Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090
rule-comments@sec.gov

SUBMITTED VIA ELECTRONIC MAIL

14 February 2023

Re: Proposed Rule, *Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting*
(Release Nos. 33-11130; IC-34746; File Nos. S7-26-22)

Dear Secretary Countryman:

The Systemic Risk Council (the "Council" or "we")[1] is grateful for the opportunity to respond to the request for comment recently issued by the Securities and Exchange Commission (the "Commission" or the "SEC") in the above-referenced notice of proposed rulemaking (the "Proposed Rule")[2] relating to the Investment Company Act of 1940 (the "Investment Company Act"),[3] the Securities Act of 1933 (the "Securities Act").[4] The Proposed Rule would alter aspects of the Commission's Investment Company Liquidity Risk Management Program[5] adopted in 2016 (the "2016 Rule").

We applaud the Proposed Rule as part of the Commission's continuing efforts to reduce the potential for market-wide risk emanating from the open-end fund industry. These changes are particularly important given the liquidity and other issues that arose during the market turmoil

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[1] The independent, non-partisan Systemic Risk Council (www.systemicriskcouncil.org) was formed to monitor and encourage regulatory reform of U.S. and global capital markets, with a focus on systemic risk. The Council is funded by the CFA Institute, a global association of more than 190,000 investment professionals who put investors' interests first and set the standard for professional excellence in finance. The statements, documents and recommendations of the private sector, volunteer Council do not necessarily represent the views of the CFA Institute. The Council works collaboratively to seek agreement on each of its recommendations. This letter fairly reflects the consensus views of the Council but does not bind its individual members.

[2] Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting. The Proposed Rule includes proposed amendments to the Investment Company Act of 1940 (the "40 Act"), including Rule 22c-1 (17 C.F.R. § 270.22c-1); Rule 22e-4 (17 C.F.R. § 270.22-e4; Rule 30b1-0 (17 C.F.R. § 270.30b1-9); Rule 31a-2 (17 C.F.R. § 270.31a-2); and amendments to Form N-PORT (17 C.F.R. § 274.150); Form N-CEN (17 C.F.R. §274.101); and under the Investment Company Act and the Securities Act, amendments to Form N-1A (17 C.F.R. §§ 239.15A and 274.11A).

[3] 15 U.S.C. § 80a-1 *et seq.*

[4] 15 U.S.C. § 77a *et seq*.

[5] See: Final Rule: Investment Company Liquidity Risk Management Programs (sec.gov).

produced by the Covid-19 virus and government actions taken in March 2020 in response to the virus.

A. BACKGROUND: OPEN-END FUNDS,[6] SYSTEMIC RISK, AND FINANCIAL STABILITY

In our 13 January 2016 letter[7] responding to the SEC's then-proposed Rule,[8] we reiterated the recommendation we made in a 25 March 2015 letter to the Financial Stability Oversight Council concerning its consultation on Asset Management Products and Activities,[9] namely that it examine liquidity and redemption provisions "to determine their sufficiency in distressed conditions." Since that letter, we have expressed similar concerns in seven different letters to five separate market supervisors concerning Fund regulation.[10] In particular, we have noted the potential for systemic destabilization that financial structures produce when certain investment vehicles mirror the purposes and characteristics of commercial banking products such as ***on-demand*** liquidity and leverage. We urged the Commission to examine open-end and money market mutual funds more thoroughly to avoid the costs of failure in this sector.

U.S. Fund rules produce particular concerns because of the availability for daily redemption of investors' shares. The maturity mismatches exposed by this daily liquidity feature are magnified when Funds underlying holdings are highly illiquid, use leverage in the instruments they hold, or by using other forms of debt to either finance their investing activities or support fund redemptions. Other factors exacerbating this mandate occur when Funds invest in assets that are opaque and otherwise hard to value. The potential liquidity risk these factors create has led to investor runs in the past.

We therefore applaud the Commission for proposing further refined steps to augment Funds' liquidity requirements in the Proposed Rule.

We also support efforts to address provisions that permit or even encourage investors, and large institutional investors particularly, to arbitrage differences in net asset values between Fund NAVs based on stale securities prices and up-to-date, and potentially lower, securities valuations

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[6] In the remainder of this letter, we will use the term "Funds" to refer to all open-end funds except for exchange-traded and money market funds. This is the approach used in the Proposed Rule in large part due to separate rule structures that apply to the excepted fund categories.

