# Potential Regulatory and Litigation Risks Relating to Recent Fixed-Income Market Concerns

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Recent events relating to the fixed-income markets — including volatility in the high-yield markets and the high-profile closings of a number of funds invested in high-yield and distressed assets — have raised concerns among investors and led many to question whether broader market instability may follow. We have divided the below into two parts: First, we review the current circumstances giving rise to these market concerns, and second, we focus on regulatory- and litigation-related risks to consider in their wake.

## Rising Market Concerns

Diminishing liquidity in some sectors of the credit markets has been on the minds of sophisticated investors for at least the past six months. Most trace the liquidity concern, at least in significant part, to the changing role of large banks post-2008. Where banks pre-2008 were willing to hold large inventories of bonds, regulatory changes have pressured these institutions to reduce their holdings. As a consequence, banks have stepped back from large parts of their traditional market-making functions, thereby leaving credit markets without their customary liquidity providers.

A second factor complicates this picture. For years now, high-rated credits have offered investors small returns. Not surprisingly, this extended condition has driven some market participants to chase yield by investing in increasingly riskier credits. Additionally, some say the increased appetite for high-yielding debt has opened the credit window for riskier, lower-quality and ultimately less liquid issuances.

We are concerned about how these forces may affect our clients that participate in the retail fund market. First, retail investor participation in the riskier end of the credit markets, including high-yield instruments, has risen to historically high levels. Second, two vehicles through which retail investors participate in the riskier credit markets — mutual funds and exchange-traded funds (ETFs) — may contain tail risks that retail investors claim were not within their contemplation when they invested. Because regulators and our judicial system regularly extend themselves to vindicate the interests of retail investors, we see this mismatch between expectation and outcome as presenting risks for our clients.

Recently, several high-yield fixed income funds announced that they would be suspending investor redemptions to allow the funds to liquidate their investments in an orderly manner and make distributions to investors. These decisions appear to be based in part on the "open end" nature of the funds, which allows investors to liquidate their positions on a daily basis. In circumstances where market illiquidity prevents a fund from selling assets at other than fire-sale prices, redemption demands may outpace the fund's ability to raise cash, leading to investor panic and so-called "runs on the funds."

Liquidity concerns have also been voiced regarding other fixed-income funds, including closed-end and "liquid alternative" ETFs.[1] ETFs were created as a tool for sophisticated investors to manage short-term risk in different market sectors.[2] In recent years, however, they have become an attractive option for retail investors because of their diversification and liquidity. ETFs also have evolved from products that have sought to track the returns of various easily measured market indices to more bespoke products

[1] The "vast majority of ETFs are organized as open-end funds" as defined by the SEC. "Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release; Proposed Rule," SEC Release No. IC-31835, 80 Fed. Reg. 62274, 62288 n.131 (Oct. 15, 2015) (Release). Nevertheless, because of the restrictions on redemptions, ETFs face challenges that are distinct from open-end mutual funds, which could face redemption requests from retail investors.

[2] *See* "A Focus on ETFs," Wall St. J.

shaped to meet the demands of specific investors. Unlike typical mutual funds, ETFs are traded on exchanges with their prices set by supply-and-demand factors. Because of this, in times of market stress, ETFs (which make it difficult to redeem shares) offer greater liquidity risks than open-end mutual funds. Some have questioned, however, whether steep disparities between the price of an ETF and the net asset value (NAV) of its portfolio (as might become the case where ETFs bundle high-yield, distressed or illiquid assets, for example) could cause ETF holders to seek to exit their positions in droves, leading to severely widened bid-ask spreads or overall trading illiquidity.[3] Recently, one prominent executive crystallized those concerns: "We believe that there is a real liquidity problem in the fixed income market in that there is far less liquidity today than 10 years ago," and "[t]he liquidity that we're really worried about isn't so much in mutual funds, but in the ETF world because a lot of new money has gone into ETFs under the assumption that they are liquid. And in the high-yield space in particular, they are not."[4] That view has some high-profile backers, including Carl Icahn, but has been rejected by others in the marketplace such as BlackRock CEO Larry Fink, who believes that ETFs "provide liquidity to the marketplace."[5]

There is thus some dispute about how the ETF market would respond to a high-yield bond crisis. Although it is clear that an individual investor would likely face a sellers' market in seeking to exit a high-yield ETF during a crisis (and therefore be forced to sell at a steep discount), ETF advocates claim that the ultimate redeemability of ETFs means that "authorized participants" who can redeem creation shares for a basket of the underlying bonds will always be offering to buy, albeit not always for a favorable price.[6] On the other hand, that logic will be tested if an ETF's underlying assets become deeply distressed.

## Isolated Events or Systemic Concern?

The illiquidity of certain assets appear to have caused certain high-yield funds to recently suspend investor redemptions.

