February 14, 2023

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

Re: Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting (File No. S7-26-22, RIN 3235-AM98); 87 Fed. Reg. 77,172 (Dec. 16, 2022)

Dear Ms. Countryman:

Better Markets[1] appreciates the opportunity to comment on the above-captioned Proposed Rule ("Proposal" or "Release").[2] The Proposal, if adopted, would make several important changes to the liquidity risk management programs for certain open-end funds and require the implementation of swing pricing and a "hard close" for these funds.

Specifically, the Proposal amends Rule 22e-4 to improve open-end fund liquidity risk management programs, thus increasing liquidity and resiliency at these funds in periods of market stress. Additionally, the Proposal amends Rule 22c-1 to require any open-end fund, other than a money market mutual fund or exchange-traded fund ("ETF"), to adjust their net asset value ("NAV") by a swing factor when the fund experiences specified levels of net inflows or outflows. To operationalize such swing pricing, the Proposal would require implementation of a "hard close" for these funds. Finally, the Proposal would require all open-end funds to report information on their funds on Form N-PORT within 30 days after the end of the month.

The events of March 2020 displayed the financial stability risks certain open-end funds can pose to the U.S. economy. As a significant investment vehicle for the retirement savings of everyday Americans, open-end funds hold more than $34 trillion in assets. Yet, many of these funds can be subject to liquidity crunches and bank-like runs in periods of stress as we witnessed in March 2020. Those events make clear that existing liquidity risk management program

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[1] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

[2] Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting, 87 Fed. Reg. 77,172 (Dec. 16, 2022).

requirements give these funds far too much discretion in classifying their ability to meet redemption demand during periods of stress. The Proposal's amendments to Rule 22e-4 are critically important to ensure certain open-end funds, especially those holding less liquid investments, can redeem shareholder shares within their statutory deadline.

In an effort to address investor dilution issues when a fund experiences net redemptions or purchases, the Proposal seeks to amend Rule 22c-1 and implement swing pricing and a hard close for many open-end funds. The goal of these provisions is laudable, as they would help ensure that fund investors do not bear an unfair share of the costs and asset price changes resulting from significant redemptions or purchases. However, while a swing pricing regime could help solve for investor dilution issues in theory, the operational challenges in implementing such a regime could present their own unique challenges, as the Proposal describes in detail. Accordingly, the changes that would need to be made to adopt and implement swing pricing and a hard close could present their own investor harms. As a result of these challenges, the Commission should give serious consideration to alternative methods for ensuring that the costs and asset price changes arising from purchases and redemptions are allocated fairly among investors within the open-end fund industry. Those alternatives could include requiring funds to impose a liquidity fee during periods of stress or enabling them to retain a percentage of funds payable for redemptions over a period of time to solve for investor dilution concerns.

The Proposal's amendments to Rule 22e-4 and the liquidity risk management programs for open-end funds are long overdue and much-needed. They would enhance the liquidity framework for open-end funds, making them more resilient during periods of stress such as those we saw in March 2020. Because these reforms are well-designed and needed in the immediate term, and because the accompanying swing pricing and hard close reforms pose a myriad of implementation challenges as described in the Proposal, the Commission should move forward with the proposed amendments to Rule 22e-4 without delay while it further contemplates additional action through a separate rulemaking on swing pricing or any other alternative the Commission deems necessary in the public interest and for the protection of investors.

BACKGROUND

An open-end fund is a registered investment company that issues and offers for sale redeemable securities.[3] The most common type of open-end funds are mutual funds and ETFs, which have seen tremendous growth over the past twenty years and are popular retirement saving vehicles for millions of American families. These funds can give investors exposure to popular stock market indexes and hundreds of stocks that make up those indexes in a single, diversified fund, freeing investors from having to manage individual stocks and bonds in their portfolios. These funds are so popular that by the end of 2021, there were more than 11,500 open-end funds holding more than $34 trillion in assets.[4] Mutual funds, in particular, hold a majority of the assets

[3] 15 U.S.C. § 80a-5(a)(1).

[4] Investment Company Institute, 2022 Investment Company Fact Book: A Review of Trends and Activities in the Investment Company Industry 21-22, https://www.icifactbook.org/pdf/2022_factbook_ch2.pdf.

within the open-fund category—roughly 77 percent.[5] Needless to say, open-end funds and mutual funds in particular play a critical role in the U.S. economy and serve as the primary retirement savings vehicle for most American families.[6]

However, like all investments, mutual funds present their own unique risks to investors. While mutual funds pool investor assets into a fund and purchase securities in the markets, they also may need to sell securities when investors deciding to redeem their shares outnumber those who are purchasing shares. Selling into an illiquid market can adversely affect the prices the fund receives for the assets. For example, if a mutual fund must sell a less liquid asset such as a corporate bond or bank-loan product quickly to meet redemption demand, the fund could be forced to sell that investment at a much lower price relative to its purchase price in order to satisfy redemption requests. This creates investor dilution issues: the remaining investors in the fund must bear the costs of the transactions and the potential reduction in the value of the fund assets following the redemptions.

