January 25, 2016

Mr. Brent Fields
Secretary
Securities and Exchange Commission
100 F Street
Washington, DC 20549-1090

Re: Swing Pricing (File No. S7-16-15)

Dear Mr. Fields:

As a long-time observer of the fund industry and advocate for investor-friendly innovations in fund structure,[1] I write to comment on the Commission's proposal to permit mutual funds to adopt "swing pricing." As proposed by the Commission, a mutual fund that adopts swing pricing would adjust the price at which it issues and redeems shares from the fund's current net asset value (NAV) by a "swing factor," determined by the fund sponsor, whenever the fund's daily net inflows or daily net outflows exceed a set percentage of the fund's total net assets, also determined by the fund sponsor, known as the "swing threshold."

Before implementing swing pricing, a fund would be required to establish policies and procedures governing the use of swing pricing, and those policies and procedures must be approved by the fund's board of trustees. In reporting daily share values and fund performance, the price at which shares are issued and redeemed would be treated as NAV, and the fund's actual (unadjusted) NAV would not be publicly disclosed. A fund's swing pricing adjustments would not be subject to any limits, and need not bear a direct relationship to the associated fund costs.

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[1] As background, I am the author of The Exchange-Traded Funds Manual (Second Edition, Wiley, 2010) and numerous articles on exchange-traded funds (ETFs), mutual funds and related topics. My paper "Protecting Fund Shareholders from Costly Share Trading" (*The Financial Analysts Journal*, May/June 2004) was one of the first scholarly studies of the fund costs that the swing pricing proposal seeks to address. See http://www.cfapubs.org/doi/pdf/10.2469/faj.v60.n3.2618. I am the principal of ETF Consultants.com, Inc. and co-inventor of the technology underlying NextShares™ exchange-traded managed funds (NextShares). I serve (or formerly served) on the editorial boards of *The Journal of Portfolio Management*, *The Journal of Derivatives* and *The Journal of Indexes*.

What's Good about the Proposal

The swing pricing proposal addresses an issue of importance to fund investors: the dilution of shareholder returns that commonly occurs when a mutual fund issues and redeems its shares for cash. Inflows into a mutual fund generally require the fund to buy securities to put the invested money to work; outflows usually cause a mutual fund to sell securities to generate cash to meet redemptions. In both cases, the fund incurs trading costs. These costs are borne, indirectly, by all fund shareholders, not just those who buy and sell. In addition, the requirement to meet redemptions on a daily basis may cause a mutual fund to hold more cash than it otherwise would, further reducing long-term shareholder returns.

The Commission observes that funds may apply transaction fees to purchases and redemptions of shares to offset the dilutive effect of inflows and outflows. While uncommon among widely held mutual funds, transaction fees are routinely used by ETFs (and, soon, NextShares) for this purpose. In addition, most ETFs (and, soon, NextShares) issue and redeem their shares primarily in kind, dramatically reducing the dilutive effect of fund inflows and outflows. The practice of issuing and redeeming shares only in creation unit quantities by or through authorized participants makes in-kind transactions and the imposition of transaction fees much simpler and more operationally feasible for ETFs (and, soon, NextShares) than for widely held mutual funds.

It is my understanding that the industry practice of holding most mutual fund shares on an "omnibus" basis through aggregated broker-dealer and retirement plan accounts, rather than directly on the books and records of the fund itself, has been a significant impediment to the widespread adoption of mutual fund transaction fees. In making the swing pricing proposal, the Commission asserts that implementing swing pricing may require less coordination with fund service providers and less operational complexity than imposing transaction fees for a broadly held mutual fund. If true, swing pricing offers practical advantages over transaction fees as a means for mutual funds to address flow-related shareholder dilution.

What's Bad about the Proposal

I am not an expert on the procedures used by mutual fund companies to aggregate their daily purchases and redemptions from multiple intermediaries and to value fund assets and liabilities to determine the daily NAV. My understanding, however, is that the Commission's premise that swing pricing requires less coordination with fund service providers and can be implemented with less operational complexity than fund transaction fees is probably incorrect.

More fundamentally, the Commission's swing pricing proposal raises significant issues of transparency, fairness and investor protection. Different from how mutual funds operate today, funds that adopt swing pricing would be permitted to issue and redeem shares at prices higher or lower than current NAV. The variance between a fund's daily transaction price and NAV would be determined by the fund's manager, with no limit to the amount of permissible adjustments and subject only to the oversight of the fund's board of directors. Fund sponsors would have a clear financial incentive to apply swing pricing as aggressively as possible, because doing so adds to reported fund returns[2]—thereby enhancing the manager's reputation and raising the amount of fees collected by the manager (especially if the fund pays a performance fee).

Quite shockingly, the Commission's proposal does not require funds employing swing pricing to inform buyers and sellers of the amount by which their transaction prices vary from current NAV. Rather, the fund's current transaction price would be termed "NAV" and the true, unadjusted NAV would never be reported. Buyers and sellers would be left with the impression that they purchased and sold fund shares at a price equal to the current value of the fund's net assets, not knowing that their transaction prices actually varied from NAV by an undisclosed adjustment determined by the fund's manager—which the manager has a financial incentive to maximize. A fund's reported returns would no longer reflect changes in the value of the fund's net assets, but rather changes in transaction prices as adjusted from NAV. Measures of fund performance would not (and could not) distinguish between investment effects and swing pricing influences. The additive effect of swing pricing on fund performance may bear little or no relation to actual fund costs in connection with shareholder inflows and outflows. Who benefits from these deceptions and distortions? Probably the fund's long-term shareholders, and most certainly the fund's sponsor.

Over its long history, the fund industry has seen occasional scandals, most recently the "late trading" and "market timing" practices of some fund sponsors first exposed by then New York Attorney General Eliot Spitzer in 2003. Unless the Commission's swing pricing proposal is withdrawn or modified to address its glaring deficiencies in fairness and transparency, I predict that its adoption will set the stage for the next major fund industry scandal. Permitting mutual fund sponsors to adjust shareholder transaction prices in an arbitrary and opaque manner to benefit reported fund performance and raise fund fees is an invitation to chicanery and an affront to the Commission's investor protection mandate.

Fortunately, the costs that open-end funds bear in connection with their shareholder capital activity can be addressed in a fair, transparent and workable manner without using swing pricing, following the practices of ETFs (and, soon, NextShares). The continuing movement toward eventual domination of the fund market by exchange-traded products should largely eliminate the concerns behind the swing pricing proposal within relatively few years.

For the reasons discussed herein, I strongly urge the Commission to withdraw this unwise proposal.

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[2] Remarkably, one fund sponsor that is a proponent of swing pricing even refers to the favorable effect of swing pricing on reported fund performance as "alpha." Imagine, a new source of fund alpha, not sourced from the fund's investment managers, but from the swing pricing team! *See* BlackRock, Viewpoint, *Fund Structures as Systemic Risk Mitigants* (Sept. 2014), *available at* http://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-fund-structures-as-systemic-risk-mitigants-september-2014.pdf at 6.

In closing, I wish to thank the Commissioners and Staff for consideration of the views and information presented in this letter.

Sincerely,

Gary L. Gatineau

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