset class such as high yield debt, and its effect on funds) or micro level (*e.g.*, whether a particular fund is under liquidity pressure, based on its monthly flows, performance, and/or the composition of its portfolio). This would greatly elevate the SEC's ability to effectively monitor the fund industry and share information with other interested regulators.

⁶⁹ See Items 4(b)(1) and 9(c) (requiring a fund to disclose all principal risks of investing in the fund, including the risks to which the fund's particular portfolio as a whole is expected to be subject and the circumstances reasonably likely to affect adversely the fund's net asset value, yield, or total return); Item 11(c)(7) and (8) (requiring a fund to describe the number of days in which the fund typically expects to pay redemption proceeds, and its methods for meeting redemption requests); and Item 16(b) (requiring a fund to describe any non-principal investment strategies and the risks of those strategies) of Form N-1A.

⁷⁰ Item C.20 (requiring a fund to disclose information regarding its use of lines of credit and interfund borrowing and lending) of Form N-CEN.

⁷¹ Based on this rich new source of Form N-PORT data and the SEC's rapidly advancing analytical capabilities, this appears to be a realistic possibility. See *Keynote Address, ICI 2018 Mutual Funds and Investment Management Conference*, Dalia Blass, Director, Division of Investment Management (March 19, 2018) (describing the Division's Analytics Office, an internal tool (MAGIC) that allows the staff to pull together a number of data sets from registrants and other sources and look at it holistically, and the ability to extend this tool to Form N-PORT data when it becomes available), available at www.sec.gov/news/speech/speech-blass-2018-03-19.

period-to-period comparisons for a fund and spotting trends (*e.g.* deterioration in the fund's assessment of its portfolio liquidity).⁷²

We recognize that the changes we have recommended in this sub-section go farther than the proposal contemplates, and we hope that the measured scope of this proposal does not foreclose the possibility of future changes to the current liquidity framework. We are encouraged by the Proposing Release's statement that "[t]he staff will monitor the information [*i.e.*, implementation-related insights from market participants] received and report to the Commission what steps, if any, the staff recommends in light of commenter experiences." On behalf of its members, ICI pledges to aid the staff in effectuating this monitoring.

C. Proposed Compliance Dates

We read the "Compliance Dates" discussion as providing that each proposed amendment would take effect at the same time as the compliance dates in the Liquidity Extension Release (*i.e.*, June 1, 2019 for larger entities and December 1, 2019 for smaller entities).

To implement the proposed cash reporting and splitting items, funds will need at least twelve months from the date of adoption. Implementing the cash reporting item will require technology changes and the building of data feeds to and from service providers. Implementing the splitting item also will require operational and technological changes, along with methodological changes to bucketing for both funds and their service providers. We foresee implementation of the Item B.8 amendment (eliminating reporting of aggregated bucketing information) taking considerably less time from the adoption date.

We recommend extending the compliance dates for the shareholder report disclosure to at least December 1, 2019 for larger entities and June 1, 2020 for smaller entities.⁷³ This would ensure that funds have the foundational elements of their liquidity programs (as set forth in the Liquidity Extension Release) in place for at least a year. Then, funds would be in position to adequately assess the "operation and effectiveness of the Fund's liquidity risk management program," which seems to presume a one-year review period. Assuming the SEC makes this change, it should clarify in the adopting release that funds need only consider the legally required program elements (*i.e.*, those that

⁷² The SEC recognizes the potential benefit of this kind of fund-specific comparative information in the Proposing Release. Proposing Release at n.82: "Even if aggregate liquidity profiles are not comparable across funds, they may be comparable across time for a given fund, which might provide useful information to investors. This would be the case if a fund maintains a consistent position classification process over time."

⁷³ This would mean that disclosure would be required in shareholder reports for periods ended on or after December 31, 2019 for larger entities, and on or after June 30, 2020 for smaller entities. This recommendation assumes SEC adoption of this provision in 2018. If adoption occurs later, our recommended dates should be extended accordingly.

larger entities and smaller entities must have in place by December 1, 2018 and June 1, 2019, respectively) in that first disclosure cycle.⁷⁴

Second, and unrelated to this proposal, we request that the SEC clear up a potential ambiguity affecting smaller entities. Specifically, we request that the SEC clarify that it intends for smaller entities to comply with the liquidity rule's bucketing and HLIM requirements beginning December 1, 2019, and to first file such related information on Form N-PORT not later than April 30, 2020 (for the month ended March 31, 2020).⁷⁵ Perhaps more critically, we request that the SEC address whether and how it expects smaller entities to prepare and retain related bucketing and HLIM information in their records during this short interim period between commencement of these liquidity rule responsibilities and the commencement of the Form N-PORT filing obligation.

