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ICI Supports Establishing Formal Liquidity Risk Management Programs for Funds

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Comments Seek Important Changes to Other Elements of SEC Proposal

Washington, DC, January 13, 2016—The Investment Company Institute (ICI) today strongly endorsed the Securities and Exchange Commission's proposed requirement that long-term mutual funds and exchange-traded funds adopt formal, written liquidity risk management programs. In comments submitted to the SEC, the Institute also encouraged the SEC to consider alternative approaches to other aspects of its proposal, arguing that prescriptive, cumbersome requirements could actually set back the Commission's and the fund industry's shared goal of reducing liquidity-related risk.

ICI and the Independent Directors Council (IDC) submitted four letters to the Commission. The first responds to the SEC's rule proposal, while the second provides an analysis of the regulatory impact study conducted by the SEC's Division of Economic and Risk Analysis (DERA). The third letter, written by the IDC, offers important perspective from fund directors, and the fourth letter, penned by ICI President and CEO Paul Schott Stevens, summarizes the Institute's concerns and calls upon the SEC to adopt alternative approaches to key provisions contained in the proposed rulemaking.

"Funds have a 75-year record of successfully managing liquidity and meeting shareholder redemptions," said Stevens. "We believe that formal adoption of liquidity risk management programs will build on this strong history, helping to ensure that funds continue to meet shareholder expectations in evolving markets. A 'one-size-fits-all' approach to liquidity management is ill-advised for an industry so varied and dynamic.

“Our comments offer substantive, workable alternatives based on decades of industry expertise and a shared goal of managing liquidity risk to protect investors. We hope the SEC will consider this input and work with engaged parties to establish a final rule that will help the sector continue its historically successful efforts to manage liquidity risk for the benefit of fund shareholders.”

Funds Should Adopt Formal, Written Liquidity Risk Management Programs

ICI strongly endorses the SEC’s proposed requirement that funds adopt formal liquidity risk management programs mandated through regulation, rather than on a voluntary basis. Though the industry has long utilized sound practices in this area, such a requirement would promote discipline, rigor, and formalized processes around fund liquidity, according to the Institute. The key to this undertaking is to implement a risk-targeted rule that would require fund managers to assess the liquidity characteristics—and risks—of the strategies they employ and assets they hold.

The SEC has experience with this type of rule. The fund compliance rule, Rule 38a-1 under the 1940 Act, has successfully enhanced compliance with the federal securities laws—a critical aspect of fund operations—by making compliance programs more rigorous and subjecting them to greater oversight by managers. Additional detail on ICI’s support for a liquidity risk management requirement can be found on page 12 of the letter to the SEC.

The Institute’s letters also outline specific concerns and recommended alternatives to other aspects of the SEC’s proposal, as outlined below.

Six-Category Classification Scheme Would Not Improve Funds’ Liquidity Risk Management

ICI opposes the SEC’s proposal to require each fund to classify assets into six distinct liquidity “buckets” on an ongoing basis, based on the fund’s ability to convert each of its portfolio holdings to cash without materially affecting the value of the holding prior to sale. This aspect of the proposal is misguided because it:

1. is not a recognized or sound liquidity risk management practice;
2. would require funds to make highly subjective, unknowable projections about asset liquidity and places an undue emphasis on the potential to move the market;
3. would provide a misleading illusion of comparability among funds;
4. would impose enormous operational burdens on funds and place undue reliance on third-party systems; and
5. would introduce new risks to markets by encouraging the use of third-party rating agencies to establish models for determining liquidity for assets, driving funds to invest in certain assets deemed “liquid” by the agencies to raise their liquidity calculations and resulting in homogenization among fund portfolios. This homogeneity could then leave funds more susceptible to price shocks in volatile markets and increase the likelihood that small market events result in larger, systemic shocks that could harm fund investors.

Though ICI understands the SEC's desire for comparable classification schemes and reporting across funds, it adds that "liquidity risk is too multifaceted, and attempts to monitor and manage it are appropriately too subjective and methodologically diverse," to be classified in such a uniform manner across the industry. Before the Commission endorses any classification schemes, it should put those schemes out for additional public comment, ICI said.

