

MEMO# 30053

July 19, 2016

ICI Letter Disputes FSOC Contentions Regarding Mutual Fund Liquidity and Redemption Risks

[30053]

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TO: ACCOUNTING/TREASURERS MEMBERS No. 19-16
CHIEF RISK OFFICER COMMITTEE No. 18-16
CLOSED-END INVESTMENT COMPANY COMMITTEE No. 12-16
COMPLIANCE MEMBERS No. 22-16
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 15-16
ETF ADVISORY COMMITTEE No. 15-16
INVESTMENT COMPANY DIRECTORS No. 20-16
SEC RULES MEMBERS No. 37-16
UNIT INVESTMENT TRUST MEMBERS No. 5-16
VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 15-16 RE: ICI LETTER
DISPUTES FSOC CONTENTIONS REGARDING MUTUAL FUND LIQUIDITY AND REDEMPTION
RISKS

As we indicated previously, at an open meeting on April 18, the Financial Stability Oversight Council (FSOC or Council) discussed its review of asset management products and activities and issued a 27-page statement (Statement) detailing the Council's views regarding potential financial stability risks in asset management and next steps to respond to these potential risks. [\[1\]](#) Yesterday, ICI sent a letter to FSOC regarding the Council's work and conclusions to date regarding liquidity and redemption risks in mutual funds. The letter discusses FSOC's failure to substantiate its conclusion that there are financial stability concerns that may arise from such risks. It includes two appendices: one examining the academic studies cited by FSOC in the Statement, and the other analyzing events in the high-yield bond fund market (with a focus on the period from November 2015 through February 2016, which included the announcement by a high-yield bond fund that it would suspend investor redemptions). The letter and its two appendices are described further below. [\[2\]](#)

Letter to FSOC

The letter begins by stating that effective liquidity risk management is central to the proper functioning of a mutual fund. It welcomes regulatory attention (particularly by the

Securities and Exchange Commission) to strengthening “what are already strong practices that have proved highly successful across the mutual fund industry for many years.” It expresses the view that, in its current liquidity risk management rulemaking, the SEC can “‘raise the bar’ for all mutual funds while allowing sufficient flexibility, because liquidity management is not a ‘one size fits all’ proposition.”

The letter observes, however, that FSOC has provided no basis for its conclusion that there are financial stability concerns that may arise from liquidity and redemptions in mutual funds, particularly funds investing in less liquid asset classes. It goes on to address FSOC’s suggestions that (1) fund investors may have incentives to redeem their shares ahead of others in times of market stress (a so-called “first mover advantage”), and (2) funds facing significant redemptions may be forced to sell portfolio holdings that in turn may result in “spillover effects” to other market participants and the broader markets that would threaten financial stability.

The letter reiterates the reasons why FSOC’s concerns about a “first mover advantage” leading to financial stability risks in mutual funds are unfounded, referring back to the discussion and analysis in ICI’s March 2015 comment letter responding to FSOC’s December 2014 request for comment on asset management products and activities. It also addresses FSOC’s assertion that a September 2015 white paper by the SEC’s Division of Economic and Risk Analysis, entitled *Liquidity and Flows of U.S. Mutual Funds* (“DERA study”), “has shown that some mutual funds manage their liquidity in response to large redemptions by disproportionately selling their relatively more liquid assets.” The letter points out that there is no explicit statement to this effect in the DERA study and offers an alternative explanation for the DERA study’s findings.

The letter then discusses FSOC’s failure to substantiate its concerns about destabilizing redemptions from mutual funds, noting ICI’s previous comments to the Office of Financial Research, the Financial Stability Board and FSOC presenting historical data that paints “a remarkably consistent picture” that is at odds with this oft-cited hypothesis. The letter states that “[t]he very consistency of the results, across different market cycles and different types of funds, suggests there are compelling and enduring reasons for mutual funds’ long history of success in meeting investor redemptions.” It briefly summarizes those reasons and explains that, absent evidence that destabilizing redemptions are likely to materialize, “FSOC’s observations about ‘the potential for outflows [from mutual funds] to cause fund distress, and hence broader stress’ remain mere conjecture.”

Finally, the letter examines a recent period of heightened volatility in the high-yield bond fund sector and the implications of the Third Avenue Focused Credit Fund’s suspension of redemptions in December 2015. Rather than illustrating FSOC’s concern, the letter explains, the Focused Credit Fund example “provides relevant and recent market experience demonstrating that redemption difficulty at one mutual fund portends neither the same fate for other mutual funds nor destabilizing impacts for markets and market participants more broadly.”

In closing, the letter respectfully requests that FSOC reconsider its conclusion about financial stability risks relating to liquidity and redemptions in mutual funds.

Appendices

Appendix A. FSOC does not offer any supporting evidence of its own to back up its hypotheses. Instead, it cites to selected academic studies. Appendix A to the letter briefly

discusses each of these studies and explains why they provide little, if any, support for FSOC's stated concerns.

Appendix B. Regulators (including FSOC) and academics have advanced a variety of hypotheses for why there could be financial stability risks associated with redemptions from mutual funds, particularly funds investing in less liquid asset classes. From an economics standpoint, these hypotheses share four "testable predictions":

- Prediction 1: Mutual fund investors will redeem heavily across most funds within the affected asset class.
- Prediction 2: During this period of heavy redemptions, investors will refrain from purchasing new shares of funds within the asset class, creating a one-way market of sellers of fund shares.
- Prediction 3: Fund managers as a group will be forced by the heavy redemptions to sell portfolio assets and will not be in a position to buy assets, with the result that managers will be on one side of the trade in a down market.
- Prediction 4: Other investors will not enter the market to buy the portfolio assets that fund managers are trying to sell.

To test the predictions, Appendix B to the letter looks at the experience of high-yield bond mutual funds from early 2014 to early 2016, with particular attention to the period from November 2015 to February 2016, a time of significant stress in the high-yield bond market. This period included the December 2015 announcement by Third Avenue Focused Credit Fund, a high-yield bond mutual fund, that it had suspended investor redemption rights. The appendix provides empirical data regarding the behavior of investors in high-yield bond funds, the managers of those funds, and other participants in the high-yield market.

Contrary to the four predictions, the data show that investors were purchasing (as well as selling) shares in high-yield bond funds during this period of market stress. Similarly, fund managers and other investors not only sold but also purchased high-yield bonds. The net result was that trading volumes of high-yield bonds actually rose during December 2015—when the high-yield bond market was under the greatest degree of stress. The appendix concludes by urging regulators and academics to reexamine their hypotheses, in accordance with these findings.

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endnotes

[1] See ICI [Memorandum](https://www.treasury.gov/initiatives/fsoc/news/Documents/FSOC%20Update%20on%20Review%20of%20Asset%20Management%20Products%20and%20Activities.pdf) No. 29847, dated April 21, 2016. The Statement is available at <https://www.treasury.gov/initiatives/fsoc/news/Documents/FSOC%20Update%20on%20Review%20of%20Asset%20Management%20Products%20and%20Activities.pdf>. The Council's review of potential risks focuses on: (1) liquidity and redemption; (2) leverage; (3) operational functions; (4) securities lending; and (5) resolvability and transition planning.

[2] The letter (with appendices) is available at https://www.ici.org/pdf/16_ici_fsoc_ltr.pdf, and a press release summarizing the letter is available at https://www.ici.org/pressroom/news/16_news_fsoc_report_response.

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