Finally, we recommend including in any adopting release a summary chart with the relevant compliance dates, similar to that provided in the Liquidity Extension Release.⁷⁶ We found that chart very helpful, particularly given the differences in dates by element and entity type.



⁷⁴ The SEC extended the compliance dates for the annual board reporting requirement in the Liquidity Extension Release. Assuming the SEC accepts the recommendations above permitting funds to prepare shareholder report disclosure in reliance on their board reporting, the SEC should clarify that funds need not accelerate compliance with this board reporting obligation to satisfy the shareholder report disclosure requirement, and that the first liquidity disclosures appearing in their shareholder reports could be based on a limited assessment of program requirements actually in place during the first period.

⁷⁵ The adopting release for temporary final rule 30b1-9(T) delayed by nine months to April 30, 2020 the date by which smaller entities must begin filing Form N-PORT (for the month ended March 31, 2020). This adopting release indicates that smaller entities are *not* subject to a requirement to prepare and then retain as a record the information required on Form N-PORT; rather, they must prepare and file Form N-PORT beginning on or after the delayed March 1, 2020 compliance date. Following issuance of that temporary final rule, the Liquidity Extension Release delayed by six months to December 1, 2019 the date by which smaller entities must comply with the bucketing, HLIM, and related reporting requirements. Footnote 56 of that Release indicates that smaller entities will be subject to these requirements on December 1, 2019, but would not be required to file that information through EDGAR on Form N-PORT until April 30, 2020.

⁷⁶ Liquidity Extension Release at 8350.

Brent J. Fields
May 18, 2018
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We stand ready to assist the SEC in any way that we can. If you have any questions, please contact me ((202) 326-5901 or paul.stevens@ici.org) or General Counsel Susan Olson ((202) 326-5813 or solson@ici.org).

Sincerely,

A handwritten signature in black ink, appearing to read "Paul Schott Stevens". The signature is fluid and cursive, with a large initial "P" and "S".

Paul Schott Stevens
President and CEO
Investment Company Institute

cc: The Honorable Jay Clayton
The Honorable Kara M. Stein
The Honorable Michael S. Piwowar
The Honorable Robert J. Jackson Jr.
The Honorable Hester M. Peirce

Dalia Blass, Director
Division of Investment Management

Appendix A: Recent Experience with Subjective Disclosure and Investor Confusion in Europe

European regulators' recent transaction cost disclosure efforts provide an unambiguous lesson in the need for caution when requiring investor disclosure based upon complex methodologies with subjective inputs. While the intent of European regulators was to provide investors with objective and comparable numbers, it has become clear that this regulatory approach has led to varying and counterintuitive results and thus confusing and misleading information for investors. For instance, some funds have reported transaction costs of zero, or even *negative* numbers, while others have reported costs of up to 2%.⁷⁷

Both the European Union's Regulation on Packaged Retail and Insurance-Based Investment Products ("PRIIPs")⁷⁸ and the recast Markets in Financial Instruments Directive⁷⁹ and the Markets in Financial Instruments Regulation⁸⁰ (collectively, "MiFID II") mandate that funds disclose "actual transaction costs," including implicit or indirect costs, to investors. Similar to US funds' bucketing requirements, there are different ways of evaluating and calculating a fund's transaction costs. The PRIIPs Regulation requires applicable fund disclosure documents to disclose "the cost associated with an investment in the PRIIP, comprising both direct and indirect costs to be borne by the retail investor, including one-off and recurring costs."⁸¹ The PRIIPs Level II Delegated Regulation (the "PRIIPs Delegated Regulation") provides a detailed methodology for calculating costs associated with investing in the PRIIP, which includes four possible methodologies for calculating transaction costs.⁸²

⁷⁷ See Chris Flood, Slippage causes confusion in MiFID II fund rules row, FIN. TIMES, Jan. 26, 2018, available at www.ft.com/content/7b37016a-00fc-11e8-9650-9c0ad2d7c5b5.

⁷⁸ Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products ("PRIIPs Regulation"), available at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014R1286>.

⁷⁹ Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU ("MiFID II Directive"), available at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0065>.

