Vanessa A. Countryman
Securities and Exchange Commission
100 F St NE
Washington, DC 20549

February 14, 2023

Re: Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting (File No: S7-26-22)

Secretary Countryman,

The Americans for Financial Reform Education Fund appreciates this opportunity to comment on the Securities and Exchange Commission's ("the Commission") proposal to better protect investors and the collective financial systems from the $21 trillion open-end funds that have shown to be vulnerable to sudden and large withdrawals, in turn leading to the sudden fire-sales of assets and further contagion.

Open-end funds have unique features and have repeatedly presented issues to the broader financial system that require the Commission to intervene

Open-end funds issue new shares when investors want to purchase the fund and repurchased and taken out of circulation when they sell them. The price at which they buy and sell is measured by a single price that reflects the value of all its assets or Net Asset Value (NAV).

The need for open-end funds to repurchase the shares its investors want to sell leave many vulnerable to problems when many investors try and sell their shares at the same time.

First, large withdrawals from open-end funds leave other remaining investors to bear the cost for the seller's decision, including forced portfolio sales to meet the redemption. This action unfairly leaves the remaining investors in open-end funds bearing the costs of the selling investor who does not share in those costs. This is also a reason many have argued that the earliest sellers from open-end funds benefit from a "first mover advantage".

Second, even as open-end funds have grown to $21 trillion in size, bringing them nearly to the same size as the balance sheets of the banking sector[1], there are few safeguards in place to stop a negative feedback loop of large withdrawals leading to forced sales by the funds that in turn lead to falling asset prices and additional redemptions.[2] Open-end bond funds in particular experienced over $100 billion in outflows in March 2020[3] or outflows averaging 10% of its NAV.[4]

The problems associated with this inherent liquidity mismatch in open-ended funds have emerged even before March 2020, however. For example, in December 2015, a $2.5 billion fund from Third Avenue Management heavily invested in higher risk and lower quality corporate credit, suffered $1.71 billion in outflows and losses[5] as investors were worried about a selloff in corporate bond prices. Third Avenue was eventually forced to wind the fund down.[6]

This disorder was not only limited to Third Avenue Management but also other funds such as the $3.85 billion hedge fund Whitebox Advisors, which also had to wind down three of its mutual funds as those funds were also heavily concentrated in illiquid corporate credit positions.[7]

The Commission should implement a dual approach of both swing pricing and imposing liquidity buffers

To address these problems inherent in open-end funds, the Commission should consider an approach that addresses:

1. The dilution other investors currently unfairly absorb in response to a selling investor, and
2. The need to hold ample liquidity reserves for the fund to better withstand volatile periods when investors want to redeem, regardless of the additional liquidity costs

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[1] Board of Governors of the Federal Reserve System. Total Assets, All Commercial Banks. Accessed Feb 13, 2023. https://fred.stlouisfed.org/series/TLAACBW027SBOG

[2] Lewrick, Ulf. Bank of International Settlements. Open-ended bond funds: systemic risks and policy implications. Dec 6, 2021. https://www.bis.org/publ/qtrpdf/r_qt2112c.htm

[3] Investment Company Institute. https://www.brookings.edu/wp-content/uploads/2021/08/Open-end-bond-funds-saw-huge-outflow-at-onset-of-pandemic.jpg

[4] Falato, Antonio and Goldstein, Itay and Hortacsu, Ali. University of Chicago Becker Friedman Institute. Financial Fragility in the COVID-19 Crisis: The Case of Investment Funds in Corporate Bond Markets. April 2021. https://bfi.uchicago.edu/wp-content/uploads/BFI_WP_202098.pdf

[5] Salditt, Richard. Bloomberg Intelligence. Caution Ahead – Accident on Third Avenue. Dec 17, 2015.

[6] Stein, Charles. Bloomberg News. Third Avenue Plans to Liquidate Focused Credit Fund After Losses. Dec 10, 2015. https://www.bloomberg.com/news/articles/2015-12-10/third-avenue-plans-to-liquidate-focused-credit-fund-after-losses

[7] Zuckerman, Gregory and Krouse, Sarah. Wall Street Journal. Hedge Fund Firm Whitebox Closes Its Mutual Funds. Dec 28, 2015. https://www.wsj.com/articles/hedge-fund-firm-whitebox-closes-its-mutual-funds-1451349226

The Commission should therefore adopt a dual approach of implementing swing pricing as well as requiring minimum liquidity reserves and/or set redemption intervals[8] that are both set that are set based on the fund's overall liquidity profile.

Implementation of "swing pricing" would address the "first mover" advantage problem of open-end funds but will also require widespread systems updates to implement

We support the Commission's proposals to amend Rule 22c-1 and enact "swing pricing," a process where the NAV of the fund incorporates the additional costs of selling its shares when the inflows/outflows of the fund exceed a certain threshold.

Open-end funds continue to face this unique challenge where a decision to redeem by an investor is not borne by itself but rather the remaining investors in the fund. In times of stress, this dynamic becomes far more noticeable as investors who choose to redeem first get far better prices than the investors who redeem later, which, by itself, is inherently destabilizing.

