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January 21, 2016

Mr. Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Submitted electronically to rule-comments@sec.gov

Re: Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release (File Nos. S7-16-15 and S7-08-15)

Dear Mr. Fields:

Dodge & Cox respectfully submits this letter in response to a request by the U.S. Securities and Exchange Commission (the "SEC" or "Commission") for comments regarding the above-referenced release (the "Proposal").[1] The Proposal and the amendment to Rule 22(e) proposed therein (the "Proposed Rule") would require most open-end investment management companies to develop and maintain formal liquidity risk management programs incorporating several mandatory elements, including (i) assessing a fund's liquidity risk based on a non-exclusive list of prescribed factors; (ii) assigning each portfolio position to one or more of six prescribed classifications based on the number of days in which the fund estimates that position could be converted to cash at a price that does not materially affect its value (the "Proposed Classification Framework" or the "Framework"); (iii) establishing a "three-day liquid asset minimum"; and (iv) limiting investments in illiquid assets to 15% of net assets).[2]

Dodge & Cox is a fundamental value-oriented manager serving as investment adviser to the Dodge & Cox Funds and other separately managed accounts totaling over $260 billion in assets under management. Dodge & Cox, one of the longest-standing professional investment management firms in the United States, is known for its thorough, independent research, and focus on the long term. The Dodge & Cox Funds consist of six series (each a "Fund," and collectively, the "Funds"): Dodge & Cox Stock Fund, Dodge & Cox Global Stock Fund, Dodge & Cox International Stock Fund, Dodge & Cox Balanced Fund, Dodge & Cox Income Fund and Dodge & Cox Global Bond Fund. The Funds are no-load and do not charge redemption or exchange fees. More than 4 million shareholders, including retail, corporate pension, and 401k investors, invest in the Funds.

[1] Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Modernization Release, 80 Fed. Reg. 62274 (October 15, 2015) (the "Proposal") (to be codified at 17 C.F.R. parts 210, 270, and 274).
[2] Proposal, p. 62286

Dodge & Cox is a member of the Investment Company Institute (the "ICI"), and we wish to express our general support for the excellent and comprehensive comment letter submitted by the ICI on January 13, 2016. In this letter, we comment only on certain elements of the Proposal most relevant to us and for which we believe our perspective as an active manager of large and small mutual funds may be useful.

EXECUTIVE SUMMARY

We support the SEC's efforts to encourage robust liquidity risk management practices in the open-end fund industry. As discussed in the Proposal, many funds already have liquidity risk management programs of varying degrees of formality to monitor and manage liquidity risk in their portfolios. We agree with the Proposal that all funds should be required to maintain formal liquidity risk management programs that are subject to board oversight, based on a thorough analysis of their sources of liquidity and reasonably foreseeable liquidity demands, and reasonably designed to manage their particular liquidity risks.[3] We agree that open-end funds should limit the extent of their illiquid holdings and therefore support the Proposed Rule's codification of existing guidance to limit fund investment in illiquid securities to 15% of fund assets.[4]

Our comments and suggestions address four areas:

A. We believe that certain of the Proposed Rule's requirements – particularly the Proposed Classification Framework – are too prescriptive. In our view, the Framework is inconsistent with sound liquidity risk management practices and mandating its use may be misleading and harmful to investors.

B. Instead of an expensive and rigid "one-size fits all" framework, we recommend a principles-based approach requiring each mutual fund to design and implement a liquidity risk management program tailored to that fund's unique liquidity risk profile.

C. We generally support the idea that funds should maintain a reserve of highly liquid assets reasonably sufficient to meet near-term cash needs, but recommend several modifications to the proposed three-day liquid asset minimum requirement.

D. We believe the Proposal focuses excessively on dilution risk and that the definition of liquidity risk is flawed to the extent it implies that funds should always be able to liquidate assets without material impact to either the value of the assets or the net asset value of a fund.

This letter does not address the Commission's swing pricing proposal. Like the ICI, we encourage the Commission conduct further research on its feasibility in the context of the current U.S. market structure before pursuing further rulemaking activities. Swing pricing may have the potential to benefit funds and long-term shareholders, but the existing structural and operational obstacles to effective implementation of a swing pricing program are substantial.

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[3] Proposed Rule 22e—4(b)(1); described in Proposal, p. 62287.
[4] Proposed Rule 22e—4(b)(2)(iv)(D); Proposal, p. 62317.