[7] See : http://systemicrisk.wpengine.com/wp-content/uploads/2016/01/SRC-Letter-to-SEC-re-Open-End-Fund-Liquidity-Risk-Mgmt-01-13-16.pdf

[8] Proposed Rule: Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release (sec.gov)

[9] See: https://www.systemicriskcouncil.org/2015/03/systemic-risk-council-letter-to-fsoc-about-asset-management-products-and-activities/.

[10] See: *Supra* note 2; http://systemicrisk.wpengine.com/wp-content/uploads/2016/10/Systemic-Risk-Council-Letter-to-FSB-re-Asset-Management-Proposals.pdf; http://www.systemicriskcouncil.org/wp-content/uploads/2017/02/Systemic-Risk-Council-Policy-Statement-to-G20-Leaders.pdf; https://4atmuz3ab8k0glu2m35oem99-wpengine.netdna-ssl.com/wp-content/uploads/2018/02/SRC-Comment-Letter-to-Treasury-Dept-2.23.18.pdf; https://www.systemicriskcouncil.org/wp-content/uploads/2019/05/Systemic-Risk-Council-Statement-on-FSOC-Proposal-May-2019.pdf; http://www.systemicriskcouncil.org/wp-content/uploads/2020/10/SRC-Reigniting-the-Reform-Debate.pdf; http://www.systemicriskcouncil.org/wp-content/uploads/2021/04/Systemic-Risk-Council-Comment-Letter-File-No.-S7-01-21.pdf; and http://www.systemicriskcouncil.org/wp-content/uploads/2022/04/SRC-MMF-Letter-4.15.2022_final.doc.pdf

for Fund holdings and NAVs. Without adequate liquidity, fulfilling redemptions in such circumstances could force Fund managers to succumb to fire sales which may have the effect of depressing market values broadly for similar assets across various markets. This potential for contagion might have dire consequences for broader market stability which may need government intervention/support. Despite the complexities involved with swing pricing, the mechanism does a better job of mitigating the initial link in the chain of events describe above by imposing the cost of liquidity transformation upon those investors who seek to redeem their shares in the threat of stressed markets.

B. SUMMARY OF PROPOSED RULE

Given the problems Funds can create if they find themselves unable to support and fund investor redemptions, the Commission has focused its attention in this Proposed Rule on three primary areas: 1) changes to Funds' liquidity classifications for portfolio investments; 2) the introduction of swing pricing to mitigate investors' first-mover inclinations; and 3) corrective procedural changes and disclosures to help achieve the first two factors.

1. **Liquidity Classifications.** The Proposed Rule recommends changes in four distinct areas of rule 22e-4, all to lessen the potential risks Funds pose when they misrepresent or misjudge the liquidity of the investment assets, they hold on behalf of their shareholder clients.

a. Definitions. In the SEC's view, many Funds failed to accurately assess and describe the liquidity characteristics of their portfolios in March 2020. Among the proposed remedies is elimination of the current "less-liquid" category of investments. Going forward, firms would have to classify holdings as 1) highly liquid, which are(convertible into US dollars within three business days without significant effect on the instruments' market prices; 2) illiquid where conversion would significantly affect market prices; or whose fair-market values are based on unobservable inputs; or 3) moderately liquid, which are neither of the other two categories. Significant price changes for various listed and unlisted securities are those that exceed certain parameters in the Proposed Rule.

b. Daily categorization. Funds would have to *daily* recategorize their holdings under the Proposed Rule, instead of the current *monthly* classifications. The proposal would preserve the current rule's 15% of net assets limit for illiquid assets, and introduce a new 10% minimum for highly liquid investments, net of liabilities.

c. Assumed Trade Size. The Proposed Rule also would eliminate Funds' discretion on trade sizes when estimating conversion of securities into cash. Proposed rule 22e-4 amendments would require Funds to assume trades in unstable markets equal to at least 10% of each portfolio investment. The context of stressed market conditions effectively imposes a stress test on each Fund.

d. Assets Used as Collateral. Funds would have to reduce the value of highly liquid assets by the value of any such assets posted for margin or collateral on derivatives transactions.

