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CAN THE LIQUIDITY RULE KEEP MUTUAL FUNDS AFLOAT? CONTEXTUALIZING THE COLLAPSE OF THIRD AVENUE MANAGEMENT FOCUSED CREDIT FUND

Nicolas Valderrama+

In 2016, the Securities and Exchange Commission ("SEC") adopted Rule 22e-4 (the "Liquidity Rule") under the Investment Company Act of 1940, as amended ("1940 Act"), and related reporting and disclosure requirements. One industry analyst described the Liquidity Rule's objective as making sure that mutual funds implement "effective liquidity risk management programs," especially in light of mutual funds' prevalence in the economy and in American households.[1] Yet, as one Reuters analyst suggested, the SEC also seemed to have adopted these liquidity regulations to avoid a "repeat of the kind of problems that surfaced with the collapse of the [mutual fund] Third Avenue Focused Credit . . . in December 2015."[2]

This Comment takes a closer look at some of the "problems" that Third Avenue Management Focused Credit Fund ("the Fund" or "Focused Credit") faced and the complex liquidity implications of some of its investments. This Comment then lays out the roots of the SEC's concern over mutual funds' liquidity and the regulatory standards in this area prior to the adoption of the Liquidity Rule. Thereafter, this Comment distills the elements of the Liquidity Rule, and observes how it could apply, in theory, to help prevent other mutual funds from suffering the same fate as Focused Credit. Lastly, this Comment provides thoughts on more recent market events (i.e., related to the COVID-19 crisis) and how they may present a good opportunity to test the effectiveness of the Liquidity Rule.

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1. Todd Ehret, *SEC Tackles Fund Liquidity Complexity with Rule Proposal, Delay, New Guidance*, REUTERS (Mar. 27, 2018), https://www.reuters.com/article/bc-finreg-liquidity-rule/sec-tackles-fund-liquidity-complexity-with-rule-proposal-delay-new-guidance-idUSKBN1H32N5; *see* Jennifer Rudden, *Share of Households Owning Mutual Funds in the U.S. 1980-2019*, STATISTA (May 7, 2020), https://www.statista.com/statistics/246224/mutual-funds-owned-by-american-households/ (illustrating that between 1995 and 2018, the share of households owning mutual funds in the United States went from 28.7% to 44.8%).

2. Ehret, *supra* note 1.

I. BRIEF BACKGROUND

An increasing number of Americans rely every year on open-end mutual funds to achieve their long-term financial goals, whether that is "preparing for retirement, saving for education, purchasing a house, or preparing for emergencies."[3] In 2018, mutual funds held $17.7 trillion in total net assets, with roughly one out of every three Americans – 99.5 million individuals and 56 million households – putting their dollars to work through these investment vehicles.[4]

At their core, mutual funds are companies that pool money from many investors, invest that money in securities (such as stocks, bonds, other types of debt, or a combination of different assets), and give to investors shares that represent their "part ownership in the fund and the income" and the gains it generates.[5] A key characteristic of a mutual fund is redeemability, that is, investors' ability to sell their shares back to the fund (*i.e.*, "redeem" their shares) on any business day" to get their money out, with the assurance that the fund will stand ready to meet such redemption requests promptly.[6] A fund's ability "to meet redemptions without significantly diluting the interests of remaining shareholders" is referred to as the fund's liquidity.[7]

During 2015, the SEC was particularly concerned with mutual funds' liquidity, and, on October 15 of that year rolled out a key rule proposal addressing funds' management of liquidity risk.[8] Concurrently, the SEC proposed rule and form amendments aimed at modernizing mutual funds' reporting and disclosure regimes.[9] Former SEC Commissioner Kara Stein noted that "[n]othing is more fundamental . . . to open-end mutual funds than redeemability," suggesting that the SEC had proposed Rule 22e-4 to protect investors' presumed expectation that they would be able get their money out promptly, if desired.[10] Coincidentally, the Rule 22e-4 Proposing Release, came

3. INVESTMENT COMPANY INSTITUTE, 2019 INVESTMENT COMPANY FACT BOOK, 54 (59th ed. 2019), https://www.ici.org/pdf/2019_factbook.pdf [hereinafter ICI 2019 FACT BOOK].

4. *Id.* at 54, 56.

5. *Mutual Funds*, U.S. SECURITIES AND EXCHANGE COMMISSION, https://www.investor.gov/introduction-investing/basics/investment-products/mutual-funds-and-exchange-traded-funds-etfs (last visited Mar. 12, 2020).

6. Investment Company Institute, *Frequently Asked Questions About Mutual Fund Liquidity*, ICI FAQS & RESOURCE CENTERS (Feb. 2018), https://www.ici.org/faqs/faq/mfs/faqs_mf_liquidity. This article focuses on open-ended mutual funds but briefly discusses exchange traded funds ("ETFs"), which offer the possibility for investors to redeem their shares by selling them on the secondary market. *Id.*

7. *Id.*

8. Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release; Proposed Rule, Release No. IC-31835, 80 Fed. Reg. 62274 (Oct. 15, 2015) (hereinafter "Proposing Release").

9. *Id.* at 62,303–305.

10. SEC Commissioner Kara M. Stein, *Statement on Open-End Fund Liquidity Risk Management Programs and Swing Pricing*, SEC (Sept. 22, 2015) https://www.sec.gov/news/

just a few months before what industry analysists referred to as "the biggest mutual fund blowup since the 2008 financial crisis," the collapse of Third Avenue Management Focused Credit Fund.[11] Then, in 2016, the SEC adopted Rule 22e-4 as well as the reporting and disclosure requirements.[12]

At Focused Credit's peak, in the first half of 2014, it held over $3.2 billion dollars in assets and outpaced its competition with above average returns.[13] Focused Credit's investment strategy centered around investing in "credit instruments . . . rated below investment grade," and "under normal circumstances," it placed "at least [eighty percent] of the Fund's net assets . . . in bonds and other types of credit instruments."[14] Specifically, the Fund focused on a "relatively small number of issuers," investing heavily in below investment-grade corporate debt such as high-yield ("junk") bonds and secured loans.[15] As an analyst at Reuters noted, the Fund even disclosed that as of July 2015, it held roughly twenty percent of its assets in securities that are "hard to value and trade."[16] Commenters later attributed the Fund's downfall to its inability to meet investors' redemptions because of the "risk[y]" and "illiquid" assets in its portfolio.[17]

As one analyst suggested, during positive conditions for the bond market, the price of some of the Fund's high-yield securities was bid up in anticipation that they would produce high returns,[18] implying that if the Fund had tried to sell

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statement/stein-open-meeting-liquidity-risk-management.html; *see* Proposing Release, *supra* note 8, at 62,276.

11. Ross Kerber & Tim McLaughlin, *Massachusetts Probes if Third Avenue Investors Had Early Word on Liquidation*, REUTERS (Dec. 14, 2015), https://www.reuters.com/article/us-funds-third-avenue-massachusetts-idUSKBN0TX2BS20151214; Tim McLaughlin, et al., *Hidden in Plain Sight: Big Risks at Failed Third Avenue Fund Were Clear to Some*, REUTERS (Dec. 22, 2015, 5:16 PM), https://www.reuters.com/article/us-funds-thirdavenue-junk-insight/hidden-in-plain-sight-big-risks-at-failed-third-avenue-fund-were-clear-to-some-idUSKBN0U627V20151223.

12. Investment Company Liquidity Risk Management Programs, Release No. IC-32315, 81 Fed. Reg. 82,142 (Oct. 13, 2016) (hereinafter "Adopting Release") (noting that Rule 22e-4 applies to "open-end management investment companies, including open-end exchange-traded funds" but does not apply to money market funds).

13. THIRD AVENUE FUNDS, PORTFOLIO MANAGER COMMENTARY AND SEMI-ANNUAL REPORT 28, 44 (2014), https://thirdave.com/wp-content/uploads/2014/06/TAF-2014-Semi-Annual-Report.pdf. Focused Credit was one of five "non-diversified . . . investment series" (i.e. funds) that were part of Third Avenue Trust (the "Trust"), an open-end, management investment company; and Third Avenue Management LLC served as investment advisor for the five funds within the Trust. *Id.* at 49.

14. THIRD AVENUE FUNDS, *Summary Prospectus: Third Avenue Focused Credit Fund*, SUMMARY PROSPECTUS 2 (Mar. 20, 2015), https://www.sec.gov/Archives/edgar/data/1031661/000093041315001348/c80771_497k.htm.

15. *Id.*

16. McLaughlin, *supra* note 11.

17. *Id.*

18. Dave Dierking, *3 Takeaways From the Collapse of the Third Avenue Focused Credit Fund*, SEEKING ALPHA (Mar. 28, 2016, 3:36 PM), https://seekingalpha.com/article/3961454-3-takeaways-collapse-third-avenue-focused-credit-fund (noting that "when the economic

such securities then, a ready market would have likely been available.[19] However, during the second half of 2014, Focused Credit produced negative returns, which the Fund's portfolio manager attributed to the weakening of the bond market and the increased volatility in the overall market caused by a wide range of macroeconomic risks.[20] The Fund's shareholders eventually started withdrawing their money, presumably uneasy due to the market's volatility and the Fund's negative returns, and by April 2015, investors' redemptions had caused a net outflow of more than $186 million dollars.[21] Focused Credit took some measures to ensure that it could meet redemptions, like "holding a net [ten percent] allocation to cash" and "ha[ving] a line of credit in place," but these proved largely insufficient.[22]

Despite the Fund's attempts to convince investors that its long-term outlook remained positive,[23] redemptions continued to accelerate, accounting for a net outflow of more than $938 million dollars for the year ended October 31, 2015.[24] According to an industry analyst, Focused Credit was unable to sell its risky and low-rated assets without doing so at far below market value prices, with demand for such debt drying up, which in turn prevented the Fund from raising the cash to meet redemptions.[25]

As an industry analyst reported, by early December 2015, Focused Credit announced the decision to cease its operations, halt all investor redemptions, and

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environment was advantageous, securities prices were bid up in anticipation that a recovery was in play"); Jeffrey Ptak & Sarah Bush, *Third Avenue Focused Credit Abruptly Shuttered*, MORNINGSTAR (Dec. 11, 2015), https://www.morningstar.com/articles/733021/third-avenue-focused-credit-abruptly-shuttered.

