

## Mutual Fund Liquidity: FAQs

### Frequently Asked Questions About Mutual Fund Liquidity

#### What is liquidity?

The term *liquidity* can have several meanings. With respect to a particular asset, it may refer to an investor's (including a mutual fund's) ability to sell that asset, considering timeliness and cost. In this respect, the liquidity of different assets and asset classes varies (and is variable), and may be viewed as falling on a spectrum.

It also may refer to the overall liquidity of a mutual fund, and its ability to meet redemptions without significantly diluting the interests of remaining shareholders. At the fund level, liquidity risk assessment includes evaluating the liquidity of the fund's portfolio investments, along with other important factors, such as cash flow projections and outside funding sources.

#### Why is liquidity important to mutual funds?

A defining feature of mutual funds is their daily redeemability. Open-end mutual fund shares are continuously offered for sale, and shareholders may redeem their shares on any business day. A fund must stand ready to meet these redemptions while also fulfilling ongoing obligations to its remaining shareholders, including the fund's duty to pursue its stated investment objective, strategies, and policies.

#### How do funds manage liquidity generally?

Fund managers have many ways to manage liquidity and meet redemption requests. Even when some fund investors are redeeming, others are buying—and so funds usually have cash inflows from the proceeds of new fund share purchases. Funds gain additional cash on a regular basis from the maturation, prepayment, and calling of bonds (fixed-income funds in particular) and from interest and dividend payments that shareholders reinvest. Funds carefully manage their cash levels and holdings in other liquid investments to balance the need to meet both unanticipated redemption demands and the funds' investment objectives. Finally, funds' high levels of liquid investments mean that they can readily sell portfolio holdings to further enhance or maintain liquidity.

#### Are there standards for liquidity that funds must meet?

Under the Investment Company Act of 1940, a fund has up to seven days to pay proceeds to shareholders who redeem shares; in practice, funds usually pay redemption proceeds even sooner, within one or two days of the redemption request. Because of this requirement, the Securities and Exchange Commission (SEC) has issued guidance that limits a fund's "illiquid assets" to 15 percent of the fund's net assets.<sup>[\*]</sup> In October 2016, the SEC adopted a liquidity risk management program rule and related reporting and disclosure requirements applicable to mutual funds and open-end ETFs, which will supersede this current guidance and substantially enhance funds' regulatory obligations in this area.<sup>[†]</sup> For most funds, the compliance dates for most of these new requirements is December 1, 2018 or June 1, 2019, depending on the requirement.

#### Does liquidity risk management differ for mutual funds and exchange-traded funds (ETFs)?

Mutual funds customarily pay redemption proceeds to all shareholders (retail and institutional) in cash. By contrast, ETFs offer their shares to, and redeem them from, authorized participants (APs)—typically, large financial institutions. Retail investors then buy and sell ETF shares on an exchange, much as they buy or sell any listed equity security. Compared to mutual funds, ETFs are far more likely to meet redemption requests from APs in kind—that is, by distributing portfolio investments (instead of cash) in exchange for ETF shares. In-kind redemptions have the effect of transferring any liquidity risk associated with the distributed portfolio investments from the ETF to the AP. Consequently, the liquidity risk management practices of mutual funds and ETFs may differ somewhat. The SEC recognizes this in its liquidity risk management program rule, which imposes different requirements on mutual funds and ETFs.

#### How successful have funds been in managing liquidity and meeting shareholder redemptions?

Mutual funds have had a history of successfully managing liquidity and meeting shareholder redemptions since the enactment of the Investment Company Act in 1940. Sound liquidity management practices have developed not only in response to legal and regulatory requirements, but also as intrinsically important elements of portfolio and risk management. Thus, liquidity management is a constant area of focus for portfolio managers, traders, risk managers, and legal and compliance personnel, and part of a fund board's oversight of a fund's compliance and portfolio management. These liquidity risk management practices will continue to evolve, as funds implement the SEC's requirements adopted in 2016.

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[\*] *Revisions of Guidelines to Form N-1A*, SEC Release No. IC-18612, 57 Fed. Reg. 9828 (March 20, 1992).

[†] *Investment Company Liquidity Risk Management Programs*, SEC Release No. IC-32315, 81 Fed. Reg. 82142 (Nov. 18, 2016). See also *Investment Company Liquidity Risk Management Programs; Commission Guidance for In-Kind ETFs* SEC Release No. IC-33010 (Feb. 22, 2018).

February 2018

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