

April 11, 2022

Vanessa Countryman, Secretary  
Securities and Exchange Commission  
100 F Street NE  
Washington, DC 20549-1090  
Filed via E-mail

Re: Money Market Fund Reforms (File No. S7-22-21)

Dear Ms. Countryman:

I am writing to comment<sup>1</sup> on the amendments to Rule 2a-7 proposed in Money Market Fund Reforms, Release No. IC-34441 (the “Proposing Release”).<sup>2</sup> My comments are limited to the “swing pricing” requirements that the Commission proposes to impose on money market funds with floating share prices (the “Swing Pricing Proposal”).<sup>3</sup> This letter sets forth the reasons why I believe that adoption of the Swing Pricing Proposal would be arbitrary, capricious, an abuse of discretion, and not in accordance with law. Furthermore, the costs the Swing Pricing Proposal would impose on redeeming shareholders would far exceed any plausible benefits.

## **1. The Swing Pricing Proposal**

The proposal would require swing pricing whenever a fund that sells and redeems its shares at a floating price (an “institutional money fund”) has net redemptions during a pricing period. A “pricing period” would be the period from the calculation of one share price to the next. For example, a fund that begins accepting orders at 9 a.m. and stops accepting orders at 4 p.m., and calculates its share price at noon and 4 p.m., would have two pricing periods: 9 a.m. to noon and 12:01 to 4 p.m.

Whether an institutional money fund has net subscriptions or redemptions during a pricing period would be determined at the fund, rather than class, level. The “swing price” would be the same as or lower than the net asset value per share (“NAV”) the fund would have used for a pricing period without net redemptions. The result would be that redeeming shareholders might receive, and subscribing shareholders might pay, a lower price than

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<sup>1</sup> These are my personal comments and do not reflect the views of the law firm or attorneys with whom I am associated, or of any of my former or current clients. I have not received any compensation or inducement for these comments nor coordinated with anyone else commenting on the Proposing Release.

<sup>2</sup> 87 Fed. Reg. 7248 (2022).

<sup>3</sup> Proposed Rule 2a-7(c)(2).

they would have absent swing pricing. Swing pricing would not be triggered by net subscriptions.

An institutional money fund would have to base the swing price on the estimated cost of selling a pro rata share of its entire portfolio (a “vertical slice”) equal to the net redemptions for the pricing period. If net redemptions amount to 2% of a fund’s net assets, the fund would need to estimate the cost of selling 2% of every investment it holds. These estimated costs must include:

- The spread, if any, between the value of the investment used to calculate the fund’s net assets and the value at which the investment could be sold; and
- Brokerage commissions, custody fees, and any other charges, fees, and taxes resulting from such sales.

In addition, if net redemptions exceed the market impact threshold, the estimated costs must also include a market impact factor. The “market impact threshold” would be 4% of the fund’s net assets divided by the number of pricing periods in a business day. A fund with only one pricing period would have a market impact threshold of 4% of its net assets, while a fund with two pricing periods would have a market impact threshold of 2% for each pricing period.

A “market impact factor” would be the estimated change in the value of a portfolio investment if it were sold under current market conditions. The Proposing Release explains that:

[m]arket impact costs reflect price concessions (amounts added to the purchase price or subtracted from the selling price) that are required to find the opposite side of the trade and complete the transaction.<sup>4</sup>

As a market impact factor relates to the sale of an investment, it would be subtracted from the current bid price of the investment. The fund may apply the same market impact factor to investments with substantially similar characteristics. Although the Proposing Release acknowledges that “it would be reasonable to apply a market impact factor of zero to the fund’s daily and weekly liquid assets,”<sup>5</sup> it does not indicate whether this would be reasonable for other investments.

Every institutional money fund would have to adopt swing pricing policies and procedures approved by the fund’s board of directors or trustees (the “Board”). The Board would have to designate a swing pricing administrator reasonably segregated from portfolio management of the fund. The swing pricing administrator may be the fund’s investment adviser, officers, or a group.

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<sup>4</sup> 87 Fed. Reg. at 7260 n.105.

<sup>5</sup> Id. at 7262.

## 2. Consequences of Swing Pricing

The immediate effects of a swing price are twofold:

- Redeeming shareholders receive fewer of the fund's assets, and
- Subscribing shareholders contribute fewer assets to the fund,

than they would in the absence of the swing price. This has two immediate consequences:

- The fund's NAV increases, and
- Subscribing shareholders can redeem the shares they receive at a higher price than they paid, unless they redeem during a pricing period subject to a swing price.

