IDC Independent Directors Council
Promoting Excellence in Fund Governance

ICI VIEWPOINTS

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Liquidity Risk Management Must Be Done Right

By Paul Schott Stevens

The following ICI Viewpoints *is a lightly edited version of a letter that ICI President and CEO Paul Schott Stevens sent to U.S. Securities and Exchange Commission (SEC) Chair Mary Jo White, as part of the Institute's overall response to the SEC's liquidity risk management proposal.*

On January 13, the Investment Company Institute and the Independent Directors Council (IDC) responded to the SEC's proposal to promote effective liquidity risk management throughout the open-end fund industry.

The Institute welcomes and strongly supports the Commission's interest in strengthening liquidity risk management by long-term mutual funds and exchange traded funds (ETFs). As the SEC notes, daily redeemability is a defining feature of open-end funds and a core element of funds' value proposition for investors. Liquidity risk management, thus, is critical to the functioning of an open-end fund, and an important issue for the SEC's attention.

Any consideration of this issue and of what regulatory actions may be appropriate must begin, as the Commission acknowledges, from the following recognition: over 75 years, funds have amassed a remarkably consistent and successful record of honoring redemptions and minimizing the impact of those redemptions on remaining shareholders. Meeting daily redemptions is, in fact, an area where the fund industry's practices far exceed statutory and regulatory requirements. This record stands as compelling evidence of the attention, effectiveness, and skill with which funds have managed liquidity risks to meet shareholder interests. Notably, fund managers have met these challenges with diverse and flexible practices that have taken into account specific characteristics of each fund—including, among other factors, each fund's portfolio holdings; its investment objectives, policies, and strategies;

its shareholder base; and current and anticipated market conditions. There is not, nor can there be, a "one-size-fits-all" approach to liquidity management for the wide range of funds offered to investors.

ICI Welcomes and Supports a Risk-Targeted Program Rule

In our response to the release, we welcome and support the SEC's proposal to build upon the industry's historic success with a regulatory requirement that funds adopt formal liquidity risk management programs. Though funds have long experience with the implementation of sound liquidity management practices, such a requirement would promote discipline, rigor, and formalized processes throughout the industry around fund liquidity management.

Under such a rule, a fund would establish risk-targeted policies and procedures appropriate for its particular liquidity risk profile. A fund manager's liquidity risk management program would include critical elements such as assessing, classifying, and monitoring the liquidity of portfolio assets. The program would be subject to rigorous management by the fund manager, and to continuing oversight by the fund's independent directors.

The Commission has had experience with this very type of risk-targeted rule—the fund compliance program rule, Rule 38a-1 under the Investment Company Act of 1940. This rule successfully enhanced a critical aspect of fund operations: compliance with the federal securities laws. In adopting the rule, the SEC made a conscious choice to provide "fund complexes with flexibility so that each complex may apply the rule in a manner best suited to its organization." We strongly urge the Commission to make that same choice for its liquidity management program rule.

The SEC also can look to other jurisdictions for support for a principles-based program rule. The European equivalent of a mutual fund—an undertaking for collective investment in transferable securities, or UCITS—must have a liquidity risk management program. In the European Union, the UCITS manager exercises a degree of latitude in managing liquidity risks. The International Organization of Securities Commissions also has identified principles against which industry and regulators should assess liquidity risk management practices and rules while eschewing prescriptive standards.

ICI Opposes Specific and Prescriptive Elements of the Proposal

Though we strongly support a principles-based, risk-targeted program requirement for liquidity risk management, the Institute opposes the release's very specific and prescriptive elements: the asset classification scheme and the "three-day liquid asset minimum." Those elements simply do not comport with sound risk management practices. If adopted, these elements could:

- Direct funds toward a one-size-fits-all approach to liquidity management with an unproven methodology that, as best we can determine, no fund uses today;
- Distort portfolio management, hamper returns, and inflate tracking error by requiring funds to maintain a cash cushion that in many cases would be larger than a fund would otherwise hold, and by limiting funds' ability to adjust to new investment opportunities;

- Encourage fund managers to rely upon third-party vendors to handle the gargantuan, ongoing task of assigning liquidity classifications to many thousands of individual securities, thus giving rise to "liquidity rating agencies," much as previous SEC regulations helped advance credit rating agencies;
- Introduce new risks to fund shareholders and the financial system by increasing the correlation of fund portfolios and trading—inducing the sort of "herding" behavior that has never before characterized the fund market; and
- Misrepresent the liquidity of funds, mechanically making large funds appear to be less liquid regardless of the assets they hold or the redemption demands they are likely to face.

