Federated Hermes

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April 22, 2024

Ms. Vanessa Countryman
Secretary
US 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)*

Dear Ms. Countryman:

Federated Hermes, Inc. and its subsidiaries (Federated Hermes)[1] submit this comment letter to the Securities and Exchange Commission to supplement our previous comments[2] on its proposed rule amendments regarding liquidity risk management programs and swing pricing.[3] We appreciate the SEC's continued willingness to review stakeholders' viewpoints in response to the Proposal. Mutual funds are a popular and useful tool for American workers saving for retirement and other important financial goals. These funds are also important investors, supplying investment capital to the US economy. We remain concerned that the Proposal will have far-reaching negative impacts that could upend the mutual fund product, denying investors a successful investment option that has existed for 100 years.

This letter will focus on our ongoing concerns regarding mandatory anti-dilution mechanisms, such as a hard close or swing pricing. This letter also provides a cautionary tale about the SEC's adoption in a final rule of an alternative that was not adequately addressed in the proposal.

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[1] Federated Hermes, Inc. (NYSE: FHI) is a global leader in active, responsible investment management, with $757.6 billion in assets under management as of December 31, 2023. We deliver investment solutions that help investors target a broad range of outcomes and provide equity, fixed-income, alternative/private markets, multi-asset and liquidity management strategies to more than 11,000 institutions and intermediaries worldwide. Our clients include corporations, government entities, insurance companies, foundations and endowments, banks and broker-dealers.

[2] Letter from Peter J. Germain, Chief Legal Officer, Federated Hermes, to Vanessa Countryman, Secretary, Securities and Exchange Commission (February 14, 2023) ("Federated Hermes Letter").

[3] *Open-End Fund Liquidity Management Programs and Swing Pricing; Form N-PORT*, SEC Release No. IC-34746 (November 2, 2022) ("Proposal").

Section 1: Swing Pricing and Hard Close Requirements

Federated Hermes continues to strongly oppose the proposed hard close and mandatory swing pricing for mutual funds. As we noted in our previous letter, the harm and disruption of a hard close is too high a price to mitigate the operational issues associated with swing pricing. A hard close would require many third-party intermediaries (e.g., broker-dealers, retirement plan recordkeepers) to impose earlier cut-off times on their investors so they can submit trades to funds on time. These changes would require significant and costly system rebuilds across the industry and have a detrimental impact on shareholders, particularly retirement market participants, who could not execute fund trades as they do today throughout regular market hours and still receive same-day pricing.

Concerning swing pricing, we strongly oppose mandating swing pricing for all funds. It simply does not follow that elevated redemptions cause material dilution to remaining shareholders.[4] Moreover, implementing mandatory swing pricing, as proposed, would fundamentally alter funds' current operations and the pricing of mutual fund shares, all at a substantial cost to funds, intermediaries, and shareholders.

The SEC uses Europe as an example of successfully implementing swing pricing, but Europe's swing pricing regime is *voluntary* and far better than the Proposal's highly prescriptive mandatory provisions. Notably, the United States and Europe have fundamentally different markets and retirement plan systems, making swing pricing a more helpful tool in Europe.[5] Indeed, as the SEC is well aware, commenters, including over 30 fund boards, bi-partisan members of the US House of Representatives, and consumer groups, have widely criticized the Proposal.[6]

More alarmingly, the Proposal appears to misapprehend the gravity of the damage that would be done to shareholders and funds by the proposed changes. It makes no genuine attempt to quantify the benefits or costs of a proposal that would "fundamentally alter[s] the way open-end funds operate, how investors interact with them, and the infrastructure surrounding them."[7]

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[4] The Investment Company Institute has estimated that dilution for the large majority of mutual funds is *de minimis*. *See* Letter from Eric J. Pan, President and CEO, Investment Company Institute, to Vanessa A. Countryman, Secretary, Securities and Exchange Commission (February 14, 2023), at Section 2 of Appendix A.

