Last October, the Securities and Exchange Commission (SEC) adopted a new rule governing the assets held by open-end mutual funds and exchange-traded funds (ETFs). (Money market funds, another type of mutual fund, are subject to a different SEC rule which took effect last fall.) These funds have become increasingly popular investment choices for households in recent years. According to the SEC, some 44.1 percent of all U.S. households owned shares in open-end funds as of 2015.

Open-end funds allow investors to sell their shares back to the mutual fund — that is, redeem them — at the end of any trading day. (As opposed to closed-end funds, which do not allow investors to sell shares back to the fund after the initial purchase.) ETFs are also considered open-end funds, but their shares are generally traded on a stock exchange rather than bought and sold from the fund directly. Only authorized participants can purchase or redeem shares from an ETF directly, and these participants are typically large financial institutions that deal in large blocks of thousands of shares at a time.

According to the SEC, the new rule is intended to protect investors and address developments in open-end funds that may have increased their liquidity risk. Over the last decade, alternative mutual funds and ETFs have grown considerably: Their total assets jumped nearly a thousand-fold from $365 million in 2005 to $334 billion in 2014. These funds tend to invest in nontraditional and more illiquid assets, such as global real estate or commodities, while still pledging to redeem shares on demand.

The fact that investors in open-end funds can redeem their shares on demand could pose a problem for some funds. On one hand, the fund needs enough cash or “liquid” assets that can quickly and easily be converted to cash on hand to satisfy redemption requests from investors. The Investment Company Act of 1940 requires that funds process redemption requests within seven days, though in practice many funds today pledge to make payments as soon as the next business day. On the other hand, many funds also choose to invest in long-term assets. These types of assets are difficult to liquidate quickly for full value, however, leading to an inherent tension in how funds manage their assets.

Even if a fund holds mostly assets that can be sold relatively easily, like publicly traded stocks or bonds, it may run into trouble if it does not have enough cash on hand to handle redemptions. When a fund’s portfolio is sustaining losses, many investors may decide to redeem their shares at the same time. Without enough cash, the fund may need to sell some of the assets from its portfolio to honor the redemption requests. That may require selling less liquid assets at a steep discount, depressing the value of the remaining assets in the fund’s portfolio and prompting more investors to redeem their shares. The fact that the investors who redeem their shares first suffer no losses until the fund’s cash is exhausted and suffer fewer losses the sooner they sell after the cash is gone encourages all investors to cash out of a fund at the first sign of trouble, making it more likely that a fund’s liquid assets are overwhelmed.

Liquidity risk has garnered a lot of attention from financial regulators since the 2007-2008 crisis, and they have adopted rules requiring banks and other financial firms to maintain greater liquidity buffers. (See “Liquidity Requirements and the Lender of Last Resort,” Econ Focus, Fourth Quarter 2015.) The new SEC rule for mutual funds and ETFs is very similar to these other post-crisis measures. Funds must classify their assets based on how long it would take to convert them into cash without altering their market value. Each fund must hold some minimum fraction of its net assets in cash or highly liquid investments (convertible into cash within three business days without significant loss of value) and no more than 15 percent of its net assets in illiquid investments (can’t be sold within seven days without significant loss). The illiquid asset minimum of 15 percent was previously an informal guideline from the SEC, and the new rule makes it official. Funds must disclose their liquidity positions and plans to their board and the SEC as well as report when they breach their liquid or illiquid asset thresholds.

Empirical evidence supports the assumption that funds holding more illiquid assets are more susceptible to runs by their investors during times of stress. In a 2010 Journal of Financial Economics article, Qi Chen of Duke University, Itay Goldstein of the University of Pennsylvania, and Wei Jiang of Columbia University looked at data on equity mutual funds between 1995 and 2005. They found that funds that were more illiquid were more likely to suffer increased redemptions by noninstitutional investors during a period of stress: The fear of being the last one out drove investors to run for the exits. Interestingly, the authors also found that illiquid funds held by large institutional investors were not as prone to increased redemptions due to bad performance. Still, they suggested that funds investing in illiquid assets might be better off operating as closed-end funds in order to avoid the problem of outflows altogether.

The new SEC rule goes into effect on Dec. 1, 2018, for funds with $1 billion or more in net assets and on June 1, 2019, for smaller funds.