19. *See Bid up*, MERRIAM-WEBSTER.COM, https://www.merriam-webster.com/dictionary/bid%20up (last visited Jan. 13, 2021) ("to raise the price of (something, such as property at auction) by a succession of offers").

20. THIRD AVENUE FUNDS, PORTFOLIO MANAGER COMMENTARY AND FIRST QUARTER REPORT 29–30 (2015), https://thirdave.com/wp-content/uploads/2016/08/TAF-Shareholder-Letters-and-Reports-Q1-2015.pdf.

21. THIRD AVENUE FUNDS, SEMI-ANNUAL REPORT 56 (2015), https://thirdave.com/wp-content/uploads/2016/08/TAF-Shareholder-Letters-and-Reports-Q2-2015.pdf. Net outflow "[f]or the Six Months Ended April 30, 2015" is calculated taking into account the reported "Net increase/(decrease)" in the dollar "amount" for both "Investor Class" shares (-$124,230,765) and "Institutional Class" shares (-$62,130,296), which resulted from adding the value of "[s]hares sold, [s]hares issued upon reinvestment of dividends and distributions", and "[s]hares redeemed." *Id.*

22. Ptak, *supra* note 18.

23. THIRD AVENUE FUNDS, PORTFOLIO MANAGER COMMENTARY AND THIRD QUARTER REPORT 29–36 (2015), https://thirdave.com/wp-content/uploads/2016/08/TAF-Shareholder-Letters-and-Report-Q3-2015.pdf.

24. THIRD AVENUE FUNDS, PORTFOLIO MANAGER COMMENTARY AND FOURTH QUARTER REPORT 75 (2015), https://thirdave.com/wp-content/uploads/2016/08/TAF-Shareholder-Letters-and-Report-Q4-2015.pdf. Net outflow "[f]or the Year Ended October 31, 2015" is calculated taking into account the reported "Net increase/(decrease)" in the dollar "amount" for both "Investor Class" and "Institutional Class" shares, which resulted from adding the value of "[s]hares sold", "[s]hares issued upon reinvestment of dividends and distributions", and "[s]hares redeemed." *Id.*

25. Dierking, *supra* note 19; Ptak, *supra* note 19.

in an "unusual legal strategy" liquidate the $778.5 million fund by "transferring all of its investments to a liquidating trust, and then using the trust to return money to shareholders over time."[26] This, another analyst noted, was "the first time a mutual fund . . . curbed redemptions without first obtaining authorization from the [SEC]."[27] Presumably, the SEC staff objected to the Fund transferring its assets to a liquidating trust and thereby escaping the redemption provisions of the 1940 Act, without SEC approval.[28]

On December 16, 2014, with its assets still in free fall (*i.e.* with net outflows of over $1.1 billion dollars) and facing an ever-growing number of investor requests for withdrawal, the Fund sought an exemption from the redemption requirements of the 1940 Act, and further asked for the exemptive order to be effective immediately and issued without a notice period.[29] Since SEC rules normally require that notice of exemptive applications be published in the Federal Register and that interested persons be given an opportunity to request a hearing, this was a highly unusual request for a mutual fund.[30] Nevertheless, the SEC approved the request that same day, recognizing that the circumstances described in the application for relief "required immediate action to protect the Fund's security holders."[31]

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26. Joe Morris, *Third Avenue CEO Out: Report*, IGNITES (Dec. 14, 2015), https://www.ignites.com/c/1255953/140173?referrer_module=searchSubFromIG&highlight=focused%20credit%20liquidating%20trust (pointing out that the liquidation trust would not trade nor charge a management fee, and would "make periodic payments to investors until the assets and any investment gains from the liquidating portfolio [were] distributed."); *see* Ptak, *supra* note 19.

> Normally, when a fund company liquidates an open-end mutual fund, it provides advance notice to shareholders, who are given the opportunity to redeem their investment up until the liquidation date. During this interim period, the fund's manager will typically sell the portfolio's holdings to raise cash, using the proceeds to pay out shareholders who redeem their investments. On the liquidation date, the fund company makes a final pro-rata cash distribution to any remaining shareholders.

Id.

27. Kristen Bahler, *Third Avenue Halts Redemptions of $778M Fund Amid Liquidation*, IGNITES (Dec. 11, 2015), https://www.ignites.com/c/1255073/140123/third_avenue_halts_redemptions_fund_amid_liquidation.

28. Third Avenue Trust and Third Avenue Management LLC; Notice of Application and Temporary Order, Release No. IC-31943, 4 (Dec. 16, 2015) (herein the "Third Avenue Temporary Order") (stating that "[u]pon announcement of the Plan of Liquidation, the Commission staff expressed concerns during discussions with the Fund and the Adviser."). The Fund ultimately decided to apply to the SEC for permission to suspend redemptions, cancel the use of the liquidating trust, return all assets from the liquidating trust to the Fund. *Id.*

29. *Id.*

30. 17 C.F.R. § 270.0–5(a), (c) (2011).

31. Third Avenue Temporary Order, *supra* note 28, at 8; *see* Joe Morris, *SEC Tweaks Third Avenue Liquidation*, IGNITES (Dec. 17, 2015), https://www.ignites.com/c/1258313/140673?referrer_module=searchSubFromIG&highlight=third%20avenue%20focused%20credit%20liquidating%20trust (pointing out that the SEC's grant of relief was "conditional on Third Avenue's changing the fund's plan of liquidation by transferring fund assets back to the fund from the liquidating trust.").

II. ROADMAP

Beyond the timing coincidence between the SEC's Proposal of Rule 22e-4 and Focused Credit's liquidity crisis, the Fund's downfall seems precisely the kind scenario that Rule 22e-4 seeks to address.[32] In fact, the Proposing Release directly cited to the Fund's meltdown as an example of the "adverse consequences to remaining investors in a fund when it fails to adequately manage liquidity."[33] This comment thus focuses on analyzing the SEC's Liquidity Rule with an emphasis on examining some of the liquidity issues that the Fund faced in 2015, and ultimately assesses whether Rule 22e-4 provides effective tools to prevent another open-end mutual fund from experiencing a liquidity crisis such as that of Focused Credit.

Part III of this comment will examine the background and prior law by: (A) discussing the importance of liquidity for open-end mutual funds; (B) examining the type of credit instruments that were at the heart of the Fund's investment strategy and why they may pose special liquidity difficulties; (C) noting the roots of the SEC's concern regarding mutual funds' liquidity; and (D) reviewing the regulatory standards around liquidity for open-end funds that were in place before Rule 22e-4 was proposed. Part III analyzes the tools in place under Rule 22e-4 to address liquidity risk. Part V hypothesizes as to the application and likely benefits of the Liquidity Rule had it been in place during and prior to Focused Credit's collapse and describes how the Liquidity Rule provides a new remedy for the SEC to bring enforcement action against persons who failed to manage liquidity sufficiently. Lastly, Part VII provides commentary regarding how recent market events related to the COVID-19 crisis might offer a good opportunity to test the effectiveness of the Liquidity Rule.

III. PRIOR LAW

A. Liquidity and its Role in Mutual Funds

> *[L]iquidity" is a straw man. Whenever markets plunge, investors are stunned to find that there are not enough buyers to go around . . . The mistake is in thinking that markets have a duty to stay liquid, or that buyers will always be present to accommodate sellers . . . If you aren't in debt, you can't go broke and can't be made to sell, in which case "liquidity" is irrelevant. But [if a] . . . firm may be forced to sell, lest fast-accumulating losses put it out of business.*[34]
>
> – Roger Lowenstein

32. Matt Wirz, et al., *Junk Fund's Demise Fuels Concern Over Bond Rout*, THE WALL STREET JOURNAL (Dec. 10, 2015), https://www.wsj.com/articles/as-high-yield-debt-reels-mutual-fund-blocks-holders-from-redeeming-1449767526?mod=article_inline.

33. Proposing Release, *supra* note 8, at 62,280.

34. ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG TERM CAPITAL MANAGEMENT 42 (2000).

Generally, "liquidity" is the "ability [to] sell an asset quickly" and turn it into cash without causing a significant "drop in its value," or in the case of investment companies, without diluting the interest of remaining shareholders.[35] For mutual funds, liquidity is especially important because shareholders have the right to redeem their shares in exchange for cash at any time, so funds must stand ready to meet those redemptions by converting some of their assets into cash.[36] Funds must make the payment to shareholders within seven days of receiving the redemption order, although investors often expect this timeframe to be less than seven days, as a number of funds disclose in their prospectuses that they will pay redemptions on a next-business-day basis.[37] In fact, fund shares redeemed through broker-dealers must be paid within as little as three business days according to a rule under the Securities Exchange Act of 1934.[38]

To understand how redemptions may dilute the interest of remaining shareholders in a mutual fund, it is key to examine the concept of per share Net Asset Value ("NAV") and how a shareholder's interest is generally measured. The per share NAV is the share price that a fund pays to a shareholder redeeming his or her share, and it is equal to the fund's total assets minus total liabilities, divided by the number of shares outstanding.[39] The per share NAV can be thought of as the "fair market value of a share of the fund" and is calculated each business day.[40] A shareholder's investment holding is then equal to "the [per share] NAV times the number of fund shares held."[41]

When a shareholder redeems his or her shares, if the fund is not holding sufficient cash, it has to sell sufficient assets to be able to generate cash proceeds to meet the redemption.[42] If the fund does not receive its carrying value[43] for the liquidated assets, a drop in the per share NAV may occur, which, if deep enough, would result in a decrease in the interest of the remaining fund

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35. *Liquidity*, THE WOLTERS KLUWER BOUVIER LAW DICTIONARY 661 (Stephen Michael Sheppard ed., Compact ed. 2011).

36. Adopting Release, *supra* note 12, at 5–6; Anne M. Tucker & Holly van den Toorn, *Will Swing Pricing Save Sedentary Shareholders?* 18 COLUM. BUS. L. REV. 130, 135–36 (2018).