[5] For swing pricing to work, funds must have timely, accurate, and complete daily flow information at the time they calculate their NAVs. Due to the highly intermediated nature of US fund ownership, particularly for retirement plan participants in 401(k) plans using open-end funds on their menu, this precondition is not met.

[6] The comment file is available here.

[7] Commissioner Hester M. Peirce, Statement, Closing Act: Statement on Proposed Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT (November 2, 2022).

The challenges, confusion, and costs generated by implementing swing pricing and a hard close would also likely impact an investor's choice of investment vehicle as intermediaries may modify their product offering lineups to include more exchange-traded funds or collective investment trusts, and other non-traditional fund structures, including private funds. To remedy the mere possibility of dilution (which, for the large majority of funds, is *de minimis*), the SEC has proposed a solution that would be more harmful than the dilution itself.

Mandating swing pricing and the related hard close are not required to satisfy the SEC's dilution concerns. As noted in our previous letter, dilution concerns are mitigated if the SEC mandates funds to price at the bid.[8] This effectively reduces the potential NAV impact of net redemptions and extinguishes any "first-mover advantage." Federated Hermes believes pricing at the bid would effectively prevent dilution during market stress and would, therefore, support this particular mandate. Additionally, the SEC's adoption of the fair value rule in 2020 should further improve funds' valuation practices and reduce dilution-related concerns.

We also agree with the ICI that, in addition to the opposition expressed by the vast majority of commenters on the Proposal, the SEC's own analysis does not support adopting the Proposal.[9]

Section 2: Anti-Dilution Alternatives

The Proposal includes various alternatives to its proposed swing pricing/hard close requirements. As the ICI has pointed out, however, these alternatives are "at best, partially sketched ideas, akin to what the SEC would discuss in a concept release or request for comment preceding a formal proposal."[10] We agree.

The liquidity fee alternative is particularly troubling, which is discussed as a general concept with "many potential variations."[11] Rather than a thoughtful and detailed proposal, the section in the Proposal that discusses liquidity fees presents a multitude of questions on the basic mechanics of such a fee, such as possible triggers, exceptions, frequency, operational feasibility, or fee determinations, such as fee size (e.g., dynamic or static).[12] Commenters' ability to provide

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[8] *See* Federated Hermes Letter, *supra* note 2, at 4; *see also* Letter from Gregory Davis, Chief Investment Officer, The Vanguard Group, Inc., to Vanessa Countryman, Secretary, Securities and Exchange Commission (February 14, 2023), at 13-14.

[9] *See* Letter from Investment Company Institute and ICI Southwest to Vanessa Countryman, Secretary, Securities and Exchange Commission (November 21, 2023) (joint letter expressing concerns with the SEC's proposal to amend the liquidity risk management rule and mandate a hard close and swing pricing), at 9 ("ICI/ICI Southwest Letter").

[10] *Id*.

[11] Proposal at 156.

[12] For a discussion of the liquidity fee concept, its various permutations, and the SEC's questions, *see* Proposal at 154-167.

meaningful feedback is severely limited without specific details.[13] Indeed, the comment file reflects little meaningful input from the public on any of the Proposal's alternatives because commenters were focused on what the SEC proposed—mandatory swing pricing and a hard close. If the SEC chooses to adopt a mandatory liquidity fee in the final rule amendments here without re-proposing and seeking public comment, we have serious concerns given our experience with the SEC's recent money market fund rule amendments.

Section 3: Mandatory Liquidity Fees for Money Market Funds: A Cautionary Tale

In July 2023, the SEC adopted a liquidity fee framework for money market funds, which includes a prescriptive, mandatory liquidity fee for institutional money market funds, instead of its proposed swing pricing framework.[14] Although the proposed rule briefly included liquidity fees as one alternative to swing pricing, it did not specify that such a regime would be mandatory for institutional money market funds or include many of the components of the final rule. In particular, the SEC failed to provide the public an opportunity to comment on the final rule's liquidity fee framework, including the 5 percent threshold for imposing a liquidity rule, the *de minimis* exception, the default 1 percent fee, or the requirement that funds with multiple daily strikes impose retroactive fees on investors when their daily redemptions exceed 5 percent.