If we were portfolio managers, we would take a position on whether such events are the beginning or the end of this story. As lawyers, the best we can do is offer our thoughts about litigation and regulatory fall-out that might follow should these events prove to be the canaries in the coal mine.

[3] *See generally* Ari Altstedter and Doug Alexander, "ETF Liquidity Risk a Concern for Regulators, Wilkins Says," BloombergBusiness, Sept. 23, 2014.

[4] Peter S. Kraus, remarks at the Goldman Sachs U.S. Financial Services Conference (Dec. 8, 2015).

[5] Matthew J. Belvedere, "Mutual Funds Riskier Than ETFs: BlackRock CEO Fink," CNBC.com, Jan. 15, 2016.

[6] Dave Nadig, "Why Icahn Is Dead Wrong on ETFs," ETF.com, July 16, 2015.

## Potential Regulatory and Litigation Considerations

### Open-End Funds

Funds that promise investors the ability to freely redeem their investments — the hallmark of an open-end fund pursuant to the Securities and Exchange Commission's (SEC) definition — may face regulatory scrutiny when mass redemptions threaten daily liquidity.

Over strong objections from major market participants,[7] the SEC has proposed more stringent rules governing open-end funds' liquidity management practices. In addition to requiring funds to implement a formal liquidity management plan and maintain sufficient investments in three-day liquid assets, the SEC's proposed rule would require funds to implement "swing pricing" in order to pass along transaction costs associated with shareholder redemptions to the shareholders.[8]

Protecting retail investors is among the SEC's announced priorities for 2016, and with public attention increasingly turning to liquidity valuations, regulators are certain to scrutinize all aspects of any failed or troubled high-yield fund. Regulators likely will look at how fund managers describe their holdings (specifically, whether they misrepresent the liquidity or value of their investments) and whether they have structured their assets to meet the risk of mass redemptions (including advance planning and communications with investors).[9] If a fund has mischaracterized or failed to disclose the illiquidity of its holdings, then the viability of a regulatory action likely will hinge on what the fund managers knew and when they knew it.[10] Finally, regulators also will look for any indications that fund management permitted employees to redeem from the fund immediately prior to suspension of redemptions.

State attorneys general and federal regulators have focused not only on cases in which investors are left with an investment they cannot redeem, but also on those in which funds have sought to redeem at less than the previously reported NAV. For example, in 2008, the Reserve Primary Fund — a major money market fund whose NAV plummeted as a result of its heavy exposure to Lehman Brothers debt — froze its assets and struggled to create an orderly liquidation plan. The SEC initiated an action seeking

[7] *See, e.g.*, Paul Schott Stevens, "Liquidity Risk Management Must Be Done Right," Jan. 15, 2016; "SIFMA AMG Recommends Improvements to the SEC Proposed Liquidity Management Rules for Mutual Funds and ETFs," SIFMA, Jan. 13, 2016.

[8] *See* Release, 80 Fed. Reg. at 2274.

[9] *See, e.g., S.E.C. v. Smith*, No. 14-cv-192(PB), 2015 WL 4067095 (D.N.H. July 2, 2015); *S.E.C. v. Yorkville Advisors, LLC*, No. 12-cv-7728(GBD), 2013 WL 3989054 (S.D.N.Y. Aug. 2, 2013); *United States v. Bloom*, No. 12-cr-409(RAG), 2013 WL 449761 (N.D. Ill. Feb. 5, 2013); *S.E.C. v. Southridge Capital Mgmt., LLC*, No. 10-cv-1685(RNC), 2012 WL 4796359 (D. Conn. Oct. 9, 2012).

[10] *See, e.g., S.E.C. v. Loomis*, 969 F. Supp. 2d 1226, 1234-36 (E.D. Cal. 2013).

a lawful distribution of the fund's assets and asserting that the Fund misrepresented its NAV prior to, and during, the redemption rush.

On the private litigation front, if market concerns regarding high-yield open-end funds continue to escalate, investors in all open-end funds, including hedge funds, could seek to bring federal securities claims (either individually or on behalf of a putative class of investors) based on alleged misrepresentations or omissions in public disclosures and marketing materials regarding the funds' risks, including whether and in what circumstances investor redemptions could be halted.[11] These claims could be brought against open-end fund managers and issuers; against brokers, underwriters and others who made the allegedly false or misleading statements; and against any individuals who signed certain public filings or served as directors of the issuing entity.[12]

### ETFs

A mass investor exodus from high-yield investments could also affect the market for ETFs. Although mass redemption risks may be less likely — the mechanism restricts redemption to very large "creation units" that may be redeemed only by banks or broker-dealers that are "authorized participants" — the downward pressure on price could leave investors with the unenviable choice between accepting a vastly discounted price (assuming that a selling investor can find a buyer) and holding an asset that the investor believed would easily be convertible into cash. Indeed, the SEC's commissioners have recently focused their attention on ETFs,[13] and if the high-yield ETF market fails or is reduced to pennies on the dollar, regulators are likely to look to whether buyers' expectations of liquidity were unreasonably set by ETF sponsors.