2. **Swing Pricing.** Swing pricing pushes the costs of redemptions or purchases to the shareholders who submit the orders and is based on an estimation of the costs of the

transactions, including market effects.[11] Such trading often occurs when institutional investors seek to quickly liquidate holdings to ensure they can obtain access to their invested Funds,[12] avoid dilution of their shares, and/or avoid certain trading fees. The Proposed Rule would make swing pricing mandatory for all Funds, would mandate the thresholds that trigger swing pricing, would determine the Fund flows triggering the thresholds, and stipulate the methods used to calculate swing-pricing factors (the "Factors"). Collectively these mandates would determine the cost allocations all Fund managers would have to apply to mitigate fund dilution and first-mover advantages.

a. Requirement to Use Swing Pricing. All Funds will have to apply swing pricing when they experience net redemptions or net purchases beyond preset thresholds.

b. Thresholds. Funds would have to apply swing pricing every time they have net redemptions or net purchases exceeding 2% of Fund assets and would have to assess the market impact if net redemptions were to reach at least 1% of total net assets, or net purchases reached 2%. Funds' swing-pricing administrators ("SPAs") could apply lower thresholds – apply swing pricing earlier – if deemed useful in mitigating dilution of remaining Fund shareholders.

c. Swing-Pricing Factors. The Proposed Rule would eliminate Funds' ability to estimate pro-rata transaction costs for trades of specific investments. Instead, Funds would have to impute expected costs for buying or selling vertical slices of their entire investment portfolios by calculating a market-impact factor ("MIF") equal to the estimated percentage change in market valuation of all portfolio investments if net redemptions or purchases exceeded standard market-impact thresholds. Investment managers could not act as their own SPAs, and Funds would have to publicly disclose any adjustments to Factors in their Forms N-PORT.

3. **Procedural and Disclosure Changes.** The Proposed Rule seeks to address the following operational issues that created barriers to Funds' use of swing pricing during the 2020 market crisis.

a. Hard Close. The Commission learned from industry participants that no Fund used swing pricing during the March 2020 market crisis in part because order-processing delays prevented collection of accurate and complete flow data needed to determine swing-pricing Factors. The delays sometimes lasted into the early morning hours of the next day, delaying the calculation of Fund NAVs.

The Proposed Rule would remedy these operational issues by imposing a "hard close" at 4 pm Eastern Time. Orders presented by or delivered to Funds, broker-dealers, transfer agents,

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[11] These costs are generated when an investor seeks to quickly sell investments in large enough quantities that other investors notice the presence of large orders hitting the market and try to trade ahead of expected changes in share prices.

[12] See Proposed rule: Money Market Fund Reforms; Conformed to Federal Register version (sec.gov), footnote 75. Invesco's letter to the Commission in 2021 stated that during March 2020, "investors were less concerned about the price of their shares and more concerned about not having access to their shares, particularly for investors who were bolstering their liquidity positions ahead of what was an unknown situation." In its letter to the Commission, the Investment Company Institute added, "investors view access to their money as paramount in stress periods and are less concerned with 'losing a few pennies' through, for example, a fee."

registered clearing agencies, and retirement plan recordkeepers after that time would be processed at prices set the following day.

b. Pricing. The Proposed Rule would allow changes to orders up to the time for pricing set by intermediaries prior to the 4 pm hard close, but no alterations or cancellations would be accepted afterward. The change is intended to enhance order flow information collection, while also stemming the potential for late trading.

c. Disclosure Forms. Going forward Form N-1A would alert investors to the existence of the proposed hard close and potentially earlier order closing times for other intermediaries. Form N-PORT would report every Fund's month-end securities portfolio by liquidity classification, and would be available to investors 60 days after delivery to the Commission.

C. RECOMMENDATIONS OF THE COUNCIL

In response to the proposals preceding the 2016 Rule, the Council expressed support for the proposed liquidity risk-management enhancements, introduction of swing pricing, and enhanced disclosures. At the time, we said these changes represented "a material contribution to mitigating the evolving systemic risks associated with the Funds industry." We also noted that the increasing role Funds were playing in credit intermediation called for a regulatory regime that addressed "the potential for socially costly systemic disturbances resulting from investor runs."[13]

As a consequence of the market tumult of March 2020, the Commission concluded that provisions in the 2016 Rule were insufficient and is proposing the changes described above. The Council members support the SEC's efforts to address the potential for Funds experiencing liquidity deficiencies that could put further pressure on already-stressed financial systems.

Standardized Liquidity Classifications. To that end, we continue to believe that portfolio liquidity requirements make Funds more resilient to significant and rapid investor redemptions and reduce the potential negative effects mass redemptions have on non-redeeming investors. Consequently, the Council sees the proposed changes to liquidity classifications as key step toward enhancing the clarity of Funds' descriptions and comparability of investment portfolios. The more accurate descriptions also may reduce the inclination of some Funds to boost yields by holding greater quantities of higher-risk assets. The new highly liquid asset minimum also should make it easier for Funds to quickly convert holdings into cash to meet redemptions in difficult markets. The definitional changes proposed would have the added benefit of lessening Funds' inconsistent interpretation of the liquidity classifications for assets.