⁸⁰ Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012, available at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014R0600>.

⁸¹ Article 8(3)(f) of the PRIIPs Regulation.

⁸² See Article 5 and Annex VI of Commission Delegated Regulation (EU) 2017/653 of 8 March 2017 supplementing Regulation (EU) No 1286/2014 of the European Parliament and of the Council on key information documents for packaged retail and insurance-based investment products (PRIIPs) by laying down regulatory technical standards with regard to the presentation, content, review and revision of key information documents and the conditions for fulfilling the requirement to provide such documents, available at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32017R0653>.

Likewise, Article 24(4) of the MiFID II Directive requires that EU “investment firms” provide clients with information regarding “all costs and associated charges . . . relating to both investment and ancillary services.”⁸³ Costs and charges information must be provided to all clients of EU “investment firm” distributors (*e.g.*, funds distributed through regulated EU distributors), which are obligated to provide an “all in” costs and charges figure to their clients. As further described in Article 50 of the MiFID II Level II Delegated Regulation, such information must be provided to prospective clients on an *ex ante* basis based upon good faith estimates and on an annual *ex post* basis based upon actual costs and charges data where the investment firm has or has had “an ongoing relationship with the client during the year.”⁸⁴ MiFID II costs and charges disclosures include indirect costs and must be calculated using the PRIIPs methodology set forth in the PRIIPs Delegated Regulation.⁸⁵

The ability of an asset manager to use different methodologies to calculate estimates of transaction costs under the PRIIPs Regulation and MiFID II, which may be calculated under four possible methodologies, along with subjective inputs, for example related to implicit and indirect costs, has led to inconsistent, confusing, and misleading information for those investors seeking to understand it and compare products among providers.⁸⁶ As mentioned above, these funds have reported transaction costs of zero, and even negative numbers. Despite every best intention, the interests of investors obviously are disserved when the disclosures they receive are unintelligible, confusing, and misleading in this way.⁸⁷ Public disclosure of US funds’ bucketing information would be no different, and this European experience is further proof that the Commission’s narrative-oriented disclosure proposal is the correct approach.

⁸³ Article 24(4) of the MiFID II Directive.

⁸⁴ Article 50 of Commission Delegated Regulation (EU) 2017/565 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (“MiFID II Delegated Regulation”), available at https://eur-lex.europa.eu/legal-content/EN/TXT/?toc=OJ:L:2017:087:TOC&uri=uriserv:OJ.L_.2017.087.01.0001.01.ENG.

⁸⁵ See Annex II of the MiFID II Delegated Regulation and the European MiFID Template. Answer 6 of the European Securities and Markets Authority’s (ESMA) Level III guidance, Questions and Answers on MiFID II and MiFIR investor protection and intermediaries topics (6 June 2017 | ESMA 35-43-349), states that calculation of costs and charges under MiFID II should follow the PRIIPs calculation methodology, which requires detailed transaction cost calculations covering both explicit and implicit costs.

⁸⁶ See, *e.g.*, Chris Flood, Slippage causes confusion in MiFID II fund rules row, FIN. TIMES, Jan. 26, 2018, available at www.ft.com/content/7b37016a-00fc-11e8-9650-9c0ad2d7c5b5 (quoting industry sources regarding the confusion arising from MiFID II costs and charges calculation methodologies); Valentina Romeo, Fool’s gold: How MiFID II has revealed the true cost of funds, MONEY MARKETING, Jan. 26, 2018, available at, www.moneymarketing.co.uk/mifidii-transaction-costs-funds/ (discussing industry fears that MiFID II costs and charges disclosure “will confuse and mislead investors and could ultimately defeat the goal of greater transparency”); Transtrend, Responsible Investing: Transaction costs according to PRIIPs (January 2018) (illustrating inconsistent results of application of PRIIPs methodology through various examples).

⁸⁷ Despite industry feedback, it is unclear whether further guidance will be forthcoming from regulatory authorities.

Appendix B: Examples of Non-Public Reporting to Regulators

Below we summarize some of the most recent and relevant instances of regulators (including the SEC) and other authorities collecting information and keeping it (in whole or in part) non-public. Generally speaking, the non-public information in the examples below is subjective and/or sensitive in some way, and the relevant authorities have recognized that the type and amount of information that funds and other financial entities provide to authorities may differ markedly from that which such entities should provide to investors. These examples provide ample precedent for the SEC's proposal to make non-public the bucketing information that funds will provide to the SEC on Form N-PORT, and indeed, very much support it.