Redeeming shareholders pay for the subscribing shareholders' gains through the reduction in the assets they receive. "Thus, redeemers would subsidize subscribers in the fund ...."<sup>6</sup>

The ultimate consequence of the increase in the fund's NAV depends on whether the net redemptions subject to a swing price cause the fund to incur transaction costs. Transaction costs are paid from the fund's net assets and thereby reduce its NAV. The increase in the NAV resulting from the swing price would mitigate any reduction in the NAV resulting from transaction costs. If the transaction costs are close to the estimated costs and market impact factors used to determine the swing price, the remaining shareholders could redeem their shares at an NAV that is the same as, or close to, the NAV they would have received in the absence of the net redemptions.

On the other hand, if the net redemptions do not require the fund to incur transaction costs, or the actual transaction costs are less than the estimated costs and market impact factors used to determine the swing price, then the increase in the NAV resulting from the swing price would increase the price the remaining shareholders would receive upon redemption of their shares.<sup>7</sup> In this circumstance, the remaining shareholders would be in the same position as subscribers, with their gains subsidized by shareholders who redeemed at the swing price.

## 3. The Swing Pricing Proposal Would Dilute Redeeming Shareholders

In the context of a mutual fund, dilution can occur in five circumstances:

- Shares are sold for less than the fund's NAV, which dilutes the remaining shareholders;

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<sup>6</sup> 87 Fed. Reg. at 7316.

<sup>7</sup> This may not be immediately evident due to rounding of the NAV to the fourth decimal place, but repeated rounds of swing pricing during periods in which the fund does not incur transaction costs must eventually result in an increase in the rounded NAV.

- Shares are redeemed for less than the fund's NAV, which dilutes the redeeming shareholders;
- Shares are sold for more than the fund's NAV, which dilutes the subscribing shareholders;
- Shares are redeemed for more than the fund's NAV, which dilutes the remaining shareholders; or
- The fund does not allocate its income, expenses, gains, and losses ratably among its shareholders, which dilutes shareholders who receive a lesser share of income or gains or a greater share of expenses or losses.

The Swing Pricing Proposal would dilute redeeming shareholders by imposing a swing price below the fund's NAV. This represents a cost of the Swing Pricing Proposal.

The Proposing Release treats any transaction costs incurred as a result of net redemptions as a version of the fifth type of dilution.

Trading activity and other changes in portfolio holdings associated with meeting redemptions may impose costs, including trading costs and costs of depleting a fund's daily or weekly liquid assets. These costs, which currently are borne by the remaining investors in the fund, can dilute the interests of non-redeeming shareholders.<sup>8</sup>

Accordingly,

Swing pricing is a process of adjusting a fund's current NAV such that the transaction price effectively passes on costs stemming from shareholder transaction flows out of the fund to shareholders associated with that activity.<sup>9</sup>

This statement is true only if the fund incurs the estimated costs passed onto redeeming shareholders. Otherwise, swing pricing simply dilutes the redeeming shareholders. In any event, the redeeming shareholders would bear the dilution resulting from selling shares to subscribing shareholders for less than the fund's NAV.

#### **4. The Swing Pricing Proposal Is Not in Accordance with the Investment Company Act**

Institutional money funds issue "redeemable securities" as defined by Section 2(a)(32) of the Investment Company Act of 1940.<sup>10</sup> According to this definition, upon redemption of the security, the holder "is entitled ... to receive approximately his

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<sup>8</sup> 87 Fed. Reg. at 7261.

<sup>9</sup> Id.

<sup>10</sup> 15 U.S.C. § 80a-2(a)(32).

proportionate share of the issuer's current net assets, or the cash equivalent thereof.” Furthermore, with respect to redeemable securities, Section 22(a) provides that:

A securities association ... may prescribe ...—

(1) a method or methods for computing the minimum price at which a member thereof may purchase from any investment company any redeemable security issued by such company and the maximum price at which a member may sell to such company any redeemable security issued by it or which he may receive for such security upon redemption, so that the price in each case will bear such relation to the current net asset value of such security computed as of such time as the rules may prescribe; and

...

*... for the purpose of eliminating or reducing so far as reasonably practicable any dilution of the value of other outstanding securities of such company or any other result of such purchase, redemption, or sale which is unfair to holders of such other outstanding securities.*<sup>11</sup>

Subsection (c) of Section 22 authorizes the Commission to “make rules and regulations ... covering the same subject matter, *and for the accomplishment of the same ends* as are prescribed in subsection (a) of this section ....”

