Yale SCHOOL OF MANAGEMENT

GREG FELDBERG
Research Director, Yale Program on Financial Stability
Lecturer in the Practice of Management

PO Box 208200
New Haven CT 06520-8200

som.yale.edu/greg-feldberg

courier
165 Whitney Avenue
New Haven CT 06511

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

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

Dear Ms. Countryman,

I am writing in response to the SEC's proposal to mandate swing pricing for open-end funds. I am the Research Director of the Yale Program on Financial Stability at the Yale School of Management, where I also teach a course on macroprudential policy. I was the Research Director and leading author of the 2011 *Financial Crisis Inquiry Report,* the official report of the independent commission Congress created to examine the causes of the Global Financial Crisis of 2007-09. Later, at the Office of Financial Research (OFR) in the US Treasury Department, I led the production of annual financial stability reports as well as the 2013 report, *Asset Management and Financial Stability,* which the Financial Stability Oversight Council (FSOC) requested to examine potential financial stability risks related to the growing role of asset management in financial intermediation.[1]

From that perspective, it has been a pleasure to read the SEC's recent proposals on the regulation of the asset management industry and I'm broadly supportive of the proposed rule on open-end funds. The liquidity classification proposals would both improve the quality and transparency of liquidity classifications and potentially reduce the amount of liquidity mismatch within these funds. The swing pricing mandate is a useful step toward reducing the first-mover advantage, by forcing investors who redeem early to bear some of the costs that they otherwise would impose on remaining investors. My main concern is that the swing factor needs to be large enough to remove the first-mover advantage for investors and limit redemptions during a market crisis. It's also important to make sure regulators of similar funds make similar changes in their rules.

Back in 2013, the OFR's asset management report noted the redemption risks that open-end funds, as collective investment vehicles, could face in a stressed market if investors perceive a first-mover advantage. The first-mover advantage stems from the funds' inherent liquidity mismatch—that is, the fact that these funds promise investors daily

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[1] Office of Financial Research, *Asset Management and Financial Stability*, 2013, www.financialresearch.gov/reports/files/ofr_asset_management_and_financial_stability.pdf.

liquidity, while a fund may not be able to sell the underlying assets on a daily basis without suffering a significant loss. Evidence from the Global Financial Crisis had shown both a substantial increase in redemptions for mutual funds and evidence that distressed selling by mutual funds had a destabilizing effect on broader asset markets. Since then, various reports by FSOC, international financial organizations, and independent researchers have echoed these risks and noted that they are potentially higher for funds that are relatively more exposed to less liquid assets, such as corporate bonds.[2] Evidence of these issues has become far more extensive, even as open-end funds have grown in size and influence.[3] The suspension of withdrawals by the manager of a relatively small high-yield bond mutual fund in late 2015 to avoid liquidating assets at fire-sale prices provided an early illustration that the liquidity-mismatch scenario was very real.[4]

But the experience of open-end funds during the "dash for cash" of March 2020 should leave no room for further doubt, as the SEC explains in the introduction of its proposal. Open-end funds, particularly those focused on fixed-income securities, faced significant redemption requests. Moreover, as the SEC notes, those redemption requests led directly to asset sales. Based on staff analysis of reported data, "funds generally were selling portfolio assets to meet redemptions and potentially for other purposes, such as to raise cash in anticipation of future redemptions."[5] Other experts have also documented these phenomena in March 2020.[6] Fund managers turned to the SEC and other authorities for extraordinary regulatory relief—for example, to permit funds to impose higher redemption fees, to mitigate the dilution caused by investor redemptions—and extraordinary official support from the Federal Reserve, which ultimately arrived in the form of unprecedented corporate-bond buying programs. Although no open-end fund suspended redemptions in the US during this episode, the SEC notes reasonably that the outcome could have been much worse if the Fed hadn't intervened. After March 2020, the possibility that a mainstream, plain-vanilla product like an open-end mutual fund could pose systemic risks should no longer be controversial.

