Statement on Proposed Amendments to Public Reporting of Fund Liquidity Information

Chairman Jay Clayton

March 14, 2018

Today, the Commission will consider a proposed rule that would amend the liquidity risk management rules for open-end funds that the Commission adopted in October 2016. Specifically, staff will recommend that the Commission propose amendments to revise the manner in which information about funds' liquidity risk management practices is provided to investors in those funds. These recommendations are designed to address the potential for investor confusion presented by a few aspects of the current rule.

Before getting into the details, I would like to commend the staff, and my fellow Commissioners, for their efforts that led us to this point. In particular, staff and Commissioners Piwowar and Stein, and their prior colleagues on the Commission, were instrumental in the Commission's consideration and adoption of the 2016 final rule. I commend them and I also recognize that liquidity risk management is a complex, dynamic exercise that is ever changing. As a result, the hard work must continue. And we must be open to assessing and re-assessing our prior work, with a vigilant eye on investor protection and market integrity. While we have nearly worked out the pre-implementation issues with the 2016 final rule, the staff and the Commission will have to continue to monitor and improve our oversight of liquidity risk management disclosure by funds following implementation of the rule and in the years to come.

Taking a step back for a minute, the Commission's 2016 liquidity risk management final rule required that funds establish significant new practices for managing liquidity risks, including a requirement that funds establish a liquidity risk management program, and that such a program include the classification of portfolio investments into one of four liquidity "buckets".

The Commission's liquidity risk management rule was the product of significant staff and Commission effort to explore the issue of liquidity in the fund industry. These efforts, which intensified after the financial crisis, had been going on for some time. In addition, other regulators, including the FSB and IOSCO, have devoted substantial resources to the examination of these issues. That said, we remain at the forefront on this issue in the fund market and we are treading new ground.

The 2016 rule was adopted to "provide investors with increased protection regarding how liquidity in their open-end funds is managed." Specifically, open-end fund investors expect that funds will be in a position to readily redeem their shares, as required under the Investment Company Act and our regulations. Failing to have sufficient liquidity to meet those obligations can cause investor harm — not only in specific funds, but in potentially undermining confidence in the open-end fund model more generally. Appropriate management of liquidity risks is therefore of critical importance in the protection of fund investors and to our markets more generally.

We are also aware of concerns that have been raised about systemic risk in the fund industry. This issue has been examined by FSOC and other domestic and multinational organizations. Our work and the work of these other organizations demonstrate that these are complex issues that do not lend themselves to panaceas or simple metrics, and I commend staff for their work to date.

The Commission's liquidity risk management rule was designed in large part to (1) promote appropriate attention to, and management of, liquidity risks at the fund level (and, as a result, enhance overall market liquidity); and (2) provide the Commission with enhanced visibility into funds' liquidity practices at a fund level and a market level, so that the Commission could be better-informed as it exercises its role as the primary regulator of the U.S. mutual fund industry.

This was and is an important rule, and an important step forward in our understanding of the markets.

But, as with any major new regulation, particularly in an area as complex as liquidity risk management and related reporting, insightful questions have been raised regarding the effects of certain aspects of the final rule. It is good government to engage with stakeholders and examine how investors are affected by our rules, including whether our rules are achieving their objectives, and whether there are unintended adverse consequences. The staff has performed admirably in this regard, developing a package of actions, and proposed actions, to resolve certain significant concerns that had been raised during the implementation process.

Specifically, (1) the staff has issued a series of FAQs addressing implementation questions regarding the final rule; and (2) in February, the staff recommended, and the Commission approved, to extend by six months the timeline for implementation of the liquidity classification and related requirements of the final rule. This gave funds and their service providers needed additional time to develop, test, and deploy their liquidity classification programs.

Today, we consider a proposed rule related to the last component of the staff-developed package of actions — a proposed change to the way open-end funds will report liquidity-related information to investors.

The 2016 final rule requires funds to (1) submit monthly, detailed position-level data to the Commission on a nonpublic basis and (2) publicly disclose only the aggregate liquidity profile of their portfolios — the percentage of investments falling into buckets 1 through 4 — every quarter. I refer to this, limited, quarterly, quantitative disclosure as the "four bucket" disclosure. This "four bucket" approach was intended to provide investors with quantitative insight into the liquidity risks of funds, while avoiding the potentially significant adverse consequences to the fund (and its investors) of requiring detailed public reporting of the position-level data submitted to the Commission.

The Commission had proposed transparency at the position-level, but commenters on the 2015 proposal asserted that this could have, among other things, led to certain predatory trading behaviors, and the Commission agreed it was not necessary or appropriate in the public interest or for the protection of investors to make this sensitive, granular information publicly available. As an alternative, the final rule settled on the "four bucket" approach.

While the "four bucket" approach was resourceful, commenters have highlighted tensions between "four bucket" reporting and the final rule's fund-by-fund approach to liquidity classification.[1] In particular, while the Commission specified the objectives of the classification analysis (bucket the fund's investments), and suggested factors for funds to consider in the analysis, the assumptions, methodologies, and outputs of the analysis are significantly subjective and fund-specific, and the staff expects that they will vary from fund to fund. While the Commission is well-situated to understand fund-to-fund variabilities in the classification process because of our access to the nonpublic data, as well as our ability to follow up with funds, many of the factors leading to those fund to fund variabilities would not be apparent to retail investors or the markets more broadly. I believe it is the Commission's responsibility to ensure that the information we are requiring funds to disclose is not only accurate, but placed in a proper context such that it will be of value to investors — e.g., promote investor understanding and, importantly, not lead to investor confusion or, worse, misleading information.