Another key factor explaining regulators' treatment of data is the regulatory purpose behind its collection. The SEC's view of its mission has evolved since the financial crisis. Former SEC Chair Mary Jo White stated her belief that "the goal of reducing systemic risk is a central tenet of the SEC's long-standing mission."⁸⁸ This goal no doubt influenced the SEC's Form N-PORT and liquidity rule initiatives.⁸⁹

The SEC's more risk-oriented data collection philosophy differs significantly from its pre-crisis investor disclosure philosophy, as reflected in the nature and volume of information that the SEC is, or will be collecting, via Forms PF and N-PORT. In light of this evolution in philosophy and practice, distinguishing between information that is necessary and appropriate for regulators and that which is necessary and appropriate for investors takes on increased importance. We would expect to see less overlap between the two to the extent that the SEC continues to pursue a more risk-oriented data collection mission.

For the most part, the SEC has made these distinctions carefully, as highlighted below, and this proposal if adopted would rectify one of the few examples to the contrary.

- *Open-End Funds' Liquidity-Related Reporting Items (Forms N-PORT and N-LIQUID)*. The most relevant examples of reported non-public information involve the liquidity-related disclosures that funds will make on Forms N-PORT (*i.e.*, information about a fund's HLIM (if applicable) and its investment-specific bucketing information) and N-LIQUID (*i.e.*, the Form that a fund must file if it exceeds the 15 percent illiquid

⁸⁸ "The SEC after the Financial Crisis: Protecting Investors, Preserving Markets," SEC Chair Mary Jo White (Jan. 17, 2017), available at www.sec.gov/news/speech/the-sec-after-the-financial-crisis.html.

⁸⁹ Former Chair White, in announcing the SEC's asset management reform initiative in 2014 (which included enhanced fund reporting and fund liquidity), stated, "The program that I have just outlined is designed to serve our historic three-part mission. But, at the same time, the measures we take will necessarily have a broader impact on the financial system." "Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry," SEC Chair Mary Jo White (Dec. 11, 2014), available at www.sec.gov/news/speech/2014-spch121114mjw.

investments limit or falls below its HLIM (if applicable)).⁹⁰ With respect to these Form N-PORT items, the SEC explained that the level of position-level detail necessary for it to effectively monitor fund liquidity may not be necessary for other users; that the liquidity classification process is subject to limitations and subjectivity, creating risks of investors potentially giving too much weight to a fund manager's individual liquidity classification choices; and that position-level information will likely be out of date when reviewed by investors.⁹¹ The SEC cited these reasons again in explaining why it would keep Form N-LIQUID information non-public.

- Form N-PORT. The SEC adopted Form N-PORT on the same day that it adopted the liquidity rule and related reporting requirements.⁹² Form N-PORT requires funds to disclose and report to the SEC information about their monthly portfolio holdings in structured data format. The SEC will receive from each fund 12 filings annually, and the SEC will make only four of those filings (one each quarter) publicly available, following a 60-day lag. Those quarterly publicly available filings also will keep certain items non-public, including miscellaneous securities,⁹³ position-level risk metrics (delta), country of risk and economic exposure metrics, and explanatory notes related to these non-public items.

In supporting its decision to make only four of these 12 filings public and subject them further to a 60-day lag, the SEC stated that more frequent portfolio disclosure could potentially harm fund shareholders by expanding the opportunities for professional traders to exploit this information by engaging in predatory trading practices (*e.g.*, trading ahead of funds (“front-running”), or “free riding” on a fund’s investment research (through reverse engineering or “copycatting” the fund’s investment strategies)). In explaining its decisions

⁹⁰ See generally Adopting Release at 82194-82196, 82206-82207, and 82226.

⁹¹ With respect to the HLIM reporting items, the Adopting Release cited several concerns from commenters (*e.g.*, that public disclosure could be misleading to investors, because any minimum reported on Form N-PORT would be subjective, presented without context, and may not reflect a fund’s actual portfolio management approach at the time; could interfere with a fund’s investment strategy and promote unwarranted, and potentially destabilizing, redemption activity by fund shareholders; and also would give undue emphasis to a single element of a fund’s liquidity risk management program and could potentially encourage third parties to use a single numerical figure as a basis for comparing funds, further encouraging undue reliance on the liquidity minimum figure by investors), and stated that the SEC was “persuaded by some of the concerns expressed by commenters regarding the potential risks to funds and fund investors of public reporting” of this information. Adopting Release at 82207.

