May 18, 2018

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Investment Company Liquidity Disclosure (Release No. IC-33046; File No. S7-04-18)

Dear Mr. Fields:

Better Markets[1] appreciates the opportunity to comment on the above-captioned proposal ("Proposal" or "Rule Proposal") released for comment by the Securities and Exchange Commission ("SEC" or "Commission"). The Commission is proposing to rescind an important, unanimously approved, pro-investor, pro-transparency, pro-market-stability rule. The Proposal is, at best, misguided and risks significant harm to investors and markets.

This Commission is proposing to rescind the 2016 Investment Company disclosure rule ("SEC Rule 22e-4") because it now believes that "effective disclosure of liquidity risks may be better achieved"[2] by requiring a fund to "briefly discuss the operation and effectiveness of the Fund's liquidity risk management program"[3] in the fund's annual statement. This Commission has preliminarily concluded that Rule 22e-4 information is no longer useful for investors.

This conclusion is flawed for several reasons. First, the rule requires the disclosure of information that plainly **would** be useful to investors. Second, the decision conflicts with the Commission's own emphasis on the need to empower investors to make informed investment decisions by requiring the disclosure of more, not less, information. Finally, the Commission has failed to adduce any evidence to support the view that the information would not assist investors. Given that the rule has not yet been implemented and the new disclosures are not yet required, it is no surprise that there is and can be no empirical basis on which to conclude that the information is of no value, calling into question the entire Proposal.

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1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

2 Release at 11909.

3 Release at 11921.

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A unanimously approved rule should not be rescinded before its implementation absent compelling evidence that the promulgation of the rule was seriously flawed from the beginning. There is no such evidence here and the Commission should not to go forward with the Proposal to rescind the rule.

Our comment letter will focus on these points and it will offer support for certain parts of the proposal that can be adopted as stand-alone provisions that can enhance Rule 22e-4.

SUMMARY

- Rescinding a unanimously approved, pro-investor, pro-transparency, and pro-stability rule based on the reasoning offered in this Proposal is contrary to the SEC's tripartite mission of investor protection, facilitation of capital formation, and maintenance of fair and orderly markets that are worthy of investors' confidence. The information that would have been disclosed, as required by SEC Rule 22e-4, would have been useful in numerous ways. It would have empowered investors and helped them make more informed investment decisions about the composition and liquidity of mutual funds, one of the most important and widespread investment products on the market today. Investors could have easily understood the liquidity profile of an investment company by studying the distribution among the four liquidity rankings or "buckets." Investors would have been further empowered to make more informed investment decisions through the work of third-party analysts: the information disclosed through the rule would have provided raw material for third-party independent analysts and other FinTech firms to evaluate, compare, and distill for the benefit of retail and institutional investors. In addition, the disclosed information would have raised investor confidence, promoting more overall participation in the market and doing so in a way that promotes efficiency and competition. Finally, this information would have aided regulators to maintain more orderly mutual fund markets, as the SEC and outside analysts would have had a comprehensive, apples-to-apples view of the mutual fund markets, and this transparency would have increased systemic stability.

- It is irresponsibly premature to declare that the information that would have been required to be disclosed by Rule 22e-4 would have been useless for investors. The information has not yet been disseminated pursuant to the rule because the rule is not yet effective. Moreover, the SEC has conducted no investor testing to determine whether indeed investors would have found the information useful. The Commission admits in the Proposal that it has discussed the usefulness of the information with the producers of this information, but nowhere in the Proposal do we find any evidence that the Commission has surveyed or otherwise asked the *consumers* of the information (*i.e.*, investors large and small, analysts, third-party FinTech providers, etc.) whether such information would be useful. This one-sided approach is unacceptable, and the Commission, at a minimum, must correct this before moving forward.

- We agree that investment companies can and should offer more context and discussion about the Fund's liquidity profile and risks in annual disclosures. We further agree that

> those more detailed discussions could be part of the broader management discussion of fund performance or "MDFP." However, we see no regulatory or public interest reason why the provision of that enhanced disclosure should come at the expense of the Rule 22e-4 disclosures. The Funds could provide both quarterly liquidity classification information **and** enhanced MDFP. These complementary information and data would empower investors to make informed investment decisions, and as shown in the Proposal (and detailed below), the provision of this information would not add significant costs to the Fund's operations.