DISCUSSION

A. The Proposed Classification Framework

The most troubling aspect of the Proposal is the Proposed Classification Framework, which would impose an artificial and arbitrary classification regime that would be both burdensome for funds and misleading to investors, and which does not reflect industry best practice in managing liquidity risk. The Proposed Classification Framework requires a fund to "assess the relative liquidity of each portfolio position based on the number of days within which it determined, using information obtained after reasonable inquiry, that the fund's position in an asset (or a portion of that asset) would be convertible to cash at a price that does not materially affect the value of that asset immediately prior to sale."[5] It prescribes six categories: (i) convertible to cash within one business day; (ii) convertible to cash within three business days; (iii) convertible to cash within four to seven business days; (iv) convertible to cash within 8-15 calendar days; (v) convertible to cash within 16-30 calendar days; and (v) convertible to cash in more than 30 calendar days. [6]

There are a number of issues with the Framework, each of which is discussed in more detail below:

1. The Framework Conveys a False Sense of Precision and is Misleading to Investors.
2. A Bottom-Up Liquidity Assessment Does Not Reflect Actual Portfolio Liquidity.
3. The Framework Creates Negative Bias Against Larger Funds.
4. Managing Funds in Constant Anticipation of Complete Liquidation Will Hurt Investors.
5. Implementing the Framework Involves High Costs, With Little or No Practical Benefit.

1. The Framework Conveys a False Sense of Precision and is Misleading to Investors.

The Proposal acknowledges, correctly, that liquidity exists on a spectrum ranging from more-to-less liquid. [7] However, it errs in its assumption that various points on this spectrum can be translated into a specific number of days within which an asset may be converted to cash at a particular price and fails to account for the fact that liquidity is a relative and fluid concept. A manager's classification of each position in a portfolio on this basis would be a highly speculative and subjective exercise.

Estimating the period within which a position could be completely liquidated involves many complex, dynamic, and interrelated variables (most of which are outside the manager's control) and requires assumptions to be made about how to apply and weight those variables. While it is true that analyzing inputs such as daily trading volume, frequency of trades and quotes, bid-ask spreads and restrictions on trading may provide insight into the relative liquidity of an asset (though certain of those inputs are more relevant to some types of assets than others), all such data is backwards looking and may not reflect future conditions. Historical data of this sort is likely to be least predictive in periods of market stress, when liquidity is most likely to be compromised. Further, this type of backwards-looking data is likely to be most predictive with

[5] Proposal, p.62292.
[6] Proposed Rule 22e—4(b)(2)(ii).
[7] Proposal, p. 62294.

respect to the liquidity of more-liquid assets and least predictive with respect to less-liquid assets.

Including the requirement that "the fund must determine whether the sales price the fund would receive for the asset is reasonably expected to move the price of the asset in the market, independent of other market forces affecting the asset's value"[8] makes this exercise even more theoretical, akin to predicting a security's (or a fund's) future performance. Trading activity is only one of many factors that affect the price of any given asset and it is not reasonable to expect managers to isolate and quantify accurately the effect of a single market participant's future hypothetical selling activity. The complexity and subjectivity of such an undertaking can be illustrated by the various models used by broker-dealers to manage the execution of large customer buy and sell orders – these models attempt to consider many factors including, but not limited to, outstanding float, historical trading volumes, volatility, and available trading venues. In our experience, different dealers asked to estimate the time required to buy or sell a given amount of equity securities without undue impact on price often provide meaningfully different responses.

We are sympathetic to the Commission's stated desire to have and to provide to the market data that can be aggregated and compared across funds. However, we believe that presenting backwards-looking and subjective estimates as though they were objective and predictive quantitative data that can usefully be compared will mislead more than it will illuminate. The Proposal suggests that these estimates will provide regulators and investors with a useful basis for comparing liquidity risk across funds – but in our view, the subjective nature of the predictions will severely limit their utility for purposes of cross-fund comparisons.

Even if the industry were to converge on some common model for predicting liquidity,[9] the 2008 financial crisis illustrates the perils of market overreliance on products and services such as credit ratings that depend on models built on historically-based assumptions about future activity (most notably in that crisis, ratings models based on historically-grounded assumptions about likely levels of mortgage loan defaults).[10] Since the Commission and the market already have access to disclosure about each fund's holdings, regulators and/or investors may apply their own assessment of the liquidity of those holdings using whatever factors or formulas they deem most relevant. While one might still question the reliability or predictive power of any such assessment, this would at least ensure a consistent methodology for comparative purposes.

