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The SEC's Liquidity Proposal: Good Goals, Unintended Consequences

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On January 13, I filed a letter with the U.S. Securities and Exchange Commission (SEC), in response to the SEC's liquidity risk management proposal and to *Liquidity and Flows of U.S. Mutual Funds*, a study by the SEC's Division of Economic and Risk Analysis (DERA). My letter was one of four components of ICI's multipart response to the SEC proposal.

The SEC's liquidity proposal is intended to improve funds' ability to meet redemption requests and reduce any potential adverse effects on remaining shareholders. In our analysis, however, we demonstrate that the prescriptive elements of the Commission's liquidity proposal could have unintended consequences—actually lowering market liquidity, increasing systemic risk, and thus exacerbating the very issues it was created to address. These risks arise from the proposal's three-day liquid asset minimum requirement and six-bucket scheme. Let's examine a few of these risks.

Proposal to Increase Liquidity Could Reduce It

We are concerned that the three-day liquid asset minimum, as proposed, may risk setting up exactly the kind of scenario that the rule proposal seeks to avoid—forcing funds to sell securities at distressed prices. That could allow other market participants to take advantage of mutual funds and their investors, and could introduce tracking errors and portfolio management techniques that would harm investors' returns.

The rule proposal defines the three-day liquid asset minimum as the minimum percentage of the fund's net assets to be invested in "any cash held by a fund and any position of a fund in an asset (or portion of the fund's position in an asset) that the fund believes is convertible into cash within three business days at a price that does not materially affect the value of that asset immediately prior to sale." If a fund's three-day liquid assets fall below that minimum percentage, the fund cannot purchase other, less liquid assets until the minimum is restored.

Suppose that during a market downturn a particular fund's liquid assets begin falling toward the established minimum. In order to continue to appear "liquid" to both the public and regulators, the fund may first sell securities that according to some process are evaluated to be "less liquid." If the fund must sell those securities at distressed prices, it may simply lock in capital losses for existing shareholders. In addition, by selling less liquid securities, the fund may perhaps undermine, rather than bolster, liquidity in the markets where it is transacting.

These kinds of effects could be exacerbated by the actions of other market participants. Events in the past few years have made clear that institutional investors seek to anticipate, and act in advance of, portfolio sales by mutual funds, such as by taking short positions in securities that a mutual fund holds. Requiring funds to adhere to a three-day liquid asset minimum may create an incentive for institutional investors to front-run mutual funds that face the prospect of having to sell securities assessed as less liquid.

The three-day minimum requirement also will subject funds' judgments about which assets are "most liquid" to second-guessing by regulators, analysts, and investors. To avoid this, funds may feel compelled to limit or restrict assets held in the three-day liquid minimum category to cash and cash equivalents. This could leave in limbo securities (or at least large portions of securities) that are typically judged to be highly liquid, such as common stocks, S&P 500 futures, and perhaps even long-term Treasury and agency securities.

The net effect could be that funds end up holding higher levels of cash and cash-equivalent securities than they otherwise would desire—encroaching on the ability of some fund advisers to achieve the objectives set forth in the funds' prospectuses. For some funds, the three-day liquid asset requirement could have the effect of imposing tracking error (for index funds) or limiting the ability to meet stated objectives (for target-date and target-risk funds).

Significantly, neither the SEC's rule proposal nor the DERA study examines these issues.

Proposal to Reduce Risks Could Increase Them

The SEC also proposes 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. Though ICI understands the SEC's desire for comparable classification schemes and reporting across funds, there is a very real possibility that the proposed six-bucket classification scheme could lead funds to undertake more correlated or "crowded" trades, thus increasing risks.

Let's look at the fixed income market, where many individual bonds do not trade frequently. For example, one-sixth (17.5 percent) of corporate bonds didn't trade even once in half of the months examined in one academic study; another 10 percent traded fewer than three times per month. More than half (51.6 percent) of such bonds traded ten times or fewer per month.

With such a lack of active trades, it would be difficult to create "liquidity scores" for individual bonds (or for over-the-counter instruments in general). The DERA study itself acknowledges this. Consequently, if funds are required to report security-by-security measures of liquidity, they probably would be forced to turn to model-based estimates for many securities (especially fixed-income securities). Because of practical considerations, funds likely would accomplish this operationally by turning to model-based liquidity estimates or "liquidity ratings" obtained from third-party vendors—much as was the case across the financial markets with credit risk and credit rating agencies. Indeed, in light of the SEC's rule proposal, third-party vendors already are ramping up such services. This could have a number of unintended and unfavorable consequences.

One is that funds' portfolios may become more correlated. Currently, funds—even funds within a given investment objective—hold diverse portfolios. For example, the number of individual bonds that high-yield bond funds hold varies widely and, generally speaking, larger funds hold a wider variety of individual bonds. Thus, as funds grow, they spread risks across a wider set of holdings.

This kind of diversification could decline under the new regime. To appear "more liquid" both to the public and regulators, funds may seek to avoid securities scored as "less liquid" by third-party vendors in favor of those deemed "more liquid." If so, funds' portfolios—especially portfolios of bond funds—likely would become more homogenous, creating more correlated risks in funds' portfolios. For example, high-yield bond funds seeking to report greater "liquidity" might shorten their portfolio durations or hold fewer individual bonds—or, in other words, more concentrated portfolios.

Greater portfolio homogeneity also might raise the probability of "cliff events" in liquidity during stress periods, similar to those arising from credit agencies' downgrading of firms during the financial crisis. If third-party vendors were to "downgrade" the liquidity of a security or group of securities, bond funds seeking to prevent deterioration in their reported liquidity might rush to sell the downgraded securities, putting even greater downward pressure on securities prices and potentially exacerbating illiquidity in particular market segments.

The six-bucket approach proposed by the SEC could also create an artificial sense of precision about fund liquidity and lead to a number of anomalous results. We'll examine these in a subsequent blog post.

For more information about ICI's response to the SEC proposal, read the Institute's news release, which contains links to all four letters to the Commission.

Brian Reid was Chief Economist of the Investment Company Institute.