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**United States Senate**  
COMMITTEE ON BANKING, HOUSING, AND  
URBAN AFFAIRS  
WASHINGTON, DC 20510-6075

July 06, 2016

The Honorable Mary Jo White  
Chair  
Securities and Exchange Commission  
100 F Street, NE  
Washington, D.C. 20549

Dear Chair White:

I write regarding two of the Securities and Exchange Commission's (SEC) recent proposed rules that address risks associated with investment companies: the liquidity risk rule for open-end funds<sup>1</sup> and the rule regarding derivatives use by investment companies.<sup>2</sup> These regulations will create additional market transparency and stability by requiring informative new disclosures and improved fund risk management practices. Accordingly, I urge you to finalize these regulations to provide important investor protections, guidelines for the operation of funds, and effective disclosures for regulators and investors.

In light of the growth in assets under management in the investment fund industry, as well as the potential for market dislocations demonstrated by the recent liquidation of a fund, the SEC's proposed fund liquidity rule is a timely and necessary step to protect fund investors and safeguard financial stability. As you are aware, the U.S. mutual fund industry has grown considerably, with the assets held by mutual funds rising from \$4.4 trillion in 2000 to \$12.7 trillion in 2014.<sup>3</sup> As detailed in the SEC's Division of Economics and Risk Analysis (DERA) report issued in September 2015, there has been particularly rapid asset growth in new sectors, such as alternative strategy,<sup>4</sup> emerging market, and high-yield mutual funds.<sup>5</sup> Additionally, market analysts have observed that more than 50 percent of high-yield bonds and 35 percent of leveraged loans—which are considered illiquid assets—are held by funds that provide

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<sup>1</sup> Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Release; Proposed Rule, U.S. Securities and Exchange Commission, 80 Fed. Reg. 62274 (Oct. 15, 2015).

<sup>2</sup> Use of Derivatives by Registered Investment Companies and Business Development Companies; Proposed Rule, U.S. Securities and Exchange Commission, 80 Fed. Reg. 80884 (Dec. 28, 2015).

<sup>3</sup> Paul Hanouna, et al., *Liquidity and Flows of U.S. Mutual Funds*, U.S. Securities and Exchange Commission: Division of Economic and Risk Analysis (Sep. 2015), pg. 4-5, <https://www.sec.gov/dera/staff-papers/white-papers/liquidity-white-paper-09-2015.pdf>.

<sup>4</sup> *Id.* at 8.

<sup>5</sup> *Id.* at 9.

continuous liquidity.<sup>6</sup> SEC staff have expressed concerns that funds that offer daily investor withdrawals may have difficulty in meeting withdrawal requests if these funds hold excessive illiquid assets.<sup>7</sup>

The recent developments at the Third Avenue Focused Credit Fund underscore the potential dangers arising from funds holding high concentrations of illiquid securities. The Third Avenue Focused Credit Fund was a high-yield bond mutual fund that invested primarily in the bonds of companies involved in restructurings or bankruptcy. Over half of the fund's assets were not rated by credit agencies, and an additional 28 percent of its portfolio comprised bonds that were rated "CCC."<sup>8</sup> Facing substantial redemptions, the fund's management halted investor redemptions and began liquidating the fund this past December. The managers explained their actions as an effort to avoid selling assets in a declining market for high-yield bonds and disadvantaging shareholders.

Although the effects of the Third Avenue Focused Credit Fund failure and high-yield bond market dislocation appear to have been contained,<sup>9</sup> the transparency created by enhanced liquidity disclosures may help improve market confidence in times of similar stress in the future, and reduce the likelihood that liquidity concerns about one fund could adversely affect other market participants.<sup>10</sup> To ensure that funds can manage investor withdrawals, even in times of market stress, the SEC should work toward a liquidity rule that creates an even more robust regulatory framework and requires comprehensive liquidity disclosure for all types of open-end funds.

To that end, the SEC should consider ways to further strengthen the proposed rule to promote even more transparency. Specifically, if the SEC were to set more clear guidelines, investors and regulators would be able to better understand funds' liquidity profiles, and funds would be able to better understand their compliance obligations. For example, under the proposed rule, funds must classify their assets into six liquidity categories, based on how quickly the funds expect to be able to liquidate the assets, and disclose these classifications to the SEC and investors.<sup>11</sup> The rule also requires funds to manage their portfolios so that no more than 15% of fund assets are

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<sup>6</sup> Katie Linsell, *Junk Debt Liquidity Threatened by Mutual Fund Holdings, UBS Says*, BLOOMBERG (Apr. 16, 2016), <http://www.bloomberg.com/news/articles/2016-04-15/junk-debt-liquidity-threatened-by-mutual-fund-holdings-ubs-says>.