The staff is therefore recommending that the Commission propose modifications to our approach to liquidity risk disclosure. The recommendation under consideration today would propose to replace the "four bucket" liquidity profiles to be reported on Form N-PORT with a new requirement that each fund discuss the operation and effectiveness of its liquidity risk management program in its annual report. I believe that this fund-specific disclosure requirement will serve investors, as they would receive information that reflects the specific liquidity risk management approach and experience of the fund.

Although, under the proposal, funds would not publicly disclose their quantitative "four bucket" liquidity profiles, if this change is adopted, I expect that Commission staff would publish a periodic report on the liquidity of funds at a market level. I believe such reports could provide valuable data to investors and the markets about the liquidity of the open-end fund industry, much like the periodic report the staff issues analyzing private fund data confidentially reported to us.

I understand that some have and will criticize a proposal not to require public disclosure of the "four buckets" or some other type of quantitative fund-level information at this time. I also recognize that the identified, and I believe potentially significant, issues with the limited value of the stand-alone "four bucket" metric and the perhaps great risks of using the metric for fund-to-fund comparability are not as acute when one is using the metric to examine a single fund over an array of periods (assuming the methodologies and judgments are consistently applied from period to period, over time). However, I agree with the staff that the potential for this data to have some incremental benefit in performing time-series analyses over multiple quarters could be outweighed by the potential for the data to be misused by investors in assessing a fund's liquidity and, in particular, in performing fund-to-fund comparisons. This is why I believe it is important to bring this proposal forward.

Just to be clear: (1) there is no change in the data we will collect; and (2) I do not believe that we should collect, and keep as nonpublic, information that we believe would be material to an investment decision and could be responsibly disclosed publicly to investors. Said another way, while the Commission will be reviewing and monitoring the nonpublic data with an eye toward fund-specific and market risks, the Commission is properly first and foremost a disclosure agency, and our primary focus should be on providing investors with the information they can use to make better-informed investment decisions.

Balancing these competing considerations, and — importantly — recognizing that we do not yet have experience with the data called for by the rule, I believe that we are best served by taking the approach recommended by the staff. Until we have the data in hand, we cannot predict what that fund-specific and market data will look like, how much fund-specific data will differ from fund to fund, and how useful (or confusing) quantitative fund-specific data might be to investors. When we have the data in hand, we, relying on our able staff in IM and in DERA, should as promptly as practicable evaluate these questions and determine whether, and in what form, quantitative fund-specific information should be disclosed to investors. The proposal calls for such a data-informed study and recommendation. I am very interested in hearing commenters' views on these issues.

Also, in the vein of continued assessment and striving to best serve our investors and markets, I agree with the Commission's 2016 statement that providing more granular fund-specific quantitative or position level detail would risk, among other things, investor confusion and predatory trading behaviors. But, again, when we actually start to receive the data, we can better judge the accuracy of these assumptions for ourselves, and then can — and will — determine whether and how we could provide better transparency to fund investors. I believe this data-driven, incremental approach is the responsible way to proceed.

I will close by noting that my comments are infused by experience. Our past efforts and the efforts of other regulators demonstrate that crafting discrete, yet meaningful measures of liquidity is not an easy task, particularly in the absence of position-level data sets. This does not mean we should not try. We most certainly should. We also should recognize that liquidity is a dynamic concept and, if we do identify discrete quantitative measures that we determine provide a reasonable basis for mandated public disclosure, a regular assessment of their continued efficacy will be required.

But back to the business at hand and speaking more broadly: I believe that addressing the issues raised in today's proposal will help achieve an effective and timely roll-out of funds' compliance with the liquidity risk management final rule.

Before I turn the proceedings over to Dalia Blass, to discuss the staff's recommendations, I would like to thank the staff for their dedication and thoughtful work on this release. It reflects input from the Division of Investment Management, the Division of Economic and Risk Analysis, and the Office of General Counsel. This was truly a collaborative effort, with coordination across the agency.

Specifically, I would like to thank Dalia Blass, Sarah ten Siethoff, Thoreau Bartmann, Zeena Abdul-Rahman, and Kathy Joaquin in the Division of Investment Management; Bob Stebbins, Meridith Mitchell, Lori Price, Marie-Louise Huth, Bob Bagnall, and Monica Lilly, in the Office of the General

Counsel; and Jeffrey Harris, Hari Phatak, Christof Stahel, and Jim McLoughlin in the Division of Economic and Risk Analysis.

I also want to thank my fellow Commissioners and their staff for their engagement on the proposal that we are considering today. Now, I will turn it over to Dalia Blass, our Director of the Division of Investment Management.

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[1] Specifically, the Commission determined, I believe appropriately, that the liquidity classification process is likely to rely on different data, assumptions, algorithms, and methodologies from fund to fund. And, as a result, classification determinations for specific positions should be expected to differ from fund to fund.