

X. *SEC Regulation of Mutual Funds' Illiquid Assets*

A. Introduction

Mutual funds are generally considered relatively safe investment vehicles, providing retail investors with diversified portfolios and the benefit of professional management.¹ Though subject to the strict provisions of the Investment Company Act of 1940 ("1940 Act"),² mutual funds are increasingly relying upon illiquid assets to generate greater returns in this low interest rate environment.³ The U.S. Securities & Exchange Commission ("SEC"), in an effort to ensure that mutual funds can meet shareholder redemption requests, has already amended Rule 2a-7 governing the portfolio composition of money market mutual funds.⁴ The agency has since turned its attention to alternative mutual funds, a relatively new type of vehicle created to give retail investors access to investment strategies more characteristic of hedge funds.⁵ In order to better understand these new funds, and to

¹ Sophia Bera, *Investing 101: What Is a Mutual Fund?*, DAILYFINANCE (Dec. 23, 2013, 11:50 AM), <http://www.dailyfinance.com/on/mutual-fund-basics/>, archived at <http://perma.cc/58AL-44M2>; *Invest Wisely: An Introduction to Mutual Funds*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/investor/pubs/inwsmf.htm> (last updated July 2, 2008) [hereinafter *Invest Wisely*], archived at <http://perma.cc/K8H2-6JZ9>.

² Investment Company Act of 1940, 15 U.S.C. § 80a-3 (2012) (defining "investment company" for purposes of the Act).

³ Nicholas B. Lewis, *Widening the Scope: The SEC Turns its Attention to Alternative Mutual Funds*, SUBJECT TO INQUIRY (July 25, 2014), <http://www.subjecttoinquiry.com/compliance/widening-the-scope-the-sec-turns-its-attention-to-alternative-mutual-funds/>, archived at <http://perma.cc/LRB4-KFWH>.

⁴ Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. 47,736, 47,958 (Aug. 14, 2014) (to be codified at 17 C.F.R. § 270.2a-7); Lisa Smith, *A Safer Money Market With Rule 2a-7*, INVESTOPEDIA, <http://www.investopedia.com/articles/mutualfund/10/a-safer-money-market-2a7.asp> (last visited Feb. 15, 2015), archived at <http://perma.cc/DWN4-SZCS>.

⁵ Mark Perlow & Matthew Rich, *Alternative Mutual Funds: Current Issues in Compliance and Risk Management*, PRAC. COMPLIANCE & RISK MGMT. FOR SEC. INDUSTRY, Sept.-Oct. 2014, at 31, 31, available at http://www.klgates.com/files/Publication/4e16fe5b-7b7a-41de-be2a-160b851e763e/Presentation/PublicationAttachment/842560a1-fcb0-4cd7-833a-23383696c54c/Alternative_Mutal_Funds.pdf, archived at <http://perma.cc/7EQ5-55QN>; Scott Weisman et al., *SEC Sweep: Liquid Alternative Funds*,

make sure they are in compliance with applicable rules and regulations, the SEC has launched an investigation of more than thirty-five alternative mutual funds.⁶ A significant component of this “sweep” is the funds’ use of illiquid assets and the procedures in place for managing associated risks.⁷ The examination comes at the same time the agency announced “three core initiatives” intended to improve the asset management industry as a whole.⁸ While it is unclear what the SEC plans to do with the information gathered in the sweep and how it will implement these new initiatives, it is apparent that the regulator is concerned with the increasing complexity of the mutual fund industry.

This Article discusses how reliance on illiquid securities can affect mutual funds’ ability to comply with regulatory requirements and the impact such a failure can have on retail investors. Part B provides an introduction to mutual funds. Part C sets forth the regulatory regime governing mutual funds’ use of illiquid assets and discusses why these regulations are needed. Part D examines money market mutual funds and a recent amendment to the rule governing their portfolio composition. Part E discusses alternative mutual funds, including the reasons for their increased popularity and why the SEC is undertaking an examination of their use. Finally, Part F highlights the SEC’s

PRICEWATERHOUSECOOPERS LLP 2 (June 2014), http://www.pwc.com/en_US/us/financial-services/regulatory-services/publications/assets/fs-reg-brief-sec-sweep-liquid-alternative-funds.pdf, archived at <http://perma.cc/99WY-FLCC>.