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[8] Proposal, p.62292.

[9] Various vendors have proposed models for assessing position and portfolio-level liquidity based on inputs such as historical trading data, market quotations and so forth; while these models may provide information useful to a fund's larger liquidity risk management program or to an investor's assessment of liquidity risk, their predictive power should not be overestimated. Funds (especially smaller funds) forced to assign positions to the various categories in the Proposed Classification Framework are likely to rely on data from third-party vendors as a way of managing their compliance burden, increasing the apparent objectivity of their liquidity estimates and reducing their litigation risk in the event those estimates are proven wrong. The Commission should be wary of rules or policies that encourage market convergence on the unproven models of a small group of private sector vendors.

[10] In response to the perception that overreliance on credit ratings may have contributed to the financial crisis, Section 939A of the Dodd Frank Wall Street Reform and Consumer Protection Act required federal agencies to review any regulations requiring the use of an assessment of the credit-worthiness of a security or money-market instrument and any references to or requirements in such regulations regarding credit ratings.

Because of the inherent unreliability of classifying positions as required by the Proposed Classification Framework, we are especially opposed to their publication, including on a delayed basis. The Proposal would require funds to report position-level liquidity classifications monthly on Form N-PORT; and contemplates the publication of the report filed at the end of each quarter, 60 days after quarter-end.[11] The publication of these filings is likely to induce reliance, particularly by less sophisticated investors, on data that may be only moderately predictive during normal market circumstances and is not at all predictive in a crisis. Further reducing the utility of such data is the fact that it would be published only on a delayed basis, which means the publicly available reports will be at least 60 and up to 150 days stale.

Investors may take false comfort in liquidity estimates that may be overly optimistic; conversely, investors may be incented to sell shares in a falling market out of misplaced concern caused by overly conservative estimates. In either case, investors may misunderstand the extent to which any estimate of liquidity may be subject to substantial revision based on changing market circumstances. We note the likelihood that data aggregators and fund ratings providers will attempt to summarize and use the published estimates to rate or classify how "liquid" various funds are, which for the reasons noted above, we believe would be misleading and not in the best interests of investors.

Not only will investors be harmed by overreliance on forward-looking and promissory statements about fund liquidity and/or unreliable liquidity ratings that may be derived from those statements, publishing liquidity estimates will expose funds to additional litigation risk. Entrepreneurial plaintiffs' attorneys may view published liquidity estimates as fertile ground for lawsuits challenging the accuracy of a fund's classifications. Given the complex, subjective and fact-intensive nature of those classifications, such suits may be difficult to resolve on summary judgment. Even if unsuccessful, these types of legal challenges will be time-consuming and expensive to defend, requiring significant legal and managerial resources. Fund investors will bear the associated costs, both direct and indirect.

2. A Bottom-Up Liquidity Assessment Does Not Reflect Actual Portfolio Liquidity.

The Proposed Classification Framework is also flawed in its focus on the liquidity of individual assets. Assessing liquidity on a holding-by-holding basis implies that the liquidity of each holding can and should be considered separately from the portfolio within which it is held. Further, it implies that the liquidity of a portfolio will equal the sum of the liquidity of its individual components. Assessing liquidity at the individual holding level is a highly academic exercise that fails to account for contextual and practical considerations. The reality of managing portfolio-level liquidity risk is far more complex and depends, among other things, on other transactions taking place in the market as well as within the portfolio. The Proposal admits that the same security may be considered more or less liquid by different funds,[12] but seems to assume that the only variable that might change a fund's assessment of a holding's relative liquidity is the size of its position.

[11] Proposed Item C.13 (requiring funds to indicate the liquidity classification for each portfolio asset (or portion thereof) of proposed Form N-PORT.
[12] Proposal, p. 62293.

