November 28, 2022

Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1010

Re: Comment Letter on File Number S7-26-22

This letter is in reference to the open comment period for the Proposed Rule under File Number S7-26-22, titled, "Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting" (the "Proposed Rule). We believe that the SEC should reconsider some changes noted in the Proposed Rule for potential unintended costs associated with its implementation, and offer suggestions for the Proposed Rule. Specifically, we want to raise concerns that the Proposed Rule in combination with previous regulation under Rule 22e-4 (the "Liquidity Rule") is incongruent with the intended goal of reducing the risk of mutual fund insolvency. Under the Proposed Rule, the liquidity classification bucket of "less liquid" is removed, which poses a substantial burden on funds' holdings choice set and can potentially lead to a loss in the breadth of available options for funds managers to achieve their investment objectives. We recognize that this tradeoff may be desirable if it lowers the risk of fund defaults and/or the chance that a fund cannot meet its required window to satisfy fund investor redemption requests. However, we do not believe that increasing the amount of securities that will be classified as "illiquid" will improve open-end mutual funds' resiliency to liquidity pressures, particularly for those funds whose investment objectives are tailored towards investing in more illiquid securities.

One of the main features of the Liquidity Rule was the 15% illiquid investment limit for open-end mutual funds. Furthermore, open-end mutual funds must also maintain a required minimum "highly liquid" investment level under a risk management program. In a study we conducted on the effects of the Liquidity Rule on funds, titled "The Consequences of Fund-level Liquidity Requirements," we document evidence that while the Liquidity Rule does result in an immediate increase of liquidity at bond funds that focus on less liquid securities, it does not result in a counter-cyclical solvency buffer for those funds.[1] Specifically, we find that post-Liquidity Rule, funds with more illiquid portfolios prior to the rule announcement increase their average cash holdings and reduce holdings of illiquid assets relative to funds with liquid portfolios. More importantly, we document that these funds do not appear to utilize this improved liquidity buffer during times of stress. In periods where funds exhibit large redemption requests

[1] Reference: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4081278

or during periods of high macro-wide market uncertainty, we find that funds further reduce their proportion of illiquid fixed-income holdings and increase their relatively liquid holdings after the Liquidity Rule. That is, funds' response to these shocks appears to be consistent with selling illiquid securities—albeit during high macro-uncertainty when doing so is the least advantageous—while maintaining cash levels proportionally the same. Such a response is concerning, and could generate even deeper illiquidity in downstream bond markets. Indeed, we find that secondary market yields on relatively illiquid corporate bonds that rely on open-end mutual fund investment increase after the promulgation of the rule. Overall, we find that fund managers appear to be broadly fixated on maintaining a constant level of liquidity at the cost of investments closer to funds' investment objectives after the Liquidity Rule.

We highlight Basel III as a relevant framework that banking institutions used to implement macro-prudential regulation of bank liquidity, and offer its dynamic features as appealing in the open-end mutual fund setting. In brief, Basel III requires a minimum Tier 1 Capital Ratio and corresponding countercyclical capital buffer (CCyB). A key feature of the CCyB is that it is only used in periods of high credit exposure to banks. A dynamic liquidity buffer that considers macro-level liquidity conditions in the bond and other illiquid securities markets may be an excellent alternative to the static nature of the existing Liquidity Rule and additions under the Proposed Rule.

Below, we summarize our suggestions to improve the Proposed Rule, based on our findings related to the consequences of the Liquidity Rule:

1) Clearly and quantitatively define what the SEC views as "liquidity risk" from the point of view of an open-end mutual fund. The SEC currently defines liquidity risk under the Liquidity Rule as, "the risk that a fund could not meet requests to redeem shares issued by the fund without significant dilution of remaining investors interests in the fund." This concept of risk is sensible but does not provide a quantitative threshold for fund managers to consider, making it challenging to evaluate fund liquidity.
2) Consider increasing the time-frame to satisfy redemption requests from 7 days to 14 days for funds that have stated investment objectives focused on illiquid securities instead of limiting the amount of securities a fund can invest in based on liquidity.
3) Consider adopting dynamic liquidity threshold requirements based on prevailing market conditions. In our paper noted above, we highlight how Basel III for banking institutions utilizes a required minimum threshold for Tier 1 capital, as well as a discretionary CCyB during periods of high liquidity constraints. Such a dynamic framework could provide the SEC with tools to satisfy both SEC concerns about liquidity buffers as well as to allow fund managers more flexibility in investment options.

4) Remove the change to Rule 22e-4 under the Proposed Rule that does away with “less liquid” classification, as this is likely to exacerbate selling activities of illiquid holdings during macro-wide liquidity stress.
5) Remove the change mandating 10% of net asset value be “highly liquid,” as this will also likely exacerbate fund managers fixating on bright-line thresholds for highly liquid investments.

We acknowledge the challenges that the SEC faces to mitigate and prevent another bond fund liquidity crisis like the one seen in the mid-2010s, while maintaining a rich and desirable competitive environment. We hope that our recommendations above contribute to the SEC’s goal of continued robust regulation for open-end funds.

Sincerely,

Indraneel Chakraborty, University of Miami
Elia Ferracuti, Duke University
John Heater, Duke University
Matthew Phillips, MIT