⁶ Norm Champ, Director, Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm’n, Remarks to the Practising Law Institute, Private Equity Forum (June 30, 2014), <http://www.sec.gov/News/Speech/Detail/Speech/1370542253660>, archived at <http://perma.cc/C6C8-L9BT>; Madison Marriage, *SEC Widens the Net of Mutual Hedge Fund Review*, FIN. TIMES, (Aug. 24, 2014, 7:16 AM), <http://www.ft.com/intl/cms/s/0/6eb13dc6-294f-11e4-8b81-00144feabdc0.html#axzz3P6o1W5qm>; Trefis Team, *How the SEC’s Examination of Alternative Funds Affects BlackRock*, FORBES (Aug. 28, 2014, 8:40 AM), <http://www.forbes.com/sites/greatspeculations/2014/08/28/how-the-secs-examination-of-alternative-funds-affects-blackrock/>, archived at <http://perma.cc/M9NG-UKTP>.

⁷ Champ, *supra* note 6.

⁸ Mary Jo White, Chair, U.S. Sec. & Exch. Comm’n, Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, Address at the New York Times DealBook Opportunities for Tomorrow Conference (Dec. 11, 2014), <http://www.sec.gov/News/Speech/Detail/Speech/1370543677722#.VL7hmS7F95w>, archived at <http://perma.cc/8RZF-P3QX>.

recently announced initiatives for improving the asset management industry and what they could mean for funds and their investors.

B. Mutual Funds

A mutual fund is an investment company that “pools money from many investors and invests . . . in stocks, bonds, short-term money-market instruments, other securities or assets, or some combination of these investments.”⁹ By joining forces, retail investors are able to create a diversified investment portfolio for much less than it would cost to do so on their own.¹⁰ Moreover, mutual funds are managed by professional “investment advisors,”¹¹ taking the onus off investors who often have little experience making purchasing decisions and maintaining a diversified portfolio.¹²

Unlike investments in other types of companies, “investors purchase [shares in a mutual fund] directly from the fund (or through a broker for the fund), instead of . . . on a secondary market”¹³ The price of each share is the fund’s net asset value (“NAV”),¹⁴ which the fund must calculate daily by dividing the excess of assets over liabilities by the total number of shares issued by the fund.¹⁵ Perhaps the most desirable attribute of mutual funds is the ability to redeem shares for NAV at any time, which enhances liquidity by extinguishing the need to find a suitable buyer in a secondary market.¹⁶ For these reasons, mutual funds have become one of the most popular types of investment vehicles, with nearly 10,000 funds managing “more than \$63 trillion of assets”¹⁷ According to recent statistics from 2013, “46 percent of all U.S. households . . . owned mutual funds.”¹⁸

⁹ *Invest Wisely*, *supra* note 1.

¹⁰ Bera, *supra* note 1; *Invest Wisely*, *supra* note 1.

¹¹ *Invest Wisely*, *supra* note 1.

¹² Bera, *supra* note 1.

¹³ *Invest Wisely*, *supra* note 1.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ White, *supra* note 8.

¹⁸ *Id.* (citing INV. CO. INST., 2014 INVESTMENT COMPANY FACT BOOK 56 (54th ed. 2014)).

C. Investment Company Act of 1940

As a type of investment company, mutual funds are regulated by the 1940 Act, and subject to the rules promulgated thereunder.¹⁹ Congress charged the SEC with administering the 1940 Act,²⁰ which is aimed primarily at protecting retail investors.²¹ The 1940 Act limits mutual funds' use of leverage—the ratio of debt to equity—and illiquid assets.²² Mutual funds must also comply with certain diversification and pricing requirements.²³ Each of these provisions helps to ensure that mutual funds are able to satisfy investors exercising their right to redemption.²⁴

Mutual funds must value all assets in their portfolio on a daily basis in order to calculate their NAVs.²⁵ While pricing exchange-traded securities is straightforward, determining the price of assets for which no market exists can be rather difficult.²⁶ Mutual funds must also be able to pay investors their proportionate share of NAV within seven days of the request for redemption.²⁷ In order to ensure that mutual funds can generate enough cash to meet redemption requests, the SEC prohibits funds from investing more than fifteen percent of their

¹⁹ Investment Company Act of 1940, 15 U.S.C. § 80a-3 (2012) (defining “investment company” for purposes of the Act); Lewis, *supra* note 3.

