

MEMO# 29605

January 4, 2016

ICI Research Draft Comment Letter on SEC Liquidity Rule Proposal and DERA's Liquidity White Paper; Your Feedback Requested by Friday January 8

[29605]

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TO: CHIEF RISK OFFICER COMMITTEE No. 1-16
FIXED-INCOME ADVISORY COMMITTEE No. 1-16
INVESTMENT ADVISERS COMMITTEE No. 1-16
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 1-16
RESEARCH COMMITTEE No. 1-16
SEC RULES COMMITTEE No. 1-16
SMALL FUNDS COMMITTEE No. 1-16 RE: ICI RESEARCH DRAFT COMMENT LETTER ON SEC LIQUIDITY RULE PROPOSAL AND DERA'S LIQUIDITY WHITE PAPER; YOUR FEEDBACK REQUESTED BY FRIDAY JANUARY 8

As previously reported, the Securities and Exchange Commission ("SEC") issued its proposed liquidity risk management rules for mutual funds and open-end ETFs ("funds") in late September. [\[1\]](#) Broadly speaking, the Proposal aims to promote effective liquidity risk management among funds, and reduce the risk that funds will be unable to meet redemptions, or else will meet redemptions in ways that dilute interests of fund shareholders. The Proposal would:

- Require each fund to establish a formal liquidity risk management program that would require the fund to, among other things: (i) assess and manage the fund's liquidity risk; (ii) classify and monitor each portfolio asset's level of liquidity; and (iii) designate a minimum amount of portfolio liquidity;
- Permit, but not require, mutual funds to use swing pricing in pricing their shares; and
- Require each fund to make public its liquidity classifications and information about redemptions and swing pricing (if applicable) through disclosure on proposed Form N-PORT, Form N-1A, and proposed Form N-CEN.

ICI will submit a comment letter in response to the Proposal. [\[2\]](#)

On the same day that the SEC issued the Proposal, SEC's Division of Economic and Risk

Analysis (“DERA”) released an accompanying study titled “Liquidity and Flows of U.S. Mutual Funds,” [3] which is apparently intended to provide economic support for the Proposal. The DERA study focuses on three key areas, including the recent growth of mutual funds with potentially less liquid strategies, the variability of fund flows across investment strategies, and the liquidity of U.S. equity fund portfolios. In particular, the study analyzes how equity fund portfolio liquidity is related to a fund’s redemption. Due to data limitations, with the exception of a very limited analysis of municipal funds, the DERA study provides no analysis of the underlying liquidity of bond fund portfolios.

The Proposal interprets the DERA study’s findings as indicating that the average U.S. equity fund sells relatively more liquid assets to meet large redemptions, rather than selling a strip of the fund’s portfolio, to the potential detriment of non-redeeming shareholders. The DERA study, however, analyzes only a single “bottom up” measure of fund liquidity (the so-called “Amihud” measure) and does not provide any analysis of the Proposal’s three-day liquid asset minimum requirement or its six liquidity buckets classification scheme.

In our draft comment letter (attached below), we discuss the lack of support in the DERA study for the Proposal’s three day liquid asset minimum requirement and the six bucket classification scheme. We indicate that funds have been highly successful in meeting redemptions. Consequently, the SEC must be cautious about introducing problems where none now exist.

We discuss how the three day liquid asset minimum and six bucket scheme could create problems. One potential issue is the Proposal could create the misimpression that certain funds (e.g., larger funds) are highly illiquid and thus unlikely to be able to meet redemptions. Significantly, the Proposal risks creating more correlated portfolios and trades across funds if funds gravitate toward securities designated by third-parties as “more liquid.” This in turn risks precipitating liquidity “cliff events” during periods of market stress—similar to those created by credit rating downgrades during the financial crisis—if third-party vendors “downgrade” the liquidity of a security or group of securities, causing a rush to sell the downgraded securities.

Please provide comments as soon as possible, but no later than January 8, to Sean Collins (scollins@ici.org; 202-326-5882).

Sean Collins,
Senior Director, Industry and Financial Analysis
ICI Research Department

[Attachment](#)

endnotes

[1] Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, SEC Release No. IC-31835 (the “Proposal”), available at www.sec.gov/rules/proposed/2015/33-9922.pdf. See Institute Memorandum No. 29370, dated September 28, 2015, for a more complete summary of the Proposal. Unless otherwise indicated, references to “funds,” “mutual funds,” and “open-end funds” do not include money market funds.

[2] See Institute [Memorandum](#) No. 29586, dated December 22, 2015, for the draft letter

and a summary.

[3] Available at
www.sec.gov/dera/staff-papers/white-papers/liquidity-white-paper-09-2015.pdf.

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