MUTUAL FUND DIRECTORS FORUM
The FORUM *for* FUND INDEPENDENT DIRECTORS

February 14, 2023

Ms. Vanessa Countryman
Secretary
United States 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:

The Mutual Fund Directors Forum ("the Forum")[1] welcomes the opportunity to comment on the Commission's recent rule proposals regarding swing pricing and liquidity risk management for open-end mutual funds.[2] We agree that addressing the costs and risks imposed on fund shareholders through the purchase and redemption process as well as the risks created by current liquidity risk management programs are important issues. However, as we discuss in more detail below, we believe that the Commission's proposals will upset investor expectations while also imposing significant and unnecessary costs on funds, key industry intermediaries and, ultimately, on the same shareholders that this rule purports to protect. For the reasons outlined below, we therefore oppose these proposed rules.

The Forum is an independent, non-profit organization for investment company independent directors and is dedicated to improving mutual fund governance by promoting the development of concerned and well-informed independent directors. Through education and other services, the Forum provides its members with opportunities to share ideas, experiences and information concerning critical issues facing investment company independent directors and also serves as an independent vehicle through which Forum members can express their views on matters of concern. The Forum's members take an avid interest in this rulemaking, both because they would be tasked with overseeing compliance with the rule should it be adopted and because of the costs the rule would impose on shareholders whose interests they represent in their role as fund directors.

1 The Forum's current membership includes over 1000 independent directors, representing 145 mutual fund groups. Each member group selects a representative to serve on the Forum's Steering Committee. This comment letter has been reviewed by the Steering Committee and approved by the Forum's Board of Directors, although it does not necessarily represent the views of all members in every respect.

2 *See* Open-end Fund Liquidity Risk Management Programs and Swing Pricing; Form N-Port Reporting, Release No. Release Nos. 33-11130; IC-34746; File No. S7-26-22, 87 FR 77172 (December 16, 2022) ("Proposing Release").

****

I. Swing Pricing Proposal

The Commission's proposed swing pricing mandate is motivated by its stated desire to shield longer term investors from the costs that buyers and sellers of fund shares impose on them as funds buy and sell portfolio securities, either to invest incoming funds or to meet shareholder redemptions. We agree with the Commission that longer-term shareholders can potentially incur some reduction in their ultimate returns as a result of this activity. However, the Commission fails to make a strong case that this is a problem that should be addressed, particularly through a rulemaking that would fundamentally alter investor expectations about how they manage their investments and how and when they choose to purchase or redeem fund shares. Given the long-term success of mutual funds as the primary way in which many Americans invest and save for their retirements, children's educations and fundamental life goals, the Commission should proceed cautiously before adopting rules that may render open-end funds much less attractive vehicles for retail investors.

First and most fundamentally, mandatory swing pricing would upset settled investor expectations of how the mutual funds in which they have invested function. Since the adoption of the Investment Company Act over 80 years ago, investors have understood that they can purchase or redeem mutual fund shares at the fund's NAV.[3] Investors' expectations that they can transact at NAV have only increased and become more settled as no-load funds have taken an increasing share of the fund marketplace. When investors purchase and sell shares with loads, they do so based on clear disclosure of the amount of the load, and therefore with a clear understanding of what the transaction will cost.

In contrast, the Commission's mandatory swing pricing proposal would introduce an element of complexity and randomness into fund transactions that run contrary to shareholder expectations. Because the swing factor cannot be known in advance – indeed, it cannot even be known on a given day whether it will apply to purchases or sales – it will be difficult if not impossible for individual investors to understand or to predict. Consider, for example, an investor that intends to sell fund shares that she holds. Whether and the extent of swing pricing costs that this shareholder will bear will be impossible for her to predict and potentially difficult to understand. This investor, for example, has no way of knowing whether the fund from which she wishes to redeem will have a larger dollar amount of purchases or redemptions on the day she chooses to transact, and hence has no way to predict whether she will even incur transaction costs.