²⁰ *Investment Company Registration and Regulation Package*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/divisions/investment/invcoreg121504.htm> (last updated Feb. 19, 2013) [hereinafter SEC Regulation Package], archived at <http://perma.cc/EP5R-QFBQ>.

²¹ *SEC Focuses on Burgeoning Liquid Alternative Funds Market*, KATTEN MUCHIN ROSENMAN LLP 3 (July 14, 2014), http://www.kattenlaw.com/files/68557_SEC_Focuses_on_Burgeoning_Liquid_Alternative_Funds_Market.pdf, archived at <http://perma.cc/M8QV-9R5B>.

²² *Id.*

²³ *Alternative Funds Are Not Your Typical Mutual Funds*, FIN. INDUS. REGULATORY AUTH., INC., <http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/MutualFunds/P278033> (last updated June 6, 2013), archived at <http://perma.cc/C5GY-6264>.

²⁴ KATTEN MUCHIN ROSENMAN LLP, *supra* note 21.

²⁵ Chris Kentouris, *Alt Mutual Funds: Seeking Alpha Under SEC Scrutiny*, FINOPS REP. (July 30, 2014), <http://finops.co/compliance/alt-mutual-funds-seeking-alpha-under-sec-scrutiny/>, archived at <http://perma.cc/7YXJ-NJJD>.

²⁶ *Id.*

²⁷ 15 U.S.C. § 80a-22(e) (2012).

portfolio in illiquid assets.²⁸ Illiquid assets are those that “cannot be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund.”²⁹

Why does the 1940 Act, as administered by the SEC, so heavily regulate mutual funds when other investment vehicles, such as hedge funds, can make use of various exemptions?³⁰ Unlike mutual funds, hedge funds are only available to so-called “accredited investors,”³¹ generally institutions or individuals who exceed a certain threshold pertaining to income and net worth.³² The practice of limiting certain investments to wealthy individuals stems from a presumption that these investors “possess the requisite sophistication and resources to . . . evaluate the risks . . .”³³ and are better equipped to withstand severe losses.³⁴ Retail investors, those not satisfying the requirements to be deemed an “accredited investor,” are thought to be less capable of making informed investment decisions,³⁵ and thus are the focal point of the SEC’s investor protection regime.³⁶ With that in mind, the SEC must pay particular attention to mutual funds as these investment

²⁸ Revisions of Guidelines to Form N-1A, 57 Fed. Reg. 9828, 9829 (Mar. 20, 1992).

²⁹ Money Market Funds, 17 C.F.R. § 270.2a–7(a)(20) (2014).

³⁰ SEC Regulation Package, *supra* note 20.

³¹ Rob Copeland & Gregory Zuckerman, *Three Ways to Invest Like a Hedge Fund*, WALL ST. J., Aug. 3, 2014, at R1.

³² 17 C.F.R. § 230.501(a) (defining accredited investors as including “[a]ny natural person whose individual net worth, or joint net worth with that person’s spouse, exceeds \$1,000,000 [and] [a]ny natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.”)

³³ So-Yeon Lee, Note, *Why the “Accredited Investor” Standard Fails the Average Investor*, 31 REV. BANKING & FIN. L. 987, 990 (2012).

³⁴ *SEC Mulls Changes to Accredited Investor Designation*, MITCHELL & ASSOCIATES (Jan. 7, 2015), <http://www.mitchell-attorneys.com/blog/2015/01/sec-mulls-changes-to-accredited-investor-designation/>, archived at <http://perma.cc/K2A3-YWM4>.

³⁵ Barbara Black, *How to Improve Retail Investor Protection after the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 13 U. Pa. J. Bus. L. 59, 60 n.2 (2010).

