February 9, 2023

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

Re: **Proposed Rule, Securities and Exchange Commission; Open-End Fund Liquidity Risk Management Programs and Swing Pricing; RIN 3325-AM98 [(File No. S7-26-22)]**

Dear Ms. Countryman:

Delta Data Software, Inc. (Delta Data) appreciates the opportunity to comment on the Securities Exchange Commission's proposed revisions to liquidity risk management programs for open-end funds and required swing pricing by open-end funds. Delta Data is, and has been, a provider of software solutions to the mutual fund industry for over 25 years, with solutions for both asset managers as well as distributors of mutual funds. We service over 50 major financial institutions, including six of the top 10 fund companies, three of the top five retirement service providers, and five of the top 10 trust companies as well as the second-largest broker-dealer in the US.

We don't believe anyone denies that during times of excessive redemption or purchases in an open-end mutual fund, non-transacting shareholders may experience a dilution of their interest. The question is not *whether* they're affected, but rather the *extent* and the *degree* to which these non-transacting shareholders are affected. The next logical point at issue is to determine the least disruptive, yet most effective way to help ameliorate the problem.

A. Summary of Proposal

In your proposal to mandate swing pricing and a hard 4PM cutoff for trading, the Commission references the March 2020 market events as a trigger for this rule, where there were substantial outflows in open-end funds at the onset of the COVID-19 pandemic. According to the Commission:

> The large outflows open-end funds faced during March 2020, combined with the widening bid-ask spreads funds encountered when purchasing or selling portfolio investments at that time, likely contributed to dilution of the value of funds' shares for remaining investors.[1]

[1] Open-End Fund Liquidity Risk Management Programs and Swing Pricing, 87 Fed. Reg. at 77,40.

Furthermore, the Commission states:

> We do not have specific data about the dilution fund shareholders experienced in Mar. 2020 because funds do not report information about their trading activity and the prices at which they purchase and sell each instrument. However, European funds experienced similar market conditions as U.S. funds and, to mitigate dilution during this period, many European funds increased their use of swing pricing and the size of their swing factors.[2]

In effect, the Commission is saying that because of the market events of March 2020, open-end mutual fund shareholders "likely" had dilution in shares, but it fails to quantify what that "likely" dilution may have been. We are hopeful that some of the asset management firms will be able to comment on what those true costs are, which may help shape a less Draconian solution than what this rule proposes.

The Commission's proposal frequently cites how European mutual funds handled the March 2020 crisis as a prescribed model for US mutual funds to follow. Swing pricing is prevalent in European funds, and the Commission references the extensive use of swing pricing in Europe during this time. In effect, the proposal asserts that since swing pricing has proven to be an effective tool in Europe, it should work in the US as well. We disagree. The European mutual fund market is very different than what exists in the US. They have much earlier trading cutoffs and the concept of "late day" trading is non-existent in Europe.

For swing pricing to be effectively implemented, it is important for a mutual fund to know their flow for the day before they start the pricing of their funds, and in order for funds to know their flow, the Commission is recommending a hard close of all trading at 4PM. As the Commission is aware, mutual funds have had the ability to impose swing pricing at their discretion since 2018. We don't think it is a mystery as to why not a single fund company in the US has implemented swing pricing to date. The current model for trading mutual funds in the US allows for the transmission of trades executed prior to 4PM to be submitted after 4PM, with retirement service providers allowed to submit executed trades even into the early hours of the following morning. Thus, the funds are unable to accurately determine their flows prior to the start of their daily pricing process. In order for swing pricing to work effectively, swing pricing requires the 4PM cutoff for submission of trades, hence the inclusion of this provision in the Commission's proposed rule change.

Our comments will focus on the implications of an imposed 4PM cutoff time for trading, as this is the lynchpin that the Commission's proposal hinges on, as well as an area in which we have considerable knowledge. Without the 4PM hard close for trading, it would be virtually impossible for a fund to implement an effective swing pricing policy.

[2] Open-End Fund Liquidity Risk Management Programs and Swing Pricing, 87 Fed. Reg. at 77,40.

B. Twenty-Five Year History of Late Day Trading in the US

In the US, retirement plan service providers and the participants they serve have benefited tremendously from the DTCC's late-day trading service known as the Defined Contribution Clearance & Settlement Service (DCC&S), which has been a huge success since its implementation 25 years ago.