COMMENTS

Brief Description of the Proposal

The Proposal replaces "the requirement for a fund to publicly report to the Commission the aggregate liquidity portfolio classification information on a quarterly basis with new disclosure in the fund's annual shareholder report that provides a narrative discussion of the operation and effectiveness of the fund's liquidity risk management program over the reporting period."[4] Second, the Proposal amends SEC Form N-PORT to allow a fund to report "a single portfolio holding in multiple classification buckets under certain circumstances."[5] Third, the Proposal would require "funds and other registrants to report holdings of cash and cash equivalents on Form N-PORT so that [the SEC] may monitor trends in the use of cash and cash equivalents and, in the case of funds, more accurately assess the composition of a fund's highly liquid investment minimum ("HLIM")."[6] Our comment letter will largely focus on the Commission's proposal to rescind the liquidity reporting obligations in Rule 22e-4.

Understanding the Liquidity Risk of a Fund Is Critical for Investors and Disclosure of Classification Information Is Vital to this End.

The Proposal would rescind important parts of a unanimously adopted rule that requires an open-end management investment company (that is registered or required to register under Section 8 of the Investment Company Act of 1940 (15 U.S.C. § 80a-8), excluding money market funds) to group the fund's portfolio investments into four classifications (also referred to

4 Release at 11907.
5 *Id.*
6 *Id.*

as "buckets"). The four buckets are: highly liquid;[7] moderately liquid;[8] less liquid;[9] and illiquid.[10] Under the rule as adopted, the fund would have been required to report on a quarterly basis using SEC Form N-PORT the percentages of the fund's holdings in each bucket. For example, a fund may have 42% of its holdings in highly liquid investments, 28% in moderately liquid, 20% in less liquid, and 10% in illiquid holdings. And, funds were to report this information to the SEC using a form that is accessible to all investors, and were to update the allocation information on a quarterly basis. Together, these four buckets represent a fund's liquidity risk. Liquidity risk is the "risk that the fund could not meet requests to redeem shares issued by the fund without significant dilution of remaining investors' interests in the fund."[11]

Liquidity characteristics are among the most important questions (along with the performance of the fund) that an investor in mutual funds faces: in the event I want my money back, how quickly can I redeem my shares and what will happen to the value of the remaining shares after my redemption? The answer to this question can either increase an investor's confidence in the fund or it can signal to the investor to stay away from a particular fund or the industry as a whole. Because if investors perceive that a fund with less liquid holdings will have difficulty preventing dilution of share value as redemptions are made, they will not invest or they will significantly scale back their investments (and at a minimum expect higher returns for the increased liquidity risk).

Investor empowerment through disclosure of material information has been a bedrock of securities regulation since its inception. As Commissioner Stein analogized at the SEC open meeting when the Proposal was released, these four buckets are "akin to disclosing the ingredient list on a food label. The Food and Drug Administration requires ingredients to be listed on food labels in descending order of predominance. Consumers can use the ingredient information to decide if they want to purchase the food product. After all, the product might contain an allergen or some other ingredient a consumer may want to avoid."[12] Similarly, under the rule as adopted, an investor could readily assess the liquidity risk profile of a fund as represented by the percentages of holdings in each bucket. This information would help investors make more informed investment decisions.

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7 Highly liquid investment means any cash held by a fund and any investment that the fund reasonably expects to be convertible into cash in current market conditions in **three business days or less** without the conversion to cash significantly changing the market value of the investment. 17 C.F.R. § 270.22e-4(a)(6).

8 Moderately liquid investment means any investment that the fund reasonably expects to be convertible into cash in current market conditions in **more than three calendar days but in seven calendar days or less**, without the conversion to cash significantly changing the market value of the investment.17 C.F.R. § 270.22e-4(a)(12).

9 Less liquid investment means any investment that the fund reasonably expects to be able to sell or dispose of in current market conditions in **seven calendar days or less** without the sale or disposition significantly changing the market value of the investment. 17 C.F.R. § 270.22e-4(a)(10).

10 Illiquid investment means any investment that the fund reasonably **expects cannot be sold** or disposed of in current market conditions in seven calendar days or less without the sale or disposition significantly changing the market value of the investment. 17 C.F.R. § 270.22e-4(a)(8).

11 *See* 17 C.F.R.§ 270.22e-4(a)(11).

12 *See* Commissioner Kara Stein's statement, available at https://www.sec.gov/news/public-statement/statement-stein-open-meeting-fund-liquidity-2018-03-14#_edn7.