The Proposal ignores the fact that in many cases, the liquidity of individual holdings actually depends in part on other holdings in the portfolio or in other portfolios under common management. For example, consider a fixed income portfolio made up of positions in ten corporate bonds with similar characteristics. Since these types of instruments settle on a T+3 basis, a manager might reasonably assume that each of these positions could be sold in three days (or some longer period, depending on the size of each position). But the likelihood of selling any one of the ten positions is much greater than the likelihood that all ten positions could be sold simultaneously – selling one bond can affect a manager's ability to sell other similar bonds at the same time, whether for the same funds or for funds under common management. And, of course, the manager's ability to sell any of the bonds depends on any given day on activity by other market participants in those bonds and other similar bonds. These dependencies arise from the relative fungibility of fixed income instruments with similar characteristics.

The Proposal's misplaced emphasis on individual holding-level liquidity is further evidenced by the list of factors it suggests should be mandatory for funds to consider in classifying the liquidity of each position, all of which assume that the asset's liquidity is to be considered separately from other assets in the portfolio.[13] A more realistic assessment would include trading activity, bid-ask spreads, outstanding amounts, and volatility of similar assets and the concentration in the portfolio and fund complex of such similar assets. While the Proposal's list of factors does not purport to be exclusive, the omission of comparative and relative factors is notable and incorrectly assumes that liquidity as an asset-specific characteristic.

3. The Framework Creates Negative Bias Against Larger Funds.

A framework that evaluates liquidity at the individual position level based on the days required to convert each position into cash is inherently biased against large funds, even those composed entirely of highly liquid assets. Under the Proposed Classification Framework, a $50 billion large-cap equity fund will appear much less liquid (and riskier) than a $1 billion fund with identical proportionate holdings. However, to state the obvious, the larger fund has a much larger pool of liquid assets available to it to fund potential redemptions even though it might take longer for the larger fund to liquidate all of its assets. Further, larger funds tend to experience smaller net subscriptions and redemptions as a percentage of net assets and less volatility in their levels of subscriptions and redemptions, possibly because such funds tend to have a broader and more heterogeneous shareholder base, decreasing the likelihood of coordinated action.[14] This negative bias against larger funds would be even more pronounced for funds that maintain more concentrated positions, even when those positions may be in highly liquid securities.

[13] The final factor on the Proposal's list is the relationship of the asset to another portfolio asset, but the Proposal describes the relationship it contemplates as that between a derivative or other forward-settling position and any collateral or other assets segregated or earmarked against a potential or known future obligation associated with the first position. Proposal, pp. 62301-2. While this letter does not address the assumptions underlying that factor directly, we concur with other commentators, including the Investment Company Institute, that the Proposal misunderstands the way in which assets are earmarked or segregated against potential future obligations.

[14] Division of Economic and Risk Analysis, Liquidity and Flows of U.S. Mutual Funds, September 2015, pp 14-17, concluding that larger funds tend to have smaller average flows in percentage terms and experience less volatility in their net flows.

4. Managing Funds in Constant Anticipation of Complete Liquidation Will Hurt Investors.

We are concerned that both the focus on liquidating entire positions and the very categories required by the Proposed Classification Framework (ranging from one day to more than 30 days) imply that a portfolio should be managed so as to be able to be mostly or completely liquidated within a short period. Nothing in the history of the fund industry suggests this is a necessary or appropriate objective for many funds, particularly for larger funds. Even during periods of extreme market stress, such as the 2008 financial crisis, funds rarely experience net monthly redemptions in excess of a few percentage points.[15] Managing a fund in constant anticipation of its complete liquidation would make it difficult to effectively pursue its stated investment strategy and would very likely compromise performance. There may be funds for which complete liquidation over a relatively short period is a reasonably foreseeable scenario that should be incorporated into their liquidity risk management programs – perhaps because of their small size and/or concentrated shareholder base – but those considerations should form part of a fund's individualized liquidity risk assessments. The more realistic challenge for many funds is maintaining the integrity of their strategies while sourcing liquidity effectively during periods of unusually high net redemptions (or subscriptions).

5. Implementing the Framework Involves High Costs, With Little or No Practical Benefit.

The Proposed Classification Framework would be tremendously expensive to implement and maintain. The Proposal estimates that establishing the liquidity risk management regime it envisions would have an initial cost to the industry of approximately $1.4 billion, with ongoing annual costs of approximately $240 million.[16] We believe the actual costs would be much higher. Individual funds may have hundreds of portfolio positions; fund complexes may cover tens of thousands or more. Establishing appropriate methodologies for assigning assets within various classes and applying them on an ongoing basis would be extremely challenging and resource intensive. Given the dynamic nature of liquidity, those assessments would require constant review (indeed, the Proposal suggests that classifications might need review on a daily or even hourly basis, depending on facts and circumstances).[17] For most funds, a good faith effort to comply with this component of the Proposed Rule would require a substantial investment in new systems, new information vendors, and new personnel. Compliance efforts are likely to divert resources from more practical liquidity risk management efforts and will increase expenses borne by fund investors.