³⁶ Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 Va. L. Rev. 1025, 1025 (2009).

vehicles account for a significant percentage of retail investment.³⁷ Moreover, most retail investors rely on mutual funds to help save for “retirement and education.”³⁸ Because investors rely heavily on these assets, the SEC has a strong interest in ensuring that mutual funds appropriately disclose risks and maintain enough liquidity to satisfy redemptions in a timely manner.³⁹

D. Money Market Mutual Funds

A money market mutual fund (“MMMF”) is a special type of mutual fund that provides less risk by investing only in “high-quality, short-term [debt] instruments.”⁴⁰ Typical investments include “government securities, certificates of deposit, commercial paper . . . or other highly liquid and low-risk securities.”⁴¹ A MMMF seeks to maintain a NAV of one dollar for each share of the fund,⁴² meaning that the return on investment generally comes in the form of dividends approximating interest rate returns on short-term loans.⁴³

Given the quality and term of their investments, MMMFs are generally thought to be one of the least risky investment vehicles available to retail investors.⁴⁴ The Reserve Primary Fund, one of the most storied MMMFs, challenged this notion by “[breaking] the buck” in September 2008 when its NAV dropped to “97 cents per share.”⁴⁵ This event, along with more general concerns regarding the safety and soundness of the financial services industry, led the SEC to amend Rule

³⁷ Mary Jo White, Chair, U.S. Sec. & Exch. Comm’n, Protecting the Retail Investor, Address at the Consumer Federation of America Consumer Assembly (Mar. 21, 2014).

³⁸ *Id.*

³⁹ See Langevoort, *supra* note 36, at 1026.

⁴⁰ *Invest Wisely*, *supra* note 1.

⁴¹ *Money Market Funds*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/answers/mfmmkt.htm> (last updated Jan. 16, 2013), *archived at* <http://perma.cc/6T25-F86N>.

⁴² *Id.*

⁴³ See *Invest Wisely*, *supra* note 1.

⁴⁴ Mark Koba, *Should You Worry About Your Money Market Fund?*, CNBC (Feb. 14, 2013, 3:14 PM), <http://www.cnbc.com/id/100461591#>, *archived at* <http://perma.cc/U9W8-L4AS>.

⁴⁵ James E. McWhinney, *Money Market Mayhem: The Reserve Fund Meltdown*, INVESTOPEDIA (Oct. 18, 2009), <http://www.investopedia.com/articles/economics/09/money-market-reserve-fund-meltdown.asp>, *archived at* <http://perma.cc/Y4KF-S6CR>.

2a-7⁴⁶ governing MMMFs in 2010.⁴⁷ Among the changes to Rule 2a-7 are liquidity requirements intended to enable funds “to meet reasonably foreseeable shareholder redemptions,”⁴⁸ and mechanisms for handling redemption requests when these requirements are not satisfied.⁴⁹ As a preliminary matter, MMMFs cannot invest more than 5% of their total assets in illiquid investments.⁵⁰ Moreover, MMMFs must invest at least 10% of their assets in “daily liquid securities,” and at least 30% of their assets in “weekly liquid securities.”⁵¹ Daily liquid assets include “cash, Treasury securities and securities that mature within one business day,” while weekly liquid assets include daily liquid assets, “discount notes issued by federal agencies with maturities of 60 days or less and securities that mature within five business days.”⁵²

Under amended Rule 2a-7, a MMMF’s board of directors may levy a fee of up to 2% on shareholder redemptions if the fund’s weekly liquid assets fall below 30%,⁵³ and is required to impose a 1% fee on redemptions if weekly liquid assets fall below 10%,⁵⁴ unless the board “determines that [such a fee] is not in the best interests of the fund.”⁵⁵ MMMFs also have discretion to institute a temporary suspension on redemptions if weekly liquid assets fall below 30%, which may be in effect for up to ten days over the course of a ninety-day period.⁵⁶

⁴⁶ Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. 47,736, 47,958 (Aug. 14, 2014) (to be codified at 17 C.F.R. § 270.2a-7 (2014)).

⁴⁷ Smith, *supra* note 4.

⁴⁸ Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. at 47,963.

⁴⁹ SEC Adopts Money Market Fund Reform Rules, SEC Release No. 14-143, 2014 WL 3611259 (July 23, 2014).

⁵⁰ Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. at 47,963.

⁵¹ *Id.*

⁵² *Recent Changes to Rule 2a-7 for Money Market Funds*, BBD, LLP, <http://www.bbdcpa.com/blog/recent-changes-to-rule-2a-7-for-money-market-funds/> (last visited Feb. 15, 2015), *archived at* <http://perma.cc/UCN9-8SG4>.