⁹² See generally Reporting Modernization Release.

⁹³ Miscellaneous securities are securities held not more than one year and not previously disclosed to shareholders in any registration statement or shareholder report. The ability to keep certain holdings non-public in Form N-PORT is based on a similar provision in rule 12-12 of Regulation S-X that permits funds to avoid identifying by name recently acquired securities in their financial statements. The ability to keep a limited amount of recently acquired securities non-public is intended to protect funds from predatory trading practices.

to keep other specified items non-public, the SEC noted that calculation of delta can require a number of inputs and assumptions, and reported deltas for the same or similar investment products could vary because of complex differences in methodologies and assumptions that are not reported on the form nor easily explained to investors; that the disclosure of delta could, for some investors, imply a false sense of precision about how a particular investment's valuation will change in volatile market conditions; that country of risk and economic exposure is evaluated by funds using multiple factors, making it subjective; that these items may convey a false level of precision; and that disclosure of such information could stifle divergences in determinations and incentivize funds to seek homogenized determinations from third party firms, potentially rendering the information less useful to the SEC staff than if it were not publicly disclosed.⁹⁴

- *Form PF*. The SEC and CFTC adopted joint rules in 2011 that require registered investment advisers to private funds to file confidential information about their private funds on Form PF.⁹⁵ The new requirements were adopted to implement a provision of the Dodd-Frank Act authorizing the SEC to require any registered investment adviser to maintain records and file reports with the SEC regarding private funds advised by the adviser, as necessary and appropriate in the public interest and for the protection of investors “or for the assessment of systemic risk by the Financial Stability Oversight Council [FSOC].”⁹⁶

Congress recognized that this type of information, while valuable for the SEC and other regulators, often can be sensitive and proprietary and thus not appropriate for public disclosure. For its part, the SEC acknowledged that “Form PF elicits non-public information about private funds and their trading strategies, the public disclosure of which could adversely affect the funds and their investors”⁹⁷ and committed to extra safeguards with respect to Form PF information.⁹⁸

⁹⁴ See generally Reporting Modernization Release at 81908-81912.

⁹⁵ *Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF*, SEC and CFTC Release No. IA-3308, 76 Fed. Reg. 71128 (Nov. 16, 2011) (“Form PF Release”), available at www.cftc.gov/sites/default/files/idc/groups/public/@lrfederalregister/documents/file/2011-28549a.pdf.

⁹⁶ Section 204(b)(1) of the Investment Advisers Act of 1940.

⁹⁷ Form PF Release at 71169.

⁹⁸ The Form PF Release states, “Prior to sharing any Form PF data, the SEC also intends to require that any such department, agency or self-regulatory organization represent to us that it has in place controls designed to ensure the use and handling of Form PF data in a manner consistent with the protections established in the Dodd-Frank Act.” Form PF Release at 71156.

Form PF has obvious parallels with Form N-PORT. Both are means by which the SEC gathers (or will gather) extensive and sensitive fund-related information, and the primary audience for each is the SEC. Most notably, Form PF also has its own aggregated “days to liquidate” bucketing item,⁹⁹ which may have been the SEC’s starting point in creating the liquidity rule’s bucketing framework.¹⁰⁰ As with all Form PF reporting items, the SEC keeps this private fund-specific aggregated bucketing information non-public.

Form 13F. Section 13(f) of the Securities Exchange Act of 1934 requires institutional investment managers who exercise investment discretion over accounts holding certain equity securities having an aggregate fair market value of \$100 million or more to file quarterly reports about those holdings with the Commission on Form 13F.¹⁰¹ Congress added this provision to increase the public availability of information regarding the securities holdings of institutional investors.

Congress also recognized, however, that in some instances, disclosure of certain types of information could have harmful effects, not only on an investment manager, but also on its clients.¹⁰² Therefore, Section 13(f) authorizes the Commission to delay or prevent the public disclosure of information as it determines to be necessary or appropriate in the public interest or for the protection of investors. Information that is eligible for confidential treatment includes information that would reveal an investment manager’s investment strategy (*e.g.*, a program of acquisition or disposition that is ongoing). Congress believed that the disclosure of an investment manager’s ongoing investment strategy would impede competition and increase volatility in the marketplace.