The Proposal does not consider costs other than those related directly to funds' implementation of liquidity risk management programs that include the prescribed elements. Indirect costs could include: (i) the negative pressure on performance that the Proposal may exert by encouraging funds to maintain unnecessarily large pools of highly liquid assets (in particular when those requirements cause funds to deviate from their strategies); (ii) the cost to issuers whose ability to

[15] Mutual Funds and Systemic Risk; The Reassuring Lessons of Stability Amid Past Periods of High Financial Markets Volatility, Strategic Insight, 2015, p. 10. Available at: http://www.sionline.com/published/Mutual-Funds-and-Systemic-Risk/Mutual-Funds-and-Systemic-Risk.pdf

[16] Proposal, p. 62361

[17] Proposal, p. 62303

access the capital markets may be compromised by the disincentives the Proposal creates for funds to invest in less liquid securities; (iii) the possibility that the Proposal would actually reduce market liquidity by creating disincentives for funds to purchase less liquid assets, and (iv) the possibility that fund shareholders who rely on speculative (and stale) estimates of liquidity will be harmed if/when those estimates do not accurately predict liquidity during a period of market stress or otherwise; and (v) the increase in litigation risk, given the inherent ambiguities in the liquidity assessment exercise.

Against these costs, we see little to no practical benefit. The mere classification of assets within a subjective framework does little to further the goal of encouraging robust liquidity risk management practices. The Proposal suggests that investors will benefit from the additional disclosure the Proposed Rule would require, but we believe that the inherent unreliability of that data proposed to be disclosed would render such a benefit illusory – we think it more likely that investors will be harmed by relying on the type of forward-looking and promissory predictions such data would represent.

B. We Recommend a Principles-Based Approach

The Proposal's highly prescriptive asset classification schema is a poor fit for the highly diverse fund industry and the wide variety of sources and degrees of liquidity risk for different funds. A principles-based approach to regulating liquidity risk management in the fund industry would be far more effective.

As discussed in the Proposal, the open-end fund industry encompasses many different types of funds that vary widely in size, organization, shareholder base, investment objective and strategy, and management style. Various funds invest in a wide range of asset classes (and sub-classes), countries and regions, sectors and industries, and so forth. While all funds (indeed, all investments) are subject to some liquidity risk, each of these variables contributes to differences in the sources and degree of liquidity risk a fund may face. A fund with liquidity risk arising from a concentrated shareholder base may use different liquidity risk mitigation tools than a fund with liquidity risks arising from concentrated positions. A fund that invests in assets that settle on a delayed or extended basis will have different needs than one that invests only in assets settling within a few days. The Proposal recognizes this diversity in its requirement that each fund conduct an individualized assessment of its liquidity risk, [18] but then inexplicably adopts a "one-size-fits-all" approach, embodied by the Proposed Classification Framework.[19]

A principles-based approach could require that each fund conduct a thorough assessment of its particular liquidity risks and design a liquidity risk management program tailored to those risks using the tools the fund deems best suited to its needs. This approach could be modelled on the Commission's regulation of funds under Rule 38a-1,[20] which requires funds to design policies and procedures reasonably designed to ensure compliance with the federal securities laws. A principles-based regime would give funds the flexibility to determine how best to manage their anticipated liquidity needs in the context of their investment objectives, strategies, portfolios, and

[18] Proposed Rule 22e—4(b)(2)(iii).
[19] Proposed Rule 22e—4(b)(2)(i).
[20] Compliance Procedures and Practices of Certain Investment Companies, 17 C.F.R. §270.38a—1.

shareholder bases and could give the Commission the latitude to observe and review various programs and to issue iterative guidance as needed (as it has done for similar rules).

In contrast to the Proposal's requirement to classify liquidity by holding, Dodge & Cox, like many fund managers, assesses liquidity risk at the portfolio level, considering the relative liquidity of different types of asset classes and the proportion of a portfolio invested in them. Holdings may be grouped based on relative liquidity at an asset class and sub-class level, taking into account the historical liquidity of assets with similar characteristics. With respect to equity securities, we often consider historical daily trading volume and other security-specific trading data in our analysis. In the fixed income markets, however, security-specific data can be less useful because of the fragmentation of those markets. Trading analysis of fixed income securities often considers data based on the broader market for securities with similar characteristics.

