Statement on Proposed Amendments to Public Reporting of Fund Liquidity Information

Commissioner Kara M. Stein

March 14, 2018

I would like to join Chairman Clayton in thanking the staff for their work on this release—in particular, Zeena Abdul-Rahman, Thoreau Bartmann, and Sarah ten Siethoff.

While I sincerely appreciate the staff's efforts, I am not persuaded that we should amend our liquidity rule and take useful disclosure away from investors.

So what is the staff proposing be taken away? Starting next year, certain investment funds, such as mutual funds, are supposed to give investors information about the liquidity of the funds' investments.[1] The proposal before the Commission today would take away that public disclosure requirement.

When you boil it down, liquidity is all about one question. How long does it take to do something? We ask that question in all sorts of situations. How long does it take to travel from point A to point B? How long does it take to sell a house or a car? Or, in this case, how long does it take for a fund to sell an underlying investment without affecting its price?

Some investments take longer to sell than others. For example, a domestic large cap equity has different liquidity characteristics than an emerging market corporate junk bond. This matters because the law requires investors to get their money within seven days after making a request to redeem their fund shares.[2]

When a fund fails to properly manage the liquidity of its investments, it can get into trouble. In late 2015, a multi-billion-dollar junk bond mutual fund ran into a liquidity crunch and spiraled out of existence. This caused the fund to suspend shareholder redemptions and ultimately liquidate.[3] History and experiences like this have shown that funds can have trouble meeting their redemption obligations.[4] Given that understanding, shouldn't funds be required to give investors basic information about the liquidity of their holdings? I think so.

And I wasn't the only one. A unanimous Commission determined that investors should have this liquidity information. The Commission debated and weighed each of the options, and decided that investor protection should win out over opacity.

The Commission's current rule requires that certain funds classify portfolio investments into four categories or buckets, from easy-to-sell to hard-to-sell. The current rule also requires quarterly public disclosure of the total percentage in each bucket. So investors would see four numbers every quarter.

This is 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.[5] 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.

Liquidity information of a fund is no different. It gives investors some indication of the liquidity profile of what's in the fund. Investors can therefore make a better determination as to whether the fund is appropriate for them to purchase.

We also should remember that the Commission adopted a final rule that reflected a compromise. The final rule was adopted after substantial comment and debate. The initial proposed rule would have required public disclosure of the liquidity classification for each individual investment in the fund. There would have been six classifications or buckets. The final rule reduced the number of buckets to **four** and allowed funds to report the aggregate value of investments that fall into each bucket, as a percentage. For example: 45% in the first bucket, which represents cash or investments the fund can convert to cash within three business days[6]; 25% in the second bucket, which represents investments the fund can convert to cash in more than three but less than seven calendar days[7]; and so on. The final rule balanced the benefits to investors and other potential users of the information with the competitive concerns voiced by some commenters.[8] In a unanimous and bipartisan vote,[9] the Commission approved the final liquidity risk management rule. In short, the prior Commission took a measured approach to providing some daylight where once there was darkness.

So what, you might ask, has changed? First and foremost, we have a new Administration and a new Commission.[10] In turn, we have heard renewed requests to block the public disclosure requirement.[11] Some claim that funds shouldn't have to disclose liquidity information because investors won't understand it.[12] They say there is too much subjectivity involved in the classifications.[13] Some of these commenters were the same ones that argued the previous proposal was too prescriptive (although more objective).[14] Simply put, there are no new arguments —just a push to keep very basic liquidity information out of the public view.

For over 80 years, the Commission has dismissed these "cry wolf" fear tactics around disclosure. Make no mistake; this proposed change is a roll-back of transparency. And it is a change that I cannot agree with.

I am willing to listen to commenters concerns, but we should use real data and real facts, rather than allowing fear mongering and investor demonization to determine if there is a problem with quarterly public disclosure. For instance, shouldn't we at least evaluate the disclosure for a period of time to allow the Commission to assess the quality of the disclosure and the potential impact on investors?[15] Then, the Commission could decide, in a reasoned way, whether to rescind the public disclosure requirement due to quote "investor confusion."[16]

Let us not forget that the financial crisis revealed again how important it is that investors and the capital markets have an insight into the liquidity of various investment products. Our capital markets are the healthiest and most vibrant in the world because of the transparency created by our disclosure system.[17] Hiding information from investors and the marketplace flies in the face of the SEC's mission, and I simply cannot support today's proposal to eliminate the Commission's requirement for transparency of liquidity information.

Thank you.

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[1] For purposes of this statement, when I refer to "funds," I am talking about open-end investment companies that are subject to the requirements of rule 22e-4 and the related disclosure requirements. *See* 17 C.F.R. § 270.22e-4; 17 C.F.R. § 274.150.

[2] The Investment Company Act of 1940, in Section 22(e), requires that shares of open-end investment companies be redeemed within seven days.

[3] *See* Third Avenue Trust and Third Avenue Management LLC, Investment Company Act Release No. 31943 (Dec. 16, 2015), *available at* https://www.sec.gov/rules/ic/2015/ic-31943.pdf; Tim McLaughlin, Ross Kerber & Svea Herbst-Bayliss, *Hidden in Plain Sight: Big Risks at Failed Third Avenue Fund Were Clear to Some*, Reuters (Dec. 23, 2015), *available at* https://www.reuters.com/article/us-funds-thirdavenue-junk-insight/hidden-in-plain-sight-big-risks-at-failed-third-avenue-fund-were-clear-to-some-idUSKBN0U627V20151223 .