37. Investment Company Act of 1940, 15 U.S.C. § 80a-22(e) (1940); *see* Adopting Release *supra* note 12, at 14–15.

38. Adopting Release, *supra* note 12, at 82,143 n.8. (noting that "broker dealers are subject to Rule 15c6-1 under the Securities Exchange Act of 1934 . . . , which establishes a three-day . . . settlement period for security trades effected by a broker or a dealer."); *see* Securities Exchange Act of 1934, 17 C.F.R. § 240.15c6-1 (1996).

39. *Net Asset Value*, SECURITIES AND EXCHANGE COMMISSION: FAST ANSWERS, https://www.investor.gov/introduction-investing/investing-basics/glossary/net-asset-value (last visited Oct. 26, 2019). The NAV is also the price that an investor pays to buy fund shares. *Id.*

40. Conrad Ciccotello, *The Nature of Mutual Funds*, *in* MUTUAL FUNDS: PORTFOLIO STRUCTURES, ANALYSIS, MANAGEMENT, AND STEWARDSHIP 5 (John A. Haslem ed., 2010).

41. Tucker, *supra* 36, at 144.

42. *Id.* at 136.

43. *Carrying Value*, INVESTOPEDIA.COM, https://www.investopedia.com/terms/c/carryingvalue.asp, ("an accounting measure of value in which the value of an asset . . . is based on the figures in the respective company's balance sheet").

shareholders (i.e. dilution).[44] A dilution in the remaining shareholder's interest can be notably exacerbated when, a fund faces an outsized stream of redemptions, lacks enough cash and cash equivalent holdings to meet them, and its assets are difficult to convert into cash without having to do so at prices lower than their carrying value on the fund's books.[45] Focused Credit seems to have faced similar circumstances prior to its collapse.[46]

B. High-Yield Bond and Secured Loan Mutual Funds May Face Particular Liquidity Challenges During Times of Economic Stress

Federal Reserve Research Staff members, Aylen Banegas and Jessica Goldering, note that a number of mutual funds looking for higher yield have, over the years, centered their investment strategies on investing in non-investment-grade corporate debt, particularly in two types of credit instruments: high-yield bonds and leveraged (secured) loans.[47] Despite the fundamental differences between these two types of credit instruments, the underlying premise remains the same, that by financing companies with below-investment-grade credit ratings, the funds will be able to get a higher yield in exchange for bearing the greater credit risks associated with lending to such companies.[48] However, as was the case with Focused Credit, mutual funds investing primarily in high-yield bonds and secured loans can carry greater liquidity risks than funds investing primarily in investment-grade debt, especially during times of financial stress.[49]

1. High-Yield Bond Funds

Mutual funds' investment in high-yield corporate bonds has grown significantly since 2008, with overall assets under management at funds investing primarily in these credit instruments increasing from around $75 billion to $225 billion as of December 2018.[50] At its core, a corporate bond is a debt obligation in which the company issuing the bond borrows money from an investor by making a "legal commitment to pay interest on the principal" and

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44. Tucker, *supra* note 36, at 144–45.

45. Dierking *supra* note 18; Ptak *supra* note 18; *see id*. at 144–46 (defining dilution, giving an example based on hypothetical numbers, and providing further technical details on how funds process shareholder redemptions).

46. *See supra* Section I.

47. Ayelen Banegas, Jessica Goldenring, *Leveraged Bank Loan Versus High Yield Bond Mutual Funds*, Fin. and Econ. Discussion Series, Wash. Board of Governors of the Federal Reserve System 2 (2019).

48. Lisa Lee, *How Leveraged Loans are (and Aren't) Like Junk Bonds: Quick Take*, BLOOMBERG, (Oct. 1, 2018), https://www.bloomberg.com/news/articles/2018-09-30/how-leveraged-loans-are-and-aren-t-like-junk-bonds-quicktake.

49. Kenechukwu Anadu & Fang Cai, *Liquidity Transformation Risks in U.S. Bank Loan and High-Yield Mutual Funds*, WASHINGTON: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM: FEDS NOTES (Aug. 9, 2019), https://doi.org/10.17016/2380-7172.2412.

50. Banegas & Goldenring, *supra* note 47, at 2.

"return the principal when the bond comes due[.]"[51] Companies that face greater financial difficulties can issue high-yield corporate bonds, offering to pay higher interest rates to compensate for the higher risk of the company defaulting on its debt.[52] Credit rating agencies like Standard & Poor's, Moody's, and Fitch give the bonds credit ratings based on the issuer's ability to make the scheduled payments, giving lower ratings to high-yield bonds, as the payment of interest and repayment of principal is considered more speculative than for bond issuances considered "investment grade."[53]

Commentary from investment management firms states that when the economy is strong, high-yield bonds are considered fairly liquid (readily tradeable) as higher yields entice investors.[54] Such commentary also notes that even under less positive economic conditions, high-yield bonds may still "present value opportunities for funds . . . structured to take advantage of them, with longer lock-ups for investor capital [i.e. closed-end funds], for instance."[55] However, as Federal Reserve researchers, Kenechukwu Anadu and Fang Cai, point out, mutual funds investing primarily in high-yield bonds may face particularly challenging liquidity conditions during economic downturns because "large redemptions . . . could lead to asset fire sales" and, unlike closed-end funds, mutual funds must stand ready to meet redemptions.[56]

During economic downturns, Federal Reserve researcher Simon Kwan notes, companies with low credit quality issuing high-yield bonds are more vulnerable and face more challenges meeting their debt obligations, which raises their risk of default.[57] This in turn could cause investors in high-yield bond funds to want to exit the market by redeeming their shares.[58] The problem then, Kwan points

51. Investor Bulletin: *What are High Yield Corporate Bonds?*, SEC OFFICE OF INVESTOR EDUCATION AND ADVOCACY, 1 (June 2013), https://www.sec.gov/files/ib_high-yield.pdf.

52. *Id.*

53. *High Yield Bonds*, PIMCO: UNDERSTANDING INVESTING, https://www.pimco.com/en-us/resources/education/understanding-high-yield-bonds/ (last visited Oct. 31, 3019). *See Bond Ratings*, CORPORATE FINANCE INSTITUTE, https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/bond-ratings/ (last visited Mar. 18, 2020) (stating that "credit rating agencies . . . provide evaluations of a bond issuer's financial strength and capacity to repay the bond's principal and interest according to the contract.").

54. *Who Owns the Assets? A Closer Look at Bank Loans, High Yield Bonds and Emerging Market Debt*, BLACKROCK: VIEWPOINT 10 (Sept. 2014), https://www.blackrock.com/corporate/en-fi/literature/whitepaper/viewpoint-closer-look-selected-asset- classes-sept2014.pdf.

55. Neuberger Berman, *High Yield Liquidity: High and Dry?*, NASDAQ (May 10, 2016 1:59 AM), https://www.nasdaq.com/articles/high-yield-liquidity-high-and-dry-2016-05-10 (suggesting that even in "less liquid parts of the high-yield universe," i.e., CCC-rated bonds, there are "value opportunities for patient capital in appropriate fund structures.").

56. Anadu & Cai, *supra* note 49.

57. Simon Kwan, *Rising Junk Bond Yields: Liquidity or Credit Concerns?*, FEDERAL RESERVE BANK OF SAN FRANCISCO ECONOMIC LETTER, No. 2001–33 (Nov. 16, 2001).

58. *Id.*; *see* Anadu & Cai, *supra* note 49 (noting that "[f]or example, in December 2018, amid heightened financial market volatility, . . . [high-yield bond mutual funds] experienced net outflows of $6 billion," stemming from redemptions).

out, is that funds investing primarily in high-yield bonds could be left without enough liquid assets to meet potential large waves of redemptions, so they would have to sell the bonds in a market with few buyers willing to take on such risk, thus forcing the funds to lower the price to lure buyers.[59] This seems to be precisely what Focused Credit faced, as it reportedly lacked enough liquid assets to cover its redemption obligations, and sought to halt investor redemptions to avoid selling its assets at fire sale prices, which risked diluting the interest of the remaining shareholders in the fund.[60]

2. *Secured Loans*

Secured loans in the high-yield world, on the other hand, are loans that banks usually make to companies with below-investment-grade credit rating, but instead of keeping the loan on their books, the banks sell all or a portion of the loans to institutional investors or mutual funds.[61] The loan is typically secured (backed) by the borrowing company's physical or other assets, and the investors earn a floating interest rate, which "increases as the loan gets riskier."[62] Mutual funds investing in secured loans face the same liquidity concerns as those investing in high-yield bonds, regarding periods of economic stress, borrowers' risk of default and the potential for outsized redemptions that may force funds to sell – in this case – loans at fire sale prices.[63]

Federal Reserve researchers suggest, however, that secured loans' settlement period represents an additional concern for mutual funds' liquidity, as their settlement time may well be past the seven days in which funds must pay out shareholder redemptions.[64] Prior to the Liquidity Rule Proposal, SEC Commissioner Stein suggested that "it is reasonable to wonder how [a] fund [investing in bank loans] could possibly meet the seven day redemption requirement in the Investment Company Act in times of market stress."[65] It takes even longer for a loan to settle, that is, for the fund to receive payment from the loan's buyer in exchange for transferring the asset than it does for "fixed income securities such as high yield bonds [to settle], which typically

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59. Kwan, *supra* note 57.

60. Bahler, *supra* note 27; *see supra* Section III.A.

61. Elisabeth de Fontenay, *Do the Securities Laws Matter? The Rise of the Leveraged Loan Market*, 39 IOWA J. CORP. L. 725, 727 (2014).

62. Lee, *supra* note 48 (pointing out that the interest rate on secured loans is equal to the Libor benchmark rate plus a fixed "margin" interest).

63. Anadu & Cai, *supra* note 49.

64. *Id.* (noting that "the mean par settlement time [for secured loans] was approximately 17 business days as of March 2019.").