These issues will deeply upset individual investors' long held understanding of how the funds they hold will work — a fundamental change for which the Commission provides little serious justification. While there may be theoretical validity to the Commission's concern that longer-term investors bear the relatively insignificant transaction costs created by the purchasing and redemption activities of other shareholders, particularly those who transact more frequently,

[3] Subject to, as we note later in the letter, to a fixed percentage load or contingent deferred sales charge that is known to the investor. All references in this comment to transacting at NAV should be understood in this context.

bearing whatever these costs are has been, in effect, part of the "deal" that investors have been making since the Investment Company Act was initially adopted.[4] In return for bearing these costs, shareholders receive the benefits of diversification, professional management and the ability to redeem whenever they choose. Altering this fundamental characteristic of funds should require significant justification – a justification that the Commission simply fails to provide in its proposal. Moreover, before imposing swing pricing on effectively all traditional open-end mutual funds, the Commission needs to make a better and more thorough case that this is a problem that needs to be addressed. Given the fundamental and successful role that open-end funds play for so many American savers and investors, this should be reason enough not to make swing pricing mandatory.

The Commission's hard close proposal will similarly upset existing investor expectations about how and when they can transact. As the Commission's proposal recognizes, in the retirement marketplace and elsewhere, a network of intermediaries has arisen that allows investors to manage their savings and investments and particularly to engage in fund transactions. This intermediary structure facilitates investors' ability to make purchases or redemptions up until the market close. Retail investors thus have significant expectations about how and when they can make transactions. In addition, market events which may occur between an earlier cutoff and the market close will not be able to be considered by a mutual fund investor, putting that investor at a disadvantage to other investors. Moreover, the ease of transacting in this way and the confidence that the ability to do so inspires is likely a significant reason why open-end mutual funds have been so successful. The Commission's proposal will disrupt these expectations, again without significant justification.

Perhaps these proposed changes would be less troublesome if they could be easily accomplished. However, adopting the Commission's mandatory swing pricing proposal would impose significant costs on the fund industry. While the Commission's cost benefit analysis is sparce and fails to estimate many of the costs that this rule would impose on funds and potentially on fund investors, even the Commission appears to sense that the costs could be significant. Moreover, the costs are numerous. Fund managers (and other parties critical to the efficient functioning of the mutual fund marketplace such as fund administrators, transfer agents and distributors) will incur costs to implement a hard close. Intermediaries likewise will incur significant costs to change their systems to comply with a hard close. And funds will experience significant costs related not just to implementation of new systems, but also the need to manage and oversee swing pricing going forward. Finally, the Commission's proposal ignores the risks and difficulties inherent in making significant changes to the multitude of systems that interact to enable mutual fund transactions.

None of these costs are incurred in a vacuum – in all likelihood, they will ultimately be passed on to fund shareholders, whether directly or indirectly, and thus will become a drag on the returns all retail investors ultimately earn through their open-end fund investments. As the Commission itself recognizes, the costs of swing pricing may lead to investors "choos[ing]to divest from the fund sector," potentially resulting in a "reduction of the economies of scale" that exist in

[4] Moreover, in the case of trading that is unduly frequent or that imposers other costs on continuing shareholders, funds and boards have other tools such as redemption fees that can be used to address this problem.

the industry today and a concomitant "further increase in fund fees."[5] Adopting a rule that reduces the appeal of open-end funds to retail investors seems nonsensical.

The impact of these costs is likely to be even more significant for smaller funds and fund groups. There is little reason to believe that the implementation costs incurred by smaller funds will be less than those incurred by larger fund groups on an absolute basis. In addition, to the extent that the costs of swing pricing and a hard close are ultimately borne by fund shareholders, the shareholders of funds in smaller fund families will bear larger costs. While it is difficult to predict, if smaller fund families are unable to bear the costs of implementation, the Commission's proposal could lead to further industry consolidation or the exit of smaller fund managers from the business. This result would certainly lead to less competition in the fund industry and could have a negative impact on innovation as well.

At the end of the day, the Commission's cost-benefit and economic analyses of the rule provide little reason to believe that mandatory swing pricing will ultimately produce a benefit for fund investors. Much of the Commission's speculation about the costs and benefits of the rule lacks quantification or cites costs that may well underestimate the true cost of the proposed rule. To the extent that the Commission wishes to better understand the potential impacts of mandatory swing pricing, it would be better served by issuing a Concept Release to develop a real data set upon which it could suggest rule amendments pursuant to which fund shareholder would recognize real benefit.

Apart from the costs associated with swing pricing, the Commission's proposal appears predicated on its belief that retail investors are forced to bear the costs of other shareholders' transactions because they lack choice. This, however, is simply not true. First, the Commission permits open-end funds to use swing pricing if they choose. The fact that none have suggests that there is no investor demand for these products – in an innovative, competitive marketplace, if retail investors desired products that offered this option, it seems likely that at least some fund managers, seeking to gain a competitive edge, would attempt offer them. The Commission offers no real evidence that investors in open-end funds desire the trade-offs and costs that swing pricing would entail. Moreover, to the extent that retail investors want other options that account for the costs of portfolio transactions differently, they have numerous options, whether closed end funds, interval funds, common investment trusts or exchange traded funds. The Commission is simply wrong if it believes that it must force swing pricing on retail investors because they lack other choices.

