

# REGULATORY MONITOR

## SEC Update

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### Potential Unintended Consequences of the SEC's Liquidity Risk Rule Proposal

In September 2015, the Securities and Exchange Commission (SEC) proposed new Rule 22e-4 (the Liquidity Rule) and certain amendments to other rules and forms under the Investment Company Act of 1940 (1940 Act) to promote effective liquidity risk management by open-end funds, enhance disclosure regarding liquidity practices, and address the effects of fund investment activities on investors and the financial markets.<sup>1</sup> Should the SEC adopt the Liquidity Rule as proposed, there are a number of potential unintended consequences that may ensue, due particularly to the liquidity classification buckets and proposed evaluation standards. This article highlights a few of these potential unintended consequences.

#### Reliance on Third Parties to Make Liquidity Classifications

As part of adopting a liquidity risk management program, the Liquidity Rule would require funds to classify each portfolio asset (or portions of a position in a portfolio asset) into one of six liquidity risk buckets based on the number of days, using information obtained after “reasonable inquiry,” that the fund’s position in the asset (or portion thereof) would be convertible to cash at a price that does not materially affect the value of that asset immediately prior to sale.<sup>2</sup> The Liquidity Rule does not identify any required method for meeting the “reasonable inquiry” standard. Thus, funds could be exposed to regulatory risk in classifying the liquidity of their holdings into the rigid set of buckets mandated by the rule.

If the “reasonable inquiry” standard is interpreted by funds to require them to obtain supporting data from a third party, broker-dealers would be logical market participants to engage, given that they provide liquidity to funds and have firsthand access to changes in the liquidity profile of both particular securities and the markets in general. However, the SEC, in one enforcement proceeding related to the valuation of fund holdings, took the view that inquiring about various pricing data from broker-dealers “could not have sufficed as the primary valuation method, given the open-end [f]und series’ obligation to daily price the securities and the closed-end [f]unds daily publication of their NAVs.”<sup>3</sup> Given this, funds may be hesitant to rely solely on broker-dealers for liquidity classifications to meet the “reasonable inquiry” standard. As a result, funds will need to find additional or alternative sources of liquidity information.

Commentators on the Liquidity Rule have said that the rule will likely give rise to reliance on service providers to provide liquidity classifications on which funds would rely to satisfy the rule.<sup>4</sup> There are clear indications that this is already happening even in advance of the adoption of the rule, as funds and their advisers enhance liquidity procedures in light of changes in market dynamics. The hiring of third-party service providers will, of course, be an additional expense of funds, which will have a greater impact on the expense ratios of smaller fund complexes. More importantly, if a significant number of funds utilize these new services to satisfy the “reasonable inquiry” standard, the liquidity classification of fund securities may ultimately be determined by a small number of third parties, since providing the service will likely require a great deal of scale. In

addition, if there is a concentration of this service in a limited number of third-party liquidity evaluators, it may potentially give rise, in effect, to businesses operating akin to “liquidity rating agencies,” with the same concentration and reliance issues that were presented by the credit rating agencies.<sup>5</sup>

### Excessive Selling in Times of Market Stress Further Aggravating Liquidity

If many funds rely on a limited number of third-party service providers to classify the liquidity of portfolio assets, those determinations may tend to become more homogenized across the fund industry. If these service providers, in the functional role of liquidity rating agencies, “downgrade” the liquidity classification of a particular asset, it could trigger “cliff events” in which multiple funds seeking to maintain a similar liquidity risk profile are forced to sell at the same time. In addition, funds that do not rely on the predominant service provider’s liquidity classifications may conform to that provider’s view (so as not to appear as an outlier) and migrate toward assets that fit into one of the more liquid classification buckets. This could over time result in funds across the industry having portfolio holdings that are more similar than they are today. In times of market stress, funds may be simultaneously forced to liquidate similar assets, resulting in selling in a cascading manner, further aggravating liquidity for shareholders, even if the fund would not have sold securities absent the liquidity buckets.

### Selling in Times of Temporary Distress

Hedge funds can provide valuable liquidity to many parts of the US securities markets. This liquidity can benefit US mutual funds in times of redemptions. However, if open-end funds are forced to sell certain securities to comply with their three-day liquid asset minimums or as a result of reclassification of portfolio assets, hedge funds may be the unintended beneficiaries. Hedge funds would not be subject to the Liquidity Rule and could purchase these forced-sale assets at artificially

weak prices, particularly during times of market turmoil, only to have the price of the asset increase once the market had stabilized. Indeed, hedge funds will likely have access to purchasing the same third-party liquidity information and the liquidity classification data for each portfolio asset (or portion thereof) that would be publicly available on proposed Form N-PORT (on a quarterly basis) to market participants. Hedge funds may also benefit by shorting these same assets.<sup>6</sup>

### Overreliance on Subjective Data Reporting

Regardless of whether fund personnel or a third-party service provider makes the liquidity classifications for a fund, the process itself is a highly subjective exercise for many types of assets and even the best intentioned managers or third parties using the most sophisticated models may inaccurately predict the number of days it would take to liquidate a position given the fluidity and dynamic nature of market liquidity. Making these predictions on the liquidity of portfolio assets, broken out in six different buckets, publicly available on Form N-PORT, will create a false sense of precision that does not achieve the regulatory goals.

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#### NOTES

- <sup>1</sup> See *Open-End Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release*, 1940 Act Release No. 31835 (Sept. 22, 2015).

- <sup>2</sup> *Proposed Rule 22e-4(b)(2)(i)*. The liquidity classification buckets are: 1 business day; 2-3 business days; 4-7 calendar days; 8-15 calendar days; 16-30 calendar days; and more than 30 calendar days. *Proposed Rule 22e-4(b)(2)(i)(A)-(F)*.
- <sup>3</sup> *J. Kenneth Alderman, CPA, et al.*, 1940 Act Release No. 30557 (June 13, 2013).
- <sup>4</sup> See, e.g., Comment Letter from Brian K. Reid, Chief Economist, Investment Company Institute, to Brent J. Fields, SEC, dated January 13, 2016, at Section IV.
- <sup>5</sup> See *Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule*, 1940 Act Release No. 31828 (Sept. 16, 2015); *Removal of Certain References to Credit Ratings Under the Investment Company Act*, 1940 Act Release No. 30847 (Feb. 7, 2014).
- <sup>6</sup> See, e.g., Matt Wirz, Gregory Zuckerman and Daisy Maxey, “Junk Fund’s Demise Fuels Concern Over Bond Rout” (Dec. 10, 2015), WALL ST. J., available at <http://www.wsj.com/articles/as-high-yield-debt-reels-mutual-fund-blocks-holders-from-redeeming-1449767526> (“As the Third Avenue fund’s holdings began to decline, rival traders at hedge funds shorted, or bet against, some of the mutual fund’s holdings, wagering that Third Avenue would experience investor withdrawals and be forced to sell some of its holdings, according to the company and one trader who made this move.”).