Dimensional

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February 14, 2023

Vanessa A. Countryman
Secretary
US Securities and Exchange Commission
100 F Street NE
Washington, DC 20546-1090

Re: Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting, File No. S7-26-22

Dear Ms. Countryman,

Dimensional Fund Advisors LP ("Dimensional") appreciates the opportunity to comment on the US Securities and Exchange Commission's ("Commission") proposal regarding open-end fund liquidity risk management programs and swing pricing.[1] Dimensional is a registered investment adviser and manages 153 registered mutual funds and exchange-traded funds ("ETFs") in the US.[2]

In our view, the Commission's proposal—which would require a prescriptive approach to liquidity risk management, mandate that all mutual funds adopt swing pricing, and impose a hard close on the mutual fund industry—will have extremely negative consequences for retail investors. We strongly believe that the proposal will increase costs for fund investors and make investing in mutual funds—a product that has served investors well for decades—less attractive, and we urge the Commission to weigh the full costs and potential benefits of its proposal.

I. An overly prescriptive approach to liquidity risk management may harm investors.

In justifying its proposal to amend the existing liquidity risk management rule, the Commission focuses on the market events of March 2020, noting that mutual funds experienced large-scale investor outflows. Without question, March 2020 was a time of great uncertainty and volatility, and yet, as the Commission notes, no fund sought to suspend redemptions during this period.[3] We believe the proposal's extremely prescriptive approach is not sufficiently justified and will result in unnecessary costs and burdens for fund investors.

For example, under the current rule, a fund must consider whether trading portions of its portfolio, "in sizes that the fund would reasonably anticipate trading," would significantly affect its liquidity. This "reasonably anticipated trade size" standard reflects the Commission's recognition that a fund's liquidity, and how much of its portfolio may have to be traded to meet redemption requests, necessarily depends on the composition, size, redemption history, and

[1] US Securities and Exchange Commission, *Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting*, Release Nos. 33-11130; IC-34746 (Nov. 2, 2022) (the "Proposing Release").
[2] As of the date of this letter.
[3] Proposing Release at 33.

strategy of the specific fund, as well as the fund's investor base. When it adopted the current liquidity risk management rule in 2016, the Commission noted that "it may be appropriate for a fund with a highly liquid portfolio, with very stable and minimal cash flow projections and significant cash holdings and operating in very stable market conditions, to adopt policies and procedures that consider whether trading relatively small fractions of each of the fund's portfolio holdings would result in significant liquidity impacts. On the other hand, we would generally consider it appropriate for a fund whose holdings are relatively illiquid and/or fairly concentrated, with unpredictable cash flow projections or deteriorating market conditions in the markets in which it invests, to consider whether trading larger portions of its portfolio holdings would result in significant liquidity impacts."[4]

Now, and despite the fact that funds did not have issues meeting redemption requests in March 2020, the Commission has determined that every fund—even one with a "highly liquid portfolio, with very stable and minimal cash flow projections and significant cash holdings"—must base its daily liquidity classifications on an assumed trade size of 10% of each of its portfolio investments. The Commission states that its 10% assumption is based on its analysis of weekly flows over a period of more than ten years and its finding that outflows of greater than 6.6% occurred only 1% of the time in a pooled sample across weeks and funds. First, it strikes us as a harsh and disproportionate response to require a fund to manage its daily liquidity as if, on any given day, it will experience approximately 50% more in outflows than what 1% of funds experienced in their worst week in a more than ten-year period. On its own, assuming a stressed trade size of 10% is very likely to affect some funds' current liquidity classifications. And when combined with the other prescriptive aspects of the proposal—such as the change in how days are counted, the formulaic definition for evaluating value impact, and the amendment of the term "convertible to cash" to "convertible to U.S. dollars"—the proposal is likely to affect liquidity classifications to such an extent that some funds may have to sell existing investments and adjust their investment strategies. For example, an international equity fund that holds primarily highly liquid assets under the current liquidity rules may find that over 15% of the exact same portfolio would now be classified as "illiquid" under the proposed rules. Such a fund would be required to reallocate its portfolio, even if it had been operating for decades without experiencing any liquidity concerns. Forced reallocations would likely hurt fund performance and alter the composition of the fund such that investors would no longer have the exposure they sought when they first invested in the fund. We urge the Commission to consider these and other downstream effects to fund investors when considering whether to amend the existing liquidity risk management rule.

