---

## SEC Approves Fund Liquidity Rules, Sparking Concern for Munis.

WASHINGTON – The Securities and Exchange Commission voted unanimously on Thursday to finalize new open-end fund liquidity requirements that market participants said would hurt the industry by damaging the funds' appetites for munis.

The rule requires funds to create liquidity risk management programs that are approved and monitored by their boards. It will apply to mutual funds and other open-end management investment companies, including exchange-traded funds, but will exclude money market funds. ETFs that honor redemptions using securities instead of cash are excluded from some of the new requirements.

The requirements respond to what the SEC sees as the recent growth of open-end funds investing in potentially less-liquid strategies and are meant to ensure that funds maintain enough liquidity that they are able to effectively deal with investor redemptions.

"It is imperative that open-end funds manage their liquidity carefully, both to ensure that redemptions can be fulfilled in a timely manner and to minimize the impact of redemptions on remaining investors and the broader marketplace," said SEC chair Mary Jo White.

Most funds will be required to comply with the liquidity risk management program requirements by Dec. 1, 2018, though funds with less than $1 billion in net assets will have until June 1, 2019. The finalized rule and amendments require funds' liquidity programs to be designed to assess liquidity based on the number of days in which the fund reasonably expects an investment could be converted to cash given current market conditions without significantly changing the market value of the investment, according to the rule.

The Government Finance Officers Association, which expressed concern about the SEC's original proposal for new requirements released in September 2015, is still worried about the finalized rule's requirement to categorize assets in a way that "overlooks some of the key features of muni securities," according to Emily Brock, director of GFOA's federal liaison center.

Munis made up about $688.9 billion of the assets mutual funds and ETFs held as of Sept. 30, according to Morningstar Inc. data.

"Trading volume is not in isolation a reliable indicator of future liquidity for municipal securities," Brock said. "Because highly rated municipal securities are considered core holdings of large institutional investors, they experience lower trading volumes during more stable financial periods than they do during periods of fiscal stress."

She also noted that during times of fiscal stress, munis are typically the first considered for sale because of their attractiveness to investors. Additionally, Brock said GFOA's concern is tied to the "critical" nature of infrastructure investment in the nation's economy.

"We expect as a result of this rule, funds will decrease their appetite for the securities of smaller, less frequent issuers," which constitute about three quarters of GFOA's membership, Brock said. "The potential loss of mutual funds as investors is alarming, given the level of investment from funds in short-and-long-term municipal bonds."

Matt Posner, a principal with the Court Street Group, said that mutual funds have played a key role in the current outperformance of munis compared with other fixed-income classes and that this rule, by making the funds' internal processes more expensive, will eventually make the cost of issuance more expensive and will hurt smaller issuers that are considered less liquid.

He added that the muni industry should have used the resources it dedicated to challenging a separate rule from banking regulators that did not classify munis as high quality liquid assets, to instead address this one, which has "a much more wide-ranging influence."

"There are lessons to be learned about how this rule got passed without much discussion," Posner said. He added that the lessons could be helpful as the Basel III fundamental review of the trading book requirements loom. The requirements are a part of revisions from bank supervisors that are designed to reform regulatory standards for banks in response to the financial crisis.

The SEC's finalized liquidity requirements build on its original proposal. Under the finalized rule, funds' programs would have to classify portfolio assets into four categories: highly liquid investments; moderately liquid investment; less liquid investments; and illiquid investments. It also generally allows funds to classify their investments by asset class instead of making them determine the time it would take to convert each investment into cash.

Funds covered under the rule also must determine a minimum percentage of their net assets that must be invested in highly liquid investments. Highly liquid investments, according to the SEC, are defined as those that are reasonably expected to be converted into cash within three business days without significantly changing their value. Funds also have to have policies and procedures for responding to a shortfall in their highly liquid holdings.

Another component of the new requirements would mandate that no more than 15% of a fund's investments are considered illiquid, defined as incapable of being sold within seven calendar days without significantly affecting the investment's market value. The rule lays out a series of steps and considerations if a fund exceeds the percentage.

The SEC additionally approved by a two-to-one vote a separate but related set of changes on Thursday that would allow open-end funds, excluding MMFs and ETFs, to use swing pricing. Swing pricing refers to a fund's adjusting of its net asset value per share to pass on to purchasing or redeeming shareholders certain costs associated with their activities.

The swing pricing amendments will become effective two years after they are published in the Federal Register.

The Securities Industry and Financial Markets Association's Asset Management Group said in a statement that it supports the SEC's "taking the initiative to enhance its ability to monitor and regulate asset management activities" with the new requirements.

"While we are still in the process of reviewing the final rules, it is clear that the commission maintained its commitment to the goals of the proposal, including strengthening the SEC's regulatory effectiveness and protecting investors, while showing thoughtful consideration of comments by SIFMA AMG and others," SIFMA AMG said.

Paul Schott Stevens, president and chief executive officer of Investment Company Institute, said ICI is still reviewing the final rules “will have a more comprehensive understanding of the rules’ impact once we have completed that work.”

“It is clear, however, that this is a tough set of new rules that will spur a number of operational changes across the registered fund industry,” Stevens said. “While some of these new rules will likely add complexity and cost, ICI commends chair White and the SEC for advancing this work, as the commission is the appropriate body to address areas of potential risk in activities and products related to asset management.”

**The Bond Buyer**

By Jack Casey

October 13, 2016