Particularly in periods of intense market stress, such as in March 2020, when many other market participants are selling, insufficiently liquid mutual funds may have to absorb losses on investments they were forced to sell into a down market. While the redeeming shareholders receive their money, the remaining shareholders are the ones who are negatively impacted. That is because the remaining shareholders still hold shares in the mutual fund, whose assets are now worth less because the fund had to sell investments at marked-down prices in order to meet redemption demand. And mutual funds are required to meet redemption orders by redeeming shareholders under the law. Any shareholder of an open-end fund has the right to redeem their shares and receive the value of those shares. Specifically, Section 22 of the Investment Company Act requires open-end funds, including mutual funds, to complete shareholder redemption orders within seven days.[7] As a result, mutual funds must effectively manage the liquidity of their funds to comply with Section 22 of the Investment Company Act.

In 2016, the Commission finalized a rule to require certain open-end funds, including mutual funds, to implement a liquidity classification methodology and file reports with the Commission.[8] Unfortunately, the 2016 final rule gave far too much discretion to funds when determining the liquidity of their investments. While the final rule restricted the amount of illiquid investments a fund could retain in its portfolio at any time (no more than 15 percent), the final rule also gave funds the flexibility to determine the liquidity of their assets under normal trading activity and did not establish a minimum percentage of highly liquid investments a fund would be required to hold. As a result, the final rule was largely toothless and ineffective. A few years later in 2018, the Commission further watered down the liquidity risk management program

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[5] *See* Investment Company Institute, 2022 Investment Company Fact Book: A Review of Trends and Activities in the Investment Company Industry 22.

[6] *See* Investment Company Institute, 2022 Investment Company Fact Book: A Review of Trends and Activities in the Investment Company Industry 25 (Mutual funds represent 58 percent of defined contribution plans and 45 percent of individual retirement accounts).

[7] 15 U.S.C. § 80a-22(e) (Subject to certain exemptions in § 80a-22(e)(1-3)).

[8] *See* Investment Company Liquidity Risk Management Programs, 81 Fed. Reg. 82,142 (Nov. 18, 2016).

requirements for open-end funds in a 3-2 vote. For example, the 2018 rule rescinded requirements for funds to publicly report the liquidity classification levels of their fund. As Commissioner Jackson stated in his dissent, "[l]ike the proposal, the final rule is based on the bizarre claim that investors might find information about liquidity so confusing that we serve them best by keeping the information secret."[9]

Stronger, more effective rules to require stricter adherence to a liquidity risk management program for open-end funds would have been helpful during the market turbulence in March 2020. During the initial outbreak of the COVID-19 pandemic in the United States, the markets experienced significant volatility as uncertainty about its economic effects spread with the virus. There were significant gyrations in both the U.S. Treasury markets and the corporate bond markets as investors sought to raise cash during these uncertain economic times. Open-end bond funds, in particular, had a difficult time meeting investor redemption demand because of the liquidity mismatch of their funds. That is because they offer investors daily liquidity while many of their assets are much less liquid. This inherent liquidity mismatch can lead to financial instability and fire sale dynamics, especially during periods of stress.[10] In fact, in 2019 the former Governor of the Bank of England, Mark Carney, said, "[t]hese funds are built on a lie, which is that you can have daily liquidity for assets that fundamentally aren't liquid."[11] This played out in real time during the events of March 2020 when some open-end bond funds experienced daily outflows of more than 10 percent.[12] In order to meet shareholder redemption demands, open-end bond funds were forced to sell their most liquid securities (U.S. Treasury securities) and investment grade corporate bonds to raise funds.

This fire sale trading activity by open-end bond funds helped contribute to the instability in the Treasury and corporate bond markets in March 2020. And it was not until federal government interventions by the Federal Reserve and Congress, including the establishment of a primary and secondary bond credit facility that committed to purchasing $250 billion in bonds, that the bond market ultimately was restored to an orderly functioning market.[13] The activity in the corporate bond markets in March 2020 revealed the financial stability risks posed by the inherent liquidity mismatch inherent in the structure of open-end bond funds. It also revealed weaknesses in the liquidity risk management programs at certain open-end funds, which had too much discretion to (mis)classify the liquidity of their assets.

