February 13, 2023

Vanessa A. Countryman, Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

VIA ELECTRONIC MAIL: rule-comments@sec.gov

Re.: File Number S7-26-22—Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting

Dear Ms. Countryman:

The Committee on Capital Markets Regulation (the "**Committee**") is grateful for the opportunity to provide comments to the U.S. Securities and Exchange Commission (the "**SEC**") on its proposed amendments to the rules for open-end management investment companies ("**open-end funds**") regarding swing pricing and liquidity risk management programs (the "**Proposal**").[1]

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-six leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Emeritus Dean, Columbia Business School) and John L. Thornton (Former Chairman, The Brookings Institution) and is led by Hal S. Scott (Emeritus Nomura Professor of International Financial Systems at Harvard Law School and President of the Program on International Financial Systems). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

Our letter proceeds in two parts. Part I describes the Proposal, including its mandatory swing pricing regime, its amendments to the rules for open-end funds' liquidity risk management programs, and its additional reporting and disclosure requirements. Part II assesses the Proposal's policy rationale and cost-benefit analysis with respect to the swing pricing and liquidity rule amendments. We find that there is substantial evidence that open-end funds maintain adequate liquidity, including during market stress. Thus, the Proposal has not established the existence of a market failure necessitating major reforms to open-end funds' pricing and liquidity risk management programs. We also raise issues with the Proposal's design of a mandatory swing pricing regime. We recommend that the SEC rescind its mandatory swing pricing proposal and that the SEC conduct an adequate cost-benefit analysis of its revisions to funds' liquidity risk management practices.

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[1] SECURITIES & EXCHANGE COMMISSION, *Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Report* 87 FED. REG. 77,199 (Dec. 16, 2022) https://www.federalregister.gov/documents/2022/12/16/2022-24376/open-end-fund-liquidity-risk-management-programs-and-swing-pricing-form-n-port-reporting ["**Proposed Rule**" or "**PR**"].

I. Overview of the Proposal

The Proposal would make several key changes to the regulatory requirements that apply to open-end funds, which include mutual funds and exchange-traded funds ("**ETFs**").[2] Money market funds ("**MMFs**") are excluded from the scope of the Proposal. The SEC has separately proposed revisions to the liquidity requirements of MMFs on which the Committee has commented.[3]

First, the Proposal would establish a mandatory swing pricing framework for open-end funds. However, exchange-traded funds ("**ETFs**") are excluded from the swing pricing framework. Second, the Proposal would amend the liquidity risk management programs that open-end funds, including mutual funds and ETFs, are required to adopt. Finally, the Proposal would impose enhanced reporting requirements on mutual funds and ETFs by requiring Form N-PORT (on which funds report portfolio holdings information) to be filed more frequently and with additional reporting items.

A. Mandatory Swing Pricing

The Proposal would require open-end funds other than MMFs and ETFs to establish and implement "swing pricing" policies and procedures. Swing pricing is the process of adjusting a fund's net asset value ("**NAV**") per share, to pass the costs of redemption and subscription activity on to the transacting shareholders.[4] The Proposal explains that these costs, such as trading costs and the costs of depleting a fund's liquidity, would otherwise be borne by non-transacting shareholders, which can dilute their interests.[5] According to the SEC, swing pricing "can more fairly allocate costs, reduce the potential for dilution of investors who are not currently transacting in the fund's shares, and reduce any potential first-mover advantages."[6]

The proposed mandatory swing pricing framework (described below) represents a significant departure from the SEC's current, voluntary swing pricing regime, whereby funds may choose to use swing pricing when net redemptions or purchases exceed a threshold that the fund itself

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[2] In this letter we use the term "mutual fund" to refer to open-end funds other than ETFs and MMFs.
[3] COMMITTEE ON CAPITAL MARKETS REGULATION, *Comment Letter Re. File No. S7-22-21 – Proposed Rule – Money Market Fund Reforms* (Apr. 11, 2022), https://capmktsreg.org/wp-content/uploads/2022/04/CCMR-Comment-Letter-MMF-Proposal-04.11.2022.pdf.
[4] Proposed Rule 22c-1. Swing pricing is defined as "the process of adjusting a fund's current net asset value per share to mitigate dilution of the value of its outstanding redeemable securities as a result of shareholder purchase and redemption activity." PR at 17,177.
[5] PR at 77,176.
[6] *Id*. at 77,199.