⁵³ Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. at 47,961.

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *Id.*

E. Alternative Mutual Funds

1. Growth and Development

While MMMFs offer a relatively safe investment, they also provide limited returns.⁵⁷ Moreover, interest rates, which constitute the bulk of MMMFs' yield, have remained low during the financial crisis recovery.⁵⁸ In response, retail investors have expressed greater interest in more aggressive investment strategies that offer the potential for higher returns.⁵⁹ These approaches, however, have largely been available only to "accredited investors"—high net worth individuals and institutional investors—through private funds, including hedge funds.⁶⁰

In response to the growing demand, investment advisors have developed a new type of fund that more closely resembles hedge fund strategies than those used by more traditional mutual funds.⁶¹ These alternative mutual funds ("AMFs") tend to invest in "(1) non-traditional asset classes (for example, currencies), (2) non-traditional strategies (such as long/short equity positions, [leverage and derivatives]), and/or (3) illiquid assets (such as private debt)."⁶² Investors often utilize AMFs to generate above-market returns or to hedge against risk through "reduc[ed] volatility [and] greater diversification."⁶³ Though AMFs represented just 2.3% of the entire mutual fund industry at the end of 2013, they accounted for nearly one-third of all new investments into the market.⁶⁴ In fact, AMFs grew by almost \$95 billion in 2013, more than 5 times the amount invested the previous year.⁶⁵ By the end of May 2014, 185 AMFs managed "\$300 billion in assets,"⁶⁶ and State

⁵⁷ See *supra* note 44 and accompanying text (describing the low-risk investment appeal of MMMFs).

⁵⁸ See *supra* note 43 and accompanying text (discussing the nature of MMMF dividends); Peter Eavis, *Gauging Funds' Emergency Preparedness*, N.Y. TIMES, Jan. 11, 2015, at BU14.

⁵⁹ Eavis, *supra* note 58; Lewis, *supra* note 3.

⁶⁰ Lewis, *supra* note 3; Weisman et al., *supra* note 5.

⁶¹ Perlow & Rich, *supra* note 5.

⁶² Champ, *supra* note 6; Perlow & Rich, *supra* note 5.

⁶³ *Alternative Funds Are Not Your Typical Mutual Funds*, *supra* note 23.

⁶⁴ Champ, *supra* note 6.

⁶⁵ *Id.*

⁶⁶ Champ, *supra* note 6; KATTEN MUCHIN ROSENMAN LLP, *supra* note 21.

Street—a leading mutual fund asset manager—expects that number to reach “\$725 [billion] by 2017.”⁶⁷

2. SEC Investigation

The increased popularity of AMFs has caught the attention of the SEC, which wants to ensure that these types of funds do not stray beyond the primary purpose of mutual funds to provide transparency to retail investors.⁶⁸ Through the Office of Compliance Inspections and Examinations (“OCIE”), the SEC has launched a “sweep” of AMFs focusing on “liquidity, [valuation], leverage, and board oversight”⁶⁹ Norm Champ, former Director of the SEC’s Division of Investment Management, said that the sweep will provide insight into how AMFs are managing liquidity to produce returns, and how well fund boards are complying with their “oversight duties.”⁷⁰ Specifically, the SEC wants to ensure that AMF’s are adequately valuing their assets and disclosing any liquidity risks to shareholders.⁷¹

The sweep, which commenced in Fall 2014, is expected to culminate in April 2015 and include between thirty-five and forty funds,⁷² though more funds may be added pending the results of the investigation.⁷³ In any event, the regulator’s agenda indicates that it plans to respond with new rules in October 2015.⁷⁴ Jane Jarcho, an associate director in the SEC’s examination program, stated that the exam will focus on four types of AMFs: “[n]on-traditional bond funds, which make up about half of the total assets in the segment; long-short

⁶⁷ Marriage, *supra* note 6.

⁶⁸ Eavis, *supra* note 58.

⁶⁹ Champ, *supra* note 6.

⁷⁰ Champ, *supra* note 6.