Of course, the authorities must be careful in designing regulations to address such risks. Episodes such as the GFC and the pandemic are rare, and the exogenous nature of the pandemic suggests that the government's interventions in that event should not raise the same level of moral-hazard concerns that government interventions typically raise. The

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[2] FSOC, *Update on Review of Asset Management Products and Activities*, April 18, 2016, home.treasury.gov/system/files/261/Financial Stability Oversight Council Update on Review of Asset Management Products and Activities.pdf; Financial Stability Board, *FSB proposes strengthening the liquidity management framework for open-ended funds*, Dec. 14, 2022, www fsb.org/2022/12/fsb-proposes-strengthening-the-liquidity-management-framework-for-open-ended-funds/.
[3] Itay Goldstein, Hao Jiang, and David T. Ng, "Investor flows and fragility in corporate bond funds," *Journal of Financial Economics* 126 (3), Dec. 2017, pp. 592-613, www.sciencedirect.com/science/article/pii/S0304405X17302325.
[4] Charles Stein, *Third Avenue Blocks Redemptions from Credit Fund Amid Losses*, Bloomberg, Dec. 10, 2015, https://www.bloomberg.com/news/articles/2015-12-10/third-avenue-plans-to-liquidate-focused-credit-fund-after-losses.
[5] SEC, *Proposed rule: Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting*, p. 32. Nov. 2, 2022, www.sec.gov/rules/proposed/2022/33-11130.pdf.
[6] Financial Stability Board, *Holistic Review of the March Market Turmoil,* Nov. 17, 2020, www fsb.org/wp-content/uploads/P171120-2.pdf.

best macroprudential regulation mitigates a potential vulnerability when markets are under stress while minimally disrupting private market participants' activities when markets are calm.

Fortunately, the global regulatory community has been thinking about and experimenting with various options for addressing the liquidity mismatch in open-end funds throughout the 10 years since the OFR published our report. In 2017, the Financial Stability Board—whose membership includes the leading central banks, regulators, and finance ministries—offered a simple basic principle: The liquidity of a fund's assets should dictate its redemption terms.[7] That principle suggests two corollaries. First, a daily dealing fund should have stricter asset-liquidity requirements than a fund whose investors have to wait for their funds. By that reasoning, money market mutual funds, with their daily liquidity promise, have always faced substantial restrictions on the liquidity of their assets. Second, a fund that invests in relatively illiquid assets should have appropriate liquidity management tools available for use during periods of stress—including tools that limit or disincentivize excessive investor redemptions. That is the reasoning behind the rules around funds that invest in properties, which are among the most illiquid assets—in this country, property funds either have to be closed-ended (i.e., real estate investment trusts) or, when managed by banks regulated by the Office of the Comptroller of the Currency, they have to require long notice periods, no less than 12 months, before investors can redeem.[8]

The open-end funds subject to the proposed rule pose a particularly tricky policy dilemma because of their popularity among investors and their important role channeling capital to the real sector; they now hold trillions of dollars in US Treasuries and corporate bonds. Significantly restricting the types of assets they can purchase isn't on the table. And the law requires them to allow investors access to their funds within seven days. In the absence of new legislation, funds can't impose longer notice periods to delay redemptions. But the FSB's principle still applies. Something must be done to reduce the risk that excessive investor redemptions could again disrupt underlying bond markets.

Given the constraints, the SEC's proposal offers a balanced solution, building on its important reforms of 2016 and 2018.

First, it has proposed to strengthen its liquidity classifications to make it harder for funds to over-estimate the liquidity of their assets under stress. The 2016 rule had set up four self-assessed liquidity buckets, from highly liquid to illiquid. The proposed rule would require funds to assume the sale of 10% of each portfolio investment under stress, taking into account the price impact of such sales, rather than the current approach based on a

[7] Financial Stability Board, *Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities*, Jan. 12, 2017, www fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf.

[8] Banks requested, and the OCC granted, even longer notice periods during the March 2020 episode. The OCC has since revised its rules to allow banks to request up to two 12-month extensions in certain conditions. See OCC, *Final rule: Collective Investment Funds: Prior Notice Period for Withdrawals*, May 26, 2021, www federalregister.gov/documents/2021/05/26/2021-11130/collective-investment-funds-prior-notice-period-for-withdrawals.

"reasonably anticipated trade size;" require at least 10% of net assets be "highly liquid;" and strengthen the calculation of the 15% limit on illiquid investments. The proposed rule would also require funds to report their aggregate liquidity classifications publicly. As mentioned, these proposals would both improve the quality and transparency of liquidity classifications and potentially reduce the amount of liquidity mismatch within these funds.