Not surprisingly, the mechanics of the final mandatory liquidity fee framework are proving unworkable and costly to money market funds, investors, and intermediaries. The rule's onerous requirements are causing institutional prime money market funds to exit the space before the October 2024 compliance date.[15] Of course, this migration of capital from the private sector to finance government debt is contrary to one of the SEC's central missions—capital formation.

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[13] To this end, we agree with the ICI that the anti-dilution measures included in the Proposal "lack the requisite specificity for adoption without a new proposal, without violating the Administrative Procedure Act." *Id*. at 10. The APA requires an agency to provide sufficient notice of a proposed rule and the agency's supporting rationale, and then a meaningful opportunity for interested parties to provide comments. 5 USC § 553. Moreover, under well-settled principles of administrative law, the substance of an agency's final rule must be a "logical outgrowth of its notice." *CSX Trans., Inc. v. STB*, 584 F3d 1076, 1079 (D.C. Circ. 2009) (quotation marks omitted). Indeed, the proposed rule must "ma[ke] clear that the agency was contemplating" the "particular change" adopted in the final rule, *id*. at 1081, such that "interested parties should have anticipated that the change was possible." *Tex. Ass'n of Mfrs. v. CPSC*, 989 F.3d 368, 382 (5th Cir. 2002) (quotation marks omitted).

[14] Money Market Fund Reforms; Form PF Reporting Requirements for Large Liquidity Fund Advisers; Technical Amendments to Form N-CSR and Form N-1A, SEC Release No. IC-34959 (July 12, 2023).

[15] Capitol Account, *As Prime Money Market Funds Disappear, SEC Rule Draws Questions* (March 27, 2024). Anticipating the deleterious impact of the final rule on the money market fund industry, Commissioner Hester M. Peirce specifically asked "[i]s one of our goals to kill prime funds?" in her statement on the final rule. *See* Commissioner Hester M. Peirce, Statement, Air Dancers and Flies: Statement on Adoption of the Latest Round of Money Market Fund Reforms (July 12, 2023).

Federated Hermes has identified many operational and structural challenges in implementing and calculating the mandatory liquidity fee, including:

Determining net flows "within a reasonable period." To determine whether a money market fund has crossed the 5 percent daily net redemptions threshold, the fund will need to use information about net asset flows that is available within a reasonable period of time after the last pricing time of that day. The rule requires funds to calculate net redemptions using actual flow data for that day, not estimates. If an institutional money market fund permits agency/T+1 (NSCC trading), incorporating adequate flow information for purposes of the final rule amendments will be more complicated due to the timing of those transactions and the processes used to ultimately deliver that information to the funds.

Accommodating funds with multiple strike times. For money market funds with multiple strike times, funds must develop a method to apply the mandatory liquidity fee to shares redeemed in an earlier pricing period. This may require funds to apply fees retroactively. The final rule suggests that to address this problem, funds could, for example, apply the mandatory fee to the remaining balances of an investor if they did not redeem all of their shares or hold back a portion of the redeeming proceeds for a time while the applicable liquidity fee is being calculated. Notwithstanding these "solutions," the continued viability of multi-strike institutional money market funds is doubtful as investors are unlikely to invest in a product with a holdback redemption feature.

Obtaining gross redemption data from intermediaries. The rule requires money market funds to properly allocate the mandatory liquidity fees across all redeeming investors. This will require intermediaries to provide daily gross trade activity data to ensure that each investor that redeems during the imposition of a liquidity fee is allocated the liquidity fee. Not all intermediaries currently trade gross. Intermediaries may be forced to change investment products as a result of their inability to trade gross since converting to gross would be a significant operational (and likely costly change). Further, current sales/services agreements between funds and intermediaries may not contemplate the timely sharing of gross activity, requiring funds to enter into time consuming negotiations to amend their arrangements with their intermediaries to receive this information. Federated Hermes estimates it needs to amend hundreds of agreements.