Additionally, ICI is concerned that public disclosure related to the proposed scheme would harm funds and their shareholders. Such disclosure would subject funds to second-guessing of subjective liquidity determinations, negatively affect portfolio management, and reveal proprietary investment strategies, to the detriment of shareholders. This level of disclosure is unnecessary for regulatory purposes, according to ICI's letter.

For more detail on ICI's concerns related to the six-category classification scheme, see page 18 of the letter to the SEC.

ICI Proposes an Alternative to the Six-Category Asset Classification Scheme

As an alternative, ICI strongly recommends that the SEC require each fund, as part of its written liquidity risk management program, to formulate policies and procedures to determine how best to classify and monitor the liquidity of portfolio assets. This approach would accomplish the SEC's policy objectives in a less burdensome manner than the proposed scheme, while ensuring process and rigor around liquidity risk management.

ICI's risk-based approach also reflects sound industry practice and places proper emphasis on asset-level liquidity assessments within the broader context of the fund's portfolio. In addition, it eliminates the need for funds to make forward-looking, subjective statements about market impact. A description of ICI's alternative begins on page 29 of the comment letter to the SEC.

Prescriptive Three-Day Liquid Asset Minimum Proposal May Negatively Affect Portfolio Management Practices and Markets

ICI also opposes the SEC's proposed requirement that each fund maintain a "three-day liquid asset minimum," because the requirement relies on the highly flawed asset classification scheme set forth in the proposal and because it could adversely affect a fund's ability to adhere to its investment objectives, policies, and strategies while limiting its investment opportunities.

Under the SEC proposal, when a fund falls below its three-day minimum, it would be precluded from purchasing "less liquid assets." Prohibiting such new purchases could affect portfolio management in very real and negative ways, including depressing investment returns to shareholders. Complying with this regulation also could lead to herding behavior and "cliff events" that deprive markets of a source of liquidity (by artificially increasing demand for more-liquid assets and depressing demand in some sectors or types of securities).

Instead, ICI recommends that the SEC require each fund to formulate policies and procedures to determine how best to reasonably ensure the fund has sufficient liquidity to meet redemptions under normal and reasonably foreseeable stressed conditions, and that these efforts are supported by disclosure and board oversight. More detailed views on ICI's concerns regarding the three-day liquidity minimum requirement, and on its alternative proposal, begin on page 36 of the Institute's comment letter.

SEC Should Carefully Explore Swing Pricing's Benefits and Operational Challenges

The SEC's rulemaking proposal would permit, but not require, long-term mutual funds to engage in "swing pricing" under specified terms. Swing pricing would allow a fund to adjust its net asset value (NAV) by a specified amount (a "swing factor") when the level of net purchases into or redemptions from the fund exceeds a specified threshold.

Though ICI's members do not share a singular view on swing pricing, the Institute's letter discusses certain operational and legal impediments to implementing swing pricing in the United States. Chief among them is the timing around the flow of information regarding transactions from brokers and other fund intermediaries compared to the timing required for a fund to strike its NAV for a trading day. If changes in market practice and applicable regulation do not remove these obstacles, funds will not be able to implement swing pricing, even if the SEC authorizes it. ICI's detailed response to the swing making rule proposal begins on page 54 of its comment letter.

DERA Analysis and SEC's Release Fail to Establish Grounds for Prescriptive SEC Rulemaking

According to ICI's research letter, the Division of Economic Risk Analysis white paper fails to make a sufficient case for growing concerns about funds' liquidity risk management practices along the lines described by the SEC or in such a magnitude to justify the prescriptive rulemaking set forth in the Commission's proposal. The letter also demonstrates how the proposed six-bucket liquidity classification scheme would falsely depict the liquidity of several types of funds, including "plain-vanilla" S&P 500 index equity funds. The scheme would make larger funds appear to be less liquid, even though the DERA analysis finds that larger funds have less variable flows and fewer liquidity challenges. See the ICI research letter for more detail.

IDC Supports Establishing Liquidity Management Program and Echoes Call for Modifications to SEC Proposal

The Independent Directors Council also supports the SEC's proposal that funds adopt a formal liquidity management program, overseen by the fund board. IDC's letter also echoes ICI's call for alternative approaches to certain elements of the initial rulemaking proposal and suggests more flexible requirements for these programs, rather than the prescriptive requirements contained in the SEC's proposal. For more detail on IDC's response to the SEC proposal, read IDC's press release.

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