<sup>7</sup> 80 Fed. Reg. 62275-62276.

<sup>8</sup> Amy Feldman, *Third Avenue Focused Credit Closes*, BARRON'S (Dec. 12, 2015), <http://www.barrons.com/articles/third-avenue-focused-credit-closes-1449899465/>.

<sup>9</sup> There were disruptions in the high-yield bond market during the immediate aftermath of the Third Avenue Focused Credit Fund failure, and even funds that did not offer daily liquidity were forced to suspend investor withdrawals. See Rob Copeland, *Stone Lion Capital Partners Suspends Redemptions in Credit Hedge Funds*, THE WALL ST. JOURNAL (Dec. 11, 2015), <http://www.wsj.com/articles/stone-lion-capital-partners-suspends-redemptions-in-its-oldest-fund-1449870782>.

<sup>10</sup> For example, after Third Avenue Focused Credit suspended investor withdrawals, some investors questioned the stability of the high-yield bond market and other related markets. See Charles Stein, *Third Avenue Sees Assets Fall 21% in Quarter as Investors Flee*, BLOOMBERG (Jan. 11, 2016), <http://www.bloomberg.com/news/articles/2016-01-11/third-avenue-sees-assets-fall-21-in-quarter-as-investors-flee>.

<sup>11</sup> 80 Fed. Reg. 62291-62302.

“standard assets,” or assets that cannot be liquidated within 7 days at carrying value.<sup>12</sup> Because the rule allows funds to create their own individual asset classification systems based on considerations suggested by the SEC, it could be difficult for investors to compare liquidity profiles of funds and assess the sufficiency of each fund’s system. The SEC should consider providing more explicit instruction on how to classify assets and how to determine whether a fund’s asset classification is reasonable. Setting clear benchmarks may be challenging due to the varied and constantly evolving nature of funds and markets, but more detailed guidance would provide considerable benefit to both investors and the SEC by reducing reliance on individual funds’ subjective and variable determinations.

As part of the rulemaking, SEC staff should also consider implementing policies and procedures to enhance the analysis of fund data and disclosures. SEC examiners should be able to use fund liquidity data and disclosures to detect situations in which different funds apply notably different classifications to identical holdings, and to evaluate markets assumptions about the liquidity of certain broad assets classes— such as the general view of mortgage-backed securities prior to the 2008 financial crisis.

The SEC should also complement the fund liquidity rule by finalizing a strong rule regarding derivatives use by investment companies. Derivatives used by funds can be opaque, and funds can become highly leveraged, increasing risks to investors.<sup>13</sup> Volatile markets may compound these risks, resulting in unexpected losses to a fund caused by a seemingly small portion of its net asset value.<sup>14</sup>

The proposed rule is an important effort to address the use of derivatives by investment companies.<sup>15</sup> As a December 2015 DERA report highlighted, there are several challenges associated with measuring derivatives exposure; for example, “a significant percentage of funds do not clearly report the notional amount for various derivatives,” and “there is no standardized

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<sup>12</sup> *Id.* at 62317-62320.

<sup>13</sup> Daniel Deli, et al., *Use of Derivatives by Registered Investment Companies*, Securities and Exchange Commission: Division of Economic and Risk Analysis (Dec. 2015), pg. 10-11, <https://www.sec.gov/dera/staff-papers/white-papers/derivatives12-2015.pdf>. Some funds have aggregate derivatives exposures that are multiples of the fund’s net asset value. High leverage is most common in alternative funds, non-traditional bond funds, and commodity funds. *Id.*

<sup>14</sup> For example, Fiduciary/Claymore Dynamic Equity Fund shut down in 2009, after incurring losses of approximately \$45.4 million (approximately 45% of its net assets) between September and October 2008 arising from its use of out-of-the-money put options and its shorts of variance swaps. Similarly, UBS Willow Management shut down in 2012 after losing over 25% of its value between 2008 and March 2009 from credit default swap-related losses. See, Order Instituting Administrative and Cease-and-Desist Proceedings, *In the Matter of Claymore Advisors, LLC*, U.S. Securities and Exchange Commission (2012), <https://www.sec.gov/litigation/admin/2012/ia-3519.pdf>; Order Instituting Administrative and Cease-and-Desist Proceedings, *In the Matter of UBS Willow Management LLC and UBS Fund Advisor LLC*, U.S. Securities and Exchange Commission (2012), <https://www.sec.gov/litigation/admin/2015/33-9964.pdf>.