Finally, we note that other aspects of the proposal—for example, requiring funds to classify their investments daily and eliminating the ability of funds to classify their investments by asset class—will increase costs for funds and their investors, not to mention the costs to funds of having to significantly overhaul their liquidity risk management programs. In our view, the likelihood that the proposed amendments would prevent all funds from encountering liquidity issues in future times of market stress is too remote to justify the costs of implementing such prescriptive amendments across the entire fund industry. We urge the Commission to carefully reconsider the

[4] US Securities and Exchange Commission, *Investment Company Liquidity Risk Management Programs*, Release Nos. 33-10233; IC-32315 (Oct. 13, 2016) at 142-143.

clear costs and possible benefits to investors of its proposal and whether such strict amendments to the existing liquidity risk management rule are necessary at this time.

II. The Commission should not adopt mandatory swing pricing.

We are opposed to the Commission's proposal to require every open-end fund,[5] regardless of its investments, its investment objective, and its investor base, to use swing pricing to adjust its net asset value ("NAV") per share by a swing factor when the fund experiences net redemptions or when net purchases exceed 2%. To be clear, we are not opposed to swing pricing in all cases; for some funds, swing pricing could be a useful tool to prevent the dilution of the interests of non-redeeming and non-purchasing shareholders. However, we strongly believe that a fund's advisor and board, including its independent directors, should have the discretion to use their fiduciary judgment to determine whether implementing swing pricing is in the best interests of the fund and its shareholders, given the specific circumstances of the fund.

For swing pricing to be an effective tool, not only should funds have the discretion to determine whether to swing price, but they should also have the flexibility to implement swing pricing in a way that is tailored to the fund's unique circumstances. The Commission's proposal is an extremely prescriptive, one-size-fits-all approach to swing pricing—it mandates that all funds use swing pricing, dictates when a swing factor must be applied, and prescribes how funds must calculate the swing factor. But for swing pricing to be effective, funds need a certain level of flexibility. For example, in determining the swing factor to be applied, the proposed rule would require funds to make a good faith estimate of the costs it would incur in selling a "vertical slice" of its portfolio (*i.e.*, a pro rata amount of each investment in its portfolio). In reality, a fund is extremely unlikely to sell a pro rata amount of each investment in its portfolio. In many instances, particularly when net redemptions are low (and under the proposed rule, a fund would be required to swing price each day it experiences net redemptions), a fund would have enough cash on hand to meet redemptions without selling any of its portfolio or incurring additional transaction costs. Using an estimate of the costs of selling a vertical slice in these cases would be an overestimate of the costs caused by redemptions and would unfairly charge redeeming shareholders.

When the Commission initially adopted the current swing pricing rule, it took a significantly more principles-based approach, recognizing, for instance, that "funds should be provided the flexibility to implement swing pricing at a threshold level that best fits their particular circumstances."[6] Given that no funds in the US have implemented swing pricing, we are puzzled by the Commission's view that a prescriptive approach is now necessary. To explain why it has rejected its current principles-based approach, the Commission cites its observations of swing pricing in other jurisdictions, but without fully appreciating the critical differences between the European and US fund markets, and despite the fact that the regulatory frameworks for swing pricing in Europe are neither mandatory nor as prescriptive as the Commission's proposed approach. The Commission also projects its concerns with funds' liquidity risk management programs onto swing pricing.[7] This type of regulatory speculation is not a sufficient basis for

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[5] Except for money market funds and ETFs.

[6] US Securities and Exchange Commission, *Investment Company Swing Pricing*, Release Nos. 33-10234; IC-32316 (Oct. 13, 2016) at 46.

[7] Proposing Release at 106.

adopting a prescriptive rule that will significantly impact how mutual funds are bought and sold by retail investors.

Furthermore, in remarks made in March 2022, William Birdthistle, the Director of the Division of Investment Management, wondered about the dearth of outflows from funds that underperform the market, noting that “sometimes in our least exemplary funds, we see less exit than we might expect.”[8] One unintended consequence of mandatory swing pricing is that investors may be further disincentivized from redeeming out of high fee, underperforming funds. Because all funds will be required to swing price each time they experience net redemptions, redeeming investors will likely be subject to a surcharge—and as noted above, possibly an unfair one—when they sell their fund shares.

Finally, we note that swing pricing is not the only way to protect investors from dilution. Given the costs that the industry will incur—and which are sure to be passed on to mutual fund shareholders—to operationalize and implement swing pricing, we urge the Commission not to require mandatory swing pricing and to retain its existing, optional, principles-based swing pricing rule.

