February 2, 2023

Ms. Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
Via email: rule-comments@sec.gov

Re: File No. 33-1130; Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting

Dear Ms. Countryman:

This letter is submitted by the Independent Trustees of the Morningstar Funds Trust (the "Morningstar Funds"). The Trust is a registered investment company consisting of 9 series with $4.3 billion in assets at the end of 2022.

The comments in this letter solely represent our views as Independent Trustees of the Morningstar Funds and do not necessarily represent the views of Morningstar Investment Management ("MIM"), the investment adviser to the Morningstar Funds, or MIM's parent, Morningstar, Inc.

Summary

Liquidity Risk Management Programs

- In the Morningstar Funds' experience with their liquidity risk management program, costs to shareholders have been high, while benefits have been limited.
- We believe that flexibility for smaller fund complexes could provide similar benefits at a significantly lower cost.
- Shareholders benefit when smaller fund complexes thrive.

Swing Pricing and Hard Close

- For shareholders in the Morningstar Funds, we believe that the significant costs of implementing swing pricing will far outweigh the benefits they will experience.
- Swing pricing creates exceptional challenges for director oversight that pose risks to shareholders.
- We are concerned by the lack of empirical support for the benefits of swing pricing.

Liquidity risk management programs (LRMPs)[1]

We ask that the Commission consider giving smaller fund complexes more flexibility in the implementation of liquidity risk management programs (LRMPs).

In the Morningstar Funds' experience with their LRMP, costs to shareholders have been high, while benefits have been limited.

Based on our experience implementing an LRMP over the past 3+ years, we believe that, at smaller fund complexes, LRMPs impose significant costs on fund shareholders but provide limited benefits.[2]

With regard to costs, like many fund complexes, we use a third-party vendor to analyze the liquidity of fund holdings and sort them into the required "buckets." In 2022, the Morningstar Funds paid $230,000 for this analysis – a fund expense that is borne by fund shareholders.[3]

With regard to benefits, the LRMP reports have provided very limited insights into portfolio liquidity. These reports consistently show that most holdings are "highly liquid." We believe that this result is, in large part, due to the smaller size of the Morningstar Funds' portfolios.[4] Because the portfolios are smaller, the anticipated trade sizes are smaller relative to market depth, leading most securities to be classified in the "highly liquid" bucket.[5]

In fact, it is usually quite clear why some holdings are classified as less than "highly liquid." For example, the holdings may be classified as Level 3 or trade in "frontier" markets or other less liquid markets.

The Funds' liquidity classifications have been quite steady over time, and market impact modeling has consistently predicted only limited changes in their liquidity profile. Again, we believe that, because of the smaller size of the Funds and their anticipated trades, liquidity classifications have not needed to change even as market conditions have varied significantly.

As a result, we believe that the Commission's proposal to require daily – rather than monthly – liquidity classifications will only add costs without adding insights that benefit shareholders.

---

[1] The Morningstar Funds' board chair, Theresa Hamacher, addressed the cost-benefit of LRMPs at smaller fund complexes in her remarks to the Asset Management Advisory Committee in September 2021.

[2] Our experience dates from June 2019, the compliance date for smaller entities.

[3] Certain of the Morningstar Funds' portfolios have fee waiver and expense reimbursements in place, and as a result, MIM also may bear a portion of these expenses indirectly.

[4] We are confused by the statement on page 384 of the release that "small funds do not entail less liquidity risk than larger funds." If two funds vary in size but are identical in all other respects (e.g., they have the same holdings as a percentage of the portfolio and the same shareholders), the smaller fund would reasonably anticipate that its trade size would be smaller than the trade size of the larger fund. Wouldn't that imply that a smaller fund has less liquidity risk than a larger fund, again assuming all else being equal?

[5] Since the inception of their LRMP, the Morningstar Funds have used a reasonably anticipated trade size of 10%, which is a very conservative estimate given the character of the shareholder base, as discussed below, and which coincidentally matches the assumed trade size as proposed by the rule.

While the cost impact is difficult to estimate, we believe that it will be significant. To look at only one implication of the change, daily reports will require daily compliance review, and, because the liquidity reports are not integrated into internal portfolio systems, they cannot be integrated into automated exception processing. Instead, they must be reconciled to other systems with exceptions manually resolved.

We believe that flexibility for smaller fund complexes could provide similar benefits at a significantly lower cost.

We believe that there are alternative approaches for smaller fund complexes, apart from exemption.[6] We suggest that, rather than mandating the highly prescriptive approach in the current rule proposal, the Commission could allow smaller fund complexes to establish a customized program.

For example, funds could identify specific types of securities (such as bank loans), trading venues (e.g., less liquid non-U.S. markets), or specific securities (such as those classified as Level 3) to monitor.