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9 Statement on Investment Company Liquidity Disclosure, Comm'r Robert J. Jackson Jr., June 28, 2018, https://www.sec.gov/news/public-statement/jackson-statement-investment-company-liquidity-disclosure.

10 Stijn Claessens and Ulf Lewrick, *Open-ended bond funds: systemic risks and policy implications*, BIS Quarterly Review 40 (Dec. 2021).

11 *Illiquid investment funds 'built on a lie', BoE's Carney says*, REUTERS (June 26, 2019), https://www.reuters.com/article/us-woodford-inv-suspension-carney/illiquid-investment-funds-built-on-a-lie-boes-carney-says-idUSKCN1TR1LK.

12 Stijn Claessens and Ulf Lewrick, *Open-ended bond funds: systemic risks and policy implications*, BIS Quarterly Review 41 (Dec. 2021).

13 Financial Stability Oversight Council, 2020 Annual Report 176, https://home.treasury.gov/system/files/261/FSOC2020AnnualReport.pdf.

OVERVIEW OF THE PROPOSAL

The Commission has proposed a number of amendments to its rules for open-end funds related to liquidity risk management programs and swing pricing. This includes amendments to Rules 22e-4 and 22c-1, as well as supporting amendments to Form N-PORT and other disclosure forms.

Amendments to Liquidity Risk Management Programs – Rule 22e-4

The Proposal makes several amendments to the liquidity risk management program requirements for open-funds in Rule 22e-4. These amendments are designed to increase the liquidity and resiliency of open-end funds, particularly during periods of market stress. Specifically, the Proposal amends these requirements for open-end funds by:

- requiring funds to maintain at least 10 percent of net assets in highly liquid investments;
- eliminating fund discretion for classifying fund investments by replacing the term "reasonably anticipated trade size" with "stressed trade size," which measures liquidity by mandating an assumption of a 10 percent reduction of each investment without changing the market value of the investment;
- reducing the number of liquidity categories in the liquidity classification framework from four to three by removing the "less liquid" investment category and expanding the scope of the illiquid investment category to include "less liquid" investments and investments whose fair value is unobservable;
- replacing the "monthly" liquidity classification of a fund's investment assets with "daily" classifications;
- removing the ability of funds to make liquidity classifications by asset class and instead requiring funds to make liquidity classifications for each investment; and
- making a fund's liquidity information available to the public.

Amendments to Swing Pricing and Implementation of "Hard Close" – Rule 22c-1

The Proposal makes several amendments to Rule 22c-1 to require open-end investment management companies (with the exception of money market funds and ETFs) to utilize swing pricing under certain conditions and implement a hard close. While Rule 22c-1 currently **permits** funds to engage in swing pricing, no funds in the U.S. currently do so. The Proposal would **require** open-end funds to establish and implement swing pricing policies and procedures to adjust the NAV of the fund by a swing factor if the fund experiences net redemptions or net purchases beyond a certain threshold. Funds would be subject to a one percent market impact threshold for net

redemptions and a two percent market impact threshold for net purchases, which would trigger application of the swing factors.

In order for a fund to effectively implement swing pricing, fund administrators need timely flow information of orders to determine whether the thresholds have been met and to calculate the swing factor and the NAV. The Proposal would require a "hard close" for investment orders to ensure the timely flow of information to the fund to calculate their NAV. Implementation of a "hard close" means that in order for investors to complete a purchase or redemption order with a fund and receive the current day's prices, they would need to submit that order prior to the fund's calculation of its NAV, which typically occurs at 4 p.m. Any orders received by the fund after calculation of its NAV would receive the price of the fund the following day.

Amendments to Form N-PORT and Other Disclosure Forms

The Proposal would amend the requirements governing reporting to the Commission and to shareholders. Specifically, the Proposal would require ***all*** registered investment management companies that file Form N-PORT, including those funds not subject to liquidity risk management program requirements and swing pricing amendments in Rule 22e-4 and Rule 22c-1, to report Form N-PORT to the Commission within 30 days of month-end and making it available to the public 60 days after month-end. This amendment replaces the current requirement to file these reports quarterly with a 60-day delay and to publicly disclose information relating only to the third month in each quarter. Additionally, the Proposal would require open-end funds subject to liquidity risk management program requirements to include information regarding the percentage of its portfolio represented in each of the three proposed liquidity categories.

The Proposal would make several minor and conforming changes to information in Form N-CEN and Form N-1A, including identifying information about service providers.