determines.[7] Notably, as the Proposal acknowledges, no fund has elected to implement swing pricing since the SEC adopted the current framework.[8]

Under the Proposal, a covered fund is required to adjust its NAV per share by a "swing factor" whenever the fund experiences net redemptions in *any* amount or net purchases that exceed 2% of the fund's net assets.[9] The Proposal applies to net redemptions *and* purchases, because there are transaction costs associated with each. For example, when a fund experiences large inflows it is required to purchase assets (e.g., equities) to provide new investors with exposure to those assets and such purchases have transaction costs associated with them. However, purchases of assets generally have lower transaction costs than asset sales, especially smaller purchases, therefore the Proposal does not apply swing pricing to net purchases below 2% of a fund's assets.[10]

The "swing factor" is the amount by which the fund adjusts its NAV per share, expressed as a percentage of the fund's NAV.[11] To determine the swing factor, a fund's "swing pricing administrator" (the investment adviser or officer(s) responsible for administering the swing pricing policies and procedures) must make good faith estimates, supported by data, of the costs the fund would incur if it purchased or sold a *pro rata* amount of each investment in its portfolio to satisfy the amount of net purchases or net redemptions.[12] The good faith estimates must include spread costs, brokerage commissions, custody fees, and any other charges, fees, and taxes associated with portfolio investment sales or purchases, as applicable.[13] In addition, if net redemptions exceed 1% of the fund's net assets or net purchases exceed 2% of the fund's net assets, the fund must include an estimate of the market impact of the hypothetical *pro rata* purchase or sale of fund assets in its swing factor.[14]

The proposed swing fee pricing regime is best described with an example. If a fund has a portfolio of $1 billion and net redemptions on a given day and receives on that day a specific redemption request with respect to 1% of its outstanding shares, then the fund must make a good faith estimate of the direct transaction costs (including spread costs, brokerage commissions, custody fees) associated with liquidating a *pro rata* slice of its portfolio worth $10 million. If the fund estimates the cost of such transactions at $100,000 or 1% based on prevailing bid-ask spreads, commission costs, and other costs, then the fund must adjust its NAV per share for purposes of the redemption by a swing factor of 1% and reduce the shareholder's redemption proceeds accordingly.

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[7] 17 CFR § 22c-1(a)(3)(i)B). Under the current framework, a fund's swing pricing policies and procedures must specify the fund's process for determining the swing threshold, considering certain factors: (1) the size, frequency, and volatility of historical net purchases or net redemptions of fund shares during normal and stressed periods; (2) the fund's investment strategy and the liquidity of the fund's portfolio investments; (3) the fund's holdings of cash and cash equivalents, and borrowing arrangements and other funding sources; and (4) the costs associated with transactions in the markets in which the fund invests.
[8] PR at 77,177.
[9] Proposed Rule 22c-1(d)
[10] PR at 77,203.
[11] Proposed Rule 22c-1(d)
[12] *Id*. 22c-1(b)(2); 22c-1(d).
[13] *Id*. 22c-1(b)(2).
[14] *Id*. 22c-1(b)(2); 22c-1(d).

Furthermore, if the fund has experienced more than 1% in net redemptions on that day, then there would be an additional "market impact" cost further reducing the proceeds for the redeeming shareholder. For example, assume a good faith estimate finds that the sale of a $10 million *pro rata* slice of the fund's assets would reduce the market value of those assets by 0.25% or $25,000. The redeeming shareholder would therefore receive $9.875 million ($10 million less the $100,000 in estimated transaction costs and $25,000 in estimated market impact).

The "Hard" Close

Funds need access to order flow information to determine the applicable swing price. Therefore, the Proposal requires a "hard close" for funds subject to its new swing pricing provisions.

Presently, an open-end fund investor that places an order with a broker before the time that a fund establishes for calculating its NAV and the value of its holdings (typically 4pm ET) will receive that day's price when the order is executed.[15] However, even though the investor has submitted the order to its broker before 4pm, the fund may not receive information about the order from the broker until hours after 4pm—sometimes even on the following morning, because it can take several hours for the broker to process orders received from clients.[16] Nonetheless, that investor still receives the NAV based on the time that the broker received the order rather than the time the fund received the order from the broker.