III. A hard close will disadvantage retail investors, particularly those investing for retirement.

As the Commission is well aware, mandatory swing pricing will not work in the current mutual fund ecosystem, because most funds generally do not receive sufficient net order flow information—which they need to determine whether to apply a swing factor to that day’s price—before striking NAV. To help operationalize swing pricing, the Commission has proposed a hard close, meaning that an order to purchase or redeem fund shares would be executed at the current day’s price only if the fund, its designated transfer agent, or a registered securities clearing agency receives the order before the fund strikes NAV. Besides fundamentally changing how mutual fund shares are bought and sold, we are extremely concerned that a hard close will disadvantage retail investors, particularly those investing for retirement.

If a hard close is adopted, intermediaries will be forced to set earlier cut-off times for their own clients, so that they have time to aggregate and transmit their orders to funds before NAV is struck. Investors in valuable retirement and long-term savings programs like 401(k) and 529 plans will be among those unfairly affected by a hard close. At present, funds typically do not receive orders from most retirement plan recordkeepers until the next morning, but such orders still receive the prior day’s NAV, *i.e.*, the NAV on the day that the retirement plan participants placed their orders.[9] A hard close would force retirement plan recordkeepers to set earlier cut-off times, putting retirement savers at a disadvantage because they would have a shorter period of time in which to submit orders to buy or sell fund shares and get that day’s price.

Similarly, retail investors that access mutual funds through omnibus accounts, including at large retail brokerage firms, will be disadvantaged by a hard close. Among households investing

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8 Birdthistle, William, *Remarks at the ICI Investment Management Conference* (Mar. 28, 2022), available at https://www.sec.gov/news/speech/birdthistle-remarks-ici-investment-management-conference-032822.

9 Proposing Release at 249.

in mutual funds outside of employer-sponsored retirement plans, 79% owned mutual fund shares through financial professionals.[10] Retail investors often engage financial professionals to assist with holistic wealth planning, asset allocation, and order placement, and in such cases, it is more cost effective to submit orders to buy and sell funds through omnibus accounts. The proposed hard close would require intermediaries to set earlier cut-off times and has the potential to increase costs for these retail investors, including by costing them time out of the market. This would become a new source of investment risk, and one that would apply only to investors who choose—or are required—to place fund trades through an intermediary.

The Commission suggests that investors who place a premium on being able to place orders up until 3:59 pm could place orders directly with the fund's transfer agent.[11] We believe it is a mistake to discourage retail investors from using a financial intermediary. In our experience, retail investors can benefit greatly from independent financial advice. Financial advisors provide a range of wealth management services and can help retail investors to understand their financial needs while encouraging the discipline essential to long-term investment success.

Furthermore, for many mutual fund shareholders, *e.g.*, investors in retirement plans, 529 plans, and variable annuity contracts, placing an order directly with the fund's transfer agent is simply not an option. If retirement plans and other products that offer mutual funds as an underlying investment option are forced to adopt earlier cut-off times, their investors will be disadvantaged, which could prompt these products to consider replacing mutual funds with other types of investment options, reducing consumer choice. Having multiple cut-off times for transactions in the same fund is also likely to confound investors and introduce uncertainty as to whether an investor will get that day's NAV. Finally, we urge the Commission to carefully consider that the proposed hard close will have a disproportionate impact on investors in mutual funds versus other vehicles, such as private funds and ETFs.[12] In light of the extent to which retail mutual fund investors will be negatively affected by a hard close, we strongly urge the Commission not to impose a hard close on the mutual fund industry.

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As with any new regulations, we believe the Commission must carefully consider whether the potential benefits to investors will outweigh the inevitable costs. In this case, we strongly believe that the costs of a prescriptive liquidity rule, a mandatory swing pricing rule, and a hard close will negatively impact retail investors, and we urge the Commission not to finalize this

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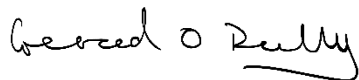
[10] Investment Company Institute, *2022 Investment Company Fact Book*, available at https://www.icifactbook.org/pdf/2022_factbook.pdf, at 112.

[11] Proposing Release at 149.

[12] For example, although the proposal makes allowances so that exchange transactions can continue to receive the same day's NAV for both the buy and sell orders, it is unclear how this will work in practice, particularly with respect to exchanges conducted through intermediaries, *i.e.*, retirement savings plans, 529 plans, and retail brokerage accounts. Investors in such accounts will be disadvantaged if exchange transactions do not receive the same day's price.

rulemaking. If we can be of further assistance, please do not hesitate to contact Stephanie Hui, Lead Counsel, Global Public Policy and Vice President. We would welcome the opportunity to expand on our discussion of these issues.

Sincerely,



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