The Commission's reliance on the European fund industry to justify the adoption of these rules is similarly misplaced. The European fund industry plays a smaller role in the investments and savings of European retail investors than the fund industry does in the United States. Moreover, the European fund industry largely lacks the established intermediary and retirement infrastructure that has both been fundamental to the success of the U.S. fund industry and that makes it unnecessarily expensive and complicated to adopt the changes the Commission sees as necessary to enable a shift to swing pricing. Finally, and most importantly, swing pricing is generally not mandatory in Europe, but is rather an option that European fund managers can use to respond to differences in the European market structure and the needs and desires of European

[5] Proposing Release at 296.

investors. Given that, it is hard to understand how the European experience somehow justifies the imposition of mandatory swing pricing on the very different U.S. fund marketplace.

In sum, the Commission's analysis of mandatory swing pricing provides insufficient reason for it to proceed to adopting the rule. Instead, if the Commission suspects that mutual fund investors are bearing unnecessary costs, it would be better served to issue a concept release and develop a much more detailed and thorough record that would allow it to propose a rule much more narrowly tailored to address any significant problems that can be addressed in a way that both preserves the appeal of open end funds for retail investors and that is clearly cost-effective.

II. Liquidity Risk Management Programs

The Commission is also proposing notable changes to the rule governing how funds manage their liquidity. As a general matter, we agree that it is crucial for funds to accurately understand and manage the liquidity of their portfolios so that they can effectively process redemptions, whether under normal or stressed market conditions. However, we question whether the Commission's proposals go too far in this area and will make it unnecessarily difficult for fund managers to implement certain strategies or achieve the best possible returns on behalf of their shareholders.

Most notably, the rule would:

- Eliminate the "less liquid" category in funds' liquidity management programs, and require that assets currently classified as less liquid instead be classified as illiquid.
- Eliminate the ability of managers to classify investments based on asset class, and instead require that investments be classified individually.
- Require funds to analyze the liquidity of portfolio securities based on a stressed trade size rather than a reasonably anticipated trade size.
- All open-end funds (apart from ETFs) would be required to adopt a highly liquid investment minimum of at least 10%.

Without commenting on any of these proposals specifically, we question whether the Commission has adequately explained or justified the need for the rules. The proposed amendments, if adopted, will limit fund advisors' ability to manage open-end funds, including, in some cases lowering returns, increasing costs, and rendering certain investment strategies untenable for traditional open-end funds. Moreover, the underlying rules governing liquidity risk management have been amended, in some cases substantially, in recent years. As a general matter, open-end funds have performed well under stressed conditions in recent years, including during the stresses that occurred during the beginning of the COVID pandemic in 2020. While open-end funds certainly did not shield investors from the market losses – they are not, after all intended to do so – they were generally able to meet redemption requests successfully. The Commission should therefore engage in a much more detailed analysis before adopting amendments that will potentially handcuff managers and reduce the choice available to retail investors.[6]

---

6 Parts of the Commission's discussion of the proposed amendments suggests that its real concern is the potential liquidity concerns bank loan funds may experience in stressed market conditions. *See, e.g.,*

III. Conclusion

For the reasons outlined above, we have deep concerns about the Commission's proposed rulemaking. We encourage the Commission to use its regulatory authority to develop better data on whether the problems it identifies in this proposed rulemaking are of sufficient importance to warrant rule amendments that could decrease the attractiveness of open-end mutual funds to retail investors, increase the costs of investing in open-end funds and limit the strategies that can be effectively managed within the structure.

We would welcome the opportunity to discuss these comments in further detail. Please feel free to contact David Smith, the Forum's General Counsel, at david.smith@mfdf.org or 202-507-4491 or Carolyn McPhillips, the Forum's President, at carolyn.mcphillips@mfdf.org or 202-507-4493.

Sincerely,

David B. Smith, Jr.
Executive Vice President and General Counsel

---

discussion at Proposing Release p. 35. Without expressing a view on whether these concerns are legitimate, to the extent that this is the Commission's concern, we suggest that the Commission fully analyze the issues potentially faced by bank loan funds and then propose any regulatory changes limited to bank loan funds that it believes are appropriate to address the issue it identifies.