⁷¹ Marie Cabural, *SEC Official: Review of Alternative Mutual Funds At Hand*, VALUEWALK (July 9, 2014, 2:12 PM), <http://www.valuwalk.com/2014/07/sec-official-review-alternative-mutual-funds-hand/>, archived at <http://perma.cc/C5BL-MZZK>.

⁷² Trefis Team, *supra* note 6; Marriage, *supra* note 6.

⁷³ Juliet Chung & Kirsten Grind, *Alternative Funds Draw Scrutiny From SEC*, WALL ST. J., Aug. 13, 2014, at C1.

⁷⁴ Dave Michaels, *Mutual Funds to Face New Rules as SEC Outlines Oversight Plan*, BLOOMBERG (Nov. 24, 2014, 2:09 PM), <http://www.bloomberg.com/news/2014-11-24/mutual-funds-to-face-new-rules-as-sec-outlines-oversight-plan.html>, archived at <http://perma.cc/E39Y-29PZ>.

equity funds; multi-alternative funds and market-neutral funds.”⁷⁵ The OCIE has not given an indication as to which funds will be subject to the examination, but it is likely to take aim at the largest providers of AMFs, including “BlackRock, AQR Capital Management, Goldman Sachs, BNY Mellon, Blackstone and PIMCO,”⁷⁶ as well as “recent entrants into the sector.”⁷⁷

The OCIE will ask these firms to provide a variety of information shedding light on their ability to adequately manage risk, including “[a] description of the additional or heightened risks relating to alternative investments and the controls in place to mitigate these risks; [i]nternal reports on portfolio holdings’ liquidity and details of access to lending facilities in the event of unexpected redemptions; [v]aluation and risk management policies . . . ; [r]esults of stress tests and scenario analyses on the funds; and (5) [t]he funds’ use of derivatives and leverage”⁷⁸ One of the focal points of the sweep will be ensuring that investment advisors, many of whom are accustomed to the more relaxed regulatory regime governing hedge funds, fully understand the requirements of the 1940 Act.⁷⁹ Moreover, those that do have extensive experience managing mutual funds may be unfamiliar with the more aggressive investment strategies they are asked to implement in AMFs.⁸⁰

While it is unclear exactly what the SEC plans to do with the information that it collects, it has given no indication that it will initiate any enforcement actions against particular firms.⁸¹ Rather, it appears that the agency is using the sweep as a way to learn more about the growing industry so that it will be prepared to take future action if necessary.⁸² In that sense, this investigation may signal a “shift from

⁷⁵ Alan Katz, *SEC Takes Aim at Hedged Mutual Funds’ Leverage, Liquidity*, BLOOMBERG (Apr. 23, 2014, 1:23 PM), <http://www.bloomberg.com/news/2014-04-23/alternative-funds-to-get-sec-test-for-leverage-liquidity.html>, archived at <http://perma.cc/JH29-XA34>.

⁷⁶ Trefis Team, *supra* note 6.

⁷⁷ Marriage, *supra* note 6.

⁷⁸ *SEC Launches Broad Examination of Alternative Mutual Funds*, ROPES & GRAY LLP (Oct. 1, 2014), <http://www.ropesgray.com/news-and-insights/Insights/2014/October/Ropes-Grays-Investment-Management-Update-August-2014-September-2014.aspx>, archived at <http://perma.cc/HRL6-PADE>.

⁷⁹ Weisman et al., *supra* note 5.

⁸⁰ *Id.*

⁸¹ Chung & Grind, *supra* note 73.

⁸² *Id.*

reactionary regulation (for which the agency was criticized after the 2008 crisis) to proactive oversight.”⁸³

3. Impact on Valuation

One of the major concerns regarding liquidity is its impact on valuation practices.⁸⁴ Unlike exchange-traded securities whose value can be derived by reference to publically available price quotes,⁸⁵ illiquid assets can be difficult to price. All else being equal, more liquid assets trade at a higher prices than their less liquid counterparts due to greater marketability of the securities.⁸⁶ Despite this general rule, fund advisors must rely on alternative pricing techniques⁸⁷ in order to determine the so-called “fair value” of illiquid securities,⁸⁸ which is used to calculate the fund’s daily NAV. Factors to consider in determining how liquidity may impact the price of a security include: “(1) the frequency of trades and quotations for the security; (2) the number of dealers willing to purchase or sell the security and the number of other potential purchasers; (3) dealer undertakings to make a market in the security; and (4) the nature of the security and the nature of the marketplace”⁸⁹ Given the imprecision of fair valuation techniques, former Director Champ believes that AMFs relying heavily on illiquid assets may overestimate NAV and be unable to satisfy a high volume of redemption requests.⁹⁰