Under such circumstances, we might expect to see events play out like they did when the auction rate securities (ARS) market froze in 2008. There, holders of ARS assumed that these assets would be highly liquid because the institutions that brought the instruments to market had regularly bid in the periodic auctions that set the instruments' yield rates. When these institutions stepped back from bidding, the auctions failed and the instruments became illiquid, leaving selling holders with very limited ability to find buyers. The SEC and dozens of state attorneys general offices (including those of California, New York and Massachusetts) brought actions to vindicate investors' expectations, alleging that banks and brokerage firms misrepresented the liquidity of ARS by failing to disclose their roles in making the market, essentially trapping vast sums of investors' money in failed ARS bonds. These actions led to settlements in which banks and brokerage firms were compelled to buy back tens of billions of dollars of illiquid ARS (even though the risks of failed auctions had been clearly disclosed). Despite these settlements, Skadden was able to secure dismissal of several lawsuits brought by private investors on the ground that the liquidity risks complained of had been adequately disclosed, including that the defendant broker-dealers or underwriters were not required to intervene in the auctions to prevent them from failing.[14] Were we to see a run of failed or frozen ETFs, we would expect to see enforcement agencies use their leverage to shift the cost of such disruptions from retail investors to sponsoring institutions.

Private litigation involving ETFs similarly could include federal securities and/or state common law claims alleging fraud or misrepresentation about the funds' liquidity or credit risks. A recent analogue is the 2009 lawsuit brought by a group of investors in 44 ProShares ETFs. The putative class action was commenced against the funds' issuers, underwriters and investment advisors, and alleged that registration statements filed with the SEC omitted key correlation and volatility risks including that "the funds' performance widely diverged from the performance of the underlying indices sometimes resulting in losses

[11] To prove a claim for securities fraud under Section 10(b) of the Securities Exchange Act of 1934, a private plaintiff must demonstrate (i) a material misstatement or omission, (ii) made with scienter (*i.e.*, wrongful state of mind), (iii) in connection with the purchase or sale of a security, (iv) investor reliance on the misstatement or omission, (v) economic loss, and (vi) loss causation. *See Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2407 (2014); *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341-42 (2005). Additionally, to prove a securities claim under Sections 11 or 12 of the Securities Act of 1933, a plaintiff must demonstrate that the registration statement or prospectus contained an untrue statement of material fact or omitted a material fact to make the statements therein not misleading. Such claims do not require the plaintiff to prove scienter and could be brought against numerous parties, including (i) those who signed the registration statement, (ii) those who were directors or partners of the issuer or were named as such in the registration statement, (iii) underwriters with respect to the security in question, and (iv) other parties specifically enumerated by statute. *See Omnicare, Inc. v. Laborers Dist. Council Const. Ind. Pension Fund*, 135 S. Ct. 1318, 1325-26 (2015) (citing 15 U.S.C. § 77k(a)).

[12] The U.S. Supreme Court has held that a party may only be held liable as the "maker" of an allegedly false or misleading statement where he or she personally made the statement or exercised "ultimate authority" over the statement, "including its content and whether and how to communicate it." *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011).

[13] On February 19, 2016, SEC Commissioner Kara M. Stein called for a "roadmap for holistic regulation of ETFs." Kat Greene, "SEC's Stein Calls for ETF Regulation 'Roadmap'," *Law360*, Feb. 19, 2016. SEC Chair Mary Jo White confirmed to *The Wall Street Journal* that "[a]ll of the [SEC's] commissioners are very focused on ETFs." Dennis Berman, "Wall Street's Top Cop Explains the New Rules: The SEC's Mary Jo White Says Regulatory Changes Have Made the Financial System Safer," Wall St. J., Nov. 24, 2015, at R7.

[14] *See, e.g., Wilson v. Merrill Lynch & Co.*, 671 F.3d 120 (2d Cir. 2011); *Ashland Inc. v. Morgan Stanley & Co.*, 652 F.3d 333 (2d Cir. 2011).

despite the overall direction of the underlying indices." The action was dismissed on the ground that "the disclosures in the registration statements accurately conveyed the specific risk that the [P]laintiffs assert materialized." The U.S. Court of Appeals for the Second Circuit agreed, holding that "the relevant prospectuses adequately warned the reasonable investor of the allegedly omitted risks."[15]

[15] *See generally In re ProShares Trust Sec. Litig.*, 728 F.3d 96 (2d Cir. 2013).

## Conclusion

In light of increased concerns regarding the scope and severity of credit and liquidity risks in high-yield fixed-income markets, we believe it is advisable for our clients to proactively assess any potential regulatory and litigation risk exposure. At minimum, such an assessment should include the review of disclosures to investors and actions of management in order to determine whether the implementation of mitigation measures may be warranted.

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