We concur with the Commission that the current rules give Fund managers too much leeway in the classification of assets, leading to overestimates of Funds' ability to quickly convert portfolio holdings into cash without incurring significant effects on market pricing. The proposal to mandate the assumed trade size is another important step toward preparing Funds for obtaining and maintaining the liquidity they might need to meet investor redemption requests, should stressed investment markets return.

The issues that have led to this Proposed Rule, namely Funds' response to the 2020 market crisis, have not produced the same degree of regulatory apprehension that money market funds have

[13] See *Supra* note 7.

created since the beginning of the new millennium. In part, this is due to differences in the universe of investors and the smaller size of these non-money market open-end products. When a money fund needs liquidity, for example, it may try to sell a fixed-income asset maturing in 67 days where the pool of potential buyers for such a bespoke instrument is often limited to the broker who sold the instrument to the holder, the instrument's issuer, or a limited number of investors willing to buy at steep discounts from par. In contrast, the instruments Funds targeted by the Proposed Rule hold are listed shares of stock or in many cases listed bonds. Whereas all the listed shares of one company are typically the same in every way as every other listed share of the company, and while the securities of one issuer are different from shares of another, there are generally investors willing to buy securities with standardized structures, ratings, or other factors, at or near the current market price, particularly when compared with customized instruments in the money market. This relative standardization and the consequent liquidity of Funds' holdings is generally true even in stressed markets.

Mandatory Swing Pricing. Most concerning to prudential regulators is the ability of investors to seek daily redemption for their mutual fund shares, whether they are the Funds targeted in the Proposed Rule, or money market fund shares. This, combined with the legal requirement that both must convert investment assets into cash for the benefit of redeeming shareholders within a few days, often amidst great market tumult, creates significant potential for Funds' to default on fulfilling these obligations.

Often the problems cited above are accentuated by investors seeking to beat others to the exit for redemptions. Such first-mover actions often leave Funds with less-resilient, less-valuable, and less-liquid assets in their portfolios for the investors who are unaware or late to redeem. To mitigate these matters, the Council supports the Commission's amendment to Rule 22c-1 to mandate swing pricing for all Funds, including proposed mandates for redemption and purchase thresholds for swing pricing's use, and the calculation of the Factors.

Liquidity Risk Management: Addressing Complexity and Changing Markets. In our 2022 letter to the Commission responding to its proposals to reform the money market fund industry, we noted the complications of swing pricing as a tool for mitigating investor dilution.[14] While we saw the second- and third-order problems that dilution creates for financial systems, we also noted the complexity and challenges swing pricing creates for Funds. We acknowledged that proper tools and infrastructure for swing pricing application and management are still a work-in-progress and will take time.

We also recognized the complexity of swing pricing as being a function of the complexity of the problem it seeks to solve, namely the business model, in that case, of prime money Funds. There is no certainty as to whether swing pricing will slow, much less prevent the likelihood of investor runs from money market funds. The Council's recommended action in that instance was to enhance stress testing and consider capital requirements for money funds. Consequently, the introduction of stressed classifications of holdings is a particularly important feature of the Proposed Rule and one we strongly support.

Even as the experience of European funds' use of swing pricing allays some concerns about the tool's application for Funds in this case, we reiterate our recommendations for the Commission

[14] See *supra* note 10, specifically, SRC-MMF-Letter-4.15.2022_final.doc.pdf (systemicriskcouncil.org).

to be prepared to impose capital requirements for Funds to provide added depth of security for the Funds, their investors, and the larger financial system.

D. Conclusion

In sum, we commend the Commission for pursuing these additional steps governing Funds. Pandemic events demonstrated that ex-post liquidity fees and gates were insufficient to prevent serious runs and potential knock-on effects to economic stability without government intervention. In our view, enhanced liquidity requirements and swing pricing are additional measures needed to reduce the systemic externalities associated with Funds. As the Council noted previously in the context of money market funds, certain of these measures will increase costs for Funds and but they are necessary to stem the greater threat and costs Funds can pose for monetary instability.

Respectfully submitted,

Simon Johnson, Co-Chair, CFA Institute Systemic Risk Council

Erkki Liikanen, Co-Chair ,CFA Institute Systemic Risk Council