Second, the SEC has proposed mandatory swing pricing. Swing pricing represents an adjustment, called the swing factor, in the price of a fund's net asset value per share that requires redeeming shareholders to absorb the costs that their redemptions would otherwise impose on remaining shareholders. (It also applies to purchases.) The SEC's 2016 rule allowed funds to apply a swing factor of no more than 2%. But no funds implemented swing pricing in response to the rule. The proposed rule would impose a mandatory swing price with no upper limit. Of course, the size of the swing factor is a key consideration. The SEC's proposed method would require a fund to make a good faith estimate of the transaction costs of selling a pro rata amount of its investments. More specifically, under the proposal, those transaction costs should fully "capture the dilutive effect of trading in response to large outflows." It would require funds to apply the swing price whenever net redemptions exceed 1% of net assets, and the size of the swing factor would reflect the market impact of the expected liquidation costs due to net redemptions each day.

Swing pricing is not a panacea. One caveat is that its effectiveness at achieving public policy goals depends on the size of the swing factor. A small swing factor can protect remaining investors when first-movers redeem their shares, by in a sense forcing first-movers to pay the remaining investors for the advantage they've gained by selling. Protecting investors is an important policy goal. But the cost a swing price imposes on first-movers may not be sufficient to disincentivize first-movers from redeeming their shares in the first place; first-movers may see the swing price as a reasonable price to pay in a crisis. A study by economists at the Bank for International Settlements (BIS) noted that swing pricing was used extensively during the March 2020 market turmoil outside the US, but that there was no evidence it had dampened investor redemptions.[9] The authors concluded that swing pricing may not achieve the public policy goal of mitigating the systemic risk that first-movers pose, unless the swing factor is sufficiently large to create a real disincentive against selling. "Swing pricing parameters… could be calibrated in a more comprehensive way to take account of the market-wide volume of potential sales. Notably, swing factors could be higher during periods of market stress to account for the impact of concerted selling."[10] To the extent that the swing factor method the SEC has proposed would not take into account the price impact of *market-wide* sales, it may be insufficient to disincentivize selling under stress.

In the longer run, a shift in investor expectations around redemption periods may be more effective than swing pricing at heading off investor runs. UK regulators recently created a

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[9] Stijn Claessens and Ulf Lewrick, "Open-ended bond funds: systemic risks and policy implications," *BIS Quarterly Review*, Dec. 6, 2021, p. 37, www.bis.org/publ/qtrpdf/r_qt2112c.pdf.
[10] Claessens and Lewrick, ibid., p. 49.

new type of investment fund, called “Long-Term Asset Funds,” to invest in long-term, illiquid assets; the rules require at least a 90-day notice period for redemptions.[11] A 2021 report sponsored by Brookings and the University of Chicago suggested something similar in this country, with more modest 14- or 21-day notice periods, alongside its endorsement of swing pricing as a companion policy.[12] Such a proposal would require legislation, given the 7-day notice required under current laws, and extensive engagement with the asset management industry and other stakeholders.

Another caveat relates to regulatory arbitrage. In a 2021 paper, my colleague, Andrew Metrick, and former Fed Governor Dan Tarullo introduced the concept of “congruent financial regulation.”[13] The point was that similar activities conducted by different agents should be subject to congruent, but not necessarily identical, regulation. If the SEC goes forward with this rule, it would be helpful for the OCC to impose similar rules on bank-run collective investment funds, which it regulates.

The SEC deserves praise for this and other proposals it has made recently to promote financial stability.

Sincerely,

Greg Feldberg
Director of Research
Yale Program on Financial Stability

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[11] The definition of illiquid assets includes venture capital, private equity, private debt, real estate, and infrastructure. See Financial Conduct Authority, *PS21/14: A new authorised fund regime for investing in long term assets,* Oct. 2021, www fca.org.uk/publication/policy/ps21-14.pdf.
[12] Glenn Hubbard et al, *Task Force on Financial Stability,* Brookings-Chicago Booth, June 2021, www.brookings.edu/wp-content/uploads/2021/06/financial-stability_report.pdf.
[13] Andrew Metrick and Daniel Tarullo, *Congruent Financial Regulation,* March 24, 2021, www.brookings.edu/bpea-articles/congruent-financial-regulation/.