COMMENTS

As the events of March 2020 have shown, open-end funds still have the potential to pose significant risks to financial stability in the U.S. capital markets. It is clear that the existing liquidity risk management program requirements put into place in 2016 and subsequently watered-down in 2018 are not sufficiently robust, as many funds were not prepared for those stressed conditions. The Commission must therefore move forward with the proposed amendments to Rule 22e-4 to ensure our markets and open-end funds are more resilient in periods of stress—and not contributors to it—in the future.

In contrast to the obvious need for stronger liquidity risk management programs at open-end funds, it is less clear that swing pricing and a hard close will significantly reduce run-risk during periods of stress.[14] While swing pricing and a hard close should help to serve investors by

[14] *See* Stijn Claessens and Ulf Lewrick, *Open-ended bond funds: systemic risks and policy implications*, BIS Quarterly Review 46 (Dec. 2021) (In discussing Europe's experience with swing pricing, the author states

mitigating the dilution that can arise during periods of significant redemptions, operational challenges may still inhibit swing pricing's ability to bring more fairness to open-end funds. The Proposal specifically identifies a scenario where different intermediaries may establish different trading deadlines prior to a 4:00 p.m. close to ensure the trading information flows to the fund in time to establish the NAV prior to the hard close.[15] If this scenario were to come to fruition after implementation of swing pricing and a hard close, it is not clear that it would be preferable to the current model we have now.

Due to the explicit need for the amendments to the liquidity risk management programs at open-end funds, coupled with the lack of clarity associated with implementing swing pricing and a hard close, the Commission should move forward without delay on the amendments to Rule 22e-4 and consider adopting alternatives to swing pricing and a hard close in a separate rulemaking.

I. The amendments to the liquidity risk management programs will improve liquidity and financial stability of open-end funds, but they should be strengthened.

The proposed amendments to Rule 22e-4 and liquidity risk management programs at open-end funds are long overdue and necessary steps to improve the liquidity and financial stability of these widely used investment vehicles. As Better Markets has advocated in prior related rulemakings before the Commission,[16] the current Rule 22e-4 gives open-end funds far too much discretion in their liquidity classification framework and should have imposed a minimum asset threshold for highly liquid investments. Additionally, the Proposal's amendments to impose stressed trade size analysis, daily liquidity classification marks, and investment-by-investment classifications are important and welcome changes. If adopted, the amendments to the liquidity risk management programs will substantially improve the liquidity and financial stability of open-end funds.

When the Commission first proposed Rule 22e-4 back in 2015, Better Markets strongly advocated for enhancements to the proposal to implement a truly effective liquidity risk management program for open-end funds. While the 2015 proposal was constructive and valuable in a number of respects, its basic premise was flawed. Ultimately, the 2016 final rule gave far too much discretion to individual funds to establish their own key liquidity benchmarks and was so discretionary that it was largely meaningless. This self-regulation mode of SEC oversight proved to be no substitute for robust, mandatory requirements and, as stated in our comment letter in 2016,

"[d]espite the adjustments in the swing factors and thresholds, we find no evidence of a dampening effect on investor redemptions in March…The estimated effect of swing pricing on daily net outflows is insignificant in regressions that control for fund characteristics and market conditions, In fact, funds that apply swing pricing exhibited somewhat larger net outflows on a weekly basis").

[15] *See* Release at 77,212.

[16] Better Markets, Comment Letter on Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-opening of Comment Period for Investment Company Reporting Modernization Release (Oct. 5, 2015); Better Markets, Comment Letter on Investment Company Liquidity Disclosure (Mar. 14, 2018).

"was unlikely to equip firms to survive a liquidity crunch."[17] The events of March 2020 certainly validated that criticism.

A. The 10 percent highly liquid investment minimum will enhance fund liquidity and mitigate dilution.

The Proposal's requirement for all open-end funds subject to Rule 22e-4 to hold at least 10 percent of their fund's net assets in highly liquid investments is a welcome and sorely needed addition to the rule. Under current Rule 22e-4, a fund is required to determine its own highly liquid investment minimum only if it does not hold primarily highly liquid investments. Under this rule, funds have wide discretion to determine their own highly liquid investment threshold if required to do so, based on several factors. As originally stated in Better Markets' past comment letter, "the failure to prescribe a discrete minimum threshold…threatens to undercut the effectiveness of this most critical feature of the Proposal."[18]

By explicitly requiring a specified percentage of a fund's assets to be held in highly liquid investments, i.e., investments that a fund reasonably expects to be convertible to U.S. dollars within three business days or less, the Proposal recognizes that funds simply have too much discretion and regularly take advantage of that discretion. This amendment will increase the liquidity and ability of open-end funds to sustain higher than expected redemptions. This is especially true and warranted for those open-end funds that currently hold assets that are not as liquid as highly liquid investments, a majority of whom reported holding less than 10 percent of net assets in highly liquid investments.[19] These funds, who do not hold a majority of their assets in highly liquid investments, are arguably the funds in most need of a SEC-mandated highly liquid investment minimum.