This customized approach would still allow funds to track liquidity risk, but at a much lower cost to shareholders. Costs would be lower because funds would be able to use core portfolio recordkeeping, trading, and compliance systems for monitoring, and would no longer need to pay for third-party vendor support.

We note that there is precedent for providing flexibility to smaller entities. For example, the Commission itself has provided relief from corporate disclosure and auditor attestation requirements for "smaller reporting companies."

We also argue that providing flexibility to smaller complexes does not significantly affect the Commission's ability to monitor liquidity risk of mutual funds in general. According to Investment Company Institute data, at the end of November 2022, fund complexes with less than $50 billion in assets– which are more than 80% of fund complexes – account for less than 10% of total industry assets. Since the Commission will still have access to more detailed data from larger complexes, it can continue to monitor market trends while relieving the cost burden on smaller complexes.

In sum, we ask the Commission to consider allowing smaller fund complexes to adopt a principles-based approach to liquidity risk management. This approach would require that smaller complexes have policies and procedures in place to ensure that the funds can satisfy their redemption obligations while mitigating potential harm to non-redeeming shareholders; however, smaller complexes would have flexibility in their approach to monitoring and addressing liquidity risk.

Shareholders benefit when smaller fund complexes thrive.

Competition is good for shareholders, and smaller fund complexes are an important component in maintaining a vibrant industry. Smaller complexes may be better able to introduce new

[6] We do not agree with the assertion to the contrary on page 385 of the release.

business models or innovative investment approaches or funds, providing shareholders with a wider range of options that can meet their needs.

Unfortunately, the cumulative burden of regulation is making launching a new fund complex an increasingly daunting task – which does not bode well for the competitive environment of the future.

The increasing burden of regulation also makes it more difficult to reduce fund expenses for the benefit of shareholders.

In general, we believe that the Commission needs to be more sensitive to the burden being placed on smaller fund complexes. We support the Asset Management Advisory Committee's recommendation that, through the Division of Economic Research and Analysis, the Commission should periodically review this cumulative burden.

We do not believe that shareholders would be well-served by a highly consolidated industry with exceptionally high barriers to entry. And, ironically given the nature of this proposal, a highly concentrated industry would likely lead to an increase in the types of liquidity issues that the Commission seeks to address with this rule.

We urge the Commission to consider providing greater flexibility for smaller fund complexes on this issue.

Swing pricing and hard close

We have profound concerns about the use of swing pricing and the imposition of a hard close.

For shareholders in the Morningstar Funds, we believe that the significant costs of implementing swing pricing will far outweigh the benefits they will experience.

We question the cost-benefit of swing pricing for shareholders in the Morningstar Funds.

On the cost side, the Commission is well aware of the operational implications of the swing pricing and hard close proposal and the significant changes in fund processing that will be required to implement this method.

While it is impossible to estimate the implementation costs at this point, it is likely that these costs will be quite substantial. It is also likely that the service providers who incur the bulk of these costs will pass these costs onto the funds – and, therefore, onto fund shareholders.

Another likely outcome is that these costs will have a disproportionate impact on shareholders at smaller fund complexes. Fees charged by service providers are generally not based solely on assets; instead, service provider fees may also include elements based on volume, such as number of securities or transactions, sometimes combined with a fixed fee component with an asset adjustment. Since volume growth generally lags asset growth, increases in service provider fees will normally have a significantly more negative impact on near-term costs at smaller fund complexes.

Also, in our experience, even when service providers have recouped the upfront costs in implementing new systems, it is hard for smaller fund complexes (as compared to larger

complexes) to negotiate a reduction in the fees charged for such systems thereby furthering competitive disadvantages.

Therefore, for shareholders at smaller fund complexes, the benefits of swing pricing must be even larger to justify the costs of putting swing pricing in place.

Unfortunately, we believe that, because of our distribution approach and the character of our shareholder base, swing pricing will provide little benefit to shareholders in the Morningstar Funds. Specifically, our funds are available only through asset allocation and other investment programs offered by financial institutions. We believe that our shareholders are almost exclusively retail investors, and a significant proportion of our investors' assets are held in retirement accounts.

With a retail shareholder base focused on longer-term asset allocation, the Morningstar Funds have not experienced large market-driven flows that have raised concerns about dilution. Therefore, our shareholders will incur the cost of implementing a swing pricing regime but are unlikely to ever experience a material benefit.[7]

We understand the value of an industry-wide insurance policy, but we believe that there needs to be some "risk rating" for the terms of coverage to be fair. We believe that our shareholders would be paying higher "premiums" to effectively subsidize protection for funds and shareholders with much more exposure to dilution risk.

Swing pricing creates exceptional challenges for director oversight that pose risks to shareholders.

We are concerned that swing pricing programs, as currently structured, present significant conflict of interest issues that directors of all mutual funds will have limited ability to oversee.