4. Illiquid Assets

To appreciate the impact of liquidity on AMFs’ ability to meet the requirements of the 1940 Act, it is useful to understand the types of securities in which AMFs invest.⁹¹ Many AMFs rely heavily on leveraged loans—those made to “companies with low credit ratings”—as a way to generate higher yields than those earned by more traditional

⁸³ Weisman et al., *supra* note 5.

⁸⁴ Kentouris, *supra* note 25.

⁸⁵ Perlow & Rich, *supra* note 5, at 36.

⁸⁶ Kentouris, *supra* note 25.

⁸⁷ *Id.*

⁸⁸ Perlow & Rich, *supra* note 5, at 36.

⁸⁹ Champ, *supra* note 6.

⁹⁰ *Id.*

⁹¹ See *infra* notes 92-100 and accompanying text (discussing potential problems associated with leveraged loans and derivatives).

loans.⁹² However, problems may occur if funds need to liquidate the loans in order to meet redemption requests.⁹³ Funds investing in leveraged loans generally must wait at least two weeks to receive cash after completing a sale, despite only having seven days to pay redeeming shareholders.⁹⁴ The originating bank is often the cause of the delay as it must register the change in ownership and, in some instances, receive approval from the borrower.⁹⁵ The result is that AMFs investing heavily in leveraged loans may be unable to generate enough cash to fill redemption requests that occur in close proximity to one another.⁹⁶ AMFs also tend to use derivatives, instruments whose value is tied to the price of another asset,⁹⁷ as a way to manage exposure to different sectors.⁹⁸ Most derivatives are not traded on an exchange, and thus present many of the same liquidity and valuation concerns as other illiquid assets.⁹⁹ Moreover, funds investing heavily in derivatives may have trouble satisfying the SEC's limits on leverage "because more payments will have to be made to counterparties" in the future.¹⁰⁰

F. SEC's Three Core Initiatives

In addition to the ongoing sweep focusing on AMFs, the SEC has announced three core initiatives aimed at improving the asset management industry.¹⁰¹ These initiatives, revealed recently by SEC Chair Mary Jo White, include (1) enhancing data reporting, (2) enhan-

⁹² Peter Eavis, *Mutual Fund Industry May Face New Rules*, N.Y. TIMES DEALBOOK (Dec. 11, 2014, 8:44 PM), http://dealbook.nytimes.com/2014/12/11/mutual-fund-industry-may-face-new-rules/?_r=1 [hereinafter Eavis Dealbook], archived at <http://perma.cc/H9NK-PB2R>.

⁹³ Eavis, *supra* note 58.

⁹⁴ Eavis DealBook, *supra* note 92; Eavis, *supra* note 58.

⁹⁵ Eavis DealBook, *supra* note 92.

⁹⁶ Eavis, *supra* note 58.

⁹⁷ *Derivatives*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/answers/derivative.htm> (last updated May 25, 2000), archived at <http://perma.cc/69SS-M729>.

⁹⁸ Ron D'Vari, *SEC Enhancing Regulatory Monitoring of Asset Managers*, SEEKING ALPHA (Jan. 8, 2015, 6:04 AM), <http://seekingalpha.com/article/2805725-sec-enhancing-regulatory-monitoring-of-asset-managers>, archived at <http://perma.cc/Y3PS-MG6X>.

⁹⁹ Perlow & Rich, *supra* note 5, at 35.

¹⁰⁰ Kentouris, *supra* note 25.