Nor is the SEC an outlier in its information gathering and disclosure philosophy and practices. Other US regulators have taken similar actions,¹⁰³ as illustrated below:

⁹⁹ Item 32 of Form PF, which requests information regarding the percentage of the reporting fund’s portfolio capable of being liquidated within the following periods: 1 day or less; 2 days – 7 days; 8 days – 30 days; 31 days – 90 days; 91 days – 180 days; 181 days – 365 days; and longer than 365 days.

¹⁰⁰ See *Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release*, SEC Release No. IC-31835, 80 Fed. Reg. 62274 (Oct. 15, 2015) at n.187, available at www.gpo.gov/fdsys/pkg/FR-2015-10-15/pdf/2015-24507.pdf

¹⁰¹ Form 13F and its instructions (including those related to requests for confidentiality) are available at www.sec.gov/about/forms/form13f.pdf.

¹⁰² See, *e.g.*, Section 13(f) Confidential Treatment Requests, SEC Division of Investment Management (June 17, 1998), available at www.sec.gov/divisions/investment/guidance/13fpt2.htm#FOOTNOTE_1.

¹⁰³ It is also worth noting that in 2016, FSOC distinguished between (i) “[a]dditional reporting requirements” that would “allow regulators to better understand how funds are assessing liquidity” and (ii) “public disclosure of funds’ liquidity and their liquidity risk management practices” that could “help improve liquidity risk management standards across the industry

- *CFTC (Forms CPO-PQR and CTA-PR)*. Along with the CFTC’s and SEC’s joint Form PF rulemaking, in 2012 the CFTC determined to require reporting by (non-dually registered) commodity pool operators (CPOs) and commodity trust advisors (CTAs) of information comparable to that required in Form PF.¹⁰⁴ The CFTC believed that the sources of risk delineated in the Dodd-Frank Act with respect to private funds also were presented by commodity pools, and the CFTC wished to have similar information to address those risks.

In adopting these new reporting requirements and Forms CPO-PQR and CTA-PR, the CFTC opted to keep large portions of these filings non-public.¹⁰⁵ The CFTC explained that “the collection of certain proprietary information through Forms CPO-PQR and CTA-PR raises concerns regarding the protection of such information from public disclosure.”¹⁰⁶ Of most relevance, the CFTC keeps non-public the information it collects under Form CPO-PQR’s aggregated “days to liquidate” bucketing item,¹⁰⁷ which is very similar to Form PF’s bucketing item.

- *Federal Reserve Board (FRB)(Form 2052a)*. Prudential regulatory authorities such as the FBR have standards in place on how to balance transparency and market discipline with the appropriate confidential treatment of information submitted to an agency as part of its prudential regulatory objectives. As one example, the FRB uses Form 2052a to collect detailed liquidity information from the large, complex firms that it regulates.¹⁰⁸ The FRB

and enhance market discipline with respect to how funds manage and measure liquidity risk.” *Update on Review of Asset Management Products and Activities*, Financial Stability Oversight Council (April 18, 2016), available at www.treasury.gov/initiatives/fsoc/news/Documents/FSOC%20Update%20on%20Review%20of%20Asset%20Management%20Products%20and%20Activities.pdf.

¹⁰⁴ *Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations*, 77 Fed. Reg. 11252 (Feb. 24, 2012), available at www.gpo.gov/fdsys/pkg/FR-2012-02-24/pdf/2012-3390.pdf.

¹⁰⁵ Specifically, for Form CPO-PQR, the CFTC designated as non-public: Schedule A: Question 2, subparts (b) and (d); Question 3, subparts (g) and (h); Question 9; Question 10, subparts (b), (c), (d), (e), and (g); Question 11; and Question 12; and Schedules B and C in their entirety. For Form CTA-PR, the CFTC designated as non-public Question 2, subparts c and d.

¹⁰⁶ *Id.* at 11271.

¹⁰⁷ Schedule C, Part 2, Question 2 of Form CPO-PQR (Liquidity of Large Pool’s Portfolio).