Most broadly, we are troubled by the juxtaposition of "redeeming shareholders" with "long-term shareholders." As directors, we have a responsibility to all shareholders – redeeming, non-redeeming, short-term, and long-term – however those categories may overlap.[8]

More specifically, we are concerned that the negative focus on redeeming shareholders could accentuate the conflict of interest inherent in the proposed swing pricing program. That is, advisers have an incentive to favor non-redeeming shareholders over redeeming shareholders in the setting of the swing factor. If the swing factor is too high, the NAV received by redeeming shareholders will be too low and redeeming shareholders will receive too little for their shares.

---

[7] Our conjecture is consistent with the very limited research available. One recent study finds that the "switch to alternative pricing has a greater impact on institutional investors than retail investors, as measured by the change in their withdrawals in stress periods." As summarized in Agostino Capponi, Paul Glasserman, and Marko Weber "[Swing Pricing: Theory and Evidence]" (SSRN, December 22, 2022)

[8] We acknowledge that the proposal does require that swing pricing be used in the event of significant inflows, not just significant outflows. However, given that the proposal sets a much higher bar for use of swing pricing on the upside, the focus of the swing pricing mandate is on redemptions.

Underpaying redeeming shareholders adds to gross assets, and thereby increasing fund returns.[9]

As a result, it causes us to worry when increases in returns are the most-commonly cited empirical justification for swing pricing programs, as investment advisers would have a moral hazard that would create subtle economic incentives to develop overly conservative swing pricing programs that over-estimate swing pricing factors.[10]

Unfortunately, we are concerned about our ability to monitor this conflict for several reasons:

- We are not aware of any widely accepted and back tested model for determining swing thresholds or swing factors. We are concerned that, in the absence of such a model, the swing thresholds and factors will be "best guess" round numbers.
- We are unaware of an accepted methodology for back testing the appropriateness of swing thresholds and factors.[11]
- Determination of swing thresholds and swing factors is done in-house by the adviser, rather than by third parties.
- The lack of transparency with regard to swing factors makes it more difficult to benchmark practices and identify areas of concern.

We contrast the current approach to swing pricing to market-level fair value adjustments, which are based on extensive data analysis, rigorously back tested, administered or evaluated by third parties, and easily benchmarked.

In sum, this proposal will require that every fund use judgmental management estimates to arrive at fund valuations under certain circumstances. This represents a significant departure from the current approach, which emphasizes verifiable third-party valuations and defaults to management estimates in only rare circumstances.

We are concerned by the lack of empirical support for the benefits of swing pricing.

More generally, we are concerned about the lack of rigor surrounding the assessment of the benefits of swing pricing. A recent literature review cited only four empirical studies of the outcomes of swing pricing in Europe.[12] This paucity of research highlights the risks of

---

[9] We note that this concern was raised in two of the comment letters on the 2015 swing pricing proposal but was not specifically addressed in the adopting release. *See* Faust comment letter (June 13, 2016); Gastineau comment letter (January 25, 2016).

[10] Of course, it would be illegal for advisers to manipulate swing factors to their benefit, and we believe that the vast majority of investment advisers will abide by their fiduciary and legal obligations. But illegality did not prevent banks from manipulating LIBOR, and creating temptation through regulation where none existed before is inherently risky.

[11] In Europe, according to the 2022 ALFI survey of swing pricing users, only one-third of respondents back tested at least quarterly, while over one-half back tested on an ad hoc basis.

[12] One of these studies was based on a very small sample size. See Agostino Capponi, Paul Glasserman, and Marko Weber, "Swing Pricing: Theory and Evidence" (SSRN, December 22, 2022).

implementing a rule that will fundamentally alter the investment experience for American investors without fully understanding the potential outcomes (both positive and negative).

While we believe that the swing pricing methodology deserves consideration, we believe that there are other approaches that might be less risky and more feasible at lower cost, including redemption fees, dual pricing, and pricing adjustments similar to those used for market-level fair value.

Other approaches might also allow for more flexibility for smaller fund complexes, unlike the swing pricing proposal, which is only feasible with major industry-wide changes.

We appreciate the Commission's concerns about dilution, and we would certainly welcome a means of providing our shareholders with protection from it, if the cost of that protection were reasonable relative to risk. Unfortunately, we believe that under the current proposal, the relationship of cost to benefit for our shareholders is highly unfavorable.

To summarize, we believe that a wider debate about the multiple options, perhaps through a concept release, would be more productive.

We appreciate the Commission's consideration of our comments and would be pleased to respond to any questions from the Commission or the staff.

Sincerely,

/s/ Theresa Hamacher
Theresa Hamacher, Chair

/s/ Barry Benjamin
Barry Benjamin

/s/ Linda Davis Taylor
Linda Davis Taylor