Prior to the DTCC's rollout of DCC&S in 1997, mutual funds made up a small portion of the investments in retirement plans. Our firm developed and licensed defined contribution software in the 1990s, and we know first-hand that most of the mutual fund investments in these plans were minimal and traded via fax. According to the ICI, as of December 31, 2021, there were $6.368 trillion in mutual fund assets held in defined contribution plans.[3] Today, most retirement plan mutual funds are traded via DCC&S. Not only is this the most cost-effective system in the world for trading mutual funds (12 cents per trade, six cents paid by the fund, and six cents paid by the submitter), but it also allows for incredible efficiency in the settlement of same-day participant transfers, as well as many other benefits.

Retirement plan participants have long enjoyed the ability to move balances from one fund to another, commonly referred to as transfers or switches. By allowing retirement plan administrators to trade late in the evening or early the following morning, they can wait until they receive the end-of-day NAVs for all their funds and then calculate the dollar value of the shares being sold and purchase shares in the fund or funds being transferred to. This process is called running the "nightly cycle". Some participant trades are in dollars only, like payroll contributions while other participant trades are in shares, like the transfer of shares out of a fund. The "nightly cycle" process extends all these trades by either dividing the dollar amounts of the trades by the end-of-day share price to get the number of shares or multiplies the shares by the end-of-day price to get the dollar value of the trade. This process generally takes hours, hence the need for retirement plans to trade late in the evening or into the early hours of the following morning. But this process is what enables the sell trades and the buy trades involved in participant transfers to go out at the same time, resulting in a zero net settlement with the DTCC. The participants benefit by not being out of the market for a day waiting for the sell fund to settle before making the purchase trade. A hard 4PM trade cutoff would eliminate this commonly accepted feature of retirement plans and would result in confusion, as well as increased settlement costs and market exposure to the participants waiting for funds to settle.

As stated above, before the NSCC introduced its Defined Contribution Clearance & Settlement Service, plan participants were denied the benefit of same-day transfers between funds, primarily due to the 4PM cutoff for submitting mutual fund trades to the fund companies. In addition, plan recordkeepers had to submit separate wires to each fund complex

[3] Inv. Co. Inst., 2022 Investment Company Fact Book 228 (2022), https://www.icifactbook.org/.

they traded with, resulting in additional costs ultimately borne by the plan participants. Prior to 1997, a retirement recordkeeper was not allowed to trade via the NSCC and unable to reap the many benefits that come from the electronic trading of mutual funds to include a single settlement with the NSCC regardless of the number of funds that were traded. Also prior to 1997, only broker-dealer firms were allowed to trade via the NSCC. In response to requests from the retirement services industry, the NSCC rolled out their DCC&S trading service for retirement plan service providers in 1997.

The Commission's proposed change, which includes implementing a 4PM hard close, would have untold consequences for the industry. Twenty-five years of systems development, processes, workflows, as well as the expectations of millions of retirement plan participants would be turned upside down. The financial costs would be enormous and the potential harm to retirement plan participants is incalculable. This would virtually eliminate mutual funds from 401k plans, as there would be a major shift to CITs and ETFs.

C. Impact on Target Date Funds

According to the 2022 ICI Fact Book, at the end of 2021, there were $1.8 trillion in Target Date Funds (TDFs), and 97 percent, or $1.75 trillion, of all TDFs are what are known as a fund of funds.[4] This means that the underlying securities in the TDF is comprised of other mutual funds, rather than stocks and bonds as is the case in the more typical 40 Act fund. The imposition of a 4PM hard close for trading creates additional issues around these fund of funds. Even if the participant transacted a purchase or a redemption in the TDF today, the underlying mutual fund trades will not go out until tomorrow due to the Commission's proposed 4PM hard close on trading. Any mutual fund trades due to rebalancing the TDF will also have to go out the following day. It is akin to taking transaction dollars intended to be invested in the market on a specific day and shifting them to be invested on a different day. What impact will that have on how these funds react to changes in the market and shareholder behavior? It's anyone's guess. But if individuals determine there is a leading or lagging indicator of a fund's NAV direction because of this delay in getting monies into the market, they will take advantage of that at the expense of the non-transacting shareholders, which would create and exacerbate the precise problem the Commission seeks to solve. The main point here is that when affecting change so dramatic as the 4PM hard close on trading, there is the potential for unintended consequences.