We focus on the total amounts of assets available in different liquidity strata. We understand that some fund managers assign holding-specific liquidity scores, but we do not believe that such scores are typically understood to correspond to a specific estimated liquidation period. We undertake liquidity-related scenario analyses and stress-testing exercises based on our estimate of reasonably foreseeable redemptions under various ordinary and stressed market environments.

If the Commission believes that some classification of portfolio assets is necessary, we recommend adopting a more qualitative, top-down schematic under which assets are grouped based on their relative liquidity without reference to specific projected liquidation periods. A possible framework might include: (i) cash and cash equivalents; (ii) highly liquid assets that can be converted quickly to cash under most circumstances; (iii) generally liquid assets; and (iv) illiquid assets (i.e., those subject to the 15% limit).

Some funds already use various qualitative schemas of this sort as part of their liquidity risk management programs. Such a framework might provide more visibility into a fund's liquidity profile while avoiding many of the problems inherent in the rigidity of the Proposed Classification Framework, particularly the misleading sense of precision implied thereby.

However, we caution that making any distinction as to relative liquidity raises some of the concerns we raise with respect to the Proposed Classification Framework – classifying assets as "highly liquid" rather than "liquid" remains subjective and requires assumptions that will vary from fund to fund as to the amount of a holding (or more realistically amount of a particular asset class) that can be liquidated on short notice and the degree of price movement that would be considered acceptable for purposes of the classification. We suggest the Commission allow funds some latitude to develop their own definitions and/or processes for identifying assets as "highly liquid" rather than liquid, and include this as a liquidity risk management program element specifically subject to board oversight.

Because of our concerns about the comparability of assets identified as "highly liquid" by different funds, we do not support public disclosure of such assessments, though we acknowledge the Commission's interest in receiving and reviewing these classifications. Instead, we recommend enhanced qualitative liquidity risk disclosure to fund shareholders. We believe that qualitative disclosure of a fund's specific liquidity risks can provide investors with useful information about the sources of liquidity risk for a particular strategy or fund, while avoiding the promissory nature of specific predictions of liquidity for each position.

Finally, while all funds (and all investments) are subject to some degree of liquidity risk, certain types of less liquid assets, such as high yield bonds, exotic derivatives, and bank loans, make liquidity risk management more challenging. As noted in the Proposal, alternative strategy funds have become more common and have grown substantially over the past ten years.[21] The Commission may wish to allocate resources to reviewing the liquidity risk management programs of funds that invest primarily in less liquid asset classes.

C. Highly Liquid Asset Minimum (Three-Day Liquid Asset Minimum)

The Proposal would mandate that all funds establish a "three-day liquid asset minimum," determined based on short- and long-term cash flow projections, taking into account factors such as the size, frequency and volatility of historical subscriptions and redemptions in normal and stressed periods; a fund's redemption policies; a fund's shareholder ownership concentration and distribution channels; and the degree of certainty associated with the cash-flow projections.[22] The Proposal suggests that this percentage should be reviewed periodically (at least semi-annually) and that the established three-day liquid asset minimum and any modification thereto would be subject to approval by a fund's board.[23]

We are generally supportive of the concept underlying the "three-day liquid asset minimum" requirement – the idea that funds should maintain a reserve of highly liquid assets that is sufficient to meet reasonably foreseeable redemption requirements – but we discuss below several concerns about the specifics of that requirement and recommend a modified approach.

Because of our objections to the Proposed Classification Framework, described above, we do not believe the definition of highly liquid assets should depend on an assessment of the precise number of days required to convert each holding to cash without material impact to price. For example, we do not believe that there is a bright line distinguishing securities that can be liquidated in three days and those that can be liquidated in four days. By necessity, liquidity determinations are based on the fund manager's opinion, which, no matter how well informed, is subjective, not fact.