The Proposal would effectively prohibit the current practice by providing that a fund (or its designated transfer agent or registered clearing agency) must receive an order by 4pm ET for the investor to receive the current day's price.[17] Any orders received after that time would be executed at the following day's price.[18] To obtain same-day pricing, intermediaries, such as broker-dealers, banks, and retirement plans, would therefore need to update their order processing systems to reduce processing times to ensure that order information they receive from customers reaches the fund (or transfer agent or clearing agency) before 4pm ET on the same day.[19] The SEC states that the hard close requirement "would serve multiple goals, such as facilitating mutual funds' ability to operationalize swing pricing by ensuring that funds receive timely flow information, modernizing and improving order processing, as well as helping to prevent late trading."[20]

B. Liquidity Risk Management Programs

The Proposal would amend Rule 22e-4 under the Investment Company Act of 1940 (the "**Liquidity Rule**"), which requires open-end funds other than MMFs to adopt and implement liquidity risk management programs.[21] The Liquidity Rule currently requires: (1) assessment, management and review of a fund's liquidity risk; (2) classification of each portfolio investment's liquidity into one of four categories (highly liquid, moderately liquid, less liquid, or illiquid); (3)

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[15] PR at 77,209.
[16] *Id*.
[17] Proposed Rule 22c-1(a)(3).
[18] PR at 77,209. The SEC's discussion assumes that a fund calculates its NAV once per day, as most funds do.
[19] *Id.* at 77,211.
[20] *Id.* at 77,209.
[21] Proposed Rule 22e-4.

determination and review of a "highly liquid investment minimum" for certain funds; (4) a 15% limit on illiquid investments; and (5) board oversight.[22]

The Proposal would make several changes to the liquidity classification framework with the effect of increasing the minimum liquidity requirements of open-end funds.[23] The Proposal would: (i) revise the liquidity categories into which a fund must classify its investments by eliminating the "less liquid investment" category and moving all investments under it to the "illiquid investment" category, making them subject to the Liquidity Rule's 15% cap;[24] (ii) change the method by which funds analyze investments when making liquidity classifications;[25] and (iii) create a definition for "significantly changing the market value of an investment"—a key term in determining the liquidity category of a given investment.[26] The Proposal would also require funds to make more frequent liquidity classifications.[27]

Eliminating the less liquid category would have a particularly noteworthy effect on open-end funds that hold bank loan interests, which are floating rate commercial loans originated by banks that are then sold by the bank to other investors, and presently classified as "less liquid" investments. By redefining bank loan interests as illiquid investments subject to the 15% cap, the Proposal would restrict the ability of open-end funds to hold bank loan interests. As of December 2021, there were approximately $204 billion in outstanding bank loan interests held by open-end funds.[28]

Additionally, the Proposal would make several key changes to the Liquidity Rule's "highly liquid investment minimum" ("**HLIM**") framework. Highly liquid investments are 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 without the conversion to cash significantly changing the market value of the investment."[29] Under the current Liquidity Rule, only funds that hold illiquid assets, such as corporate bonds, are required to establish an HLIM and these funds have discretion as to the amount of HLIM to hold. Funds that primarily hold assets that are highly liquid investments, such as equities, need not establish an HLIM.[30] The Proposal would require all funds to maintain an HLIM and effectively establish an HLIM floor of 10% of the fund's NAV.[31]

C. Enhanced Reporting Requirements – Amendments to Form N-PORT

The Proposal would revise the frequency and content of Form N-PORT, on which mutual funds and ETFs are required to file information on their portfolios and portfolio holdings as of month-end.[32] Currently, Form N-PORT is filed with the SEC on a quarterly basis with a 60-day delay,

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[22] PR at 77,176.
[23] Proposed Rule 22e-4.
[24] PR at 77,190.
[25] *Id*. at 77,187.
[26] *Id*. at 77,188.
[27] Proposed Rule 22e-4(b)(1)(ii); PR at 77,194.
[28] PR at 77,244.
[29] Rule 22e-4(a)(6).
[30] Rule 22e-4(b)(1)(iii).
[31] Proposed Rule 22e(b)(1)(iii).
[32] PR at 77,226.

and only the information for the third month of each quarter is made available to the public.[33] Under the Proposal, Form N-PORT filings would be required on a monthly basis within 30 days of month-end, and would be made public within 60 days of month-end.[34] According to the SEC, "[t]hese changes are intended to provide more timely information regarding the fund's portfolio, including its liquidity profile."[35]

