MSCI

January 13, 2016

Submitted electronically
Secretary Brent J. Fields
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: **File No. S7-16-15**
Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release

Dear Secretary Fields,

MSCI appreciates the opportunity to offer these comments to the Securities and Exchange Commission (the "Commission") in response to the proposals set forth in the Commission's recent release entitled *"Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release."* We support the Commission's goals to promote effective liquidity risk management practices and increase transparency through enhanced disclosure and we thank the Commission for the opportunity to provide our perspective on the proposed rules.

Background

MSCI is a leading provider of risk management and equity analytics (under the RiskMetrics and Barra brands) and equity indexes (under the MSCI brand) to the world's largest banks, exchanges, hedge funds and asset managers. MSCI has been actively engaged in research on the subject of liquidity risk management since 2009 and licenses sophisticated liquidity risk analytics to market participants to support both risk management and regulatory compliance activities (e.g., UCITS, Form PF). MSCI's views on the subject of liquidity risk have also been informed by the feedback we have received from the asset managers who utilize our liquidity risk management tools.

MSCI considers the Commission's proposal to promote effective liquidity risk management practices a historical turning point that should benefit investors. Assessing liquidity risk is not an easy task and poses unique challenges compared to other types of risk such as market, credit or counterparty risk. Liquidity risk measures suffer from scarcity of appropriate data sources for many asset classes. Consequently, quantifying asset or portfolio liquidity can require heavy assumptions, which may compromise objectivity, testability, auditability and comparability of the metrics. In this respect, assets traded over-the-counter, and specifically bonds, pose a serious challenge.

In our view, the proposed rules address several important objectives while striking a good balance between precision and enforceability:

- Protecting fund shareholders from "investor dilution", namely the unfair transfer of costs across different shareholders of the same fund;
- Enforcing fund liquidity risk disclosure and transparency; and
- Raising liquidity risk to the level of a key, non-negligible component of investment risk.

The proposed rules are generally in line with MSCI's views on liquidity risk. In particular, we believe it is critical that the regulation requires assessment of liquidity risk:

- Across a full spectrum of liquidity, and not only as a binary characteristic (i.e., liquid vs. illiquid);
- In its entire complexity, namely along the multiple dimensions of transaction cost, size, and time to liquidation, and not only as a one-dimensional scoring number; and
- Using metrics that are comprehensive yet still relatively simple to understand, in order to avoid over-engineering.

Recommendations Summary

We offer two recommendations that we believe are critical to the long-term success of the proposed rules. First, we call for additionally requiring improved post-trade trasparency in the bond markets to enhance market participants' ability to observe and measure liquidity in these markets. Second, we believe that the "days to liquidation" definition for asset liquidity classification in the proposed rules should account for bid-ask spread effects responsible for an important piece of investor dilution. We propose two possible alternative measures for asset liquidity classification which overcome this difficulty, for the cases when bid-ask effects are non-negligible.

Recommendation 1 : Post-Trade Transparency of Bonds

To the extent possible, liquidity risk regulations should adopt measures of risk that are data-based and limit the role of discretionary assumptions. This is particularly challenging for the OTC bond market where there is a general lack of post-trade transparency. For standardized derivatives markets, Dodd-Frank reforms have greatly improved post-trade transparency including with respect to the availability of liquidity sensitive data, such as trade data, volumes, frequency and prices. This information is still largely unavailable for bonds due to the absence of general post-trade reporting obligations in the bond market.

We believe that effective liquidity regulation also jointly necessitates market structure reforms requiring timely, granular, mandatory reporting of trades for all bonds in order to provide the necessary transparency for measuring bond liquidity. This data is currently available only for a few segments (listed bonds, TRACE), which is insufficient to meet the proposed rule's requirement for a comprehensive, uniform classification of all positions held in a given fund.

In order to circumvent data scarcity in bond markets, MSCI currently conducts a systematic survey of direct front office information collected among multiple asset management firms and redistributes aggregated data for model calibration purposes to its clients. For details we refer to the article *Introduction to LiquidityMetrics*, MSCI Research Insight, Acerbi and Szekeres, 2013.

Short of full post-trade transparency, requiring standardized disclosure of the assumptions made to assess liquidity in the context of the liquidity risk management programs would be also useful for general benchmarking purposes and for providing an indirect source of bond liquidity information.

Recommendation 2: Days-to-Liquidation and Bid-Ask Effects

We believe that the the notion of "days-to-liquidation", introduced for asset liquidity classification in the context of liquidity management programs, needs to be further clarified. The phrase "number of days in which the position would be convertible to cash at a price that does not materially affect the value of that asset" is ambiguous. The Commission should clarify whether this determination is intended to be inclusive or exclusive of possible bid-ask effects. In other words, does "value" mean revaluation price (which could be bid or mid at the fund's choice) or bid price? We assume the Commission intends exclusive of bid-ask effects (otherwise all funds would need to be required to adopt mid pricing). If so, this leads us to note that the proposal accounts for price impact effects but neglects the effects of bid-ask spreads altogether, which can also be a significant cause of dilution effects, as we explain in more detail later in this section.