We are also concerned that, while it tasks each fund with setting its own three-day liquid asset minimum, the Proposal seems to assume: (a) that a fund's liquid asset minimum should be relatively static, requiring only periodic review; and (b) that funds should maintain a significant percentage of their assets, representing some multiple of historical average or worst net redemptions, in highly liquid assets at all times. While maintaining a reserve of highly liquid assets should form a part of any fund's liquidity risk management program, an equally important component is the fund's ability to track and anticipate daily cash flows. Fund managers track expected cash inflows from payments of dividends, coupons, and principal repayment, among other things. They may anticipate seasonal fluctuations in the volatility of net subscriptions and redemption. Depending on their funds' shareholder bases, such fluctuations may be attributable

[21] Proposal, p. 62281.
[22] Proposed Rule 22e—4(b)(2)(iv)(A).
[23] Proposed Rule 22e—4(b)(3)(i).

to tax-motivated transactions, periodic opportunities for investors to rebalance investments, or historical patterns. It is also common for fund managers to communicate regularly with large shareholders and encourage advance notice of large fund inflows and outflows. It is usually in the interests of such shareholders to cooperate in providing reasonable notice of pending purchases and sales so that fund managers can invest subscription proceeds and fund redemptions efficiently.

We acknowledge that estimating inflows and outflows is not an exact science, but note that funds have additional tools to help manage unexpectedly large net redemption requests. Some funds have lines of credit, and some have inter-fund lending arrangements. All funds have the right under the 1940 Act to take up to seven days to make redemption payments, as well as the right to make redemptions in-kind (subject to applicable Rule 18f-1 elections), by transferring securities and other assets in satisfaction of a redemption request. As a practical matter, most funds do not rely on these tools in the ordinary course. Nonetheless, they are available in the event of a large unanticipated redemption request. In addition, in the rare case of a fund experiencing severe liquidity issues, it may request permission from the SEC to suspend redemptions in order to protect shareholders.

Many stock and bond funds are designed for and sold to long-term investors, including those saving for retirement. Maintaining a large amount of cash and other highly liquid assets on a constant basis may be unnecessarily conservative for many funds and is likely to be a drag on performance. If the final rule makes it too cumbersome for funds to change its liquid asset minimum, it will cause many funds to either underestimate their potential liquidity requirements or hold an excessive amount of short-term investments to the detriment of long-term shareholders.

The Proposed Rule would require board approval of both an initial three-day liquid asset minimum and any change to that minimum thereafter.[24] Given the difficulty of soliciting board action on short notice, this requirement implies that the minimum would be subject only to periodic review. Determining an appropriate liquid asset minimum is a complex and continuous process and not one in which a board is well positioned to engage in directly.

In light of these concerns, rather than requiring funds to maintain a static percentage of liquid assets, the Commission should allow and encourage funds to determine their liquid asset needs by adopting dynamic models or processes designed to respond efficiently to changing market conditions and fluctuations in projected near-term cash requirements. Similarly, we recommend that funds be given the flexibility to seek board approval of a process or methodology for determining a liquid asset minimum instead of a fixed percentage. A diligent board should assess the robustness of the process or methodology used to determine the minimum rather than the minimum itself.

D. Liquidity and Dilution Risk

We understand the Commission identifies as its objective not only mitigation of the risk that a fund will not be able to meet its redemption requests, but also the risk that in meeting such

[24] Proposed Rule 22e-4(b)(3)(i).

requests, a fund will dilute the interests of its remaining investors. The Proposal's concern with dilution risk is evidenced both in its definition of liquidity risk as "the risk that the fund could not meet requests to redeem shares issued by the fund … without materially affecting the fund's net asset value"[25] and in its reliance on the Proposed Classification Framework, which is based entirely on the days within which a fund's position in an asset can be converted to cash "at a price that does not materially affect the value of that asset immediately prior to sale." Both the definition and the Framework seem to assume that significant amounts of assets can be sold without affecting price and that only those assets that can be liquidated without impacting price should be available as a source of liquidity to fund redemptions. These expectations are not reasonable. Fund managers strive to (and are highly incented to) maximize execution efficiency, balancing the relative urgency of acquiring or disposing of a particular position against the possible impact their trading activity may have on price. But in theory, all sales of assets have some impact to price, and in practice, few assets can be sold in significant quantity without observable price impact (though, as discussed, the degree of that impact is difficult to anticipate with precision).[26]