The Proposal would also require a fund's Form N-PORT reports to include the percentage of its assets represented in each of the three revised liquidity categories: highly liquid investments, which are those that can be converted to cash in three business days, moderately liquid investments, which are those that are neither highly liquid nor illiquid, and illiquid investments, which are those that can be converted to cash in seven business days.[36] And the Proposal would introduce a new Form N-PORT item requiring information about the number of times a fund applied a swing factor each month and the amount of each swing factor applied.[37]

II. Assessment of the Proposal

Part II assesses the Proposal's (1) imposition of a mandatory swing pricing and hard close regime (the "Swing Pricing Amendment") and (2) amendments to the Liquidity Rule (the "Liquidity Amendments"). Subpart A assesses the Proposal's assertion of a liquidity-related failure in open-end fund markets that necessitates the Swing Pricing and Liquidity Amendments and finds that the Proposal fails to show the existence of such a market failure. Subparts B then further evaluates specific issues with the Swing Pricing Amendment finding that certain aspects of this proposal would fail to achieve their stated objectives and could instead create new problems. Subpart C reviews the Proposal's cost-benefit analysis ("**CBA**") and finds that the CBA fails to substantiate several purported benefits and to consider or quantify several important costs.

A. The Proposal does not establish the existence of an open-end fund market failure.

The Proposal has not established the existence of a market failure necessitating major reforms to the liquidity-related rules for open-end funds. On the contrary, there is substantial evidence that open-end funds maintain adequate liquidity, including during market stress. We again note that the Proposal excludes MMFs from its scope as does our analysis.

The Proposal asserts that "some open-end funds were not prepared for the sudden market stress that arose [in March 2020] after many years of relative calm" and that its proposed amendments are intended to prepare for "the possibility that future stressed periods—whether specific to certain funds or the markets as a whole—may be more protracted or more severe than March 2020."[38] However, the Proposal does not cite any specific examples of open-end funds that had inadequate liquidity during March 2020 or any other period of market stress. Indeed, no open-end funds sought

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[33] *Id*. at 77,226.
[34] *Id*.
[35] *Id*.
[36] *Id*. at 77,230.
[37] *Id*. at 77,231.
[38] *Id*. at 77,183.

to suspend redemptions during the market turmoil of March 2020,[39] nor does the Proposal cite any instance of such a suspension during the 2008 financial crisis. Moreover, in neither case did mutual funds, in contrast to MMFs, rely on liquidity support from the government.[40]

In fact, there is significant empirical evidence indicating that open-end funds are resilient in periods of market stress and that fund investors do not redeem heavily in such periods. According to Bloomberg, MSCI, and ICI data on open-end fund redemptions, mutual fund net redemptions were modest during the most extreme periods of market turmoil over the past two decades.[41] For example, during the 2008 financial crisis, net equity fund outflows were only 3.6% of aggregate fund asset value.[42] And an NBER study examining the March 2020 market turmoil found that net outflows from actively managed mutual funds were a modest 1.3% of AUM.[43] Academic research finds similar historical results prior to the 2008 and 2020 crises. For example, Kosowski (2006) concludes that U.S. open-end funds have performed better during recessions than during economic expansions.[44] The analysis finds specifically that average open-end fund cash holdings in recession periods are "statistically significantly higher than in expansion period[s]"[45] suggesting that funds are already adjusting the liquidity of their portfolios in response to market conditions and are not required to deplete their cash holdings to meet redemptions in periods of recession.

According to the SEC, the Proposal would "better prepare [funds] for stressed market conditions." However, as described above, there is no evidence that open-end funds have lacked the liquidity needed to meet investor redemptions in stressed market periods. There is thus no evidentiary basis for the fundamental rationale of the Proposal.

B. The Swing Pricing Amendment as proposed is unlikely to achieve its stated objective and will create new problems in open-end fund markets.

The Proposal offers two principal rationales for requiring open-end funds (excluding ETFs) to implement swing pricing and a hard close: (1) increasing the price efficiency of such funds by more fairly allocating the costs of share purchases and redemptions, and (2) reducing the "first mover" advantage and thereby increasing the stability of such funds during periods of market stress