¹⁰¹ White, *supra* note 8.

cing controls on risks related to portfolio composition, and (3) improving transition planning and stress testing.¹⁰² Each of these initiatives addresses concerns over mutual funds' increased reliance on illiquid assets, including derivatives, and seek to ensure that funds are able to adequately manage risk without impacting the financial system as a whole.¹⁰³ With regards to data reporting, the current regime does not require "standardized reporting" on many of the "emerging products and strategies being used in the asset management industry,"¹⁰⁴ including a variety of derivatives that have become very popular among mutual funds.¹⁰⁵

From a liquidity standpoint, Chair White stressed the importance of funds' ability to satisfy increased redemptions during times of market stress, noting that a distressed fund having to sell assets at sub-market rates could lead to declining asset prices for other market participants.¹⁰⁶ Moreover, heavy reliance on derivatives can increase a funds' leverage, exposing it to significant risk when required to make payments on those contracts.¹⁰⁷ The SEC is also recommending that investment advisors "create transition plans to prepare for a major disruption in their business," including transferring assets when they are "no longer able to serve [their] clients."¹⁰⁸ Finally, the SEC is proposing that mutual funds conduct routine stress tests that will provide advisors and the agency with important information about the fund-specific and market-wide effects of a failure to satisfy redemption requests.¹⁰⁹

What provoked this new regulatory agenda, and what does this mean for the asset management industry? Some believe that the SEC's increased focus on the industry is an attempt to maintain oversight amid speculation that the Financial Stability Oversight Council was preparing to designate certain funds as "systemically important financial institutions."¹¹⁰ Rather than focusing only on the key players

¹⁰² *Id.* (outlining the three core initiatives).

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ Andrew Ackerman, *SEC Preps Mutual Fund Rules*, WALL ST. J., Sep. 8, 2014, at A1; Jay Baris, SEC to Require Living Wills and Stress-Testing for Investment Advisers, THE BD/IA REGULATOR (Dec. 12, 2014), <http://www.bdisia.com>.

in the market, the SEC appears to be taking a more holistic approach by subjecting asset managers to requirements similar to those “put in place for big banks and other large financial institutions.”¹¹¹ The SEC will likely look to incorporate “updated liquidity standards, disclosures of liquidity risks, [and] measures to appropriately limit the leverage created by a fund’s use of derivatives.”¹¹²

Nonetheless, Chair White was adamant that the “objective . . . is not to eliminate all risk,”¹¹³ highlighting the importance of “preserving the principle of ‘reward for risk’ that is at the center of our capital markets.”¹¹⁴ Thus, it appears more likely that the SEC will look to improve management practices rather than institute categorical limits on certain types of assets.¹¹⁵ As for the stress tests, the SEC appears cognizant of the need to develop procedures that reflect the uniqueness of the industry.¹¹⁶ Even if funds are not required to “set aside capital”¹¹⁷ in the same manner as banks, “these requirements undoubtedly will increase compliance costs, and take up real estate on crowded fund board agendas.”¹¹⁸ Thus, depending on how the SEC chooses to implement these initiatives, new portfolio requirements could simultaneously diminish mutual fund returns and increase operating costs that must be passed on to investors.¹¹⁹

G. Conclusion

While mutual fund portfolios vary based on investment strategies, all funds must adequately manage liquidity if they are to remain viable during times of market stress and increased redemptions.¹²⁰ While the provisions of the 1940 Act help guide funds in this endeavor, the advent of new investment strategies requires the SEC to closely monitor the industry and use its rulemaking authority to ensure

bdiaregulator.com/2014/12/sec-to-require-living-wills-and-stress-testing-for-investment-advisers/, archived at <http://perma.cc/5JS5-CDD5>.

¹¹¹ Andrew Ackerman, *Regulator Zeroes In on Risk at Funds*, WALL ST. J., Dec. 12, 2014, at C1.

¹¹² White, *supra* note 8.

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ Ackerman, *supra* note 111.

¹¹⁶ White, *supra* note 8.

¹¹⁷ Ackerman, *supra* note 110.

¹¹⁸ Baris, *supra* note 110.

¹¹⁹ *Invest Wisely*, *supra* note 1.

¹²⁰ White, *supra* note 8.

that retail investors are being adequately protected.¹²¹ As we await the SEC's response to its sweep of AMFs, its "three core initiatives" should provide fund advisors and investors with insight as to what changes may be forthcoming.¹²²

Drew Singer¹²³

¹²¹ See *supra* notes 35-37 and accompanying text (outlining the SEC's focus on protecting relatively unsophisticated retail investors).

¹²² See *supra* Part F (discussing the SEC's "three core initiatives.")

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