¹⁰⁸ The FRB first introduced Form 2052a in August 2014. See *Agency Information Collection Activities: Announcement of Board Approval Under Delegated Authority and Submission to OMB*, 79 Fed. Reg. 48158 (Aug. 15, 2014), available at www.gpo.gov/fdsys/pkg/FR-2014-08-15/pdf/2014-19323.pdf. The form has been amended since then. At present, reporting is required on a daily or monthly basis, depending on the size of the regulated institution (with larger, more complex firms subject to the daily reporting requirement).

uses this report (which provides detailed liquidity information within different business lines) to monitor the overall liquidity profile of institutions. In recognition of the sensitive nature of this information, the FRB has stated that the information it receives will not be available to the public and will be afforded confidential treatment under exemption 4 of the Freedom of Information Act (FOIA), 5 U.S.C. § 552(b)(4), which protects from disclosure trade secrets and commercial or financial information.¹⁰⁹

Foreign jurisdictions also draw sharp distinctions regarding regulatory reporting and public disclosure:

- *European Alternative Investment Funds (AIFs)*. The liquidity risk management requirements applicable to European collective investment schemes that are not UCITS are contained in the Alternative Investment Fund Manager Directive (AIFMD), which outlines the responsibilities of alternative investment fund managers (AIFM) with respect to their AIFs.¹¹⁰ The AIFMD requires disclosure to both investors and regulators regarding liquidity risk management, with much more extensive reporting to regulators.¹¹¹ AIFs are subject to an aggregated “days to liquidate” bucketing item that is very similar to that found in Forms PF and CPO-PQR in the US,¹¹² and once again, only the competent authorities receive this information.

Finally, in addressing open-end fund liquidity, other standard-setting bodies such as the Financial Stability Board (FSB) and IOSCO have recognized the critical distinction between information that is appropriate for regulators and the public:

¹⁰⁹ *Agency Information Collection Activities: Announcement of Board Approval Under Delegated Authority and Submission to OMB*, 80 Fed. Reg. 71795, 71796 (Nov. 17, 2015), available at www.gpo.gov/fdsys/pkg/FR-2015-11-17/pdf/2015-29348.pdf.

¹¹⁰ Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers (AIFMD), available at eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32011L0061. The AIFMD and its implementing regulation contain detailed requirements regarding an AIFM’s liquidity risk management system, as well as disclosure to both investors and Member State regulators.

¹¹¹ *Cf.* Article 23(4) of AIFMD and Article 108 of AIFMD Delegated Regulation (outlining investor disclosure requirements) *with* Article 24(2) of AIFMD and Article 110 of AIFMD Delegated Regulation (outlining reporting obligations to competent authorities). The AIFMD Delegated Regulation is available at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32013R0231>.

¹¹² *See* Annex IV of the AIFMD Delegated Regulation, AIF-specific information to be provided to competent authorities, Item 19.

- *FSB*. In its 2017 report on asset management activities,¹¹³ the FSB made nine liquidity-related recommendations. Significantly, it made separate recommendations related to authorities' collection of liquidity information (Recommendation 1) and the appropriateness of investor disclosure requirements (Recommendation 2). The FSB makes the distinction clearer still in its discussion of Recommendation 2, stating, "In determining the content and frequency of disclosure to investors, it is important to consider the potential for unanticipated consequences from public disclosure of detailed information (e.g. the potential for predatory trading and/or herding behaviour by funds and other market participants)."¹¹⁴
- *IOSCO*. The FSB recommendations discussed above required IOSCO to take further action. IOSCO's work on Recommendation 1 is ongoing,¹¹⁵ and the US is far ahead of most jurisdictions in any event. With respect to the FSB's Recommendation 2, the IOSCO Report included liquidity-related recommendations for funds earlier this year. As part of that work, IOSCO provided additional guidance under its Recommendation 7 (related to liquidity-related investor disclosure). The most specific and relevant statement in this revised guidance suggests that investors receive "on a periodic basis and where appropriate, on an aggregate basis, information regarding the investment portfolios of the CIS [*i.e.*, funds] that may allow investors to assess the liquidity risk attached to the CIS e.g. holdings of various asset classes/types of securities, detailed holdings of individual securities."¹¹⁶ Given that US fund investors will receive complete portfolio holdings and other investment- and portfolio-specific information on a quarterly basis through Form N-PORT filings, this more than satisfies this recommended disclosure standard.

¹¹³ *Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities*, FSB (12 January 2017) ("FSB Recommendations"), available at www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf.

¹¹⁴ FSB Recommendations at 17.

¹¹⁵ See IOSCO's June 2016 Statement on "Priorities Regarding Data Gaps in the Asset Management Industry," available at www.iosco.org/library/pubdocs/pdf/IOSCOPD533.pdf.

¹¹⁶ IOSCO Recommendations at 11.