65. Kara M. Stein, Commissioner, Securities and Exchange Comm'n, Speech at the Brookings Institution: Mutual Funds — The Next 75 Years (June 15, 2015); *but see Loan Mutual Fund Liquidity Risk Management: A Case Study*, LOAN SYNDICATIONS & TRADING ASSOCIATION (May 14, 2019), https://www.lsta.org/news-resources/loan-mutual-fund-liquidity-risk-management-a-case-study/ (asserting that "nearly all loan mutual funds have lines of credit that bridge the gap between the sale and settlement of loan assets").

settle in three days."[66] Such a long settlement period "further constrains [bank loan mutual funds'] ability to quickly convert their loans into cash to meet large redemptions."[67]

C. The Roots of Mutual Fund Liquidity Concerns

As a response to the financial crisis of 2007–2008, Congress enacted the Dodd Frank Act, which established the Financial Stability Oversight Council ("FSOC") to "identify risks" and "respond to emerging threats" "to the financial stability of the United States."[68] In 2014, FSOC seemed to be concerned that the nature of redeemable mutual funds could exacerbate stress in the markets, and as part of its mission, it issued a notice seeking public comment on "whether asset management products and activities may pose potential risks to the U.S. financial system."[69] Specifically, FSOC sought to explore "whether investments through pooled investment vehicles that provide redemption rights, as well as their management of liquidity risks and redemptions, could potentially influence investor behavior in a way that could affect U.S. financial stability differently than direct investment."[70]

FSOC's initial push to assess liquidity risk in the asset management industry seems to have ignited the SEC's concerns regarding mutual funds' liquidity. SEC Chair Mary Jo White, as a FSOC member, first welcomed FSOC's request for comment and noted that it was "a constructive complement to the SEC's initiatives."[71] Then in September 2015, the SEC's Division of Economic Risk Analysis (DERA) conducted an independent study which observed that funds when facing redemptions, may sell their most liquid holdings first, which could increase funds' risk profile for remaining shareholders.[72] Unsurprisingly, the Rule 22e-4 Proposing Release, despite stating the "rulemaking proposal [was]

66. BlackRock, *supra* note 54; *see* Julia Kagan, *Settlement Date*, INVESTOPEDIA, https://www.investopedia.com/terms/s/settlementdate.asp (last updated June 22, 2019).

67. Anadu & Cai, *supra* note 49; *but see* LOAN SYNDICATIONS & TRADING ASSOCIATION, *supra* note 65 (suggesting that, after polling some loan mutual fund managers about their approach to the market turmoil of 2018, they mentioned having "used their long experience to successfully predict redemption patterns in normal and stressed environments . . . and sell loans (and settle those sales) well ahead of redemptions.").

68. H.R. REP. NO. 111-517, at 20 (2010) (Conf. Rep.); 12 U.S.C. § 5322 (a)(1)(A), (C) (2018).

69. Financial Stability Oversight Council, Notice Seeking Comment on Asset Management Products and Activities, 79 Fed. Reg. 77,488 (Dec. 24, 2014).

70. *Id.* at 77,490.

71. Minutes of the Financial Stability Oversight Council 1, 12 (Dec. 18, 2014), https://home.treasury.gov/system/files/261/December%2018%2C%202014%2C%20Meeting%20 Minutes.pdf.

72. Proposing Release, *supra* note 8 at 62,279; Paul Hanouna, et al., *Liquidity and Flows of U.S. Mutual Funds*, DIVISION OF ECONOMIC AND RISK ANALYSIS 1, 3 (2015), https://www.sec.gov/dera/staff-papers/white-papers/liquidity-white-paper-09-2015.pdf (noting that "all investors who redeem from a mutual fund during the day transact at the fund's end-of-day NAV. . . .The costs of providing liquidity to investors are partially or entirely borne by the non-redeeming investors.").

independent of FSOC," addressed many of the industry comments responding to FSOC's notice, and discussed DERA's findings as part of the economic analysis.[73] Ultimately, the SEC noted that, as the primary regulator for the securities industry, it was proposing rules that aimed at "mitigating the adverse effects that liquidity risk in funds can have on investors and the fair, efficient and orderly operation of the markets"; and that "[t]o the extent there are any potential financial stability risks from poor fund liquidity management, [the] proposal may mitigate those risks as well."[74]

D. Regulatory Standards Around Liquidity for Mutual Funds Prior to Rule 22e-4

Before the SEC adopted Rule 22e-4, there were several statutory and regulatory provisions intended to ensure that mutual funds, like Focused Credit, maintained enough liquidity to meet redemptions without diluting shareholder's interests.[75] Under Section 22(e) of the 1940 Act, open-end mutual funds cannot "suspend the right of redemption or postpone the date of payment of redemption proceeds for more than seven days after tender of the security absent specified unusual circumstances."[76] Rule 22c-1 under the 1940 Act "requires funds, their principal underwriters, and dealers to sell and redeem fund shares at a price based on the current NAV next computed after receipt of an order to purchase or redeem fund shares," even if the fund needs to sell assets in the following days to meet the redemptions.[77]

Further, per "[R]ule 15c6-1 under the Exchange Act . . . broker-dealers [must] settle securities transactions, including transactions in open-end fund shares, within three business days after the trade date[,]" which means that funds must be able to pay such redemptions within that three-day settlement period.[78] The SEC had repeatedly clarified its position, that a fund "should maintain a high degree of portfolio liquidity," monitor its portfolio liquidity regularly to ensure

73. Proposing Release, *supra* note 8 at 62,281.

74. *Id.*

75. *Id.* at 62,277, 62,279.

76. *Id.* at 62,283. Funds may suspend the right of redemption:

> Section 22(e) permits open-end funds to suspend redemptions and postpone payment for redemptions already tendered for any period during which the New York Stock Exchange ("NYSE") is closed (other than customary weekend and holiday closings) and in three additional situations if the Commission has made certain determinations. First, a fund may suspend redemptions for any period during which trading on the NYSE is restricted, as determined by the Commission. Second, a fund may suspend redemptions for any period during which an emergency exists, as determined by the Commission, as a result of which it is not reasonably practicable for the fund to: (i) liquidate its portfolio securities, or (ii) fairly determine the value of its net assets. Third, a fund may suspend redemptions for such other periods as the Commission may by order permit for the protection of fund shareholders.

Id. at 62,283 n.82.

77. *Id.* at 62,283.

78. *Id*. at 62,287 n.109; *see* Exchange Act Rule, 17 C.F.R. § 240.15c6-1(a) (1996).

that it is able to meet redemptions, and take steps if it determines that it lacks sufficient liquidity or that its previously liquid holdings have become illiquid.[79]

Lastly, while the SEC had never required "funds to invest in a minimum level of liquid assets," the SEC guidelines limited mutual funds "holdings of 'illiquid assets' to 15% of the fund's net assets (the '15% guideline')."[80] Under the '15% guideline', the SEC deemed a security to be "illiquid" if the fund could not sell or dispose of it "in the ordinary course of business within seven days at approximately the value at which the fund ha[d] valued the investment."[81]

The '15% guideline' had prompted funds to limit their exposures to certain types of securities that the SEC indicated may be "illiquid."[82] However, former Commissioner Stein believed that the guideline "ha[d] arguably become more of a compliance exercise than a true restriction," asserting that some mutual funds' large holdings of what she referred to as "illiquid bank loans, . . . would seemingly violate the 15% threshold."[83] Former Commissioner Stein thus suggested that funds seemed to have found a way around the '15% guideline', by relying on the interpretation that "rather than requiring the settlement of a sales transaction within seven days, the Commission's liquidity standard requires only that a contract price be struck."[84]

IV. ANALYSIS

The SEC adopted Rule 22e-4 under the 1940 Act on October 13, 2016, requiring each fund, for the first time, to "adopt and implement a written liquidity risk management program ('Program') that is reasonably designed to assess and manage its liquidity risk."[85]

The Adopting Release laid out a "tiered set of compliance dates based on asset size" whereby large fund complexes (with $1 billion or more in net assets) had to adopt a Liquidity Risk Management Program by December 1, 2018, and smaller fund complexes (with less than $1 billion net assets) by June 1, 2019.[86]

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79. Proposing Release, *supra* note 8, at 62,284.

80. *Id.* at 62,351–352.

81. *Id.* at 62,352.

82. *Id.*

83. Commissioner Stein, Speech at the Brookings Institution, *supra* note 65.

84. *Id.* at n.26 (citing Investment Company Institute (ICI), Valuation and Liquidity Issues for Mutual Funds (1997)).

85. 17 C.F.R. § 270.22e-4(b) (2019); Adopting Release, *supra* note 12 at 82,229–230 (stating that the Liquidity Rule's primary goals are to: "[(1)] promote investor protection by reducing the risk that funds will be unable to meet their redemption obligations, [(2)] elevate the overall quality of liquidity risk management . . . , [(3)] increase transparency of funds' liquidity risks and risk management practices, and [(4)] mitigate potential dilution of non-transacting shareholders' interests.").

86. Adopting Release, *supra* note 12, at 82,228–82,229; *see* John M. Baker and Joel D. Corriero, *Fund Alert: What You Need to Know About the SEC's New Liquidity Risk Management Rule*, STRADLEY RONON STEVENS & YOUNG, LLP, 21–22 (Nov. 2, 2016), https://www.stradley.com/~/media/Files/Publications/2016/Fund_Alert_November_2_2016.pdf.

The SEC later extended the compliance dates for three of the Liquidity Rule's provisions: the liquidity classification requirement,[87] the Highly Liquid Investment Minimum ("HLIM"),[88] and the Board's approval of the liquidity risk management program.[89] Compliance with these key provisions was then set out to be June 1, 2019 for large fund complexes, and December 1, 2019 for smaller fund complexes.[90]

Section IV.A. discusses the Liquidity Risk Management Program's main tools, and Section IV.B. describes the liquidity disclosure regime that the SEC adopted parallel to Rule 22e-4.

