

Vanessa A. Countryman
Secretary, Securities and Exchange Commission
100 F Street NE, Washington, DC 20549–1090

February 14, 2023

Re: S7-26-22, Open-End Fund Liquidity Risk Management Programs and Swing Pricing Form
NPORT Reporting

Dear Ms. Countryman,

I appreciate the opportunity to comment on the SEC’s proposal to make swing pricing mandatory for all U.S. open-end mutual funds. I am a PhD candidate in Finance at the Wharton School of the University of Pennsylvania. My research focuses on the tradeoffs between ETFs and open-end mutual funds. As part of a joint project with researchers at the IMF, I contributed to a chapter of the IMF’s latest financial stability report which analyzes the contributions of open-end investment funds to fragilities in asset markets.¹

In this letter, I would like to highlight some of the empirical findings from this report with respect to the effectiveness of swing pricing in reducing spillovers from open-end funds to asset markets. I would also like to address Commissioner Hester M. Peirce’s Statement on the proposed rule.

Open-end investment funds play a key role in financial markets, but those offering daily redemptions while holding illiquid assets can amplify the effects of adverse shocks by raising the likelihood of investor runs and asset fire sales. This contributes to volatility in asset markets and potentially threatens financial stability – an effect that has been broadly documented in the academic literature.²

The IMF’s latest financial stability report examines how open-end funds’ use of different liquidity management tools can reduce such adverse spillover effects to asset markets.

First, for a global sample of funds domiciled in advanced and developing economies, the authors find significant evidence that fixed-income securities held by less-liquid funds substantially underperformed otherwise identical securities during the Covid-19 market sell-off in March 2020. These results are consistent with the empirical evidence provided by Jiang, Li, Sun and Wang (2022) for U.S. based corporate bond funds and support the need for regulatory action.³

Second, the report analyzes the effectiveness of fund liquidity management tools, including cash buffers and swing pricing, on fund induced asset price fragility. The empirical evidence for the

¹ See IMF (2022). Global Financial Stability Report. Chapter 3 – Asset Price Fragility in Times of Stress: The Role of Open-End Investment Funds.

² See for example Chen, Qi, Itay Goldstein and Wei Jiang (2010). “Payoff Complementarities and Financial Fragility: Evidence from Mutual Fund Outflows.” *Journal of Financial Economics*, 97: 239-262.

³ See Jiang, Hao, Yi Li, Zheng Sun, and Ashley Wang. 2022. “Does Mutual Fund Illiquidity Introduce Fragility into Asset Prices? Evidence from the Corporate Bond Market.” *Journal of Financial Economics* 143 (1): 277–302.

potential benefits of liquidity buffers is mixed. While cash buffers may in theory provide open-end funds with increased flexibility to meet investor redemptions, funds appear reluctant to deplete cash buffers during periods of increased market stress when liquidity is most valuable.⁴ In contrast, swing pricing appears to be an effective tool for mitigating fund induced asset fragility. Empirical evidence from funds domiciled in countries where swing pricing is commonly used, such as Luxembourg and the UK, implies that swing pricing can significantly reduce open-end funds' contribution to bond return volatility. In particular, an increase of one standard deviation in a corporate bond's ownership by funds with access to swing pricing reduces the adverse impact of funds on the volatility of bond returns by about one-third. The reduction in bond price volatility associated with swing pricing is especially large for bonds held by relatively more illiquid funds. However, swing pricing does not appear to fully reverse the effects from fund related vulnerabilities on asset price volatility. This may be due the insufficient calibration of swing factors. Based on a sample of European open-end mutual funds for which data on swing factors is available, swing factors for bond funds tend to be capped at 2% of the fund NAV. Accordingly, I believe that it is crucial to provide funds with detailed guidance on the calibration of swing factors and to ensure that these factors fully incorporate all flow related transaction costs, including direct trading costs, such as such as commissions and bid-ask spreads, as well as indirect costs due to funds' price impact in security markets.

Finally, in her statement, Commissioner Hester M. Peirce's raises the important point that "investors concerned about dilution can invest in ETFs".⁵ ETFs have grown substantially and do constitute a popular alternative to open-end mutual funds, especially in the index fund segment. Because ETFs are traded on exchange at the prevailing market price and do not guarantee investors the ability to redeem shares at the fund NAV, they are not subject to the same first-mover advantage that gives rise to run risks in open-end mutual funds. In addition, empirical evidence from the Covid-19 market sell-off suggests that bonds held by ETFs experience less of an increase in volatility than otherwise identical bonds held by open-end mutual funds during periods of market stress.⁶ Yet, research has also linked ETFs to an increase in nonfundamental asset price volatility.⁷ Besides, in practice investors do not always have a choice between ETFs and open-end

⁴ Empirically, in normal times, investor redemptions equal to 1% of fund AuM are associated with a 1.5% drop in fund cash buffers, suggesting liquidity buffers are depleted to pay out investors. However, in times of severe market stress the same outflows are associated with a significantly lower decrease in fund cash buffers. This result is consistent with the empirical findings by Jiang, Li and Wang (2021) as well as the theoretical predictions by Zeng (2017). See Jiang, Hao, Dan Li, and Ashley Wang. 2021. "Dynamic Liquidity Management by Corporate Bond Mutual Funds." *Journal of Financial and Quantitative Analysis* 56 (5): 1622–52. See also Zeng, Yao. 2017. "A Dynamic Theory of Mutual Fund Runs and Liquidity Management." ESRB Working Paper 42, European Systemic Risk Board, Frankfurt.

⁵ See <https://www.sec.gov/news/statement/peirce-statement-open-end-funds-110222>.

⁶ See Box 3.1. (p. 86 – 87) in IMF (2022). *Global Financial Stability Report*. Chapter 3 – Asset Price Fragility in Times of Stress: The Role of Open-End Investment Funds. See also Falato, A., Goldstein, I., & Hortaçsu, A. (2021). *Financial Fragility in the COVID-19 Crisis: The Case of Investment Funds in Corporate Bond Markets*. *Review of Financial Economics*, 123, 35-52.

⁷ See Ben-David, Itzhak, Francesco Franzoni, and Rabih Moussawi. 2018. "Do ETFs Increase Volatility?" *Journal of Finance* 73 (6): 2471–535. See also Dannhauser, Caitlin and Saeid Hoseinzade. 2022. "The unintended consequences of corporate bond ETFs: Evidence from the taper tantrum." *The Review of Financial Studies* 35 (1): 51-90

mutual funds. Most defined contributions retirement plans restrict investors' choice to open-end mutual funds. Adoption of ETFs in 401(k) plans has been slow. Hence, I think it is important to evaluate the tradeoffs between ETFs and open-end mutual funds, both, from a portfolio allocation as well as a financial stability perspective, more carefully before drawing any conclusions regarding their substitutability.

Overall, I support the SEC's proposal to introduce swing pricing for U.S. open-end mutual funds.

Sincerely,

Anna Helmke
PhD Candidate
Wharton Finance Department,
University of Pennsylvania
<https://www.annahelmke.com/>