While we support a minimum threshold for highly liquid investments, the percentage specified by the Commission should be at least equal to, or more than, the maximum percentage of assets a fund can hold of illiquid investments. Under current Rule 22e-4 this would mandate a minimum 15 percent threshold of net assets for highly liquid investments. Alternatively, this could mean a 10 percent minimum for highly liquid investments if the illiquid investment maximum threshold was lowered to 10%. In light of recent liquidity challenges by certain open-end funds during the events of March 2020, the Commission should give due consideration to raising the 10 percent minimum threshold for highly liquid investments.

B. The proposed investment classification methodology is clearly appropriate.

The Proposal's amendments to the investment classification methodology are necessary to increase liquidity for open-end funds and remove the funds' nearly unbounded discretion. Under current Rule 22e-4, funds are given considerable discretion to classify their assets in four liquidity buckets: highly liquid, moderately liquid, less liquid, and illiquid. Funds have additional discretion to make their own determinations about which investments to classify by asset class or on an

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17 Better Markets, Comment Letter on Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-opening of Comment Period for Investment Company Reporting Modernization Release 8 (Oct. 5, 2015).

18 Better Markets, Comment Letter on Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-opening of Comment Period for Investment Company Reporting Modernization Release 8 (Oct. 5, 2015).

19 Release at 77,195.

individual basis. As stated in Better Markets' 2016 comment letter, this approach gave far too much discretion to funds to fashion their own liquidity risk management programs and render them relatively toothless. The Proposal's amendments to the investment classification methodology represent a well-designed classification system that would have made open-end funds far more resilient and more liquid during March 2020.

By removing the "less liquid" investment category from the investment classification methodology, the Proposal will greatly reduce funds' ability to game their liquidity risk management programs. The Proposal makes a particularly strong case for removing the "less liquid" category, which would have the effect of "less liquid" investments being considered as "illiquid" after implementation. As the Proposal cites, the "most common" investment in the "less liquid" category are bank loans.[20] Bank loans are notorious for taking a long period of time to settle and therefore, are very suspect for including in any category other than "illiquid" for purposes of liquidity classifications. The Proposal notes that the "average time to settle a bank loan per trade in the secondary market" was T+23 in July 2021.[21] This is obviously far in excess of the statutory 7-day period within which open-end funds must meet redemption requests. As witnessed during the events of March 2020, these illiquid bank loans can cause havoc in an open-fund when redemptions outpace inflows and cause investor harm. The Proposal notes that bank loan funds saw net outflows of 13 percent in March 2020, which was more than any other type of fund experienced.[22] This problem has only intensified with investments by registered investment companies in bank loan funds growing by 50 percent since March 2020,[23] which further emphasizes the need for this particular amendment to Rule 22e-4 in the Proposal.

Similarly, expanding the definition of "illiquid" investment in Rule 22e-4 to include investments whose fair value is unobservable would lead to more accurate liquidity classifications and increased liquidity at open-end funds, with only marginal effects on portfolio construction. The Proposal notes that roughly 2,000 open-end funds held investments with unobservable inputs, comprising $76.3 billion (0.27 percent of all open-end fund assets).[24] According to the Proposal, this amendment to Rule 22e-4 will only affect a small percentage of all open-fund assets (0.07%), but is an important change nonetheless because it recognizes that assets with unobservable inputs, do not trade in "active, liquid, and visible markets."[25] By their nature, these assets are illiquid and should be recognized within the liquidity classification methodology as such.

C. <u>The enhanced frequency of classification and reporting will provide greater and more timely transparency.</u>

The Proposal's amendments to require more frequent classification of a fund's assets, on an investment-by-investment basis, and more regular reporting to the Commission, would greatly increase the Commission's insight into the current liquidity of these funds, especially during

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[20] Release at 77,190-77,191 (The Proposal also finds that "over 90% of bank loan investments reported by open-end funds are classified as less liquid").
[21] Release at 77,191.
[22] Release at 77,191.
[23] Release at 77,191.
[24] Release at 77,192.
[25] Release at 77,192.

periods of stress. Currently, Rule 22e-4 requires funds to reclassify their investments at least monthly and more frequently if there is a reasonable expectation market events have materially affected one or more of their investment classifications. Additionally, Rule 22e-4 currently allows funds to make liquidity classifications on only an asset-class-by-asset-class basis and only requires Form N-PORT reports on a quarterly basis with a 60-day reporting delay.