We conclude that the proposed notion of "days-to-liquidation", the corresponding liquidity classification in the Liquidity Risk Management Programs and the three-day-liquid-minimum, are appropriate measures of risk only for monitoring market impact (and not bid-ask) driven investor dilution. As such, the proposed rule appears comprehensive only if:

- The fund weighted average bid-ask spread has negligible magnitude; or
- The fund adopts entrance/exit fees that compensate weighted average bid-ask spreads.

Without these conditions a fund is significantly exposed to bid-ask induced dilution effects and the proposed metrics are insensitive to it. In particular, the liquidity classification in days-to-liquidation buckets could have distortive effects, underestimating risk for positions with higher bid-ask spreads.

For this reason we make the following recommendations:

- The Commission should clarify whether days-to-liquidation is intended to be inclusive or exclusive of bid-ask spread effects.

- Funds should be required to report the weighted average bid-ask spread, which is a key indicator of overall fund liquidity and justifies the possible adoption of entrance/exit fees and quantifies their magnitude.

Finally, we notice that in the presence of non-negligible bid-ask effects, a more comprehensive asset liquidity risk classification could be based on:

- A different time-to-liquidation notion which includes mid-bid spread. It is defined as the expected minimum liquidation horizon for keeping the transaction cost (= mid – realized price) below some predefined "material " threshold, in bps (say 10 bps). Note that if an asset bid-mid spread is larger than the threshold, it would automatically rank in the longest classification bucket.
- The transaction cost (= mid – realized price) in percentage points of a certain fixed redemption amount (say 20%) of every position.

In MSCI's experience, the latter choice (directly based on cost and not on time) would be more robust to overcome any input noise. Time-to-liquidation measures are extremely sensitive to input uncertainty. This is why we generally prefer cost measures to time measures for liquidity risk management purposes.

Bid-Ask Spreads and Investor Dilution

We recall that bid-ask spread is the roundtrip percentage cost of a small trade in a given asset. Buying and reselling in a short time a fund share determines a cost entirely born by all other fund shareholders, proportional to the weighted average bid-ask spread of the fund's assets. This is true regardless of whether the fund NAV is computed marking assets at mid or bid prices. In the latter case it is true that the redemption NAV would correspond to its assets redemption value, but the subscription NAV would have been discounted of the entire bid-ask spread to begin with, at the expense of the shareholders.

On top of bid-ask spread effects there are further price impact effects typically due to large trades executed at suboptimal prices, such as large sales (purchases) of an asset at a realized average price below best bid (above best ask). See Figure 1. Both the Commission's proposed asset liquidity classification, based on the days to liquidation notion, and the concept of swing pricing, which is triggered only above specified size redemption/subscription thresholds, capture price impact effects but are completely insensitive to bid-ask effects that take place for trades of all sizes.

But "investor dilution", the avoidance of which is the primary objective of this proposed rule, is caused by both bid-ask effects and price impact effects, and while the latter take place only occasionally, in times of large redemptions/subscriptions or market disruption events, the former occur on a regular basis at each and every redemption and subscription, even in normal market conditions. Price impact effects are responsible for possibly dramatic dilution effects in the case of fire sales or market crashes, but bid-ask spreads, more subtly, can contribute systematically to the steady erosion of performance, especially by funds subject to large shareholder turnover. Also, note that bid-ask effects cannot be "diversified away" as opposed to price impact effects which can be reduced through portfolio diversification. By neglecting bid-ask effects, the proposed rule is missing a fundamental component of the problem it is meant to address.

We ackonwledge that for some assets, such as large cap stocks in developed markets, bid-ask effects are completely negligible, as the size of the bid-ask spread is typically far lower than one-day price volatility. In many other markets, however, this is not the case, with bid-ask spread representing material trading costs when entering or exiting a position. A potential remedy to dilution effects caused by bid-ask effects would be the quotation of bid and ask NAV share prices or equivalently corresponding entrance/exit fees, summing up in total to the fund weighted-average bid-ask spread. Currently, only a few US asset managers adopt entrance/exit fees, and typically only in special circumstances (such as short term investments) because these represent a strong deterrent for potential investors.