D. Impact on Broker-Dealer Single Omnibus Accounts

The 4PM hard close on trading would also cause tremendous disruption within broker-dealer firms. Today, most broker-dealer firms trade in single omnibus accounts at the fund, which has been the

[4] ICI generally excludes funds of funds from total net asset and net new cash flow calculations to avoid double counting. Although target date funds are classified as hybrid funds by ICI, 97 percent of target date fund assets are in funds of funds, and therefore, their flows are excluded from the hybrid mutual fund flows presented in Figure 3.13 *See* Inv. Co. Inst., 2022 Investment Company Fact Book 45 (2022), https://www.icifactbook.org/. *Id*. at 124.

practice for many years. It's an efficient and cost-effective way of trading the millions of retail mutual fund shareholders that broker-dealer firms have as clients. The firms roll up all trades for the day from their clients into a single omnibus trade for each CUSIP. A client may choose to have their mutual fund dividends reinvested in the fund, or they may choose to receive them in cash. Most firms hold single omnibus accounts at the fund, and they typically choose to have all the dividends reinvested.

Since some shareholders may wish to receive their dividends in cash, on the dividend ex-date the broker-dealer firms calculate the amount of cash dividends the clients that are electing the cash option are due to receive. They then create a dividend sell-off trade in the late evening that gets transmitted to the funds via the NSCC's DCC&S service. The Commission's proposed 4PM hard close on trading would require broker-dealer firms to create both dividend reinvest and cash dividend omnibus accounts at the fund, as it would not be able to create the dividend sell-off trades to fund the cash dividend to clients on ex-date. This adds costs as well as complexity when clients switch from reinvest to cash or vice versa, as the broker-dealer would have to affect a transfer of shares at the fund between the two omnibus accounts.

In addition to the dividend issue mentioned above, there is also a timing issue. It takes time to pull the individual retail trades and roll them up into single omnibus trades. With the proposed 4PM cutoff for trading, the broker-dealers would have to have a much earlier cutoff for trading so that they would have time to roll up the trades and get them submitted to the NSCC. We do not believe firms will revert back to individually registered accounts at the fund, so the results could be a blackout period for trading mutual funds prior to 4PM or a wholesale shift to ETFs.

E. Historical Perspective on Implementing a 4PM Hard Close

As the Commission is aware, this is not the first time the SEC has proposed doing away with the late-day trading of mutual funds. In 2003 and 2004, a 4:00 PM hard-close of trading was considered as a remedy for firms that were allowing trades to be illegally initiated after 4PM. At the time, we were part of the retirement services industry delegation that met with the SEC to explain how a hard 4PM trading close would cause untold harm to participants. If a reminder of all the issues this would cause is warranted, we encourage the Commission to revisit the nearly 1,000 comment letters from those years that were submitted in objection to a hard 4PM trading cutoff. Fortunately, our concerns and the concerns of many other organizations were heeded, the proposed policy change was abandoned, and the industry implemented controls to prevent future such occurrences.

The GAO issued a report in May 2005 concerning the SEC's actions to stop illegal late-day trading and market timing, which stated that "the penalties SEC obtained in the market timing and late trading cases are among the highest in the agency's history."[5] The penalties imposed

[5] Government Accountability Office. (2005). Mutual Fund Trading Abuses: SEC Consistently Applied Procedures in Setting Penalties, but Could Strengthen Certain Internal Controls. (GAO Publication No. 05-385). Washington, D.C.: U.S. Government Printing Office.

in these cases reached billions of dollars, not to mention the reputational losses and the billions of dollars that left fund companies as a result of either their illegal behavior or their lack of suitable controls. As a result, illegal late-day trading no longer occurs. Lessons were learned the hard way and controls over late-trading are so tight today that no trade can be initiated after 4PM for any amount of money. It is inaccurate for the Commission to assert that if a 4PM hard close on trading were implemented, "it would more effectively prevent late-day trading."[6] You cannot stop something that is not currently happening.

F. Costs of Implementing the Proposed Rule

In the SEC's PRA costs disclosures for the OMB, it appears that the current annualized cost for funds to comply with Rule 22c-1, Rule 22e-4, N-Cen, N-1A, and N-Port filings is around $205 million per year. The increased annualized costs to comply with swing pricing would be an estimated $195 million, or almost double the current annual costs. However, we believe it is common knowledge that these estimates are basically a best guess. We have seen errors and omissions in the past with these estimates for the OMB, so cannot put a lot of faith in the $195 million projected increase.[7]

It would be one thing if that were the sum of the costs to implement swing pricing. But the cost estimates for the OMB do not account for the effects it would have on the distributors of mutual funds, which would be much steeper than the $195 million increased annual cost for the fund companies. As stated previously, the costs involved in changing systems and processes that have been in place for 25 years are incalculable, but without a doubt, would be quantified in the billions of dollars as opposed to millions.