The Proposal posits that fund investors are threatened by the possibility of a first-mover advantage or incentive that could cause shareholders to engage in large-scale, short-term redemption activity to avoid liquidity-related dilution; and that this threat may cause funds to become unable to meet redemption requests in a timely manner and/or lead to further dilution of the interests of remaining shareholders at an unacceptable level.[27] However, there is little evidence in the 75 year history of the mutual fund industry to suggest that such a threat exists beyond the theoretical realm. Indeed, the Proposal acknowledges that "fund investors may not have historically been motivated to redeem on account of a perceived (or actual) first-mover advantage during previous periods of stress …"[28] including during the 2008 financial crisis, during which many funds experienced dramatic investment losses. Research indicates that during periods of financial uncertainty, investors tend to reduce the turnover of their financial assets with the result that redemption activity tends to decline.[29]

To the extent it is premised on protecting investors from a "first-mover"-driven run on funds, we believe the Proposal is a disproportionate response to a risk that is relatively remote. As a whole, the fund industry has been highly successful in its efforts to meet shareholder redemption requests without undue dilution of remaining shareholder interests, as evidenced by the evolution in common industry practice of paying redemption proceeds within one or two business days rather than the seven days permitted under the 1940 Act. In the Proposal, the Commission cites

[25] Proposed Rule 22e—4(a)(7). We have concerns about the way in which the Proposal's definition of "liquidity risk" refers to a fund's net asset value. Since fund NAV is calculated only once a day, the definition is inherently backwards looking and could be understood to suggest that assets are an appropriate source of liquidity only to the extent they can be sold based on the prior day's valuation.

[26] The degree of price movement that may be considered "material" is a question of trading judgment and may vary from security to security depending on a number of factors, including a security's liquidity profile.

[27] Proposal, p. 62280.

[28] Proposal, p. 62358.

[29] Mutual Funds and Systemic Risk: The Reassuring Lessons of Stability Amid Past Periods of High Financial Markets Volatility. Strategic Insight, p. 8. The paper suggests that this phenomenon may relate to the large percentage of mutual fund shares held by pension plans and other long-term investors as well as investor psychological aversion to realizing loss.

only three examples of its issuing orders suspending redemptions, and two of the three funds referenced were money market funds, which are excluded from the Proposal's scope.[30] The Commission's recent issuance of an order permitting a high yield bond fund to suspend redemptions in connection with its liquidation[31] was notable for its rarity. While the circumstances of that particular fund underscore the need for vigilance and robust risk management practices, an isolated incident is not evidence of a systemic issue. Many mutual funds have absorbed significant net redemptions in the past without material impact on performance, including in the fixed income market. In those few instances where a fund's liquidity is so compromised that it is unable to meet its redemption requests within seven days, Section 22(e) already provides an effective tool allowing the Commission to intervene to protect remaining shareholders.[32]

Dilution relating to unusually high net redemptions is but one of many risks to which fund investors are subject. By concentrating only on a scenario in which shareholder redemptions cause the manager to sell securities in a falling market, the Proposal fails to consider that other investors may be incented to subscribe in the same circumstances, to the benefit of existing shareholders. It does not address another source of shareholder dilution: investor subscriptions in a rising market, given both transaction costs and the challenges associated with purchasing significant amounts of a security while attempting to minimize the possible resulting price impact. The Proposal's fixation on redemptions in a falling market suggests an attempt to protect investors from a single source of downside market risk without due consideration for possible consequences, such as performance drag, tracking error, and reduced investment flexibility. As discussed more specifically with respect to the Proposed Classification Framework in Section B.5, we urge the Commission to consider carefully both the direct and potential indirect costs of any final fund liquidity risk management regulation.

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In conclusion, we commend the Commission's efforts to develop and implement rules that further encourage thoughtful and effective risk management practices in the open-end fund industry, and hope that our feedback, along with that of our colleagues and peers, is helpful in this respect. We appreciate the opportunity to comment on the Proposal. If you have any questions regarding our comment letter or would like additional information, please contact me at [redacted] or Roberta R. Kameda, General Counsel of Dodge & Cox, at [redacted].

Sincerely

Dana M. Emery

Dana M. Emery
Chief Executive Officer
Dodge & Cox

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[30] Proposal at n.82, p. 62283.

[31] See SEC Release No. IC-31943 (Third Avenue Trust and Third Avenue Management LLC; Notice of Application and Temporary Order under Section 22(e) of the Investment Company Act) (Dec. 16, 2015).

[32] Rule 22e-3.