<sup>15</sup> Historically, the SEC regulated fund use of derivatives through staff guidance and no-action letters. See *Report of the Task Force on Investment Company Use of Derivatives and Leverage*, American Bar Association: Committee on Federal Regulation of Securities Law, ABA Section of Business Law (July 06, 2010), pg. 11-15, <https://apps.americanbar.org/buslaw/blt/content/ibl/2010/08/0002.pdf>.

reporting for derivatives.”<sup>16</sup> The SEC’s efforts to shed light on this opaque market through the proposed rule’s disclosure requirements are an important and necessary development. If adopted, the rule would provide a clear framework for the use of derivatives by investment funds and additional standardized data—which would help the industry, investors, and the SEC better understand the variety of derivatives used and any related risks.

As with the liquidity rule, the SEC should consider additional guidance for fund managers as part of the proposed rule on derivatives. In particular, additional instruction with respect to assessing and determining the risk-based coverage amount of segregated assets could provide investors with a better understanding of the types of risk borne by a fund. The proposed rule requires funds that use derivatives to segregate enough assets to cover not only the funds’ “mark-to-market” obligations (the costs of exiting the derivatives transaction at the time of determination),<sup>17</sup> but also a risk-based coverage amount based on an estimate of exit costs during “stressed conditions.”<sup>18</sup> Because this risk-based coverage amount and calculation methodology would be determined by fund management,<sup>19</sup> the SEC should consider steps to improve standardization, which would reduce subjectivity and the potential for firms to underestimate the risk-based coverage amount.

I appreciate that the SEC recognized the potential need for more detailed guidance and included requests in the proposed rule for additional comment regarding the risk-based coverage amount.<sup>20</sup> I encourage the SEC to require the use of clear risk-based coverage amounts based on a prescribed methodology and, where possible, to provide uniform guidance on how to determine stressed conditions. Additional instruction would reduce undue subjectivity and the potential for funds to underestimate the amount of liquid assets needed to cover their derivatives-related obligations, especially during stressed conditions.

As the SEC works to finalize its rules and considers other regulatory requirements for funds and their related market participants across markets, the SEC should remain focused on preventing potential threats to financial stability arising from illiquid market conditions or excessive leverage. As the SEC mentioned in the proposed fund liquidity rules, the current focus of the rules is on “mitigating the adverse effects that liquidity risk in funds can have on investors and the fair, efficient and orderly operation of the markets [.]” and “[t]o the extent there are any potential financial stability risks from poor fund liquidity management, [the] proposal may mitigate those risks as well.”<sup>21</sup> In its 2016 Annual Report, the Financial Stability Oversight Council recognized these risks and stated “there are financial stability concerns that may arise

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<sup>16</sup> See Deli, et. al., *supra* note 13. It is also important to note that several funds do not clearly report the notional amounts of derivatives, and there appears to be anomalies with some funds’ derivative data. *Id.*

<sup>17</sup> *Id.* at 80926-80929.

<sup>18</sup> *Id.* at 80929-80932.

<sup>19</sup> *Id.*

<sup>20</sup> For example, SEC staff requested comment on whether, “rather than determining the risk-based coverage amount in accordance with policies and procedures approved by the [fund’s] board,” the SEC should “prescribe risk-based coverage amounts in the proposed rule.” The SEC staff also requested comment regarding whether it should clarify the definition of “stressed conditions” with respect to the risk-based coverage amount. *Id.* at 80931.

<sup>21</sup> 80 Fed. Reg. 62281.

from liquidity and redemption risks in pooled investment vehicles, particularly where investor redemption rights and underlying asset liquidity may not match.”<sup>22</sup>

Given the SEC’s mandate to maintain fair and orderly markets,<sup>23</sup> the SEC should use all tools at its disposal to prevent risks to fair and orderly markets arising from declines in investor confidence and increases in systemic risk with respect to the funds that are the subject of these rules. The SEC should also prioritize financial stability concerns when considering regulations that impact the operation of financial markets.

Thank you for your work on these important rules, and your continued attention to this important matter.

Sincerely,



Sherrod Brown  
United States Senator

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<sup>22</sup> *FSOC 2016 Annual Report*, Financial Stability Oversight Council (June 2016), pg. 9-10,  
<https://www.treasury.gov/initiatives/fsoc/studies-reports/Documents/FSOC%202016%20Annual%20Report.pdf>.

<sup>23</sup> 15 U.S.C. § 78k-1.