These baleful effects could be exacerbated if the final rule requires, as proposed, that funds disclose to the public their liquidity classifications. Under such a regime, rather than appear to be outliers, fund managers would likely focus on accumulating "more liquid" assets (as determined by the dominant liquidity rating agencies), further increasing portfolio correlation and increasing the chances of "cliff events" caused by changes in liquidity ratings—similar to the events triggered by credit rating adjustments during the financial crisis.

Independent directors would have significant responsibilities under the proposed rules. Therefore, IDC urges the SEC to pursue regulations in this area with extreme caution. Like ICI, IDC advocates a more flexible, principles-based approach and strongly opposes the prescriptive elements of the proposal, which would be challenging for boards to oversee.

There Is No Justification for Such Detailed Regulatory Intervention

Notably, ICI's letter responding to the Division of Economic and Risk Analysis (DERA) study issued with the release finds that neither the release nor the DERA study establishes a reasonable basis for the proposed level and type of regulatory intervention. The DERA study does not provide evidence that funds have had difficulty meeting redemptions, or that funds' management of redemptions has harmed non-redeeming shareholders. In addition, the DERA study does not analyze the six-bucket liquidity classification scheme; it ventures close to such an analysis only in the case of equity funds. DERA's omission of any such classification scheme for fixed-income funds implies—and we certainly would agree—that such a scheme is impracticable and would produce inaccurate results.

The highly prescriptive liquidity classification scheme and three-day liquid asset requirement bear a striking resemblance to the asset-limiting or capital-classification schemes that banking regulators historically have imposed. In numerous cases—the U.S. savings and loan industry in the 1980s, for example, or the Basel I and Basel II capital standards—the conformity and correlation induced by those standards have undermined the resilience of banking institutions, to disastrous effect.

These prescriptive elements depart sharply from principles of sound capital market regulation because the release's definition of liquidity hinges crucially on a fund's ability to sell a security without materially moving the price of the security or the net asset value (NAV) of the fund. Numerous factors influence the purchases and sales of securities, including at the margin redemptions of fund shares that occasion the liquidation of portfolio assets. Together these factors influence the prevailing prices for securities.

This dynamic is part of the risk that investors accept when they invest in the capital markets, whether through direct holdings of securities or through funds. In our view, it would be very ill-advised for the SEC to seek to dampen or cushion this mechanism. Shareholders of long-term funds have never been guaranteed a protected NAV, and the SEC should reject any proposal that creates the impression that such a guarantee is likely.

ICI Offers Alternatives to Achieve the SEC's Goals

In place of these aspects of the proposal, we recommend alternatives for the Commission's consideration, designed to achieve the primary goals of the rulemaking. Instead of the six-category asset classification scheme, we recommend that the SEC require each fund to formulate policies and procedures to determine how best to assess, classify, and monitor the liquidity of portfolio assets. By way of illustration, we offer other types of classification schemes that funds actually employ.

Similarly, in place of the three-day liquid asset minimum, we recommend that the SEC require each fund to formulate policies and procedures to determine how best to reasonably ensure that the fund has sufficient liquidity to meet redemptions under normal and reasonably foreseeable stressed conditions. These policies would be part of the fund's board-approved program.

Swing Pricing Would Require Significant Reengineering of Fund Operations

Our letters further address the release's proposal that the SEC would allow, but not require, a long-term mutual fund to engage in swing pricing—adjusting the fund's NAVs on days when net purchases into or net redemptions from the fund exceed a specified threshold. ICI's members hold a range of views on swing pricing. Notably, however, all the members with which we have consulted recognize the significant differences in fund industry operational practices between Europe, where swing pricing is used, and the United States, and the substantial operational barriers that those practices pose to swing pricing in the United States. If these barriers are not addressed, through widespread changes in market practices or by regulatory mandates—and with significant reengineering of U.S. operations—funds will not adopt swing pricing, even if the SEC authorizes it.

A Clear Path Forward

In sum, there is a very clear path for the SEC to advance a final package of reforms that would enhance effective liquidity risk management practices—by building on the release's risk-based approach and existing sound liquidity management practices, adopting reasonable alternatives to the proposed liquidity classification scheme and three-day liquidity minimum, and avoiding public disclosure of liquidity classifications. ICI and IDC stand ready to assist in these efforts.

Paul Schott Stevens was President and CEO of ICI.