A. Tools for Liquidity Risk Management Under Rule 22e-4

Per Rule 22e-4, the Program must contain the following key elements: (i) liquidity risk assessment and management; (ii) classification of investments into four buckets of liquidity; (iii) for some funds, determination of the minimum percentage that the fund must invest in highly liquid investments; (iv) limitation on the acquisition of illiquid investments, and (v) careful board oversight.[91]

Under the Liquidity Rule, the fund's board of directors, including a majority of independent directors, must approve the designation of the person(s) responsible for administering the Program as well as its policies and procedures ("Program Administrator").[92] The Program Administrator has a number of specific responsibilities such as providing the fund's board of directors with a written report: (1) on the adequacy and effectiveness of the Program[93]; (2) if there is a highly liquid investment minimum shortfall,[94] and (3) if the fund holds more than fifteen percent of its net assets in illiquid investments.[95]

(clarifying that per the final rule, a fund's board must have approved the "[c]ompliance policies and procedures that satisfy the requirements of Rule 22e-4, . . . on or before the applicable compliance date.").

87. *See infra* Section IV.A.2.

88. *See infra* Section IV.A.3.

89. Investment Company Liquidity Risk Management Programs; Commission Guidance for In-Kind ETFs, Investment Company Act Release No. 33,010, 83 Fed. Reg. 8342 (Feb. 27, 2018) [hereinafter the "Compliance Date Extension Release"]; *see infra* Section IV.A.5.

90. Compliance Date Extension Release, *supra* note 89.

91. 17 C.F.R. § 270.22e-4(b).

92. § 270.22e-4(b)(2)(ii); *see also* (a)(13) (stating that the Program Administrator may be the fund's "investment adviser, officer, or officers" but an individual that is solely the portfolio manager of the fund may not act as Program Administrator).

93. § 270.22e-4(b)(2)(iii) (stating that reporting on the Program's "adequacy and effectiveness" includes discussing, if applicable, "the operation of the highly liquid investment minimum, and any material changes to the program").

94. *See infra* Section IV.A.3.

95. *See infra* Section IV.A.4.

1. Liquidity Risk Assessment

The Liquidity Rule defines "liquidity risk" as "the risk that the fund could not meet requests to redeem shares issued by the fund without significant dilution of remaining investors' interests in the fund."[96] Through the Program, a fund must "assess, manage and periodically review" (no less frequently than annually) its "liquidity risk," considering the following Liquidity Risk Factors.[97]

a. Liquidity Risk Factors

When assessing, managing, and reviewing its liquidity risk, a fund must consider the following non-exhaustive list of factors, as applicable:

> (A) [I]nvestment strategy and liquidity of portfolio investments during both normal and reasonably foreseeable stressed conditions . . . ; (B) Short-term and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions; [and] (C) Holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources[.][98]

b. Review of Investment Strategy and Portfolio Liquidity

Under the Liquidity Rule, evaluating the fund's investment strategy includes considering: "[(1)] whether the investment strategy is appropriate for an open-end fund, [(2) includes] a relatively concentrated portfolio or large positions in particular issuers,[99] and [(3)] the use of borrowings for investment purposes and derivatives."[100]

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96. § 270.22e-4(a)(11); Adopting Release, *supra* note 12, at 82,158; *see* Jeffrey S. Puretz, et al., *Drowning in Liquidity: The SEC's New Liquidity Management Rule for Mutual Funds (Part 1)*, THE PRACTICAL LAWYER 43 (June 1, 2019) (noting that the Liquidity Rule's definition of "liquidity risk" suggests that a fund must consider not just the possibility that it is unable to meet redemption requests entirely, but also "the method(s) by which portfolio assets may be sold for the purpose of meeting shareholder redemptions, so as to seek to avoid a potentially significant dilution in value or a significant change in risk profile for remaining investors' interests.").

97. Adopting Release, *supra* note 12, at 82,157–158.

98. § 270.22e-4(b)(1)(i); Adopting Release, *supra* note 12, at 82,160–162 (stating that the Liquidity Risk Factors are non-exhaustive and rather serve as a "baseline," as the SEC sought to leave room for a fund to consider additional factors it thought necessary for evaluating its liquidity).

99. § 270.22e-4(b)(1)(i)(A); Adopting Release, *supra* note 12, at 82,162 (pointing out that a relatively concentrated portfolio (i.e. less diversified) might limit the choice of investments that the fund is able to sell in case it needs cash to cover redemptions, which might in turn force the fund to sell the securities in unfavorable markets).

100. § 270.22e-4(b)(1)(i)(A); *see* Proposing Release, *supra* note 8, at 62,308–09, n. 321 (noting that under Section 18 of the Investment Company Act, some ways in which a fund can borrow are: (1) from a bank, subject to the terms agreed to with the bank, including those related to the loan's repayment and maturity date, and as long as it maintains a percentage of asset coverage (at least 300% for all borrowings of the fund); or (2) through financing transactions like reverse repurchase agreements, firm commitment agreements or standby commitments, which, generally requires fund to segregate liquid assets).

In particular, the Adopting Release notes that requiring a fund to consider whether its investment strategy is appropriate for an open-end structure is a key tool for liquidity risk management, as it is likely to lead funds "to evaluate the suitability of investment strategies" that involve significant liquidity risk even if permitted under the fifteen percent illiquid investment requirement.[101] This assessment for example, might lead a fund to reconsider the suitability of investing in securities "so sensitive to stressed conditions" that the fund may not find a buyer when selling them under such conditions.[102] Similarly, the Adopting Release noted that funds investing primarily in securities with settlement periods longer than seven days (e.g. Secured loans) may not be operating under the proper structure, as they might not be able to meet redemptions within the seven days required by the 1940 Act.[103]

c. Cash Flow Projections

In assessing its cash flow projections, the Adopting Release highlights five factors that a fund should consider, including: "(i) the size, frequency, and volatility of historical purchases and redemptions of fund shares during normal and reasonably foreseeable stressed periods, (ii) the fund's redemption policies, (iii) the fund's shareholder ownership concentration, (iv) the fund's distribution channels, and (v) the degree of certainty associated with the fund's short-term and long-term cash flow projections."[104]

d. Holdings of Cash and Borrowing Arrangements

Lastly, in its liquidity risk assessment, a fund must consider its cash and cash equivalents as well as borrowing arrangements. The Adopting Release notes that these holdings and arrangements give flexibility to the fund's investment adviser to "readjust its portfolio [in case of] . . . changing market circumstances," helping the fund "meet some redemption requests without significant dilution of remaining investors' interests."[105] Further, borrowing arrangements could help the fund meet redemption requests when necessary by, for instance, bridging timing mismatches between redemption obligations and the realization of sales initially made to pay for redemptions.[106]

101. Adopting Release, *supra* note 12, at 82,162 (illustrating "if a fund's illiquid investments exceed 15% of net assets, this could indicate that the fund is encountering liquidity pressures that could significantly impair [its] ability to meet its redemption and other legal obligations."); § 270.22e-4(a)(11). *See infra* Section IV.A.4.

102. Adopting Release, *supra* note 12, at 82,162.

103. *Id.* at 82,169–170; *see* § 270.22e-4(a)(8) (defining "illiquid investment").

104. Adopting Release, *supra* note 12, at 82,164–165.

105. *Id.* at 82,166.

106. *Id.*

2. Classifying the Liquidity of Fund Investment

At the core of the Liquidity Risk Management Program is the requirement that a fund classifies its portfolio holdings into one of four liquidity categories, based on the number of days that "it reasonably expects an investment [to] be convertible to cash" "or, in the case of the less-liquid and illiquid categories," to sell the investment, "without . . . significantly changing" its market value.[107] The liquidity categories are as follows:

> (1) "Highly Liquid Investment" defined as "any cash held by a fund and any investment that the fund reasonably expects to be convertible into cash in current market conditions in three business days or less[;]"
>
> (2) "Moderately Liquid Investment" defined as "any investment that the fund reasonably expects to be convertible into cash in current market conditions in more than three calendar days but in seven calendar days or less[;]"
>
> (3) "Less Liquid Investment" defined as "any investment that the fund reasonably expects to be able to sell or dispose of in current market conditions in seven calendar days or less . . . but where the sale . . . is reasonably expected to settle in more than seven calendar days[;]"
>
> (4) "Illiquid Investment" defined as "any investment that the fund reasonably expects cannot be sold or disposed of in current market conditions in seven calendar days or less."[108]

Per the Adopting Release, funds have the discretion to determine whether to classify portfolio holdings on an investment-by-investment basis, or "according to their asset class."[109] Nevertheless, the SEC stipulates that a fund must classify the investment individually (instead of on an asset-class basis), "if the fund or its adviser has information about any market, trading, or investment-specific considerations . . . reasonably expected to significantly affect the liquidity characteristics of that investment" when compared to other holdings in the same asset class.[110] This exception to the ability to classify with reference to asset class connotes the need for some level of micro analysis on a security-by-security basis.

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107. *Id.* at 82,167–168; *see* § 270.22e-4(a)(3) (stating that under the Liquidity Rule, an investment is "convertible into cash" when it can "be sold, with the sale settled.").

108. §§ 270.22e-4(a)(6), (8), (10), (12).

109. § 270.22e-4(b)(1)(ii)(A).

110. *Id.*; Adopting Release, *supra* note 12, at 82,265 (stating that examples of such information include knowledge that: (1) the liquidity characteristics of a large-capitalization equity security were affected and made different from those of the asset class as a whole, because of adverse events impacting the security's issuer; and (2) the bid-ask spread of certain high-quality corporate bonds was "significantly wider or more volatile than those of their peers[.]").

a. Classification Procedures

With regards to a fund's procedures for classifying investments on an asset class basis, these must include "sufficient detail to meaningfully distinguish between asset classes and sub-classes" (i.e., Should avoid categories that are too general such as "equities" or "fixed income").[111] Further, in classifying investments, whether on an asset-class basis or investment-by-investment basis, the fund must consider "relevant market, trading, and investment-specific considerations," based on "information obtained after reasonable inquiry."[112] The fund is also required to consider an investment's "market depth,"[113] and the Adopting Release provided nine additional factors that funds "may consider" in classifying their investments but which are not required under the Liquidity Rule.[114]

Rule 22e-4 also requires a fund to "identify the percentage of [its] highly liquid investments that it has segregated to cover, or pledged to satisfy margin requirements in connection with, derivative transactions[,]" which "the fund has classified as moderately liquid investments, less liquid investments, and illiquid

111. Adopting Release, *supra* note 12, at 103, 82,180–181 (noting that, for instance, certain assets could be sub-classified as follows: (a) "equity securities" based on "the market(s) in which the security's issuer is based, market capitalization, and whether the security is common or preferred stock[;]" (b) "fixed income securities" based on "issuer type, the market(s) in which the issuer is based, seniority, age, and credit quality[;]" and (c) "structured products based on tranche seniority and credit quality.").

