SEC Open End Mutual Fund Liquidity Risk Management Program and Loans

What does the SEC Proposed Rule on Open End Fund Liquidity Risk Management Program attempt to do? The SEC has been concerned that open end mutual funds promise investor redemptions in three days, while the funds may invest in assets that may not be able to be sold (at least not at the quoted price) in the same time period. Simply put, the SEC rule looks to ensure that open end funds will always be able to meet redemptions.

What asset classes does the SEC proposal apply to? The SEC proposed rule applies to open end funds *for every asset class* – from large cap equities, to corporate bonds, to high yield bonds, to loans, to munis and more – as long as these assets are held in open end funds. According to an SEC White Paper, in 2014, excluding money market funds and ETFs, there were approximately $12.7 trillion in assets held by U.S. Mutual Funds[1]. To be clear, this is not a rule about loans.

What are "illiquid" assets? The rule codifies the prohibition against funds owning more than 15% in "illiquid" assets. Illiquid assets are those that ***cannot be sold in seven days*** at approximately their current value. The rule ***does not*** require the assets to be converted to cash in seven days. Importantly, the illiquid category includes assets such as private equity securities, restricted IPO securities and real estate investments, but ***not*** loans.

What is the SEC proposing that an open end fund manager must do? The proposal is principles-based – each fund needs to figure out how to meet redemptions themselves – but the proposal also lays out a number of specific steps.

- First, the manager must determine the liquidity of its assets, based on the number of days it would take for a fund's position to be converted to cash at a price that does not materially affect the value of that asset. The "convertible to cash" time frame includes both the asset sale and settlement. There are six "convertible to cash" day-count buckets (1 day, 2-3 days, 4-7 days, 8-15 days, 16-30 days and over 30 days).
- Second, once the fund has determined the liquidity of its assets, it needs to develop a plan to manage liquidity and redemption risk. To do so, the fund must consider the following factors: i) cash flow projections of the fund; ii) the fund's investment strategy and the liquidity of assets; iii) use of borrowings and derivatives for investment purposes; and iv) other sources of liquidity, such as cash and equivalents, and borrowing lines or other funding arrangements.
- Third, once a fund has determined its liquidity and redemption risk, it needs to develop a board-approved plan to address it. In effect, based on all the tests above, the fund must ensure that it can meet investor redemptions in a stressed environment.

[1] SEC White Paper; Liquidity and Flows of U.S. Mutual Funds; September 2015

How does the proposal apply to loans?

- First, the Open End Fund Liquidity Risk Management Program is much broader than just loans. It applies to $12.7 trillion of assets in open end funds. In contrast, according to Thomson Reuters LPC, there are $109 billion in open end loan mutual funds and loan ETFs[2], as compared to $866 billion of loans outstanding in the S&P/LSTA Leveraged Loan Index.
- Second, loans are not captured in the "illiquid asset" category, because they can be sold within seven days.
- Third, it is true that loans can take longer to settle than other asset classes. The relevant statistic is the median settlement time for buyside sales – in other words, how long it takes asset managers to settle the loans they sell. In third quarter 2015, this was 12 days. Realizing that loans can take longer to settle, loan mutual funds have developed procedures to ensure their ability to meet redemptions in other ways: They hold cash and securities that can be settled in three days; they also have lines of credit that they can draw upon if necessary to meet redemptions. Indeed, long before the SEC's proposal, loan mutual funds used cash, securities that settle in three days, and liquidity lines to ensure they could meet redemption requests. And the result has been clear: Despite significant market turmoil during the Financial Crisis in 2008, sharp loan mutual fund outflows in August and September 2011, and sustained outflows in 2014, no loan mutual fund has ever failed to meet a redemption request.

About LSTA

The Loan Syndications and Trading Association was founded in 1995 and is the trade association for the corporate loan market, dedicated to advancing the interests of the marketplace as a whole and promoting the highest degree of confidence for investors in corporate loans. The LSTA undertakes a wide variety of activities to foster the development of policies and market practices designed to promote a liquid and transparent marketplace and to encourage cooperation and coordination with firms facilitating transactions in loans and related claims. For more information, please visit http://www.lsta.org.

[2] Closed end and interval mutual funds account for another $18 billion of assets