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[39] *Id*.
[40] *Id*. at 77,182, Note 57; MICHAEL J. FLEMING, FEDERAL RESERVE BANK OF NEW YORK, FEDERAL RESERVE LIQUIDITY PROVISION DURING THE FINANCIAL CRISIS OF 2007-2009 Table 1 (2012), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr563.pdf. Although mutual funds were eligible to participate in the term asset-backed securities loan facility (TALF), this support was provided to any eligible holder of asset backed securities, not mutual funds specifically. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, Term Asset-Backed Securities Loan Facility (TALF), https://www.federalreserve.gov/regreform/reform-talf.htm (last visited Jan. 31, 2023).
[41] INVESTMENT COMPANY INSTITUTE, REGULATED FUND SHAREHOLDERS' REACTIONS TO MARKET TURMOIL 1944-OCTOBER 2018 (2018), https://www.ici.org/doc-server/pdf%3Amisc_18_reactions_to_markets.pdf.
[42] *Id*.
[43] Lubos Pastor & M. Blair Vorsatz, *Mutual Fund Performance and Flows During the COVID-19 Crisis* (2010), https://www.nber.org/system/files/working_papers/w27551/w27551.pdf.
[44] Robert Kosowski, *Do Mutual Funds Perform When It Matters Most to Investors? U.S. Mutual Fund Performance and Risk in Recessions and Expansions* (2006), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=926971.
[45] *Id*. at 23.

or large withdrawals. However, the design of the Swing Pricing Amendment is unlikely to achieve either objective and may instead create new problems.

i. The Swing Pricing Amendment will fail to fairly allocate redemption costs because it does not reflect the realities of open-end fund redemptions.

The Proposal asserts that the Swing Pricing Amendment will more fairly allocate the costs associated with investor redemptions to the redeeming investors and thus increase the price efficiency of open-end fund shares. However, the specific design of the Proposal's swing pricing regime is such that it will not achieve this effect. The Swing Pricing Amendment requires a fund to estimate redemption costs by assuming that the fund sells a *pro rata* slice of its entire portfolio to meet the redemption request. In practice however, funds maintain a cash buffer and therefore do not necessarily sell portfolio assets to meet net redemptions.[46] Even when funds are required to sell assets, they generally do not sell a *pro rata* slice of their portfolio. Instead, they sell more liquid assets with lower transaction costs.[47] The Swing Pricing Amendment would therefore impose costs on redeeming investors with respect to assets that are not in fact sold by the fund, such that the proceeds the investor receives may be a less accurate reflection of the costs associated with the investor's redemption.

ii. Swing pricing can potentially increase outflows when markets are stressed.

The Proposal asserts that swing pricing will eliminate the advantage that a shareholder might derive from withdrawing before other shareholders in a hypothetical liquidity crisis (referred to as a "first mover" advantage) by requiring a withdrawing shareholder to bear the implicit transactions costs associated with its withdrawal.[48]

Although there may be instances in which a suitably designed swing pricing system can achieve this effect, there may also be instances in which swing pricing could have the opposite effect in stressed market conditions. Investors may be more likely to withdraw from funds if they are concerned that worsening market conditions will increase the cost of a future withdrawal. This is particularly true in a crisis.[49] In such cases, swing pricing could exacerbate the incentive to withdraw early because the swing pricing factor would get higher as market conditions worsen, so investors may withdraw early in part to avoid higher swing pricing fees.[50] This occurs because as market conditions worsen, transaction costs, such as bid-ask spreads, and market impact costs

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[46] Hannah Miao, *Bank of America Global Fund Manager Survey: Highest Cash Levels Since 2001* (Oct. 18, 2022), https://www.wsj.com/livecoverage/stock-market-news-today-2022-10-18/card/bank-of-america-global-fund-manager-survey-highest-cash-levels-since-2001-fPJCke0TF86mu6jq3794; Katherine Lynch, *Has Holding Cash Helped Equity Fund Managers?* MORNINGSTAR (Sept. 1, 2022), https://www.morningstar.com/articles/1112829/has-holding-cash-helped-equity-fund-managers.

[47] PR at 77,259.

[48] *Id*. at 77,258.

[49] Ulf Lewrick et al, *An Assessment of Investment Funds' Liquidity Management Tools*, CSSF Working Paper, (2022), https://www.cssf.lu/wp-content/uploads/An_assessment_of_investment_funds_liquidity_management_tools.pdf; HAL S. SCOTT, INTERCONNECTEDNESS AND CONTAGION (2012), https://www.aei.org/wp-content/uploads/2013/01/-interconnectedness-and-contagion-by-hal-scott_153927406281.pdf.

[50] COMMITTEE ON CAPITAL MARKETS REGULATION, *supra* note 3 at 8-9.

increase. Imposing swing pricing on a mandatory basis means that fund managers cannot make their own determination as to whether swing pricing is likely to mitigate investor withdrawals with respect to a particular fund or not. Indeed, we note that European jurisdictions that have implemented swing pricing have done so on a voluntary basis and have allowed fund managers to make good faith determinations about the design of a fund's swing pricing system.