The Swing Pricing Proposal would be contrary to Sections 2(a)(32) and 22 insofar as:

- it would deprive redeeming shareholders of the cash equivalent of a proportionate share of the institutional money fund’s current net assets, and
- it would cause, rather than eliminate or reduce, dilution of the fund’s shares.

The Commission attempts to justify the Swing Pricing Proposal as a means of eliminating or reducing results of redemptions that the Commission considers unfair to the remaining shareholders, namely, dilution from the costs incurred as a result of redemptions. The Swing Pricing Proposal is not limited to circumstances in which a fund is likely to incur such transaction costs, however. In fact, the Swing Pricing Proposal would dilute redeeming shareholders even when the fund does not incur any transaction costs and would systematically overestimate such transaction costs.

a) Net Redemptions Rarely Result in Transaction Costs

The Proposing Release concedes that:

[g]iven the nature of money market fund holdings ..., money market funds typically absorb redemptions out of daily and weekly liquid assets. ...

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<sup>11</sup> 15 U.S.C. § 80a-22(a) (emphasis added).

Thus, *the realized transaction costs of most redemptions may be zero as funds absorb them out of daily liquidity ....*<sup>12</sup>

The Proposing Release observes

[h]owever, the fund would have less remaining daily and weekly liquidity and transacting shareholders would be diluting remaining investors in a manner not captured by estimated transaction costs. Thus, this aspect of the proposal would make redeeming investors bear not just the immediate costs of covering redemptions, but also the costs of rebalancing the fund portfolio to the pre-redemption levels of liquid asset holdings.<sup>13</sup>

This assumes that (1) reductions in liquid assets require a fund to rebalance its portfolio and (2) any such rebalancing will incur transaction costs. Neither of these assumptions is correct in most circumstances.

First, most institutional money funds maintain daily and weekly liquid assets well above the 10% and 30% levels required by Rule 2a-7. According to the Proposing Release:

from October 2016 to February 2020, the average amount of daily liquid assets and weekly liquid assets for prime money market funds was 31% and 49%, respectively.<sup>14</sup>

The most recent Money Market Fund Statistics<sup>15</sup> reported by the Commission show institutional prime money funds with daily liquid assets comprising over half, and weekly liquid assets comprising two-thirds, of their total assets. Over eighty percent of the total assets of institutional tax exempt funds consist of weekly liquid assets. At these levels, institutional money funds can absorb substantial redemptions without needing to rebalance their portfolios.

Second, institutional money funds have net subscriptions as well as net redemptions and use the net subscriptions to increase their liquidity without selling investments. The Commission can see an example of this at the “Holdings and Characteristics” tab<sup>16</sup> of the GS Financial Square Prime Obligations Fund website. The daily flows chart shows substantial inflows at the beginning of most weeks, followed by substantial outflows (several in excess of the market impact threshold) the next day. The chart above this shows

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<sup>12</sup> 87 Fed. Reg. at 7306 (emphasis added).

<sup>13</sup> Id. at 7305-06.

<sup>14</sup> Id. at 7274.

<sup>15</sup> [https://www.sec.gov/files/mmf-statistics-2022-02\\_1.pdf](https://www.sec.gov/files/mmf-statistics-2022-02_1.pdf).

<sup>16</sup> <https://www.gsam.com/content/gsam/us/en/advisors/fund-center/fund-finder/gs-financial-square-prime-obligations-fund.html#activeTab=holdings>.

an increase in the percentage of daily liquid assets that corresponds to the inflows, as the fund retains this liquidity in anticipation of the next day's outflows.

The liquidity provided by net subscriptions is particularly important for funds that have multiple pricing periods. Such funds price their shares throughout the day so that shareholders can access their cash and apply it on a same day basis. As shareholders access cash by redeeming shares, these funds typically experience net redemptions during their early pricing periods.

These funds will also frequently have net subscriptions during the last pricing period. This is because institutional investors typically determine their cash available for investment toward the conclusion of each day. These end of day subscriptions provide some or all the liquidity needed to cover the earlier redemptions at no cost to the fund.

Third, maturing investments provide a substantial source of liquidity for institutional money funds. The current Money Market Fund Statistics report that the average institutional prime money fund had a weighted average life of just over six weeks and 94% of its portfolio maturing in less than six months. This implies that the average maturity of over 90% of the portfolio is just over a month at most, giving funds a steady source of liquidity at no transaction costs.