This Commission now argues that the classification of a fund's holdings into four buckets and the disclosure of that classification for investors is not in the public interest because the information will not be useful. But this judgment has no factual basis and is no more than unfounded speculation. The required disclosures are specific, relevant, comprehensible, and would be useful to investors on their face. Tellingly, the SEC has produced no evidence to the contrary. The SEC has both the authority and the ability to conduct unbiased, objective investor testing, whereby actual investors could be surveyed to understand the usefulness or effectiveness of any disclosures. However, for reasons that have not been disclosed, this Commission has declined to conduct such testing. And as Commissioner Stein noted in her statement, the Commission has also rejected the idea of at least conducting what is essentially a pilot program, where the Rule 22e-4 disclosures would be required for a year or two, giving both the Commission and investors an opportunity to test their usefulness in practice. There is simply no defensible basis for refusing to conduct such a pilot program.

Instead, the Commission has reversed course based primarily on – as the Proposal states in several instances – discussions with and input from exclusively industry representatives, who are self-interested and biased. The Proposal states that since adoption of Rule 22e-4, the SEC staff has "engaged in extensive outreach with funds and other interested parties as they have sought to design the new systems and processes necessary to implement the new rules."[13] If, as it appears, the Commission has heard only from members of the supply side of the industry and those who service the industry, such as intermediaries and third-party entities that facilitate the classification and reporting of the data (and the Proposal lists no other engagement efforts), then it is patently clear that the Commission staff has deprived itself and the Commission of critical insight from those who actually use such disclosures, namely, investors and those who serve investors (be they advisers, third-party analysts, or FinTech firms). Furthermore, the Proposal cites several exclusively industry letters addressed to SEC Chairman Jay Clayton as part of the record that has influenced and propelled the release of the Proposal.[14] It thus appears to have been a result-oriented inquiry designed to come to a pre-determined outcome.

This one-sided, industry-only "outreach" also assured that the results would be for the benefit of the industry and at the expense of those who were not heard from nor invited to the table, namely investors. It is also telling that the industry made essentially the same arguments and objections to convince the Commission in 2016, but it nonetheless unanimously approved the rule as in the best interests of investors. Inexplicably, these same one-sided, baseless arguments are now found persuasive enough for the Commission to propose rescinding important parts of Rule 22e-4.

In short, the Commission has failed to provide a complete, substantial, substantive, or convincing factual basis for the abrupt change in direction that it now proposes. The other justifications set forth in the Release are equally unavailing, as we address below.

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13 *See* Release at 11907.

14 It is concerning to note that there seems to be a coordinated effort by the Commission to build-up the record which in turn can be used as a legitimate basis for the rescission of the rule. The Release cites letters in notes 11 and 12 that are exclusively industry. Release at 11907. Then, throughout the Proposal, the Commission draws from these industry letters and agrees with the concerns raised in those letters.

The Inherent Subjectivity in Classification Is Overstated and to a Degree Desirable.

The Proposal discusses how, through its engagement with the industry, the Commission has learned that each fund may use different methodologies and assumptions in assigning a liquidity classification for their own fund. Furthermore, the industry argues, and the Commission seems to agree, that because investors will not have access to these methodologies and assumptions used in assigning the liquidity classification, investors would be confused when they are exposed to the liquidity risk classification information (*i.e.*, what percentage of holdings are in each bucket). In other words, the industry insists that each fund manager may have a different view as to where on the liquidity spectrum a particular security belongs. And, the argument goes, because each fund uses their own methodologies and assumptions in assigning classifications, the results are inherently subjective and, most importantly, cannot be compared from one fund to another. Because of this supposed confusion, investors would be making investment decisions on inappropriate grounds.

As a threshold point, this concern is exaggerated. Unless funds are attempting to deliberately distort their disclosures, the classifications will not diverge widely among funds, as the basic criteria to be applied have clear meanings. More importantly, this issue is not a flaw or an unintended consequence of the 2016 Rule. When adopting the final rule in 2016, the Commission was well-aware of the issue of subjectivity, and it purposefully adopted the final rule to allow for such subjectivity since the Commission wanted the funds' advisers to apply their real-world trading experience to inform the classification. In other words, the Commission did not want to establish rigid, uniform classification methodologies and assumptions since it did not want to supplant the discretion, judgment, and expertise of industry practitioners. And so the Commission in 2016 gave latitude and flexibility to fund managers to classify their portfolio holdings according to the four buckets using their discretion and experience.

Subjectivity is inherent in finance. While prices of a given security are readily available, predicting how this security (or a lot of it) will be valued under different market conditions is inevitably to some degree a judgment call. Each trader has his/her own counterparts to trade with and possesses a unique style and ability when trading securities. One trader or fund manager who works with traders may have an easier time selling a particular security under certain economic conditions (and therefore this security may be deemed liquid) compared to another trader or fund manager who has had more difficulty selling the same security under similar market conditions. The fund managers who work with these two traders may classify the same security into two different liquidity buckets. And this subjectivity is exactly what the SEC did not want to take away from fund managers and the private sector.

