



The Importance of Mutual Fund Liquidity Risk Management

Liquidity management is the cornerstone of open-end fund management, and the LSTA strongly believes that funds should have adequate policies and procedures to address meeting investor redemption requests. Consequently, we agree with many of the tenets in the SEC's proposed rule. We strongly support:

- Requiring open-end funds and ETFs to have formal liquidity risk management programs designed to address and manage liquidity risk, classify and monitor liquidity of investment portfolios, and maintain a minimum level of liquidity
- Reporting to the SEC and other regulators regarding portfolio liquidity
- The codification of the 15% illiquid asset test, as proposed

However, as with most regulations, a one-size-fits-all approach with specific and narrow requirements would be ineffective at accomplishing the goal of reducing investor risk. Prescriptive parameters would be unnecessarily expensive and possibly unworkable for many industry participants. Instead, we urge the SEC to adopt a top-down, principles-based approach to managing liquidity risk.

Specifically, we encourage the SEC to re-evaluate:

- the proposed liquidity classifications, which are not well-suited for a number of asset classes
- the three-day liquid asset minimum, which could lead to herding behavior and actually increase systemic risk
- the public disclosure of liquidity determinations, which could lead to investor confusion

Additionally, to date, the mutual fund industry has demonstrated success in satisfying investor redemption requests in normal and stressed environments. Based on these experiences, we believe the SEC should codify and build on best practices and avoid prescriptive standards.

Application to Open-End Loan Mutual Funds

Open-end loan mutual funds invest in syndicated loans and would be required to meet the liquidity, disclosure and reporting requirements of the SEC proposal. As proposed, syndicated loans would *not* be included in the 15% illiquid asset bucket, which applies to assets that cannot be sold within seven days.

While syndicated loans have settlement times that are typically longer than other asset classes, loan investors have developed techniques to effectively manage the liquidity of their portfolios. Additionally, loan market participants are focused on improving standardization, procedures and best practices to speed up settlement from the current median buy-side sale settlement time of 12 days.

Existing Safety Mechanisms

The industry is working to reduce settlement times. In fact, settlement times have decreased by two days since 2014. Additionally, managers have developed techniques to manage their portfolios in light of extended loan settlement periods. In particular, loan mutual fund managers:

- hold cash reserves
- invest in securities that settle in three days
- maintain a line of credit from banks to ensure access to liquidity

In an August 2015 survey, the LSTA collected information from open-end funds and ETFs with a total of \$72 billion in assets; this is over half the open-end loan fund and ETF universe. The median fund had 3.5% of assets in cash, another 6.1% in securities that settle in three days, and a material line of credit with a bank.

Past Performance

Thanks to robust liquidity management, loan mutual funds have weathered significant periods of stress and have always met investor redemptions. Importantly, loan mutual funds have met all requests through three significant periods of stress in the past ten years alone:

- July 2007-December 2008: During the financial crisis, loan mutual funds experienced more than \$15 billion of outflows – a very substantial proportion of their assets.
- August 2011: During a time of global turmoil, open-end loan mutual funds experienced \$7 billion of outflows – or 13% of their assets in just one month.
- 2014: As it became clear in early 2014 that interest rates would not rise in the near term, open-end loan mutual funds saw more than \$38 billion – or 20% of their assets – redeemed between April 2014 and January 2015.

In all of these cases, open-end mutual funds met redemptions.

Ensuring Future Performance

Open-end mutual fund managers typically stress test their portfolios to ensure that they can meet redemptions in volatile markets. Working with our members, the LSTA tested two types of funds (one with large cash and T+3 securities holdings, but a smaller line of credit and one with smaller cash and T+3 securities holdings, but a larger line of credit) in two scenarios (a short fast shock of a one-day 10% redemption and an extended period of record outflows). As discussed in

detail in the LSTA Comment Letter, in both cases, both funds showed the ability to meet investor redemptions. Through stress tests like these, as well as active management, open-end loan funds demonstrate the ability to meet redemptions in foreseeably stressed scenarios.

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>.