Draft as of September 11, 2023
To be discussed at the September 21, 2023 meeting of the Investor Advisory Committee

Recommendation of the SEC Investor Advisory Committee's
Investor-as-Purchaser Subcommittee regarding
Open-End Fund Liquidity Risk Management Programs and Swing Pricing

On March 2, 2023, the Investor Advisory Committee (IAC) held a panel discussion[1] on the SEC's recent proposal on open-end fund liquidity.[2] Among other elements, the SEC proposes to mitigate the potential dilution of open-end fund shareholders' interests by requiring a fund to use swing pricing, implemented through a "hard close," to adjust the fund's net asset value ("NAV") per share and pass on transaction costs to redeeming or purchasing shareholders. Our panel included representatives from Columbia University Business School, the Investment Company Institute, the Spark Institute and Vanguard. The panelists discussed a wide range of topics related to the SEC proposal, including the economic evidence regarding open-end fund shareholder dilution during stressed periods (particularly March 2020), the experience of European regulated funds in using swing pricing and the potential impact of swing pricing and hard close requirements on retirement savers. The discussion centered on investor protection and how the SEC's proposal might promote, or alternatively, adversely impact, investors' interests.

We describe the swing pricing and hard close elements of the proposed rule below, including the SEC's economic analysis and investor and industry response to the proposal. We also discuss the approach to swing pricing that the SEC took in its recent rulemaking on money market fund reform. Given the concerns about the impact of the proposal on Main Street investors and retirement savers we conclude by recommending that the SEC consider ways to narrowly tailor any final rule specifically to the risks observed and to minimize any impact on these investors.

Proposed Swing Pricing and Hard Close

The SEC issued its proposal in the context of concerns that, even for funds that manage their liquidity effectively, transaction costs associated with redeeming shareholders can create dilution for remaining fund shareholders. To address this concern, the SEC's proposal would require an open-end fund (but not a money market fund or ETF) to adjust its daily NAV to pass on transaction costs to redeeming or purchasing shareholders, rather than diluting other shareholders. Specifically, the proposal would require funds to adjust NAV per share by a "swing factor" when the fund experiences net redemptions or when net purchases exceed a threshold. The swing factor would reflect bid-ask spread and certain other costs of selling or purchasing a vertical slice of the fund's portfolio.[3]

[1] https://www.youtube.com/watch?v=h8RFxcocg_g.
[2] https://www.sec.gov/files/rules/proposed/2022/33-11130.pdf (the "Proposal").
[3] It would also include an estimate of market impact costs when net redemptions or net purchases exceed a threshold.

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For funds to implement swing pricing, the proposal also would require a "hard close." In a hard close, a shareholder's purchase or redemption order would be eligible for a given day's price only if the fund, its transfer agent, or a registered clearing agency received the order before the time as of which the fund calculates its NAV, typically 4 p.m. ET. Under current practice, a shareholder would receive a given day's price if an intermediary (e.g., broker-dealer) received the order during that timeframe. The SEC believes that proposed hard close would help operationalize swing pricing by ensuring that funds receive timely flow information to allow them to assess and calculate the swing factor.

The SEC's Economic Analysis

While the SEC concludes in its economic analysis that investors would benefit from the proposal's efforts to mitigate dilution, it also acknowledges that swing pricing used in other jurisdictions has mitigated stress only in "certain" cases and "may not always fully reduce the potential first-mover advantages" it is seeking to relieve.[4]

Regarding costs of the proposal, the SEC acknowledges that it is not able to quantify many of the costs associated with the proposed swing pricing framework because it lacks data on fund operating costs and predictive models for investors who would experience an increase in costs to invest in mutual funds and replace their open-end funds with other investment vehicles, among other reasons. For similar reasons, the SEC acknowledges it is not able to quantify the costs of the hard close requirement, including because it does not have access to "detailed information about the number of intermediate steps" between an investor placing an order and a fund receiving an order.[5]

Since the time of the proposal, several commenters have provided quantitative data and qualitative economic analysis that merit careful review. In particular, the comment file has provided data on the perceived benefit to investors of reduced dilution[6] as well as the costs to investors, particularly retirement savers,[7] stemming from swing pricing and a hard close. Several of those analyses illuminate issues that were not addressed in the SEC's economic analysis, including one analysis estimating that a "set and forget retirement plan participant… could face an erosion of approximately $53,342 of retirement savings over a 26-year period" due to the costs of the SEC proposal to impose swing pricing with a hard close.[8]

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[4] Proposal at 233.

[5] See Proposal at 302-21.

[6] See, e.g., (Yiming Ma: https://www.sec.gov/comments/s7-26-22/s72622-20153065-320629.pdf)

[7] See, e.g. (Chamber: https://www.sec.gov/comments/s7-26-22/s72622-235259-490642.pdf (the "Chamber Analysis"); Investment Company Institute: https://www.sec.gov/comments/s7-26-22/s72622-20157306-325651.pdf).

[8] See Chamber Analysis.

As discussed further below, we believe that the SEC and staff should incorporate these data and analyses in an updated economic analysis that fully evaluates the benefits and costs to investors.

Public Response to the Proposal

Thousands of commenters submitted responses to the proposal. Almost without exception, commenters saluted the SEC's commitment to investor protection.