C. The CBA for the Swing Pricing and Liquidity Amendments is inadequate.

In this section we identify three significant issues with the Proposed Rule's cost-benefit analysis. As the Committee has noted in recent comment letters,[51] shortcomings in the CBA are a serious concern because under the National Securities Markets Improvement Act of 1996, the SEC is required "to promote efficiency and capital formation in the financial markets," and "[w]henever . . . the [SEC] is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the [SEC] shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[52]

The U.S. Court of Appeals for the District of Columbia Circuit (the "**D.C. Circuit**") has held that the statutory language of the Administrative Procedure Act ("**APA**") imposes an obligation on the SEC to weigh the costs and benefits of proposed regulation, and to quantify those costs and benefits where possible.[53] In *Chamber of Commerce v. SEC* (2005), the D.C. Circuit considered the validity of an SEC rule requiring that mutual fund boards be composed of no less than 75% independent directors and be chaired by an independent director. The court found that the proposed rule violated the APA because the SEC had failed to "adequately consider the costs mutual funds would incur in order to comply with the [proposed rule]"[54] and rejected the SEC's contention that such costs were not practically quantifiable.[55] Similarly, in *Business Roundtable v. SEC* (2011), the D.C. Circuit remanded an SEC rulemaking on shareholder proxy access due to inadequate economic analysis, including a failure to quantify the costs of the rulemaking.[56] The court found that the SEC "inconsistently and opportunistically framed the costs and benefits of the rule" and "failed adequately to quantify the certain costs of its proposed rule or to explain why the those costs could not be quantified."[57] For these and other reasons, the court found that the proposed rule violated the APA.

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[51] *See, e.g.*, *id*. at 5.
[52] National Securities Markets Improvement Act of 1996, Pub. L. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.).
[53] *Chamber of Commerce v. SEC*, 412 F.3d 133, 144 (D.C. Cir. 2005); *see also* PAUL ROSE & CHRISTOPHER WALKER, THE IMPORTANCE OF COST-BENEFIT ANALYSIS IN FINANCIAL REGULATION, CENTER FOR CAPITAL MARKETS COMPETITIVENESS 24–33 (2013), http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/CBA-Report-3.10.13.pdf.
[54] *Chamber of Commerce*, 412 F.3d at 136.
[55] *Id*. at 143.
[56] *Bus. Roundtable v. SEC*, 647 F.3d, 1144 (D.C. Cir. 2011).
[57] *Id*. at 1148-49.

i. The CBA fails to fully consider or quantify the extent to which the Swing Pricing Amendment is costly and impracticable for open-end funds.

The Proposal acknowledges that to implement the Swing Pricing Amendment, “funds and intermediaries would need to make significant changes to their business practices, including updating their computer systems, altering their batch processes, or integrating new technologies that facilitate faster order submission.” [58] However the full extent of the changes that may be necessary is unknown, and may require a complete overhaul of the systems and processes for open-end fund redemptions, including on the part of fund intermediaries.[59] The costs associated with these system upgrades will ultimately be borne by investors—for example, through increased expense ratios.

In addition, the hard close would make it more difficult for investors to receive same-day pricing. Investors transacting through intermediaries such as retail broker-dealers and retirement plan recordkeepers will need to submit their orders earlier than the 4pm cut-off to receive same-day pricing, to provide intermediaries with time to batch and submit the orders to the fund.[60] Investors seeking execution at the current NAV will consequently have an even narrower timeframe in which to submit their orders. Investors will also be unable to respond to market events that occur between the intermediary’s cut-off and the 4pm hard close, exposing them to increased market risk.[61]

Retirement plan recordkeepers would have particular difficulty complying with the hard close because of such recordkeepers’ unique operational systems and the calculations they must perform under plan rules.[62] Most retirement plan recordkeepers do not process investor orders until they receive a fund’s NAV, and the time between order submission and processing can exceed six hours.[63] Funds therefore typically receive orders from retirement plan recordkeepers the day after the investor submits the order, and execute the orders at the previous day’s price.[64] This change is particularly consequential given the significant amount and percentage of retirement assets invested in mutual funds—as of the end of 2021, mutual funds made up 58% ($6.4 trillion) of the assets of defined contribution plans (such as 401(k) plans) and 45% ($6.2 trillion) of IRA assets.[65]

While the CBA acknowledges generally that the hard close will impose “operational burdens” on funds and their intermediaries, particularly for retirement plans, it does not seek to quantify these costs.

