Crane Data •*measuring money*

Bond Fund News, Performance & Indexes

Bond Fund Intelligence

January 2018 ***Reprinted w/Permission*** **ISSN 2381-2273**

Dechert's Cohen on Regulations Impacting Bond Funds

This month, ***BFI*** interviews **Stephen Cohen**, a Partner at **Dechert LLP**, on **regulations impacting bond funds**. Cohen has been focused on a number of topics involving fixed-income funds, such as **liquidity, reporting, and issues involving ultra-short bond funds**. (He will also be presenting the "**Regulatory Update**" at our upcoming ***Bond Fund Symposium*** in **Los Angeles, March 22-23**.) Our Q&A with Cohen follows.

BFI: *Tell us about your background.*
Cohen: We have a very long history representing bond mutual funds as well as closed end bond funds and bond ETFs as well. We organized some of the earliest municipal bond funds for **E.F. Hutton** in the early 1980s…. We also helped launch bond funds for **Templeton** in the 1980s and 1990s. **Currently, we represent a number of the largest bond fund groups in the industry**…. So we have a pretty rich history representing bond funds…. Personally, I've been working with bond funds since I started at **Dechert** in 2005. **Almost every client I work with offers bond mutual funds, or bond ETFs or closed end bond funds**…. As you know, I work with a number of money market fund groups and most of those by extension have **ultra short bond funds or other bond funds**.

Steve Cohen

BFI: *What are the big regulatory issues?*
Cohen: I think that the two major issues that bond funds are dealing with now are liquidity risk management and the reporting modernization rules…. These two new rules particularly impact bond funds. With respect to liquidity risk management, I think it's clear that, at the time that the rule was adopted, the SEC was very concerned about the growth of bond funds and the perceived liquidity mismatch between daily redemptions offered by those funds and the ability to liquidate their bond holdings in order to meet those redemptions. **So I think liquidity risk management is very much aimed at bond funds.**

Reporting modernization is very similar to liquidity risk management in terms of its particular impact on bond funds, because bond funds typically hold more securities. **Form N-PORT** actually asks very detailed questions about the overall portfolio of bond funds, their risk metrics, as well as each underlying security that a bond fund holds. **Because bond funds hold so many securities and those securities often have unique features**, there is a lot more to think about and more answers that have to be provided to complete their Form N-PORT filings…. In many ways, **Form N-PORT is very similar to Form N-MFP in the sense that funds have to provide information about each security**. If a fund holds thousands of securities that means the fund has to provide information about each of those thousands of securities, which can be operationally challenging.

BFI: *What's the current status of these?*
Cohen: As of now, the liquidity risk management regulations go into effect for large fund groups — defined by the SEC as those that have $1 billion or more in assets – on Dec. 1, 2018. For fund groups with less than $1 billion, the compliance date is Dec. 1, 2019. [But] **there have been several requests and developments that might convince the SEC to modify those compliance dates.** First, in July, the **ICI** submitted a letter to **SEC Chairman Jay Clayton**…. **The ICI requested that the SEC amend the rule to allow funds to formulate their own policies and procedures to determine how to classify investments**…. The ICI also asked that, even if there are no amendments to the rule itself, **the SEC at least delay the compliance date for the liquidity classification requirement**, which we often refer to as the '**bucketing**' requirement, by at least one year.

Next, in October, the U.S. Treasury issued a report and recommended postponing and modifying the bucketing requirement, and also rejected the "highly prescriptive" approach of the bucketing requirement and argued for a "principles based" approach. That report became another arrow in the quiver for a delay. Most recently, **in November, the ICI again urged the SEC to delay the compliance date by at least one year**. In that letter, the ICI provided a formal survey data of its members with respect to their readiness, as well as the perceived readiness of the vendors that those fund groups are going to use for bucketing, to show that there would be difficulty meeting the December 1, 2018 compliance date. **So stay tuned…. You could see something coming out any time, or not at all.** We just don't know.

BFI: *Tell us about the delay in N-PORT.*
Cohen: On Dec. 8, 2017, the SEC issued a temporary final rule that provides a 9-month delay to the dates by which funds must (and the keyword here is) 'file' new Form N-PORT on the EDGAR system. Under the temporary rule, those funds that are subject to the original June 1, 2018 compliance date will still need to gather and maintain all the data required by Form N-PORT as of the original compliance and reporting date; the required information will be subject to examination by the SEC. Put another way, **there is a delay with respect to the filing on the EDGAR system but not a delay with respect to actually compiling all that data**…. The key reason was the cyber security concerns. The ICI had been raising

(Continued on page 2)

(***Dechert's Cohen*** *from p.1)*

that issue since the proposal stage of the data reporting rules.