G. Proposed Alternative Solution

The Commission's proposed rule seems to be a case where the cure is more harmful than the disease itself. For the sake of solving this problem by imposing a 4PM trading cutoff to support the imposition of swing pricing on all open-end mutual funds, the Commission appears to be willing to cause untold disruption and costs to the mutual fund industry. All of this in response to a problem the Commission has identified without quantifying the true costs to the non-transacting shareholders that supposedly serves as the basis for this proposal.

We would like to propose a potential solution that would cost the industry virtually nothing, and it would involve allowing funds to establish a provision for stressed liquidation expenses on the fund's balance sheet. Many industries have ways to manage potential and anticipated

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[6] Open-End Fund Liquidity Risk Management Programs and Swing Pricing, 87 Fed. Reg. at 77,134. While the Commission adopted rules to address concerns about late trading, we believe that the hard close proposal, when coupled with our current rules, would more effectively prevent late trading.

[7] Keller, L. Burton, Letter on Mandatory Fees for Redeemable Fund Securities, File Nos. S7–11–04. https://www.sec.gov/rules/proposed/s71104/lbkeller030904.htm

expenses, even without advanced knowledge of exact amounts or dates of incurrence. For example, banks are allowed to establish a provision for loan losses. They know they will have bad loans over time based on historical experience and prevailing economic conditions. When loans do go bad, they write them off against the loss provision account rather than the income statement. The income statement is affected when the loan loss provision is created and adjusted over time based on historical experience and economic conditions. The same concept could be used to establish and maintain a "stressed liquidation expenses" provision account.

Since mutual fund accounting requires a daily closing of the books to calculate end-of-day price or NAV, the fund would need to accrue a relatively small, incremental expense every day to the provision account for anticipated stressed liquidations expenses. When a fund experiences stressed liquidation days, the additional expense of meeting the excessive redemptions or purchases would be charged to the provision account that has been accrued. This has the added benefit of allowing the fund as much time as it needs to accurately calculate the true stressed liquidation expense that it has incurred. Since it is a charge to the provision account, and thus does not affect the NAV calculation, this keeps the expense out of the NAV calculation for that day, so non-transacting shareholders are not carrying the full amount of the stressed liquidation expense, as they are today. This distributes the additional liquidation cost incrementally across all shareholders. Redeeming shareholders would have borne at least some of the liquidation costs while they held positions in the fund through the daily accrual of the provision account.

We understand that there will need to be controls and procedures established around the creation of this stressed liquidation provision accounting concept. This is an area where the Investment Company Institute (ICI) and the American Institute of Certified Public Accountants (AICPA) could work together to form the framework for implementing this accounting provision. Just one example of successful collaboration of the ICI and the AICPA was the establishment of the Financial Intermediary Controls and Compliance Assessment (FICCA), a framework to help funds with the oversight of financial intermediaries that service mutual fund shareholders. I am sure that these two organizations would be more than willing to work together to establish a comprehensive framework that enables funds to implement a provision for stressed liquidation expenses in compliance with generally accepted accounting principles.

H. <u>Conclusion</u>

In closing, we would like to emphasize that there may not be a perfect solution for the problem the Commission seeks to solve. Remember, "perfect is the enemy of good." The accounting provision we are recommending may not be the perfect solution, but it is a good solution that can be implemented with minimal cost and disruption to the mutual fund industry, which is good for everyone.

However, we are still not convinced there is even a problem in need of a solution. We believe there should be more analysis of the stressed liquidations costs as well as the frequency of these stressed liquidation events. If the analysis indicates there is a significant frequency of these types of events, as well as significant costs to non-transacting shareholders, then perhaps a solution like we are proposing is warranted. But if the events are scarce, and the costs are not all that significant, then we say, as is true with many things in life, some things are better left alone.

Should you have any questions, please do not hesitate to contact L. Burton Keller at [redacted].

Sincerely,

/s/ L. Burton Keller
L. Burton Keller, Director, Delta Data Software, Inc.