112. § 270.22e-4(b)(1)(ii); Adopting Release, *supra* note 12, at 82,171 (noting that the SEC found it important for funds to consider such market information, as opposed to just taking into account the "structural characteristics of an investment," since doing so would prevent the possibility of overlooking the fund's "actual ability to sell" an investment "without significant dilution.").

113. Adopting Release, *supra* note 12, at 82,168 n.281 (defining "market depth" as the extent to which "trading varying portions of a position in a particular investment, in sizes that the fund would reasonably anticipate trading, is reasonably expected to significantly affect the liquidity of that investment.").

114. Adopting Release, *supra* note 12, at 82,170 n.313. The following factors serve as guidance in evaluating portfolio investments liquidity characteristics:

> (1) existence of an active market for the asset, including whether the asset is listed on an exchange, as well as the number, diversity, and quality of market participants; (2) frequency of trades or quotes for the asset and average daily trading volume of the asset (regardless of whether the asset is a security traded on an exchange); (3) volatility of trading prices for the asset; (4) bid-ask spreads for the asset; (5) whether the asset has a relatively standardized and simple structure; (6) for fixed income securities, maturity and date of issue; (7) restrictions on trading of the asset and limitations on transfer of the asset; (8) the size of the fund's position in the asset relative to the asset's average daily trading volume and, as applicable, the number of units of the asset outstanding; and (9) relationship of the asset to another portfolio asset.

Id.

investments[.]"[115] The fund must then "disclose these percentages on its Form N-PORT filings." [116]

Lastly, under Rule 22e-4 "a fund must review its portfolio investments' classifications at least monthly" in connection with its Form N-PORT liquidity classification reporting, and "more frequently if changes in relevant market, trading, and investment-specific considerations are reasonably expected to materially affect one or more of its investments' classifications."[117]

3. Highly Liquid Investment Minimum (HLIM)

Another key aspect of the Liquidity Risk Management Program is the introduction of the concept of a fund's "highly liquid investment minimum" ("HLIM"), that is, the minimum "percentage of the fund's net assets that the fund invests in highly liquid investments that are assets."[118] Under Rule 22e-4, "any fund that does not primarily hold assets that are highly liquid investments" is required to: (1) determine a HLIM, taking into account the Liquidity Risk Factors[119] as applied to the fund; (2) review the HLIM periodically and "no less frequently than annually;" and (3) "adopt and implement policies and procedures for responding to a shortfall of the fund's highly liquid investments below its" HLIM (i.e. an HLIM shortfall).[120]

As some practitioners have interpreted, the Liquidity Rule does not seem to require the HLIM to be approved by the board of directors,[121] nor "prohibit[] [the fund] from acquiring assets that are not highly liquid when a shortfall occurs."[122] Nevertheless, the HLIM "may not be changed during any period of time" in which there is an HLIM shortfall, "without approval from the fund's board of directors, including a majority" of independent directors.[123]

a. Responding to a HLIM Shortfall

Under the Liquidity Rule, the "policies and procedures" needed for responding to a HLIM shortfall "must include requiring the [Program Administrator] to report to the fund's board of directors no later than its next regularly scheduled meeting with a brief explanation of the causes of the shortfall, the extent of the shortfall, and any actions taken in response."[124]

115. § 270.22e-4(b)(1)(ii)(C).

116. Adopting Release, *supra* note 12, at 82,182 (noting that such reporting aims at informing both the SEC and the public that some of the fund's "highly liquid investments" are encumbered or otherwise "may not be immediately available for liquidity risk management purposes.").

117. § 270.22e-4(b)(1)(ii).

118. § 270.22e-4 (a)(7).

119. *See supra* Section IV.A.1.a.

120. § 270.22e-4(b)(1)(iii)(A).

121. Puretz, *supra* note 96, at 46.

122. Baker & Corriero, *supra* note 86, at 4–5.

123. § 270.22e-4(b)(1)(iii)(A)(1).

124. § 270.22e-4(b)(1)(iii)(A)(3).

Further, "if the shortfall lasts more than 7 consecutive calendar days," the policies and procedures must require the Program Administrator "to report to the board within one business day thereafter with an explanation of how the fund plans to restore its minimum within a reasonable period of time."[125]

4. Limitation on Funds Illiquid Investments

Under the Liquidity Rule, a fund may not "acquire any [additional] illiquid investment if, immediately after the acquisition, the fund . . . would have invested more than [fifteen percent] of its net assets in illiquid investments that are assets."[126] As the Adopting Release suggested, this key provision aims to "increase the likelihood that a fund's portfolio is not concentrated in investments whose liquidity is extremely limited, and thus will serve as an across-the-board limit on fund illiquidity."[127]

Moreover, "if a fund . . . holds more than [fifteen percent] of its net assets in illiquid investments" the Program Administrator must report to the board "within one business day" of exceeding the fifteen percent limit, "with an explanation of the extent and causes of the occurrence and how the fund . . . plans to bring its illiquid investments that are assets to or below" the limit.[128]

If the fund continues to exceed the fifteen percent illiquid investment limit after "30 days from the occurrence," the board must assess whether the plan that the program administrator had presented (to bring the illiquid investments to or below the fifteen percent limit) "continues to be in the best interest of the fund[.]"[129]

5. Board Oversight

Per the Liquidity Rule, "a fund['s] . . . board of directors, including a majority of" independent directors, must:

> (i) Initially approve the liquidity risk management program; (ii) Approve the designation of the [Program Administrator]; and (iii) Review, no less frequently than annually, a written report prepared by the [Program Administrator] that addresses the operation of the program and assesses its adequacy and effectiveness of implementation, including, if applicable, the operation of the [HLIM] and any material changes to the program.[130]

Additionally, as previously discussed, the Liquidity Rule affords the board two more instances in which to exercise oversight power, as it must: (1) approve

125. *Id*.
126. § 270.22e-4(b)(1)(iv).
127. Adopting Release, *supra* note 12, at 82,208.
128. § 270.22e-4(b)(1)(iv)(A).
129. § 270.22e-4(b)(1)(iv)(B).
130. § 270.22e-4(b)(2).

changes to the HLIM if implemented during an HLIM shortfall;[131] and (2) if the fund has exceeded the fifteen percent limit on illiquid investments during more than 30 days, determine if the Program Administrator's plan for reducing illiquid investments continues to be in the fund's best interest.[132]

B. Liquidity Disclosure Regime Post Amendments

The SEC also implemented notable policy changes with the Liquidity Rule and form amendments for modernizing mutual funds' reporting and disclosure regimes, as there was no prior requirement on funds to expressly disclose how they managed their liquidity.[133] Such reforms were designed to "increase the transparency of fund portfolios and investment practices both to the Commission and to investors."[134] The reporting and disclosure requirements adopted were the following:

1. Form N-LIQUID

The SEC adopted new Rule 30b1-10, requiring all mutual funds (except for money market funds) to "file . . . a . . . [non-public] report on Form N-LIQUID," within one business day of any of the following liquidity related occurrences: (1) if the fund exceeds the fifteen percent limitation on illiquid investments; (2) if it returns to compliance with the illiquid investments limitation; and (3) if the fund's highly liquid investments fall below the established minimum (HLIM) for more than seven consecutive calendar days.[135]

2. Amendments to Form N-PORT

On new Form N-PORT, adopted concurrently with Rule 22e-4, funds are required to report on a monthly basis: (1) the liquidity classification for each investment;[136] (2) the "aggregate percentage of its portfolio" that falls in "each of the four [liquidity] classification categories";[137] (3) the fund's HLIM (if applicable);[138] and (4) "the percentage of the fund's highly liquid investments that is segregated to cover, or pledged to satisfy margin requirements in connection with [the] fund's derivative transactions[.]"[139]

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131. § 270.22e-4(b)(1)(iii)(A)(3); *see supra* Section IV.A.3.

132. § 270.22e-4(b)(1)(iv)(B).

133. Baker & Corriero, *supra* note 86, at 19.

134. Investment Company Reporting Modernization, Release No. IC-21314, 81 Fed. Reg. 81,870, 81,872 (Nov. 18, 2016) (hereinafter "Reporting Modernization Release").

135. 17 C.F.R. § 270.30b1-10 (2020); *see* Form N-LIQUID, General Instructions, Part B, Part C, Part D.

136. § 270.22e-4(b)(1)(ii).

137. Adopting Release, *supra* note 12, at 82,196 (noting that the fund only needs to publicly disclose its aggregate levels of liquidity "for the third month of each fiscal quarter with a 60-day delay").

138. *Id.* at 82,257; *see* Form N-PORT, Item B.7.

139. Adopting Release, *supra* note 12, at 82,257; *see* Form N-PORT, Item C.7.

3. Amendments to Form N-CEN

Lastly, on new Form N-CEN, the SEC requires funds to disclose information about the fund's committed and uncommitted lines of credit, their size, number of days used, institution with which a line of credit is held, and whether the fund engaged in interfund lending or borrowing.[140] The SEC estimates that such information would "facilitate [its] oversight of funds and its ability to monitor trends and risks."[141]

As one Commentator to the Liquidity Rule Proposal noted, such increased reporting and disclosure requirements could help the SEC "monitor fund holdings and liquidity determinations, examine potential outliers, and if an unexpected market event occurs (*e.g.* the default of a significant institution), quickly assess the potential impact on mutual funds it [regulates]."[142]

V. COMMENT

A. Rule 22e-4 Presents Effective Mechanisms to Prevent a Focused Credit-Type of Mutual Fund Meltdown

Considering the tools that the Liquidity Rule provides as described herein, the question then becomes whether they would make a difference in preventing a liquidity meltdown like the one Focused Credit faced. To answer such inquiry, this comment hypothesizes as to the likely application of some of the key provisions of Rule 22e-4 to Focused Credit's facts and circumstances, had the Liquidity Rule been in place during and prior to the Fund's collapse. This a limited approach, especially given the complexity of implementing all the systems and processes required under the Rule. However, such exercise illustrates how some of the Liquidity Rule's provisions may have helped prevent Focused Credit's downfall, especially by providing earlier warnings about the Fund's liquidity issues and presenting new tools to address them.