[4] As one commenter put it, situations like this "easily suppl[y] the compelling case that diligent and consistent disclosure of mutual fund liquidity is a key component of investor protection and efficient fund selection." Letter from The TCW Group, Inc. to Chairman Jay Clayton, Commissioner Kara M. Stein & Commissioner Michael S. Piwowar (Sept. 15, 2017) ("TCW Letter"), *available at*

https://www.sec.gov/comments/s7-03-18/s70318-3129317-161932.pdf (but arguing that disclosure of public liquidity classifications in the current rule would be confusing for investors).

[5] *See* 21 C.F.R. § 101.4(a).

[6] *See* 17 C.F.R. § 270.22e-4(a)(6) ("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, as determined pursuant to the provisions of paragraph (b)(1)(ii) of this section.").

[7] *See* 17 C.F.R. § 270.22e-4(a)(12) ("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, as determined pursuant to the provisions of paragraph (b)(1)(ii) of this section.").

[8] *See* Investment Company Liquidity Risk Management Programs, Investment Company Act Release No. 32315, at 180 (Oct. 13, 2016) [81 FR 82142 (Nov. 18, 2016)] ("Final Adopting Release"), *available at* https://www.sec.gov/rules/final/2016/33-10233.pdf.

[9] With a 3-0 vote, the Investment Company Liquidity Risk Management Program final rule was approved on October 13, 2016. *See Final Commission Votes: October 2016 (last visited Mar. 14, 2018), available at https://www.sec.gov/about/commission-votes/commission-votes-2016-10.xml.*

[10] In addition, the U.S. Department of the Treasury wrote a report on asset management that criticizes components of the rule. Steven T. Mnuchin & Craig S. Phillips, U.S. Dep't of the Treasury, A Financial System That Creates Economic Opportunities: Asset Management and Insurance (Oct. 2017), *available at* https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-That-Creates-Economic-Opportunities-Asset_Management-Insurance.pdf ("Treasury Report"). *But see* Ben McLannahan, *Watchdog Warns of Gaps in US Financial Regulation*, Financial Times (Feb. 26, 2018), *available at* https://www.ft.com/content/e81d525a-1797-11e8-9376-4a6390addb44 (noting that there may be regulatory gaps where Treasury recommends eliminating stress testing "in favour of a 'strong liquidity risk management framework'") (quoting the Treasury Report).

[11] *See e.g.,* Letter from SIFMA AMG to Chairman Jay Clayton, Commissioner Kara Stein & Commissioner Michael Piwowar, at 21 (Sept. 12, 2017) ("SIFMA AMG Letter"), available at https://www.sec.gov/comments/s7-03-18/s70318-3129348-161933.pdf ("Our Members have, **from the beginning**, strongly opposed public disclosure of fund liquidity classifications.") (emphasis added).

[12] *See e.g., id.*, at 4.

[13] *See id.* The fact that there is subjectivity involved in the classification process was something that the final adopting rule release discussed. *See* Final Adopting Release, at 179-80 ("While we acknowledge that liquidity classification determinations may be to some extent subjective and that such information reported on Form N-PORT may be non-standardized, we believe that, on balance, our staff, investors, and other potential users would benefit from the information that will be reported on Form N-PORT that currently may not be reported or disclosed by funds. We believe that this greater transparency about liquidity at the fund-level will provide our staff, investors, and other potential users with a helpful picture of the general liquidity characteristics of funds and help them better understand the liquidity risks associated with a particular fund. We also believe that this information will help investors make more informed investment decisions."). Acknowledging the subjectivity, the Commission indicated that "on balance . . . investors and other potential users would benefit from the information." *Id.*

[14] *Compare* Letter from the Investment Company Institute to The Honorable Jay Clayton (Jul. 20, 2017) (noting "there is substantial risk that the SEC and other regulators will overemphasize and be misled by this limited, subjective, and forwardlooking classification information. . . . Our concerns surrounding public reporting are even greater, because the public is even more likely to be misled by (or fail to fully understand the inherent limitations of) this information.") *with* Comment Letter of Investment Company Institute (Jan. 13, 2016) ("We oppose the proposal's very specific and prescriptive elements . . . .").

[15] In fact, this more measured approach was what at least one commenter originally suggested. *See e.g.*, Comment Letter of Securities Industry and Financial Markets Association (Jan. 13, 2016), *available at* https://www.sec.gov/comments/s7-16-15/s71615-64.pdf ("At the very least, we urge the Commission to study the information it receives for a reasonable period of time before reaching a determination as to whether making some or all of it publicly available will, in fact, benefit the investing public.").

[16] *See* TCW Letter, at 1 (noting that ". . . the only result will be investor confusion"); Letter from Nuveen, LLC, at 3 (Nov. 20, 2017), *available at* https://www.sec.gov/comments/s7-03-18/s70318-2779639-161631.pdf ("We agree with SIFMA AMG's position that the public dissemination of classification information reported via Form N-PORT will likely lead to investor confusion.").

[17] In fact, some have noted that "'[n]ow that managers will be required to measure [liquidity] and have tools to manage it and report to the SEC… it's only natural to expect that investor base will be looking for more transparency around that.'" *See* Beagan Wilcox Volz, *Liquidity Rule Countdown: Next Up, 'Highly Liquid' Minimums*, Ignites (Feb. 20, 2018), *available at* http://ignites.com/c/1889814/220884?referrer_module=SearchSubFromFF&highlight=next%20up%2C%20%27highly%20liquid%27%20minimums.