The Proposal's amendments to replace monthly liquidity classification of a fund's investments to daily classifications would limit a fund's discretion and incentive to improperly classify the liquidity of their assets. While periods of stress in the markets can build over a period of months, they can also build and erupt over a period of days. These sudden shocks often result in panic selling and bank-like runs on less liquid open-end funds, much like we saw in March 2020. Despite the panic selling in markets across multiple asset classes in March 2020, an analysis by SEC Staff of Form N-PORT filings by open-end funds during that period showed "roughly 75 percent of funds did not reclassify any investment held in both Feb. and Mar. 2020."[26] This is a result of the wide discretion given to open-end funds to self-regulate. The Proposal rightly removes this discretion by requiring funds to reclassify their assets on a daily basis and should be implemented as proposed.

The Proposal's amendments to require investment-by-investment classification of assets and regular reporting to the Commission on Form N-PORT will give regulators more accurate insight into liquidity levels of open-end funds. Requiring investment-by-investment classification of assets, as opposed to allowing funds to make liquidity classifications by asset class, will require fund administrators to have more precise liquidity profiles of the investments in their funds. This makes sense because when fund's buy and sell assets, they transact on an investment-by-investment basis, not an asset-class-by-asset-class basis. The Commission will also benefit from more precise investment classifications when reviewing Form N-PORT filings. Additionally, more regular reporting of Form N-PORT will give regulators more up-to-date information about open-end funds. As stated in Better Markets' 2016 comment letter, activity at open-end funds at the beginning of the first month of a quarter will not flow through to the Commission until five months later. The Proposal highlights the real-world implications of this lag time by noting that the SEC did not receive Form N-PORT filings covering the events of March 2020 until June and July.[27] This information would have been beneficial to regulators and policymakers in crafting regulatory and legislative responses to the economic effects of the COVID-19 pandemic.

D. Incorporating stressed trade size in liquidity classifications will enhance reliability and better prepare funds for stressed market conditions.

The Proposal would require funds to incorporate stress into their liquidity classifications by assuming the sale of a stressed trade size, which would be 10 percent of each portfolio investment, rather than the rule's current approach of assuming the sale of a ''reasonably anticipated trade size'' in current market conditions. The "stressed trade size" factor is a more appropriate measure of liquidity, especially when liquidity is needed most—in times of market stress. While reasonably anticipated trade size may be a useful standard to measure liquidity during

[26] Release at 77,194 n.128.
[27] Release at 77,227.

times of normal market activity, it is of little utility during times of market stress. If a fund is experiencing larger than usual demand for redemptions and needs to sell assets to meet redemption levels, in an ideal world they could sell their liquid assets for market value to raise funds. In this scenario, a reasonably anticipated trade size could accurately measure the liquidity of the investments in a fund.

However, when funds are experiencing net redemptions, especially a significant flow of net redemptions, there is usually turmoil in the markets and with it, stressed trading. That is why a more appropriate standard would incorporate some level of stress into its analysis. As explained in the Proposal, requiring a fund's classification model to assume the sale of larger-than-typical position sizes may better emulate the potential effects of stress on the fund's portfolio, similar to an ongoing stress test, and help better prepare a fund for future stress or other periods where the fund faces higher than typical redemptions.

In fact, research has suggested that the liquidity assumptions made by open-end bond funds, in particular in March 2020, underestimated "the adverse effects of collective sales on market liquidity in times of stress."[28] The Proposal would introduce this stress-variable into the liquidity analysis with the stressed trade size and will help increase the resiliency of funds facing unusually larger than normal redemptions. This is a critically important component of the Proposal that would help ensure funds are considering the effects of stressed market conditions on their ability to liquidate assets, and the prices of those assets, in the face of mounting redemptions requests.

II. Swing pricing and a hard close may help to solve investor dilution issues, but the impacts on the markets and potential harm to investors are still uncertain.

Implementing swing pricing and a "hard close" for open-end funds would likely help to alleviate many investor dilutions issues, to the extent they are significant, but its implementation could also raise other, potentially more significant investor protection issues. The Proposal does a thorough analysis of the potential consequences of implementing swing pricing and a hard close, some of which could be negative. Admittedly, it is difficult to foresee all the challenges that may be associated with implementation and operation of swing pricing and a hard close in the open-fund industry. For these reasons, the Commission should proceed with their well-designed amendments to Rule 22e-4 to improve the resiliency and liquidity of open-end funds and their liquidity risk management programs and defer implementation of the swing pricing and hard close proposals pending further analysis of those measures and their reasonable alternatives.