In a recent speech, Commissioner Peirce, who did not support the final 2023 money market fund rule and expressed concerns regarding mandatory liquidity fees,[16] cited the rule as an example of "the dwindling of genuine Commission and staff engagement with the public."[17]

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[16] *Id*.

[17] Commissioner Hester M. Peirce, Speech, At the SEC: Nothing but Crickets, Remarks at SEC Speaks, Washington, DC (April 2, 2024) (italics added and citations omitted).

> One manifestation is the way rules are made these days: very broad proposals, unreasonably short public comment periods, pared back final rules with substantial elements on which the public has not commented, and little SEC engagement in implementation discussions. The recent money-market fund rule is an example of this phenomenon. It went out with—among other provisions—an unworkable swing-pricing element and emerged with a mandatory liquidity fee. *Had the Commission sought robust comment on the fee before adopting it, we would have learned that it is unworkable for many funds.* The Commission should think about each rule proposal as an opportunity to foster a public discussion with the goal of developing the best solution to a carefully identified problem, not as the opening bid in a hard-driving negotiating strategy designed to force a cowed public to accept a slightly less onerous—though perhaps still unworkable—final rule.[18]

Section 4: Conclusion

We firmly believe that neither mandatory swing pricing nor mandatory liquidity fees (which, in any event, were not proposed) are necessary or appropriate for those mutual funds otherwise in compliance with current liquidity requirements (including money market funds and all other open-end mutual funds). Indeed, the widespread application of mandatory anti-dilution mechanisms, such as swing pricing or liquidity fees, is simply unsupported by any credible data and would be detrimental to investors and the capital markets.

Instead, the SEC should require funds to price at the bid to alleviate concerns about potential material dilution during market stress. If the SEC needs more, it should permit a fund's board to determine how to handle material dilution through anti-dilution mechanisms, such as voluntary swing pricing or discretionary liquidity fees.[19] Mandatory swing pricing or mandatory liquidity fees, with their operational complexities and steep but unquantified costs and risks, are neither necessary nor appropriate and fail any reasonable cost/benefit analysis.

If, after evaluating the Proposal's comment file and the impact of mandatory liquidity fees on the money market fund industry, the SEC continues to believe a mandatory anti-dilution mechanism

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[18] *Id.* Commissioner Mark T. Uyeda expressed similar concerns regarding the potential "pitfalls" of the mandatory liquidity fee mechanisms "that warrant the benefit of public feedback." "The Commission should have reproposed [the mandatory liquidity fee] portion of the amendments, especially because the proposing release did not include a mandatory liquidity fee mechanism, the details of which are now being disclosed to the public for the first time." *See* Commissioner Mark T. Uyeda, Statement, Statement on Final Money Market Fund Reforms; Form PF Reporting Requirements for Large Liquidity Fund Advisers; Technical Amendments to Form N-CSR and Form N-1A (July 12, 2023).

[19] The fund board is best-positioned to consider the interests of all fund shareholders and in appropriate circumstances evaluate the costs and benefits of potential anti-dilution measures, especially considering the pooled nature of the investment vehicle and its traditional sharing of transaction costs.

is necessary, the SEC should issue a new proposal explaining in detail the particular mechanism along with a robust economic analysis that demonstrates how the benefits of such a requirement outweigh the costs. We agree with the ICI that the "alternative anti-dilution measures discussed or alluded to in the [P]roposal lack the requisite specificity for adoption without a new proposal, without violating the Administrative Procedure Act."[20] To this end, and for the same reasons, we urge the SEC to consider withdrawing the mandatory liquidity fee portion of the final money market fund rule.

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Federated Hermes strongly opposes the Proposal for all of the reasons stated in this letter and our previous submission. Please let us know if you have any questions or comments on this submission.

Sincerely,

/s/ Jane G. Heinrichs

Jane G. Heinrichs
Head of US Regulatory Affairs

cc: Chair Gary Gensler
Commissioner Hester M. Peirce
Commissioner Caroline A. Crenshaw
Commissioner Mark T. Uyeda
Commissioner Jaime Lizárraga

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[20] ICI/ICI Southwest Letter, *supra* note 9, at 10.