

IDC Urges SEC to Pursue a More Flexible Liquidity Risk Management Rule for Funds

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Washington, DC, January 13, 2015—The Independent Directors Council (IDC) supports the essential goal of the rule proposal by the Securities and Exchange Commission (SEC) to promote effective liquidity risk management across the open-end fund industry, IDC said in a [comment letter](#) to the agency today. Liquidity risk management is critical to a fund’s ability to ensure daily redeemability, the IDC letter observed. IDC supports requiring funds to have a formalized program to manage their liquidity risks and suggests an alternative, more flexible approach to the overly prescriptive approach proposed by the SEC.

“We believe that a flexible rule requiring funds to adopt and implement a liquidity risk management program would enhance liquidity risk management across the fund industry,” said IDC Managing Director Amy Lancellotta. “Regrettably, aspects of the SEC’s initial proposal are highly prescriptive and excessively rigid. IDC recommends a flexible approach that would avoid negative unintended consequences of the SEC proposal—such as diminished returns for shareholders and less diversity in investment choices. In addition, while we commend the SEC for recognizing the important oversight role of fund boards, we have requested the SEC to make it clear that a board’s responsibilities for the liquidity risk management program are limited to oversight.”

SEC Should Clarify the Fund Board’s Oversight Role

The IDC letter expressed appreciation that the SEC proposal recognizes the critically important oversight role of a fund board for the fund’s liquidity risk management program. IDC said it is pleased that the proposal “generally relies on fund directors as overseers and not micro-managers.”

More broadly, the letter disagreed with the proposal’s suggestion that liquidity risk management presents the type of potential conflict of interest between a fund adviser and the fund that would typically require heightened scrutiny by a fund board. In this regard, IDC asked for statements in any adopting release making it clear that:

- the fund board is not responsible for determining the liquidity of any security, and that its role is to provide oversight of a liquidity risk management program; and
- the board’s oversight responsibility with regard to the liquidity risk management program is the same as in other areas of portfolio management and fund operations, and that the SEC would thus evaluate any action a board takes in overseeing the program based upon a reasonable business judgment standard.

Underlying Requirements of Program Present Operational and Oversight Challenges

Two components of the SEC’s proposed liquidity risk management program, however, would impose unwarranted burdens on funds and would be difficult for boards to meaningfully oversee, the letter said, citing:

- the six-category classification scheme, an overly granular method that is not proven or widely used, and would require extremely difficult determinations about the potential market impact of the disposition of a portfolio asset; and
- the three-day liquid assets minimum requirement, which relies on the same classification structure as the six-category scheme, and thus would be subject to the same problems and would unnecessarily restrict portfolio management, to the detriment of fund shareholders.

Proposed Reporting, Disclosure of Liquidity Information Is Misguided

IDC opposed the SEC’s proposed requirement that funds report to the SEC on Form N-PORT detailed liquidity information based on the six-category classification scheme. Similarly, IDC strongly objected to making any reported liquidity classification information publicly available. The letter made the following points:

- The six-category classifications data would not be particularly useful for the SEC or investors. In particular, the subjective nature of the judgments regarding the liquidity classifications, as well as funds' use of different methodologies for assessing liquidity, would not produce reliable industry-wide data or make the reports suitable for comparisons between or among different funds.
- Public disclosure of detailed liquidity information based on the six-category classification scheme could lead to second-guessing of views regarding an asset position's liquidity. Such disclosure could adversely influence portfolio management decisions, such as by leading funds to take unduly conservative approaches to liquidity, which could result in greater homogenization in the industry and diminished returns for investors.
- Finally, investors are well served by the ample information they already receive about funds' liquidity risks and redemption policies. In addition, IDC noted that proposed Form N-PORT's portfolio holdings data will provide the SEC and investors with robust information about funds. IDC is also proposing that funds provide a narrative description of their liquidity risk management program in the registration statement.

IDC Recommends an Alternative, Flexible Approach

IDC recommended an alternative, flexible approach that would require a fund's liquidity risk management program to include the following elements.

- Policies and Procedures. Funds would be required to adopt and implement written policies and procedures that would enable funds to:
 - Assess and periodically review the fund's liquidity risk. Instead of requiring funds to classify portfolio assets according to the proposed six-category scheme, IDC suggests that funds classify the liquidity of their portfolios as follows:
 - Most Liquid Assets: any cash held by a fund, and any position in an asset that the fund believes is convertible into cash within three business days, within the context of normal trading.
 - Illiquid Assets: assets that are considered "15% standard assets," as defined in the proposal.
 - Intermediate Liquidity Assets: assets that are not Most Liquid Assets or Illiquid Assets.
 - Manage the fund's liquidity risk. A fund's policies and procedures would be required to include processes for reasonably ensuring that the fund has sufficient liquidity to meet redemptions under normal and reasonably foreseeable stressed conditions, consistent with its investment objective. Those procedures might include establishing targets or ranges for "highly liquid assets" (to be defined by the fund), but a fund would not be required to maintain a three-day liquid asset minimum.
 - Stress test. A fund's policies and procedures would require periodic stress testing, at such intervals as the board determines appropriate, of the fund's ability to meet redemptions during reasonably foreseeable stressed conditions.
- Liquidity Program Administrator. The fund's investment adviser or an officer or officers of the fund would be designated as the fund's "Liquidity Program Administrator." However, unlike in the proposal, the board would not be responsible for approving the designation.
- Board approval and oversight. The board would be responsible for initially approving the program as well as material changes to it, and would receive a written report, at least annually, from the Liquidity Program Administrator that describes the adequacy of the fund's liquidity risk management program and the effectiveness of its implementation.
- Disclosure. Funds would report to the SEC on Form N-PORT the percentages of the fund's portfolio that fall into each of the three liquidity categories described above. This information, however, would not be made publicly available. A fund would provide in its registration statement a narrative description of the fund's liquidity risk management program.

Swing Pricing Proposal Requires Further Study

The letter also observed that the SEC's swing pricing proposal—which would permit funds to allow investors to buy or sell mutual fund shares at an adjusted net asset value (NAV) under specified circumstances—would introduce a significant shift in the way mutual funds are priced and sold. For 75 years, IDC noted, the daily NAV has been "sacrosanct." IDC cited operational concerns with swing pricing, such as the limited availability of intra-day fund order flow information needed to implement swing pricing (in contrast to the operating model in Europe, where swing pricing is used successfully). Further study should be given to making swing pricing available in the United States, IDC advised.

The Investment Company Institute has submitted [comment letters](#) about the SEC proposal and the accompanying white paper by the agency's Department of Economic and Risk Analysis. ICI's comments are similar to those submitted by IDC, supporting the adoption of a more flexible rule to require funds to have a formalized liquidity risk management program.

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