As mentioned above, the Proposal describes many of the potential issues that could arise in implementing a swing pricing and hard close regime. For instance, swing pricing and a hard close could create confusion among investors and create a multi-tiered system for trade settlement that ultimately outweighs its benefits in terms of preventing unfair dilution among non-redeeming shareholders. The Proposal discusses the potential effects of the proposed rule on intermediary cut off times, envisioning a scenario where:

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[28] Stijn Claessens and Ulf Lewrick, *Open-ended bond funds: systemic risks and policy implications*, BIS Quarterly Review 47 (Dec. 2021).

> the proposed rule would likely cause some intermediaries to set their own internal cut-off time for receiving orders to purchase or redeem fund shares that is earlier than the pricing time established by the fund. Intermediaries may use earlier cut-off times to provide time to transmit order flow information to a designated party so those orders receive that day's price. Investors, therefore, depending on the entity through which an investor is transacting (e.g., a broker-dealer, retirement plan recordkeeper, or the fund's transfer agent), may have different deadlines for the same fund for submission of orders to receive that day's price. For example, an investor submitting an order to a fund's transfer agent might have until 3:59 p.m. ET to submit its order, while an investor submitting an order to an introducing broker would likely have to submit its order earlier to provide enough time for the introducing broker to send the order to the clearing broker and for the clearing broker to send it to the transfer agent or to Fund/SERV.[29]

In this scenario, investors could receive different prices based on the intermediary they used to conduct their transaction, causing some to receive the next day's NAV of the fund despite submitting their trade before another investor with a different intermediary. For example, if Investor A submits a trade at 12:00 pm ET and Investor B submits a trade at 3:00 pm ET to their respective intermediaries, depending on varying cutoff times of each intermediary, investor B could receive that day's NAV, while investor A is forced to receive the following day's NAV. It would be unrealistic to expect investors to keep track different cut off times for different intermediaries in order to get a strike price at that day's NAV. If this scenario is a byproduct of implementing swing pricing and a hard close, then the medicine may be, in fact, worse for investors than the disease.

Another factor to consider in light of these potential operational challenges with implementing swing pricing and a hard close is that investors who are truly concerned with potential dilution in certain open-end funds have alterative investment options. For example, ETFs offer many of the same benefits of other open-end funds that would be subject to the amendments in this Proposal, but without similar risks of dilution. ETFs, specifically bond ETFs, also fared much better in terms of liquidity than other open-end bond funds during March 2020, suggesting they are more resilient in times of stress.[30] In other words, investors concerned with dilution in open-end bond funds currently have other investment options to get exposure to broad-based, and these alternatives ameliorate the need for immediate action by the Commission on swing pricing. They in effect give the Commission more leeway to further refine the swing pricing proposal or devise an appropriate alternative that solves the problem of dilution without the disruptive impact that the Proposal may have if it is finalized.

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29 Release at 77,212.

30 *See* Antonio Falato, Itay Goldstein, and Ali Hortacsu, *Financial Fragility in the COVID-19 Crisis: The Case of Investment Funds in Corporate Bond Markets*, National Bureau of Economic Research July 2020, https://www.nber.org/system/files/working_papers/w27559/w27559.pdf.

For the reasons outlined above, the Commission should consider proceeding with the proposed amendments to Rule 22e-4 and the liquidity risk management programs for open-end funds separate and apart from the amendments to Rule 22c-1, which implement swing pricing and a hard close for open-end funds. Implementing swing pricing and a hard close pose unique and complex challenges, some of which could adversely affect some investors. As part of a separate rulemaking on implementing swing pricing and a hard close, the Commission should further consider alternative regulatory approaches that could help increase the liquidity of open-end funds, protect investors from dilution, and avoid operational changes that create confusion and unfairness.

III. Other approaches to increasing liquidity and disincentivizing redemptions during a bank-like run could serve as better alternatives to swing pricing and implementation of a hard close.

The Proposal lays out a number of potential alternatives to swing pricing and a hard close for open-end funds. The Commission should be applauded for this approach. The goal of any potential alternative should be focused on increasing and maintaining liquidity, especially during periods of stress; disincentivizing redemptions during a bank-like run; and addressing the unfairness that arises from the dilution in the value of shares during periods of significant redemptions or inflows. Achieving these goals will not only help to smooth out cost and dilution issues but also enable funds to raise funds and disincentivize redemptions, which further dilutes the value of remaining shareholder assets. The Commission should consider exploring alternatives that can:

(1) serve as a type of countercyclical capital buffer, such as imposing liquidity fees on redemptions during periods of stress; or

(2) allowing funds to retain a small percentage of redeeming investor funds during periods of stress in an escrow account, which can be used to smooth out dilution over time, not to exceed seven days.