1. Focused Credit's Liquidity Risk Management Program

At the outset, the Liquidity Rule would have required Focused Credit to implement a written Liquidity Risk Management Program to assess, manage and review its liquidity risk (at least annually).[143] Likewise, the Fund had to designate, with the board's approval, the person(s) who would administer the Program and provide written reports to the board about the Program's operation, about material changes to the Program, and about the operation of the HLIM.[144]

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140. Adopting Release, *supra* note 12, at 82,260; *see* Form N-CEN, Item C.20.

141. *Id.*

142. J.P. Morgan Asset Management, Comment Letter on Proposed Rule on Mutual Funds Liquidity Risk Management 9 (Jan. 13, 2016), https://www.sec.gov/comments/s7-16-15/s71615-67.pdf [hereinafter J.P. Morgan Comment Letter].

143. § 270.22e-4(b)(1); *see supra* Section IV.A.1.

144. § 270.22e-4(a)(13), (b)(2); *see supra* Sections IV.A.1., IV.A.3.

These two initial requirements contrast with what the Fund appeared to have in place according to its Quarterly Reports, where it barely discussed its liquidity and made no mention of any program or specific plan to manage its liquidity risk.[145] The Adviser to the fund complex indeed established a "Valuation Committee" responsible for "fair value and liquidity determinations" for all five funds, including Focused Credit.[146] However, valuation is itself a significant responsibility for a fund group, particularly where, as here, market quotations are not readily available for a fund's holdings. The implementation of a Program exclusively focused on liquidity and designation of a Program Administrator exclusively for the Fund may have benefitted it through increased internal scrutiny and a more personalized approach to its liquidity risk management.

Then, in assessing its liquidity risk, among the various factors that the SEC highlighted for funds to consider, Focused Credit may have particularly benefitted from reviewing its "investment strategy and liquidity of portfolio investments during both normal and reasonably foreseeable stressed conditions."[147] This review may have yielded preliminary warnings about potential shortcomings in the Fund's liquidity management.

a. Review of Investment Strategy

To review its investment strategy, Focused Credit would have assessed (at the very least), whether such strategy (a) was "appropriate for an open-end fund," (b) "involve[d] a relatively concentrated portfolio or large positions in particular issuers," and (c) the extent to which it used "borrowings for investment purposes and derivatives."[148]

First, in assessing whether its investment strategy was appropriate for an open-end fund, Focused Credit might have, for instance, considered the fact that its strategy included investing "a substantial amount of its assets in credit instruments that are rated below investment grade," like "unrated" high-yield bonds, and other credit instrument such as secured loans.[149] As was discussed in Section II, such investment strategy might prove worrisome for a mutual fund like Focused Credit, which had to stand ready to meet shareholder redemptions, and during times of economic stress could be forced to sell its assets at fire sale prices just to cover redemptions. The Fund's board may have considered whether a different form of fund organization, such as a closed-end or interval fund format, would have been more appropriate for the Fund's strategies.

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145. *See, e.g.*, THIRD AVENUE FUNDS, SEMI-ANNUAL REPORT, *supra* note 21, at 38, 59 (broadly noting, in a subsection titled "Liquidity Risk" that the Fund "hold[s] investments . . . having substantial market and/or credit risk which may be difficult to sell at certain periods of time" and which the Fund "may not be able to dispose of … at the value the Fund places on them.").

146. *Id.* at 38 (stating that the Committee also had "oversight of any third parties to whom any responsibility for fair value and liquidity determinations [was] delegated.").

147. § 270.22e-4(b)(1); *see supra* Sections IV.A.1, IV.A.3.

148. § 270.22e-4(b)(1)(i)(A).

149. *Summary Prospectus: Third Avenue Focused Credit Fund*, *supra* note 14, at 2.

Second, in considering whether its strategy involved a highly concentrated portfolio or large positions in particular issuers, Focused Credit might have taken into account, for example, that "[a]s of July 2015, management had invested half the fund's assets in bonds rated below B and another 40% in nonrated" credit instruments.[150] Likewise, it would have considered some of the fund's large holdings, such as its "nearly 5% stake" in then troubled IHeartMedia (the fund's "largest individual holding" as of July 2015);[151] or the roughly 20% ownership "of a $250 million issue of low-rated bonds sold by New Enterprise Stone & Lime Co."[152] These investments might have raised red flags for the Program Administrator reviewing the Fund's investment strategy and its liquidity risk.[153]

Lastly, with regards to the use of borrowings and derivatives for investment purposes, no report has suggested that the Fund had an issue in this area. Focused Credit was subject to stringent coverage requirements (*i.e*. to ensure it had enough assets to cover its obligations) under Section 18 of the 1940 Act, whether it borrowed from a bank or through financing transactions (which require the segregation of liquid assets).[154] Nevertheless, this may be an important consideration for the Fund's liquidity because "[s]egregated assets are considered to be unavailable for sale or disposition, . . . unless replaced by other appropriate non-segregated assets of equal value."[155] Thus, if the Fund received significant redemption requests, it may have had to "unwind" (repay) portions of its financing transactions (borrowings) by using its liquid assets, thereby leaving less available to fulfill redemption requests.[156]

2. Classification of the Fund's Portfolio Holdings and HLIM

As part of the Liquidity Program, Focused Credit would have had to classify its portfolio investments into one of four liquidity categories (highly liquid, moderately liquid, less liquid, and illiquid investment).[157] The Fund had to classify its investments after conducting a "reasonable inquiry," taking into account (1) "relevant 'market, trading, and investment-specific considerations'[,]" as well as (2) the "market depth" of the investments.[158] The SEC also suggested nine non-exclusive factors that the Fund could consider, and

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150. Ptak, *supra* note 19.

151. *Id.*

152. Gregory Zuckerman & Matt Wirz, *How the Third Avenue Fund Melted Down*, THE WALL ST. J. (Dec. 23, 2015 3:38 PM), https://www.wsj.com/articles/how-the-third-avenue-fund-melted-down-1450903135.

153. Adopting Release, *supra* note 12, at 71. The Rule Release directly referred to Focused Credit's as an illustration of how a "concentrated portfolio" can "directly affect liquidity risk" and in turn, shareholder's ability to redeem their shares. *Id.* at 72.

154. Proposing Release, *supra* note 8, at 62,308.

155. *Id.*

156. *Id*.

157. 17 C.F.R. § 270.22e-4(a)(6), (8), (10),(12) (2019); *see supra* Section IV.A.2.

158. Adopting Release, *supra* note 12, at 90–91.

under the Liquidity Rule, it must review its investments classifications on a monthly basis.[159]

Complying with the classification requirement has proved to be a highly complex task,[160] and as such, it is impracticable to speculate as to how the Fund would have classified each of its holdings. Nevertheless, Focused Credit may very well have deemed some of its concentrated investments (mentioned above) and other high-yield bond holdings, as being "less liquid" or "illiquid." As one industry analyst noted, a fund with "large stakes in lower-quality bonds" may be "particularly illiquid" and "could be difficult to unwind in a stressed credit market," especially if redemption requests pressure the fund to sell at "punishingly low prices."[161] Ultimately, as one commenter to the Rule Proposal highlighted, analyzing how a fund's "portfolio's assets are spread across" the "spectrum from highly liquid to illiquid" provides an "important input into the assessment, monitoring and management of a fund's liquidity risk."[162]

3. Highly Liquid Investment Minimum

After classifying its investments, Focused Credit then had to "determine and periodically review"[163] a minimum percentage of assets held in highly liquid investments (a HLIM), and implement policies and procedures for responding to a HLIM shortfall. This may have benefitted the Fund, especially in ensuring that it maintained enough liquid assets to cover potential "redemption requests without significant dilution to remaining investors' interests."[164]

Moreover, had the Fund faced a HLIM shortfall before its collapse became imminent, there would have been key early warnings that might have prompted it to take serious remedial action. Specifically, the Fund's HLIM shortfall policies and procedures had to require the Program Administrator to: (1) report to the Fund's board no later than its next regularly scheduled meeting, the causes and extent of, as well as responses to, the shortfall; and (2) if the shortfall lasted more than seven consecutive calendar days, "report to the board within one business day thereafter with an explanation of how the fund planned to restore its minimum within a reasonable period of time." As the SEC suggests, such reporting may allow a fund's board to exercise more oversight, understand the circumstances surrounding the fund's liquidity risk, and evaluate the

159. *See supra* Section IV.A.2.a.

160. Compliance Date Extension Release, *supra* note 89, at 8342, 8344 (noting how the SEC ultimately decided to extend the compliance date for the classification and the HLIM requirements after receiving requests from commenters who had concerns "regarding the difficulties . . . in preparing to comply in a timely manner" with the initial compliance dates).

161. Ptak, *supra* note 19.

162. J.P. Morgan Comment Letter, *supra* note 142, at 3.

163. Adopting Release, *supra* note 12, at 82,238 n. 1102.

164. *Id.* at 82,166.

effectiveness of the HLIM and that of the Program as a whole.[165] Focused Credit would likely have benefited from such additional safeguards.

4. Limitation on Illiquid Investments

The Liquidity Rule would have also prohibited the Fund from acquiring "any illiquid investments, if immediately after the acquisition, [the Fund] . . . would have invested more than 15% of its net assets in illiquid investments that are assets."[166] Indeed, the Fund first needed to determine what it considered to be an "illiquid investment" under its classification regime. However, as industry analysts suggested, by July 2015, the Fund held almost twenty percent of its assets in "hard to value and trade" securities, held highly concentrated investments and centered its investment strategy on below-investment-grade credit instruments.[167] Under such circumstances, the Fund may well have exceeded the fifteen percent limit before its collapse.

