Blogs
June 22, 2015
Asset Management ADVocate

Liquidity: An Afterthought to the Investment Company Act

SEC Commissioner Kara Stein gave a thoughtful speech at the Brookings Institution the other day, identifying some urgent questions regarding mutual fund regulation. I am simpatico with many of the views expressed in her speech. But I cringed when she referred to liquidity as "a foundational principle of the Investment Company Act since its inception." Far from being part of its foundation, liquidity wasn't even in the blueprints for the Act. **Origins of the Illiquid Security Limit** As Commissioner Stein noted, "Commission guidance only allows mutual funds to invest up to 15% of the fund's assets in illiquid securities." But this guidance dates to 1969, not 1940. This was when the Commission issued Accounting Series Release No. 113, in which it announced "the view that a prudent limit on any [mutual fund's] acquisition of restricted securities, or other assets not having readily available market quotations, would be 10 per cent." (This was lower than an earlier 15% limit informally adopted by the Commission's staff.) Note that this limitation applied to "restricted securities" (i.e., unregistered securities) and other securities without readily available market values. According to the SEC's website, the term "illiquid security" was first defined in a release amending rule 2a-7 in 1986. The SEC increased the limit for mutual funds from 10% to 15% in 1992 by revising the guidelines to Form N-1A. Meanwhile, money market funds remained subject to a 10% limit, which was lowered to 5% in the 2010 amendments to rule 2a-7. Rule 2a?7 (which applies only to money market funds) is the only SEC regulation that currently restricts acquisitions of illiquid securities. The SEC rescinded the guidelines in 1998, so Form N-1A no longer requires disclosure on liquidity (although you will get a comment if you omit it). **Statutory Basis for the Limit** The Commission bases its limitation of illiquid securities on Section 22(e) of the Investment Company Act, which prohibits a mutual fund from "postpon[ing] the date of payment or satisfaction upon redemption of any redeemable security in accordance with its terms for more than seven days after the tender of such security." But this section does not require the redeeming shareholder to receive cash. (Section 2(a)(32) states that the holder of a "redeemable security" "is entitled … to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof.") Nor does it require payments to be made from sales of portfolio securities. A mutual fund may pay redemptions with, for example, money borrowed from a bank in compliance with Section 18(f). I'm not aware of any empirical research supporting 15% as a "prudent limit." And, if you'll pardon the pun, liquidity is a more fluid concept that the Commission's definition of an illiquid security ("a security 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"). Different markets provide different degrees of liquidity and available liquidity varies from moment to moment. Securities may be more liquid or less liquid, but it is hard to draw a bright line where a security becomes "illiquid." I doubt Congress intended to draw such a line by adopting Section 22(e). **Conclusion** So rather than being a "cornerstone" of the Investment Company Act, the illiquid security limit is more like a home addition that was framed and roofed over a weekend and then intermittently tied back into the main structure. While I agree with Commissioner Stein that it is vital that shareholders receive redemptions as promised in the prospectus, it might be more beneficial to approach this as an exercise in risk management rather than regulatory compliance. In any event, it may require more than tinkering with an ad hoc guideline to achieve this objective.

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