



Meredith Jackson  
General Counsel

September 15, 2017

Chairman Jay Clayton  
Commissioner Kara M. Stein  
Commissioner Michael S. Piwowar  
Director of the Division of Investment Management, Dalia Blass  
U.S. Securities and Exchange Commission  
100 F. Street, NE  
Washington, DC 20549

Re: New Liquidity Rule 22e-4

Dear Chairman Clayton, Commissioners Stein and Piwowar, and Director Blass:

First, we would like to thank each of you and your Staff for taking time to consider liquidity rule issues, and to meet with us with the SIFMA group to discuss our concerns around the new liquidity rule. We appreciate the opportunity to engage in that dialog and your thoughtful questions. We stand ready to assist in providing further information in any way that will be useful.

Second, TCW applauds the SEC's policy decision to require asset managers to implement liquidity management programs. We consider thoughtful monitoring of liquidity an essential aspect of prudent stewardship of our clients' investments and assurance of daily liquidity for our mutual funds. Third Avenue easily supplies the compelling case that diligent and consistent disclosure of mutual fund liquidity is a key component of investor protection and efficient fund selection. We are also strong advocates of transparency and robust disclosure to investors.

Notwithstanding, we are concerned that any model-based approach to measuring liquidity is challenged along multiple dimensions. Liquidity does not exist in a vacuum but rather relies on the willingness and ability of counterparties to supply liquidity when it is demanded. In our experience, liquidity tends to be enhanced when the capital markets are populated with a myriad of investor types expressing heterogenous views. Hence, when an entire industry, especially one as large as the fixed income mutual fund industry, is asked to follow a uniform framework for measuring "liquidity", the result, in aggregate, may be to reduce the liquidity of the whole system. Further, as liquidity can be characterized in different ways by different investors, a singular model based approach may have the effect of causing different investment managers relying to a greater or lesser degree on different liquidity criteria. The more complex the approach, the greater the likelihood that differing assumptions, definitions, and implementations will lead to different results. When managers inevitably report different liquidity results for similar portfolios, the only result will be investor confusion.

As TCW is fortunate to manage a sizeable stable of active fixed income mutual funds, we thought it might be appropriate to focus our discussion on the fixed income market, as its over-the-counter nature presents some unique liquidity challenges. As it relates to fixed income funds, our apprehension is that the proposed liquidity reporting may appear on the surface to provide comparable fund liquidity information, but that appearance will be misleading. In fact, the liquidity scores will be based on widely differing underlying data, measurement periods, complex statistical algorithms and ultimately subjective assumptions. The issues are that based on current guidance, managers are required to create liquidity scores ostensibly for security types, but using multiple factors that relate to individual bonds (CUSIPs). The results of many different managers weighting different factors and using disparate data will result in wildly different (and potentially manipulated) results across managers for the same security. Large subjective elements will by necessity be imbedded in models intended to look quantitative and objective as managers select different data, data providers, data periods and factor loadings for these models. The one certainty is that the model choices and subjective determinations will vary from manager to manager, and from fund to fund. To date, TCW has not seen a proposed vendor solution that can address these issues, and in fact vendor selection in this area might also be a source of manipulation of results. Managers would typically request vendors to provide pilots, or proof of concept demonstrations. Managers could be unintentionally incented to select those vendors whose model or process results in the best possible results, particularly for the managers' preferred asset classes. (See Annex 1, Vendor Issues).

It would be natural for investors reviewing these liquidity reports to assume that the assigned liquidity scores are equivalent. For this reason, the classification system itself creates an unintended incentive for managers to mark securities aggressively, to make their funds appear more liquid. Even with the best intent from the industry, there will be substantial disparities based on the different managers' philosophies and efforts to bridge the data gap and assign factor loadings in the models. As a result, the investors could be misled by the very reporting that was intended to provide protective information. Investors could flock to more apparently liquid funds, only to discover when it is too late, that the classifications did not actually provide comparable liquidity data.

The underlying disparities will be compounded by the fact that most of the available recent trade data has been derived from the post-2010 years of relatively stable markets. Technical data capturing capabilities have been enhanced significantly since that time. As a result, the industry's ability to back-test actual data from a stressed and volatile market with any accuracy will be limited. Even in those cases where we are able to source data that accurately reflects liquidity in today's regular way markets, it is not necessarily a trustworthy proxy for the liquidity in stressed and volatile markets.

While all the flaws above are significant, the ultimate irony is that none of these complex quantitative models have been shown to correctly predict liquidity in turbulent markets. In these cases the simplest model has been the best performer. The basic disclosure of the holdings of the most liquid sectors is the most reliable, accurate, transparent and consistent predictor of a funds ability to meet redemptions in times of market stress. Hence disclosing a fund's holdings in true cash equivalent securities - cash US treasury holdings and cash US Agency backed debentures and MBS (not TBAs) - provides a consistent guide post for comparing how different funds would fair in a liquidity crisis. We believe that, on the

worst days of 1994, 1998, 2003 and 2008, the large and liquid markets listed above were the only consistent sources of substantial market liquidity.

We also believe that the logistics of managing processes and systems to address the complexities of the current rule would disproportionately burden smaller managers, and create greater barriers to entry.

For the foregoing reasons, it is TCW's view that the proposed rule's four-bucket classification system could generate more risk for the investor than the status quo. We suggest instead a focus on the two key elements that would provide the most accurate information to investors: an objective limitation on the least liquid assets, and an objective disclosure of highly liquid assets (those types listed above) to withstand stressed and volatile market conditions. This will benefit from the rule's contemplated commitment and disclosure of the minimum level that each fund manager thinks is prudent in these most liquid categories. TCW believes that both of these limitations are critical to investor protection, and should be cast in objective terms that will provide transparent insight into the actual risk structure of a fund.