The situation is somewhat different for institutional tax exempt money funds, which hold weekly liquid assets in the form of obligations subject to seven-day demand features. Exercising the demand feature provides the fund with the full principal amount of and accrued interest on the tendered obligation at no cost to the fund, so an institutional tax exempt money fund can easily obtain liquidity for net redemptions at no cost to the remaining shareholders.

Therefore, net redemptions do not necessarily require institutional money funds to rebalance their portfolios and, when rebalancing is required, net subscriptions, maturing securities, and the exercise of demand features normally allow funds to rebalance without incurring any transaction costs.

b) The Swing Pricing Proposal Would Systematically Overestimate the Costs of Net Redemptions

If an institutional money fund does not incur any transaction costs as a result of net redemptions, then any swing price will simply dilute the redeeming shareholders in contravention of Sections 2(a)(32) and 22. But even on the rare occasions that a fund must sell investments because of sustained significant net redemptions, the Swing Pricing Proposal's "sale of a vertical slice" approach to estimating costs and market impacts would systematically overestimate the transaction costs of such sales.

The Swing Pricing Proposal would require the swing pricing administrator to estimate the cost of selling a pro rata share of every portfolio investment. I sampled the

month-end portfolios a several funds, and found that even small institutional prime money funds have over 100 positions in certificates of deposit (“CDs”) and commercial paper (“CP”). So, if a fund had net redemptions of \$100,000 in a pricing period, the swing pricing administrator would have to pretend that the fund would enter into over 100 trades, some for less than \$1,000, to raise the cash for these redemptions. Whereas, in reality, a fund that needed to raise \$100,000 would sell a single investment.

As the Swing Pricing Proposal anticipates, the transaction costs of selling portfolio investments include fees charged by the fund’s custodian. Specifically, custodians impose a “ticket” fee or charge on each trade order (“ticket”) submitted to the custodian for clearance and settlement. One major custodian charges \$5 for a trade involving CDs or CP; another charges \$4.50. Thus, if a fund actually sold a vertical slice of its portfolio, it would incur ticket fees on the order of \$500 (assuming only one trade per investment).

These ticket fees would be a fixed cost of selling a vertical slice of the portfolio and would cause the swing factor to decline as the amount of net redemptions increased. For example, passing a \$500 cost onto shareholders redeeming \$100,000 requires a swing factor of 50 basis points, whereas a swing factor of 5 basis points would suffice to pass a \$500 cost onto shareholders redeeming \$1 million. This means that the Swing Pricing Proposal would require lower swing prices for smaller redemptions, even though smaller redemptions are less likely to require the sale of any of the fund’s portfolio, much less the sale of multiple investments.

c) The Frequency of Swing Pricing Would Not Be Reasonably Related to the Incurrence of Transaction Costs

As demonstrated above, institutional money funds should rarely incur transaction costs as a result of net redemptions on a single day, much less a single pricing period. I have worked with money market funds for over thirty years and, apart from the exercise of demand features, I have not heard of a fund needing to sell assets in response to ordinary redemption activity. Yet the Swing Pricing Proposal would potentially require a swing price whenever an institutional money fund has net redemptions in a pricing period. As the swing price would have to reflect the potential ticket charges of selling a “vertical slice” of the portfolio, the swing price is likely to be lower than the NAV, thereby diluting redeeming shareholders to compensate for transaction costs the fund will never incur.

The propose market impact threshold also fails to bear a reasonable relationship to circumstances in which net redemptions might have a market impact. The Proposing Release explains that the threshold was selected so that:

[a]pproximately 3 out of the 53 (5%) institutional funds as of October 2021 would have outflows exceeding this threshold *on an average trading day*.<sup>17</sup>

In other words, while an individual institutional money fund might expect to experience “daily outflows greater than 4% on approximately 5% of trading days,”<sup>18</sup> the Commission expects more than one fund to cross the market impact threshold on any trading day. The Commission proposes this threshold even though:

net flows on most days are low, so funds rarely experience large net redemptions that have significant market impact that would dilute investors.<sup>19</sup>

Apart from the 2008 financial crisis and March 2020, the Proposing Release does not cite any instances in which net redemptions from institutional money funds have had a market impact. Thus, the Commission did not even attempt to propose a market impact threshold based on when net redemptions might plausibly have a market impact. Instead, the Commission selected a threshold that an institutional money fund might experience on 5% of its trading days, which is about once a month. The Commission cannot seriously contend that net redemptions from an institutional money fund are impacting the short-term funding market on a monthly basis.