Overwhelmingly, however, many commenters, including bipartisan members of Congress,[9] investor groups,[10] and industry participants, raised concerns about the practical impact of the proposal on Main Street investors and retirement savers. Objections from these communities focused on the following issues:

- The competitive advantage that sophisticated investors, which can predict, time, and structure their trades, would have over retail investors, who would bear the brunt of swing pricing costs;
- The costs to retirement savers whose redemption or purchase orders must first run through a retirement plan recordkeeper before reaching the fund;
- The disadvantage that retail investors that seek advice and services from an intermediary would have compared to investors who invest directly with funds; (approximately 80% of mutual fund investors invest through an intermediary);[11]
- The disadvantage to investors physically located on the West Coast, who may not have the ability to make trades during normal trading hours due to the hard close;
- The impact on open-end funds, which could become more costly and less attractive, to retail investors, despite being a transparent and reliable investment product;
- The complications and operational risks that a hard close could impose on investors in fund of funds and life insurance and annuity products;
- The lack of evidence that open-end funds have been unable to meet redemptions, even during stressed market conditions;
- The lack of evidence that the experience of some funds applying swing pricing in other jurisdictions would be applicable in the US market with a vastly different investor base and market structure; and
- The likelihood of investor confusion on trade cut-off times, swing pricing adjustments, and inability to receive same-day pricing.

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[9] See, e.g. (Wagner/Sherman: https://www.sec.gov/comments/s7-26-22/s72622-20160286-328932.pdf).
[10] See, e.g. (Healthy Markets: https://www.sec.gov/comments/s7-26-22/s72622-20158488-326470.pdf; Consumer Federation of America: https://www.sec.gov/comments/s7-26-22/s72622-20157315-325658.pdf).
[11] See SIFMA AMG: https://www.sec.gov/comments/s7-26-22/s72622-20157254-325503.pdf.

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Lessons from the Money Market Fund Reform Rulemaking

Before proposing swing pricing for most open-end funds, the SEC had proposed requiring that tool for certain money market funds.[12] The SEC proposed swing pricing in this context because it found that certain prime money market funds, unlike open-end funds, were subject to "fees and gates" that provided strong incentives to shareholders in March 2020 to redeem shares. This liquidity event led the Federal Reserve to establish a Money Market Mutual Fund Liquidity Facility to purchase securities from money market funds and un-freeze markets.

Specifically responding to this observed risk, the SEC adopted money market fund reforms this year. The SEC jettisoned its proposal for swing pricing for money market funds and adopted a liquidity fee instead, albeit without having issued a full economic analysis for liquidity fees in the proposal stage.

The SEC adopted liquidity fees in an effort to reduce operational burdens compared to swing pricing. The adopted reforms were narrowly tailored to apply only to institutional prime and institutional tax-exempt money market funds (excluding retail and government money market funds). The liquidity fees for those funds would trigger only when daily net redemptions exceed five percent and when the costs associated with such redemptions are more than *de minimus*.

IAC Recommendations

The IAC applauds the efforts of the SEC to promote the protection of retail investors. While the IAC supports the SEC's aims in this rulemaking, we recognize that many commenters' concerns about the impact of swing pricing and a hard close on retail investors and retirement savers have not yet been fully explored or considered in a cost-benefit analysis. Given this context, the IAC makes the following recommendations, with the goal of achieving the stated objectives in making the proposal.

1. **The SEC should expand and revisit its economic analysis to incorporate the comprehensive information commenters provided on the costs and benefits of swing pricing and hard close.** The SEC acknowledged that the economic analysis in its proposal was incomplete for lack of data and models on several crucial investor impact measures. Moreover, the comment file has elevated additional areas of potential investor impact that were not fully studied in the proposal. Given the bolstered availability of qualitative and quantitative analysis, the SEC should revisit its economic analysis before making any conclusion for supporting the final adoption of swing pricing and a hard close. A robust and fully considered economic analysis is not only "a matter of good regulatory practice"[13] but also supports the validity of the SEC's rulemaking.

[12] https://www.sec.gov/rules/2021/12/money-market-fund-reforms; https://www.sec.gov/files/rules/final/2023/33-11211.pdf.

[13] https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf.

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2. **The SEC should further examine anti-dilution alternatives such as liquidity fees and conduct a robust cost-benefit analysis.** The Proposal asks for comments on alternatives to swing pricing which could require funds to pass on costs resulting from shareholder purchase or redemption activity. The alternatives suggested included the imposition of liquidity fees, dual pricing, and alternatives to a hard close such as indicative or estimated order flows. However, most commenters did not focus on these alternatives as the Commission expressed its preference for swing pricing and a hard close. We therefore urge that the Commission seek additional input on such alternatives and conduct a robust economic and cost benefit analysis before proceeding with any of these alternatives. The various alternatives could be structured and designed in various ways. For example, liquidity fees could be static or dynamic as discussed in the proposing release. Additional comment on the design and structure of liquidity fees would be particularly relevant given their recent adoption for certain money market funds. The Commission could invite additional input through extending the comment period on the Proposal, issuing a concept release, establishing working groups of relevant stakeholders or getting additional input through roundtable discussions.

3. **As it did in the Money Market Fund Reform final rule, the SEC should narrowly tailor any requirement for open-end fund liquidity management tools to actually observed risks, with an aim to reduce burdens on retail investors.** While we do not make any recommendation as to whether a mandatory liquidity fee may or may not be a preferable alternative to swing pricing, given the lack of a full cost-benefit analysis for that tool, we support the SEC's approach in the Money Market Fund Reforms rulemaking in two crucial ways. First, the mandatory liquidity fee requirement applied only to those institutional funds that the SEC found had a nexus to observed outcomes in March 2020, thus excluding retail-facing funds from any mandatory levy. Second, the mandatory fee had a heighted threshold for application (*i.e.*, redemptions over 5%) and a *de minimus* exception. These approaches will spare retail investors from the impact of the mandatory fee and lessen the impact on other investors. We recommend the SEC keep in mind these goals in considering their approach to other open-end funds: tying any requirements to observed risks, minimizing, if not eliminating, direct impact on retail investors, and reducing impact on other industry participants to only that which is necessary.

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