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[58] PR at 77,212.
[59] Ropes & Gray LLP, *SEC Proposes Overhauled Open-End Fund Liquidity Framework Including Mandatory Swing Pricing* (Nov. 15, 2022), https://www.ropesgray.com/en/newsroom/alerts/2022/november/sec-proposes-overhauled-open-end-fund-liquidity-framework-including-mandatory-swing-pricing.
[60] PR at 77,212.
[61] *Id.* at 77,261.
[62] *Id.* at 77,212.
[63] *Id.* at 77,212; 77,238.
[64] *Id.* at 77,238.
[65] *Id.* at 77,248, citing ICI 2022 Investment Company Factbook, Chapter 8.

The CBA also overstates the purported benefits of mandatory swing pricing and the hard close. The primary asserted benefit is that it will shield non-redeeming investors from bearing the transaction costs associated with other investors' redemptions ("dilution"). But such dilution is most likely to occur during periods of substantial redemptions when the liquidity of a fund's portfolio is stretched to its maximum. As noted above, the evidence indicates that in general open-end fund investors are not prone to mass redemptions, even in periods of market stress, and that open-end funds maintain adequate liquidity to meet investor redemption requests. As such, the probability that any such benefits could be realized on a general basis by imposing a specific mandatory swing pricing regime across all such funds is very low. The CBA does not consider or quantify how the low probability of such events discounts the expected benefits of the swing pricing proposal.

ii. The CBA does not adequately consider the empirical evidence on the effects of swing pricing in Europe.

The Proposal seeks to substantiate the benefits of swing pricing based on European funds' implementation of swing pricing.[66] However, swing pricing is voluntary in Europe, not mandatory. Further, the Swing Pricing Amendment mandates a specific process for calculating the swing factor, which is repeated each day, whereas in Europe funds are generally permitted to calculate swing factors using any good faith method, and daily updates are not required.[67] Moreover, as of early 2022, 54% of U.S. open-end fund assets were held in retirement accounts, which as noted above are likely to be disproportionately disadvantaged by the hard cap, whereas only 10% of European investment funds shares were held in such accounts.[68] Although the CBA acknowledges in principle that these differences in "regulatory frameworks and investor base . . . may influence investors' sentiment towards anti-dilution tools and the extent of the potential stigma effects,"[69] it does not quantify the effect of those differences on its estimation of the costs and benefits of the Swing Pricing Amendment.

More generally, empirical support for the efficacy of swing pricing in enhancing fund resilience is mixed, and there is meaningful empirical evidence that swing pricing can erode fund resilience in certain instances. A 2020 ESMA/ESRB report found that in February and March of 2020, European non-MMF funds that activated swing pricing actually experienced higher outflows than those that did not.[70] A 2021 Bank of England study found only very weak or inconclusive evidence of the efficacy of swing pricing on reducing outflows from U.K.-domiciled non-MMF funds during the first quarter of 2020.[71] Lewrick & Schanz (2017) compared bond mutual funds domiciled in

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[66] *See, e.g.*, *id.* at 77182-77183, 77200, 77206, 77209, 77236.

[67] ANIL KASHYAP ET AL., BROOKINGS, WHAT IS SWING PRICING? (2021), https://www.brookings.edu/blog/up-front/2021/08/03/what-is-swing-pricing/.

[68] PR at 77,239.

[69] *Id.* at 77,257, n.481.

[70] *See* EUROPEAN SECURITIES AND MARKETS AUTHORITY, *Recommendations of the European Systemic Risk Board (ESRB) on liquidity risk in investment funds*, 31 (Nov. 2020), *available at* https://www.esma.europa.eu/sites/default/files/library/esma34-39-1119-report_on_the_esrb_recommendation_on_liquidity_risks_in_funds.pdf.

[71] BANK OF ENGLAND AND THE FINANCIAL CONDUCT AUTHORITY, *Liquidity Management in UK Open-Ended Funds* (Mar. 26, 2021), *available at* https://www.bankofengland.co.uk/report/2021/liquidity-management-in-uk-open-ended-funds.