After more consideration and comments from the public, the Commission should seriously consider these and other methods to increase liquidity and solve dilution issues associated with open-end funds.

As a threshold matter, the Commission should consider whether the enhancements to the liquidity risk management programs as in the Proposal would adequately address run-risk as well as dilution concerns. In fact, perhaps the best way to increase the liquidity and resiliency of open-end funds during periods of stress may be by requiring funds to have a strong liquidity risk management program, as proposed amendments to Rule 22e-4 would accomplish. Funds that are better prepared for stress events—by using a stressed trade size analysis with daily classification of their investments under the umbrella of a strong liquidity classification framework that is strictly enforced by regulators—are more likely to be able to meet investor redemptions without engaging in a fire sale of less liquid assets to meet redemptions demand. Additionally, funds that are more liquid and better prepared for these periods of stress will be less likely to experience a bank-like

run because investors should not be as concerned with issues of dilution. The proposed amendments to Rule 22e-4 in the Proposal would greatly increase liquidity and resiliency in open-end funds, which should lead to funds being better prepared to deal with periods of rising redemptions. These changes alone may stem some dilution concerns the Commission seeks to solve with swing pricing and a hard close.

However, if the Commission believes that investors will still face significant dilution even with the adoption of the proposed amendments to Rule 22e-4, then the Commission should proceed with any additional tools they view as necessary to protect investors. One such potential alternative to swing pricing and a hard close would be to enable funds to implement a liquidity fee during periods of stress. Allowing funds to impose a liquidity fee on redemptions during periods of stress will serve as a type of countercyclical liquidity buffer that could be used to offset any dilution remaining shareholders would experience at the expense of those who are redeeming their shares. By raising the cost of redeeming shares during periods of stress, a liquidity fee may also serve as a disincentive for existing shareholders contemplating redeeming their shares. The parameters or triggers for imposing such a fee could parallel the parameters found in the Proposal for initiating swing pricing. This approach has the benefits of smoothing out transaction costs between redeeming shareholders and remaining shareholders, with redeeming shareholders paying the fee to help cover the dilution remaining shareholders may experience due to transactions the funds may be forced to effect to cover redemptions.

While there would still be some operational challenges associated with implementing a liquidity fee, such as ensuring coordination of the fee between a fund and various intermediaries, these challenges would seem more modest in comparison to those associated with implementing a hard close. Furthermore, while we know that similar fees used in the money-market fund industry do not stop bank-like runs on funds, a sufficiently strong liquidity risk management program should make open-end funds much more resilient to bank-like runs in periods of stress. The advantage of the liquidity fee is that it could effectively address the investor unfairness arising from dilution, while the enhanced liquidity risk management reforms in the Proposal could address the issues surrounding run risk. Additionally, any concerns about potentially incentivizing bank-like runs by imposing a liquidity fee as opposed to swing pricing would be muted if the conditions for imposing a liquidity fee are similar to the conditions for implementing swing pricing within the Proposal. In short, the Commission should consider a liquidity fee as a potential preferred alternative to swing pricing and implementing a hard close.

The Commission could also consider an alternative to swing pricing and implementing a hard close that enables a fund to retain a percentage of a redeeming investor's assets during periods of stress that would be used to smooth out costs of dilution to remaining shareholders. The percentage of redeeming investor funds could be held for a period of time (within the seven-day mandatory redemption threshold under the Investment Company Act) to cover the costs of dilution to remaining shareholders, with any remaining funds being distributed to the redeeming shareholder. In effect, this would act as a form of swing pricing without having to implement a hard close. In fact, it may even be more beneficial to remaining shareholders because it could smooth out the dilution costs to the fund over a longer period of time. Like the previous alternative

offered, there would still be challenges with implementing this alternative approach but they too may be modest in comparison to those associated with implementing a hard close.

Ultimately, there may not be a perfect solution for addressing the Commission's legitimate concerns surrounding investor dilution in open-end funds. However, dilution concerns regarding open-end funds are not new and have been a function of certain open-end funds, especially less liquid funds, for some time. No investment is riskless and dilution has typically been considered a feature of investing in certain open-end funds. Fortunately, investors have alternative ways to invest in diversified funds if they are truly concerned about dilution in certain open-end funds. For all of the reasons set forth above, the Commission should give serious consideration to alternative approaches to addressing dilution issues before requiring open-end funds to implement swing pricing and a hard close.

CONCLUSION

We hope these comments are helpful as the Commission finalizes the Proposal.

Sincerely,

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