There is a clear parallel between the adoption of entrance/exit fees and a swing pricing mechanism. They mitigate investor dilution due to bid-ask effects and price impact effects, respectively. However, unlike swing pricing entrance/exit fees don't need any regulatory approval because they are already permitted practices that a fund can adopt. We note that:

- The current proposal, while not ruling them out, does not seem to promote the adoption of fees to mitigate dilution in the same way it does for swing pricing. And the explanation of dilution effects presented in the proposal fails to recognize a bid-ask effect component in it;
- The proposal should require disclosure of the weighted-average bid-ask spread of the fund, which is the most accessible indicator of a fund's liquidity across all asset classes (even in the bond markets where quote data is much more easily available than trade data). Reporting wide bid-ask spreads would be a means for the fund to justify the adoption of fees in order to mitigate dilution; and
- In the absence of entrance/exit fees, the proposed notion of "days-to-liquidation" excluding bid-ask effects can potentially result in a misleading characterization of the liquidity profile of a fund.[1]

We acknowledge that the proposed rule mentions bid-ask spread as one of the factors to be used to determine "days to liquidation" of a position, which in the proposed version is only related to price impact effects. However, this does not take bid-ask spread into account as a fixed, unavoidable component of transaction cost, complementary to market impact. We also acknowledge that the problem we describe here is not unique to the proposed rules. Similar time-to-liquidation based

[1] As an example, a hypothetical fund with very small AUM investing in assets which have very wide bid-ask spread (say 5%), would appear as holding only 1-day-liquid assets under the proposed classification. However, a fund of this type would be very illiquid. A hypothetical newcomer investor who doubled the AUM but immediately redeemed his shares, in absence of fees, would make the NAV drop by 2.5% for all shareholders.

approaches for asset liquidity classification have already been introduced in other regulations, for instance Form-PF.

Figure 1

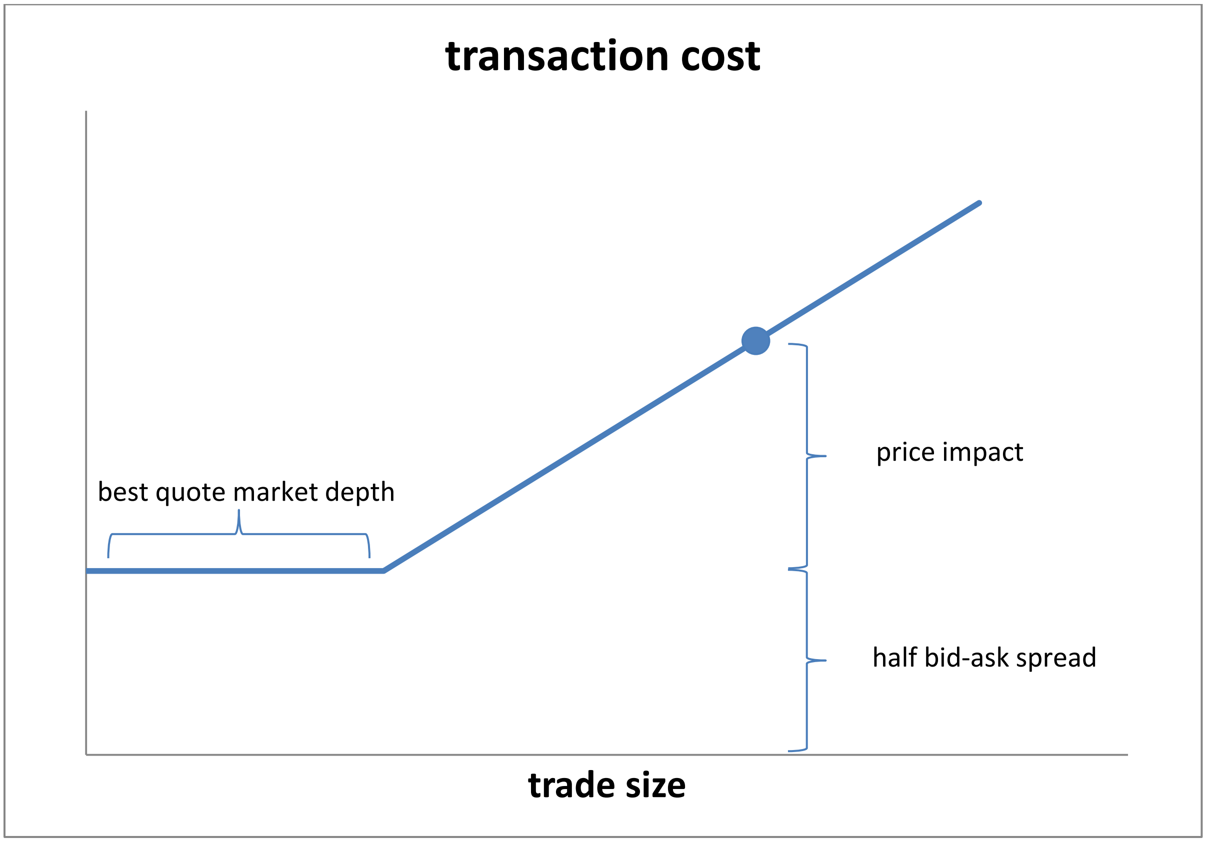

Figure 1: Transaction cost split in the two components of bid-ask effect and market impact effect. Price impact occurs only for large trades, above best quote market depth. Bid-ask effects affect all trades, regardless of their size.

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Thank you again for the opportunity to comment on the Commission's proposals. If you have any questions about MSCI's comments or would like additional information, please contact me at [redacted].

Sincerely,

/s/ Carlo Acerbi

Carlo Acerbi
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MSCI