Luxembourg (where swing pricing is permitted) to funds domiciled in the US (where it was not permitted at the time) and found that swing pricing failed to offset investor first-mover advantages and does not enhance fund stability during stress episodes.[72] Baena & Garcia (2022) found that swing pricing had limited effectiveness in maintaining the financial stability of French mutual funds during the COVID-19 market turmoil.[73] The Proposal's CBA does not assess the findings or implications of these studies for the effects of the Proposal, nor does it attempt to quantify their implications for the expected costs and benefits of the Swing Pricing Amendment.[74]

iii. *The CBA fails to consider or quantify how the Liquidity Amendments may limit or eliminate the marketplace for funds investing in bank loan interests.*

As described in Part I.B., the Liquidity Amendments would eliminate the "less liquid" liquidity category and reclassify such investments as "illiquid." "Illiquid" investments are subject to a 15% cap under the Liquidity Rule. Open-end funds' investments in formerly "less liquid" assets will thus be significantly limited and funds that invest heavily in them will need to fundamentally alter their investment strategies or be wound down.

This change would in particular limit the ability of funds to invest in bank loan interests, which currently constitute 71% of all investments reported as less liquid.[75] Bank loan interests are floating rate commercial loans originated by banks and sold by banks to other investors. As of December 2021, there were 746 open-end funds that reported approximately $204 billion in bank loan interests on Form N-PORT.[76] Among these were 53 "bank loan" funds that devote a significant portion (and more than 15%) of their portfolios to bank loan interests.[77] Because the Liquidity Amendments would effectively cap such investments at 15% of a fund's assets, these bank loan funds would no longer be viable. The CBA acknowledges that the Liquidity Amendments may reduce the viability of such funds, but it does not quantify the resulting costs.[78]

Retail investors' access to bank loan interests would thus be severely restricted, as registered funds are in general the only way for them to obtain exposure to this asset class. The change would also negatively impact the bank loan market and companies that access capital via bank loans. Restricting the ability of open-end funds to invest in such assets will likely result in an overall reduction in demand for bank loan interests, which would in turn harm the ability of non-investment grade borrowers, especially smaller issuers, to raise capital.[79] Indeed, one study has found an average 14-basis point reduction in the cost of borrowing for companies that allow their

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[72] Ulf Lewrick & Jochen Schanz, *Is the price right? Swing pricing and investor redemptions* BANK FOR INT'L SETTLEMENTS, BIS Working Papers No 664 (Oct. 2017), *available at* https://www.bis.org/publ/work664.pdf.
[73] Antoine Baena & Thomas Garcia, *Swing Pricing and Flow Dynamics in Light of the COVID-19 Crisis* (2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4298540.
[74] PR at 77,236.
[75] *Id*. at 77,244.
[76] *Id*. at 77,191.
[77] *Id.* at 77,244.
[78] *Id.* at 77,253.
[79] *Id*. at 77,265.

bank loans to be sold on the secondary market.[80] This reduction was 16 and 25 basis points in the case of non-investment grade and non-rated borrowers, respectively.[81] By reducing funds' ability to invest in bank loans, the cost of capital for such borrowers is thus likely to increase. The CBA does not consider these costs.

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[80] Mark J. Kamstra, *et al.*, *Does the Secondary Loan Market Reduce Borrowing Costs*, REVIEW OF FINANCE (2014) 1139-1181.
[81] *Id.*

III. Conclusion

The underlying rationale for the Proposal is flawed as there is no evidence of a failure of open-end funds to retain adequate liquidity to meet net redemption requests, including during periods of market stress. Moreover, the design of the proposed swing pricing and hard cap regime is such that it will be operationally burdensome and may fail to more fairly allocate costs from investor redemptions and purchases. The CBA also fails to substantiate several asserted benefits and to consider or quantify several important costs of the Proposal. We therefore recommend that the SEC rescind the Swing Pricing Amendment as proposed and that it conduct an adequate cost-benefit analysis of the implications of its revisions to funds' liquidity risk management practices.

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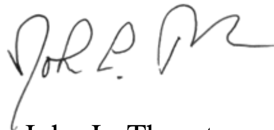
Thank you very much for your consideration of the Committee's position. Should you have any questions or concerns, please do not hesitate to contact the Committee's President, Professor Hal S. Scott (hscott@law.harvard.edu), or its Executive Director, John Gulliver (jgulliver@capmktsreg.org), at your convenience.

Respectfully submitted,



John L. Thornton	Hal S. Scott	R. Glenn Hubbard
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