BFI: *So the public won't see this holdings information until the end of 2019, right?*
Cohen: Yes, because, on top of the 9-month delay, there is a 6-month lag on the information being publicly released.

BFI: *Remind us about Third Avenue.*
Cohen: The SEC had to issue a temporary order to **Third Avenue Focused Credit Fund** to **permit the fund to suspend the right of redemption in connection with the fund's orderly liquidation**. This is a very rare type of order that allows an open end fund, which allows for daily redemptions, to suspend the right of redemption. The background here is that the board of the fund sought to liquidate the fund following significant outflows while the fund was holding illiquid securities. What they did was announce that the fund would provide a liquidation payment and then the fund would establish a liquidation trust to pay out the remaining assets over time.... The SEC essentially pushed back on that plan and required the fund to work with the SEC and seek the exemptive relief, which, among other things, allowed the SEC to be more involved in the liquidation process. **Overall, I think the takeaway on Third Avenue is that it happened at a point in time that gave support to the SEC's push for the liquidity risk management rules.**

BFI: *Are there any new issues with ultra-short bond funds?*
Cohen: So-called "**shmoney funds**" [ultra-short bond funds that look like money market funds] **have been a focus of the SEC staff**, especially in light of money market fund reforms. **The SEC disclosure staff, which is responsible for reviewing new products, has been, and continues to be, very focused on new short term bond fund disclosures.** They want to make sure that the funds are not trying to market themselves as money market funds, without the need to value at a floating NAV out to four decimal places and without fees and gates. **The message from the staff is that if you try to offer a short term bond fund that tries to say, 'We do everything in Rule 2a-7 but without the basis point pricing and fees and gates,' that's a problem**…. Taking a step back, there is always the concern about how these types of funds are marketed. **Ultra-short bond funds have the difficult task of walking that tight line of offering an alternative to money market funds, but at the same time making sure it is clear to investors that the fund is not a money market fund, that the NAV can fluctuate and that investors can lose money.**

BFI: *What about cash-like ETFs?*
Cohen: What we've seen is significant growth in the ultra-short bond market. I think every manager, again, who has money market funds, as well as traditional bond managers, has looked at offering ultrashort funds or some hybrid of an ultra short, such as an **ETF**…. It's been a very hot area…. **You hear so much about active versus passive and the flight to passive index funds, but the actively managed ultra-short space is one that's actually seen a lot of growth and one that is still able to offer a better return than the indexes.**

BFI: *Do you have any comments on the new Administration?*
Cohen: I would say the regulatory environment is completely different than it was a year ago. If you recall, a year and a half ago, **Chair White**, who was the chair of the SEC at the time, had a very aggressive regulatory agenda aimed at the investment management industry. The FSOC and Treasury were also very focused on the industry. That's just not the case anymore. **The SEC recently issued its regulatory agenda and the SEC does not seem to be as focused on the fund industry.** Overall, I think the Administration is completely different than the prior Administration in terms of its regulatory focus, and, in particular, its focus on the fund industry.

BFI: *What about any predictions or advice for the New Year?*
Cohen: We've got a full Commission now. We've got all five Commissioners who have been appointed and approved by the Senate, so we'll have to see how the two new Commissioners impact the Commission and its agenda, if at all…. **At the SEC, the Chair really does drive the agenda, so the two new Commissioners may not impact the agenda very much.** But we'll see…. Separately, we've got a new **Director of the Division of Investment Management**, **Dalia Blass**. We'll have to see where she leads the Division, which is primarily responsible for overseeing funds.

I think what you can say is, 'Now we've got all the pieces in place,' at least from a regulatory perspective, which we didn't have in 2017. We'll see where it goes…. Like I said, **I don't expect a lot of new regulation in our industry**. And hopefully, the things that the industry has wanted, like a delay of liquidity risk management, perhaps internet delivery of shareholder reports that was initially part of the reporting modernization, and **maybe some other industry-friendly regulations, will be adopted**. ◈

Reprinted with Permission from the January 2018 issue of Bond Fund Intelligence *with permission of Crane Data LLC. The opinions expressed are those of* ***Stephen Cohen*** *and are current through Jan. 16, 2018.*

An investment in a money market fund is neither insured nor guaranteed by the FDIC or any other governmental agency. It is possible to lose money by investing in a money market fund.