## 5. The Cost of Swing Pricing Would Exceed Any Plausible Benefits

As explained above, swing pricing imposes a cost on redeeming shareholders equal to the excess of the fund’s NAV over the swing price. This is in addition to the cost the fund would incur to implement swing pricing and should be included in any cost/benefit analysis. The Proposing Release does not identify sufficient benefits to justify the costs the Swing Pricing Proposal would arbitrarily impose on redeeming shareholders.

The primary benefit cited for the Swing Pricing Proposal is that it would “make redeeming investors bear not just the immediate costs of covering redemptions, but also the costs of rebalancing the fund portfolio to the pre-redemption levels of liquid asset holdings.” As funds rarely incur such immediate costs, and regularly use net subscriptions, maturing securities and demand features to rebalance at no cost, this intended benefit cannot justify a regular, indeed daily, imposition of swing pricing by some institutional money funds. The purported benefits also cannot justify the imposition of costs (such as ticket fees) well in

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<sup>17</sup> 87 Fed. Reg. at 7305. The subdivision of the market impact threshold among pricing periods and the tendency for there to be net redemptions in early pricing periods makes it likely that funds with multiple pricing periods will cross the threshold every trading day

<sup>18</sup> Id. at 7263.

<sup>19</sup> Id. at 7305.

excess of what a fund might reasonably be expected to incur, or the inclusion of market impact factors which, as the Commission admits, funds rarely experience.

With respect to the subsidy that redeeming shareholders would pay to subscribing shareholders, the Proposing Release posits “an incentive effect that may be particularly important when liquidity is scarce and a fund is facing a wave of redemptions.” There are several problems with this contention. First, the Swing Pricing Proposal would not limit swing pricing to circumstances in which liquidity is scarce and the fund faces a wave of redemptions. The subsidy would be paid every time the fund has net redemptions and the swing factor reduces the swing price below the fund’s NAV.

Second, to provide an incentive effect, the subscribing shareholders would have to know in advance that the fund will have net redemptions in a pricing period. This might be the case if a fund with multiple pricing periods regularly has net redemptions in an early period and net subscriptions in a later period. But this would incentivize subscribers to market time the fund by trying to buy at the swing price in the early pricing period and redeem at the higher NAV in the last pricing period. Any liquidity subscribers provide in the early period would be withdrawn in the later period, so they would receive a subsidy without providing additional net liquidity to the fund.

Subscribers might also expect net redemptions due to adverse market conditions (as in March 2020) or a portfolio default (like the Lehman bankruptcy). Even assuming that there would be some investors willing to subscribe for shares in such circumstances, they would need to know that the swing price was low enough to provide a reasonable return for the risk they would be taking. As the swing price depends on the amount of net redemptions, which could not be predicted, I doubt such investors could estimate their potential returns. Potential subscribers also could not predict when the fund would stop using a swing price or whether the redemptions might force the fund into liquidation. Hence, I expect the anticipated “incentive effect” is chimeric.

Therefore, the Swing Pricing Proposal would systematically impose substantial costs on redeeming shareholders in the form of dilution in return for, at best, episodic benefits in the cases when the redemptions cause the fund to incur transaction costs. The magnitude of the costs would far exceed the occasional benefits, as the swing price would be based on unrealistic cost and market impact estimates. Subscribing shareholders would also receive a windfall from redeeming shareholders whenever their subscriptions are priced at the swing price.

## **6. Conclusion**

The Swing Pricing Proposal is based on several arbitrary premises. These false premises include:

- that institutional money funds are likely to incur transaction costs whenever they have net redemptions in a pricing period;
- that sales by institutional money market funds impact the short-term funding markets five percent of the time; and
- that sales of a vertical slice of a fund's portfolio will provide a reasonable estimate of the transaction costs and market impacts a fund would incur to restore the liquidity used to pay net redemptions.

The Commission should not be surprised that these unrealistic assumptions would produce capricious results, in that the Swing Pricing Proposal would routinely dilute redeeming shareholders to provide unjustified windfalls to subscribers and remaining shareholders and would not increase the resilience of institutional money funds in any respect.

I hope that the Commission will learn from its mistakes in formulating and promulgating the Swing Pricing Proposal. Investors deserve a more deliberate and critical process from the Commission before it amends regulations for funds that safeguard trillions of dollars of their assets.

Sincerely,

/s/ Stephen Keen