Exceeding the illiquid investment limit would have triggered important reporting obligations for the Program Administrator to the Fund's board. Specifically, the Program Administrator had to report to the board within one business day of the occurrence of the excess with an explanation of the extent of the excess, what caused it, and a plan for the Fund to bring its holdings to or below the fifteen percent limit within a "reasonable . . . time."[168] This could have brought the Fund's liquidity issues to light earlier and allowed more time for the Fund and the board to address them. Likewise, if the excess continued for more than 30 days, the board had to assess whether the remedial plan presented to it continued to be in the Fund's best interest.[169] Such periodic review should have "provided sufficient information and regular updates" for the Fund's board to "make an informed judgment," as the SEC suggests, ideally prompting the board to ask management for further remedial actions before it was too late.[170]

5. Focused Credit's Board Oversight

In addition to the oversight authority that the Fund's board had with regards to the HLIM and the limitation on illiquid investments, as noted in Sections V.A.2 and V.A.3, the Liquidity Rule also required a majority of the Fund's independent board directors to: (1) approve the initial Liquidity Management Program, (2) approve the Program Administrator, and (3) review, at least annually, the Program Administrator's written report about the Program's operation, and assess the adequacy and effectiveness of its implementation.[171]

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165. Adopting Release *supra* note 12, at 82,204.
166. 17 C.F.R. § 270.22e-4 (b)(1)(iv) (2019).
167. McLaughlin, *supra* note 11; *see supra* Section III.A.2.
168. § 270.22e-4 (b)(1)(iv)(A).
169. Adopting Release, *supra* note 12, at 82,2007.
170. *Id*.
171. § 270.22e-4 (b)(2).

Under these requirements, Focused Credit's board would have obtained key additional knowledge and oversight of the Fund's liquidity, as well as additional leverage over the Fund's liquidity risk management practices. Through the review of the Program, assuming it was in place for long enough, the board may have learned of the Fund's liquidity issues well before they became untenable, thus encouraging the adoption of greater measures to mitigate them. Thus, if management was being aggressive or naïve in its assessment of liquidity risk, the board may have had a more objective perspective and would have had the authority to dictate greater prudence in managing the Fund.

B. Rule 22e-4 Also Provides the SEC with a New Remedy to Bring Enforcement Actions Against Persons Who Failed to Manage Liquidity Sufficiently

With the Liquidity Rule enacted, the SEC can now bring enforcement actions under Section 41[172] and Section 48[173] of the 1940 Act alleging a violation of the Liquidity Rule. Additionally, the liquidity disclosure and reporting requirements likely gives the SEC a clearer picture of funds' investment practices and how they manage their liquidity. Taking advantage of such increased transparency, and depending on the facts, the SEC could bring enforcement actions against persons such as: (1) the Liquidity Administrator, if he/she did not adequately and objectively analyze the fund's liquidity and failed to flag problems in time; (2) the fund's board, if there is evidence that it should have taken more robust action; (3) the adviser, if it failed to meet any responsibilities under the Program; (4) the fund's investment personnel, if they knew there was a problem and ignored it; or (5) the chief compliance officer (CCO) or the adviser's general counsel, if there is evidence that they should have acted but failed to do so.[174]

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172. 15 U.S.C. §§ 80a-41(d), (e)(1) (2012); *see also* James G. Cavoli, et al., *The SEC's Mutual Fund Fee Initiative: What to Expect*, 16 WESTLAW J. SEC. LITIG. & REG. 1, 7–8 (2010), https://www.milbank.com/images/content/1/0/1033/111610_Westlaw_SCL1614_Commentary_Cavoli.pdf. Noting that under Section 42 [now Section 41] of the 1940 Act, the SEC has

> [T]he power to bring an action for injunctive relief and/or monetary penalties "whenever it shall appear to the commission that any person has engaged or is about to engage in any act or practice constituting a violation of any provision of this subchapter, or of any rule, regulation or order hereunder."

Id.

173. 15 U.S.C. § 80a-48 (2006); *see also* Cavoli, *supra* note 172, at 7 (highlighting that Section 48 gives the SEC the ability to pursue "aider and abettor liability" under the 1940 Act, whereby "any person that knowingly or recklessly provides substantial assistance to another person in violation of a provision of this act . . . [or of any rule or regulation hereunder], shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.").

174. *See* BlackRock Advisors, LLC and Bartholomew A. Battista, Investment Company Act Release No. 31558, 2 (Apr. 20, 2015) (finding Mr. Battista, BlackRock's Chief Compliance Officer ("CCO"), at fault, in part because he "knew about [the portfolio managers'] violations [of Rule

The SEC could potentially bring an enforcement action against the relevant persons for missing the early warning that a robust liquidity management program would have picked up. Moreover, management's failure to adequately report liquidity problems to the fund's board could also form the basis for SEC action; and even if a fund's liquidity classifications appear to be too generous, potential enforcement action could ensue for making a filing with the SEC that includes a misstatement.[175]

Ultimately, the potential for liability might provide an additional incentive for funds (like Focused Credit) and their related persons to establish robust liquidity risk management programs and to address liquidity issues promptly. Otherwise, the SEC would have the option to go after those responsible for failing to manage fund's liquidity adequately and perhaps even provide some relief for the affected investors.

C. Recent market developments: COVID-19 Tests Funds' Liquidity Risk Management Programs

In mid-March of 2020, markets "entered bear-market territory," as COVID-19 "was officially declared a pandemic."[176] An industry analyst then reminded us that "[r]ecession fears typically spark a flight to quality," and, as this Comment highlighted, such fears may lead to large waves of mutual fund investors seeking to redeem their shares to get their money back.[177] Such "heavy redemptions" briefly took place in various parts of the mutual fund world.[178]

Indeed, researcher Antonio Falato and his peers noted that the COVID-19 crisis brought about "large outflows [that] were sustained for weeks, widespread among both investment-grade and high-yield funds, persistent, and correlated across asset-classes within-funds."[179] Further, Falato's group's analysis

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38a-1(a)(4)(ii)(B) under the 1940 Act] and knew or should have known that they were not reported to the funds' boards.").

175. *See* Evergreen Investment Management Company, LLC, Investment Company Act No. 28759, 2, 13 (June 8, 2009) (providing an example of an SEC enforcement action against an adviser for, among other things, overstating the fund's net asset value ("NAV") and withholding information that could have negatively affected the price of the fund's securities, which resulted in the fund filing documents with the SEC that contained "untrue statements of material fact" in violation of Section 34(b) of the 1940 Act).

176. Russel Kinnel, *How Mutual Funds Look After the Coronavirus Meltdown*, MORNINGSTAR: FUND TIMES (Mar. 16, 2020), https://www.morningstar.com/articles/969801/how-mutual-funds-look-after-the-coronavirus-meltdown.

177. John Rekenthaler, *Did Mutual Funds Perform as Expected During the Mini-Crash?* (Mar. 6, 2020), https://www.morningstar.com/articles/970581/did-mutual-funds-perform-as-expected-during-the-mini-crash; *see supra* Section III; *Flight to Quality*, INVESTOPEDIA (May 4, 2020), https://www.investopedia.com/terms/f/flighttoquality.asp (defining "flight to quality" as investors' actions to move their capital "away from riskier investments and into safer ones").

178. Rekenthaler *supra* note 177.

179. Antonio Falato, et al., *Financial Fragility in the COVID-19 Crisis: The Case of Investment Funds in Corporate Bond Markets* 11 (U. Chi., Becker Friedman Inst. for Econ.,

suggests that such "large outflows" were in part driven by funds' "illiquidity and vulnerability to fire-sales," and that funds holding less liquid bonds tended to suffer more severe outflows.[180] This seems to fall in line with this Comment's assessment in Section III regarding the increased liquidity challenges that funds primarily holding high-yield bonds or secured loans may face in times of stress (when such assets tend to be less liquid).[181]

Ultimately, Falato and his colleagues point out that outflows started to cede in the last week of March, and "fully reverse[d]" after April 9th, likely in response to the Federal Reserve's announcements "about extraordinary direct interventions in corporate-bond markets," which "alleviat[ed] fund stress."[182] However, the question remains: what role (if any) did the newly required liquidity risk management programs play in helping funds withstand the stress from the COVID-19 crisis? Although not by design, the March episode could serve as a good test for the Liquidity Rule's effectiveness, and the SEC might benefit from using this opportunity to conduct sweep exams to see if fund groups used a robust approach to comply with their own procedures.

VI. Conclusion

The Liquidity Rule may have helped Focused Credit better assess and manage its liquidity risk by requiring it to implement a Liquidity Risk Management Program, classify its investments, adopt a Highly Liquid Investment Minimum, limit the Fund's illiquid investments and allow the board more opportunities for oversight. The Fund may have particularly benefitted from reconsidering the appropriateness of its investment strategy, which focused on debt instruments that may pose increased liquidity issues in times of financial stress, and from the early warnings that the Program would have provided. Moreover, Focused Credit would have had an additional incentive to implement an effective liquidity risk management program, if nothing else, to avoid any potential liability for violating the Liquidity Rule.

Altogether, the tools that the Liquidity Rule provided may have better prepared the Fund for covering large redemption requests in light of a faltering bond market, at least to a certain extent. This, of course, discounts the notion that in the face of a true crisis, if a fund faces redemption requests by virtually

Working Paper No. 2020-98, 2020), https://bfi.uchicago.edu/wp-content/uploads/BFI_WP_202098.pdf.

180. *Id.* at 16–17, 19.

181. *See supra* Section III (breaking down the role of liquidity in mutual funds and explaining that, when a fund faces outsized redemptions, the interests of shareholders that stay in the fund may be hurt if it lacks cash and cash equivalent holdings," and "its assets are difficult to convert into cash without having to do so at prices lower than their carrying value on the fund's books" (i.e., fire-sales)).

182. Falato, *supra* note 179, at 11–12 (detailing two announcements from the Federal Reserve (the "Fed") describing actions that the Fed took in March and April to restore liquidity in the corporate-bond and other markets).

all of its investors, there is very little that a liquidity risk management program may be able to do to save it, as the fund might have to sell *all* of its assets to pay investors back. Ultimately, with the liquidity crunch from the COVID-19 crisis (at least temporarily) behind us, regulators and the industry will have the opportunity to assess whether the systems and precautions that the Liquidity Rule mandated actually made any difference in helping funds stay afloat when market liquidity evaporated.