

Junk Bond Fund Failure Challenges Industry

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The December failure and ongoing liquidation of the Third Avenue Focused Credit Fund (TAFCF) provides potential ammunition to significant financial services industry players who believe mutual funds and investment managers can present significant risks to the financial system and, in some cases, should be subject to special regulation by the Federal Reserve or more bank-like regulation by the SEC. See "FSOC Presses SEC on Money Managers' Systemic Risks," *Expect Focus*, Winter 2015.

Due to heavy redemption requests and insufficient liquidity in its portfolio of high-yield securities, TAFCF elected to suspend redemptions and liquidate. The SEC issued a temporary order on an emergency basis to facilitate that process, subject to certain conditions.

The SEC staff also immediately sent "sweep" requests to managers of other high-yield funds, requesting numerous types of information relevant to the funds' liquidity and related practices. The staff's sense of urgency was underscored by the unusually tight response deadline it set. In addition, the SEC's Office of Compliance Inspections and Examinations subsequently published its 2016 Examination Priorities that included scrutiny of liquidity controls of advisers to funds "that have exposure to potentially illiquid debt securities." Similarly, two major pending SEC rule proposals share the principal objective of reducing any possibility of inadequate fund liquidity: see "SEC Proposes New Limits on Funds' Use of Derivatives" on page 9 and "SEC Proposes Liquidity Risk Programs for Funds," *Expect Focus*, Fall 2015.

These strong responses by the SEC and its staff bolster the SEC's argument that it has the expertise and vigor to remain the primary regulator of the risks associated with funds and money managers, and that neither bank-like regulation nor much greater involvement by other regulators is necessary or desirable. The fund industry generally agrees with those arguments and, therefore, should hope that, as it seems, the circumstances leading to TAFCF's failure were aberrational.

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