It is illuminating that, in the first iteration of the of the Rule 22e-4 proposal, the SEC proposed a much more detailed, prescriptive, and discretion-free approach to classification process, including prescribing specific methodologies. But in response to this, the industry argued that the Commission's approach was too prescriptive. Responding to the industry's input, the Commission adjusted the rule when finalized by making it more subjective and flexible. The industry's recent complaints about the very subjectivity that it sought proves that their complaints are not a credible basis for yet another change.

Finally, if the Commission's concern is that subjectivity involved in classification and disclosures can confuse or ill-inform investors, then it should doubly be concerned when allowing the fund to discuss its liquidity risk management programs in the fund's annual statement. Allowing a brief, unstructured (and parameter-less) discussion of liquidity risk in a statement that is often dozens of pages long (and sometimes hundreds of pages long) is an invitation for the fund to be maximally subjective. How would investors, and those third-party analysts and FinTech firms that serve investors, use this annual, super-subjective narrative to compare and contrast the liquidity risk management programs of two otherwise comparable mutual funds?

The answer, of course, is that these investors, or those entities serving them, would have a much easier time comparing the liquidity risks of two otherwise comparable funds (say, in terms of performance and costs) by relying on the provisions of Rule 22e-4: assessing the distribution of liquid-to-illiquid holdings among the four buckets.

<u>Lack of Context, to the Extent It Is a Genuine Problem, Can Easily Be Remedied.</u>

Industry commenters also argue that Form N-PORT, the vehicle through which the liquidity classification information would be disclosed, does not allow industry to provide context about how the fund's classification results relate to its liquidity risk and risk management. They argue that without context, only sophisticated investors and intermediaries will understand the raw classification.[15]

It is unclear why these funds cannot provide this supposedly indispensable context in other forms (*e.g.*, the annual Form N-1A) or through other voluntary disclosures. Investors seeking context can then read those and add that information to the total mix of information they need to make informed investment decisions. And, if context is as critically important as industry claims, then the industry could petition the Commission to amend Form N-PORT to allow the industry to provide it in their preferred format. Of course, the Commission must ensure that any such contextual information is not misleading and does not hide or obfuscate the true reasons why, for example, a fund is holding a significant portion of illiquid securities in its portfolio (said differently, the fund should not be able to "explain away" its junk bucket). But in any case, assuming that more information is necessary or desirable to provide context, the solution is certainly not to repeal the classification system itself.

<u>The Threat of Undue Weight on Liquidity Considerations Through Liquidity Risk "Isolation" Is a Fictitious Notion.</u>

The Proposal discusses industry's arguments that disclosure of liquidity classification would in essence single out liquidity risk from other risks and fund characteristics such as returns and performance.[16] The industry contends that this will be a disservice to investors because investors would focus on those at the expense of other risks and characteristics. For example, the Release explains that an isolated focus on liquidity risk "may result in investors not evaluating whether such a fund is achieving comparable performance despite maintaining low-yielding assets

[15] *See* Release at 11909.
[16] *Id.*

through use of derivatives or other leverage, and whether the investor is comfortable with the trade-off of liquidity versus leverage risks."[17]

The argument that investors somehow will be hypnotized by the liquidity classification information and not review and assess a fund's other risks and characteristics cannot be taken seriously. It is unfounded. Neither the industry nor the Commission provide any evidence that reasonable investors, or those intermediaries who serve investors, lack the ability to be discerning in their consumption of the various types of disclosures or classification information. Investors can and do read and digest a broad range of information when making investment decisions, provided of course that the information is provided in clear, accurate, and timely fashion. The liquidity classification information, as described in detail above, can easily be understood as it simply states the percentages of liquid-to-illiquid holdings a fund has in its portfolio. Investors and those who serve them then can add this liquidity classification information to their total mix of information and make better and more informed investment decisions.

CONCLUSION

The Commission should withdraw its ill-advised and baseless Proposal, which risks harming investors and allowing opacity to remain in the mutual funds market. At the absolute minimum, the Commission should allow the 2016 rule to become effective for 2-3 years which should generate at least some empirical data for the Commission to assess, including how investors are using the classification data and how funds are behaving given the increased transparency and investor focus on liquidity risks.

Such actual, real-life data should be the only basis for the Commission to revisit or revise Rule 22e-4, which is a step that should only be undertaken if it in fact benefits investors, fair and orderly mutual fund markets, and capital formation.

Sincerely,

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17 *Id.*

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