The maximum 15% illiquid rule has generally been well-integrated into the industry's compliance programs. Nonetheless, it retains a subjective aspect for certain security types, which some managers might classify as liquid, even if the prevailing view was that those securities were illiquid. This uncertainty increases risk. We propose objectifying the standard with a uniform list of security types that are automatically presumed illiquid. This will result in straightforward and transparent comparison between different funds' illiquid securities holdings. We would be prepared to provide suggestions as to security types to be presumed illiquid.

Similarly, the highly liquid asset minimum should be subject to a clear and objective standard, a list of those securities (like the list provided above) that are presumed liquid because they have proven their ability to maintain liquidity in periods of market volatility and stress. Eliminating the guesswork requirement for managers with an objective test will reduce costs, simplify the compliance infrastructure burden, and most importantly, assure consistent, reliable, and understandable results.

If we can provide any information that would be helpful in further analyzing these issues, please let us know. We thank you again for your commitment to these issues, and look forward to continuing the productive discussions.

Sincerely,



Meredith Jackson  
General Counsel

cc: David Lippman, President and CEO  
Laird Landmann, Co-Head of Fixed Income  
Marcos Gutierrez, Head of Fixed Income Risk Management  
Cal Rivelle, Head of Investment Operations Technology  
Jeff Engelsman, Global Chief Compliance Officer

## **Annex 1: Vendor Issues**

Among our key concerns are vendor issues, including the readiness of vendors to provide a reliable solution on a timely basis, and the probability that multiple vendors will provide differing solutions that ultimately serve to obfuscate the underlying fundamentals. We have entered into discussions with a number of vendors, generally those we would consider market leaders. Each of these vendors is working to develop a quantitative model, essentially a framework for aggregating data and applying rule sets. At this time, it is not at all clear what the realistic timeframe for rollout by these vendors of quantitative models for the most challenging types of securities, such as non-agency securitized products, will be. We have been told to expect Q1 2018. That's a challenging timeframe if we need to have the system fully integrated and operating in a reliable fashion by December 2018, exacerbated by the uncertainty that the projected Q1 2018 date will be met.

The vendors seem to be taking a number of widely varying approaches to developing their models, which in and of itself raises the question of how consistent the end results will be. The bigger question from our perspective, however, is the source of the underlying data. Each of these models will require inputs of robust multi-sector data. We currently have little or no visibility into different vendors' methodology for sourcing this critical data. Some of the vendors who claim to have built comprehensive models in fact have no data sourcing solutions, and are expecting the asset manager users to provide the data. We understand that other vendors may be developing independent data sets, or relying on data from affiliated pricing vendors. Each of these scenarios presents certain concerns.

1. **Data sourced from asset manager users.** As discussed above, every asset manager has its own methodology for managing securities data, and the process inevitably includes a subjective component, particularly with respect to thinly-traded CUSIPs, where the manager will have to apply its judgment and experience of similar securities to extrapolate liquidity. It follows that, if the asset manager users are the source of the underlying data, the result will be liquidity classifications that are not consistent. The investor will not have access to information explaining the differences in the underlying data, and so will have no ability to look behind the liquidity classifications. Far from providing transparency, by creating an apparent apples-to-apples comparison, the liquidity classifications could actually be used to mask differences in process that could be substantial, which could in turn confuse or mislead the investors. Misinformation is worse than no information.
2. **Data sourced from affiliated pricing vendors.** We understand that some vendors that are affiliated with pricing service providers may intend to rely on trade data collected by those pricing vendors. The same trade data that the pricing vendors use to calculate pricing for securities could be used by liquidity vendors to estimate liquidity. The issue here is that, in our perception, coverage by pricing vendors of different asset classes and sectors varies significantly, as evidenced by the existence of multiple competing, leading pricing vendors. Like many asset managers, we rely on one leading vendor for non-agency mortgage data, but a different vendor for corporate bonds, and yet another vendor for emerging markets. We have not encountered a single vendor who has comprehensive, reliable coverage of every asset class that will be subject to the liquidity rules. It follows that, if a single pricing vendor supplies the data used by an affiliated liquidity vendor to estimate liquidity, the liquidity classifications will be built upon

data that is not necessarily the most reliable for certain asset classes. Again, if different asset managers rely on different vendors with different models populated by differing data, the result is the risk that the investor is misled to believe that an apples-to-apples comparison is possible.

3. **Data developed by vendors through independent analysis.** We do not have full visibility into the vendors' methodology. We do understand that certain vendors currently purchase trade data from one or more asset managers, and intend to analyze this sample data to populate their liquidity models. What is not transparent to us is, how extensive or accurate are the data samples, and how reliably do they represent the overall spectrum of trading. Particularly in the case of complex, thinly-traded securities such as non-agency securitized products, it will be very difficult to ascertain whether the data sample is actually reliably predictive. In this case also, the results will mask below-the-surface inconsistencies.

It is possible that certain managers will conclude that the only viable way to resolve the data adequacy issues is to use inputs from multiple vendors. A multiple-vendor approach, however, would increase the complexity of building out systems and interfaces to integrate all of the data formats, will add cost and delay to implementation, and ultimately will not resolve the inconsistencies among the multiple data sources.

There may be additional vendor data solutions, or refinements to the foregoing, that have not come to our attention at TCW.