However, as the Commission acknowledges, significant operational improvements would need to be made to the ecosystem of companies behind open-end funds including transfer agents, broker-dealers, recordkeepers, and the National Securities Clearing Corporation, especially if the Commission is proposing a hard close deadline of 4pm Eastern Time for fund investors to submit an order to qualify for that day's prices.

A number of funds, however, often do not know the full size of their inflows and outflows until the evening or the next morning.[9] Several funds also receive orders for intermediaries such as 401k plan administrators and financial advisers where requests can be submitted up until the Commission's proposed 4pm hard close deadline, forcing those end investors to wait another day.

Despite these challenges, we support the Commission's 4pm hard close as any continued delay between the NAV to the prices of the fund's underlying assets incentivizes investors in the fund to sell first to receive the current price while the fund may receive the trade order the next morning, potentially having to sell additional assets whose costs are borne by the remaining investors.[10]

While the Commission certainly has a strong case to implement swing pricing on open-end funds to better protect all investors in open-ended funds from seeing the value of their holdings getting diluted from a large seller whose costs are passed to the fund's remaining investors, the

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[8] Brookings Institution. Task Force on Financial Stability. June 2021. https://www.brookings.edu/wp-content/uploads/2021/06/financial-stability_report.pdf

[9] Kashyap, Anil and Kohn, Donald and Wessel, David. Brookings Institution. What is swing pricing? Aug 3, 2021. https://www.brookings.edu/blog/up-front/2021/08/03/what-is-swing-pricing/

[10] Tarullo, Daniel. Brookings Institution. The SEC should – and can – pay more attention to financial stability. May 13, 2021. https://www.brookings.edu/blog/up-front/2021/05/13/the-sec-should-and-can-pay-more-attention-to-financial-stability/

Commission should strongly consider coordinating with the Department of Labor (who oversees retirement plans) and all of the participants involved with these funds to ensure that the significant operational upgrades are made to properly implement swing pricing.

Open-end funds should hold the equivalent of reserves depending on the illiquidity of its portfolio

In addition to implementing swing pricing, we also suggest the Commission amend rule 22c-1 in a way that requires open-end funds to hold a percentage of its net assets in highly liquid assets so that it can still find enough liquidity to meet large redemptions.

Although swing pricing addresses the problems of the first mover advantage in open-end funds and the ensuing dilution the other remaining investors experience, swing pricing alone does not address the challenges a fund experiences when its investors are heavily motivated to redeem regardless of paying the shared costs of redeeming.

Instead of the Commission's proposal of a flat 10% of the fund's net assets to be invested in highly liquid assets, we instead propose a percentage of liquid reserves that are determined by the illiquidity of the assets they are invested in.

As part of that, we support the Commission's proposal to an open-end fund's liquidity buffer to vary based on three different categories, similar to how banking regulators classify level 1, level 2A, and level 2B assets under the Basel III accord.[11] Such distinctions are important especially as some open-end funds invest predominantly in bank loans,[12] which still can take more than 20 days to settle.[13]

The Commission should therefore mandate open-end funds' comply *monthly* with a varying range of minimum liquidity buffers determined by the overall illiquidity across its portfolio.

Conclusion

The Commission plays an important role as a member of the Financial Stability Oversight Council (FSOC) in addressing the inherent liquidity mismatch between the near-daily liquidity most of the $21 trillion open end funds offer their investors while they own many assets that can take days or weeks to sell.

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[11] Yankov, Vladimir. Board of Governors of the Federal Reserve System. The Liquidity Coverage Ratio and Corporate Liquidity Management. Feb 26, 2020. https://www.federalreserve.gov/econres/notes/feds-notes/the-liquidity-coverage-ratio-and-corporate-liquidity-management-20200226.html

[12] Cetorelli, Nicola and La Spada, Gabriele and Santos, Joao A.C. Federal Reserve Bank of New York. Monetary Policy and the Run Risk of Loan Funds. March 2022. https://www.newyorkfed.org/research/staff_reports/sr1008.html

[13] Seligson, Paula. Bloomberg News. Old-School Leveraged Loan Market Is a Step Closer to Ditching Faxes. Mar 16, 2022. https://www.bloomberg.com/news/articles/2022-03-16/old-school-leveraged-loan-market-steps-closer-to-ditching-faxes

The Commission is finally addressing the issues around how open-end funds are inherently vulnerable to runs and as the industry has grown significantly, needed to rely on government backstops[14] (which is a form of free insurance the industry does not pay for). The Commission's proposals are an important step to reforming this industry, better protect investors, and safeguard the financial system.[15]

If you have any additional questions, do not hesitate to reach out to Andrew Park at andrew@ourfinancialsecurity.org. Thank you.

Sincerely,

Americans for Financial Reform Education Fund

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[14] Claessens, Stijn and Lewrick, Ulf. Bank of International Settlements. Open-ended bond funds: systemic risks and policy implications. December 2021. https://www.bis.org/publ/qtrpdf/r_qt2112c.pdf

[15] Cai, Fang et al. Board of Governors of the Federal Reserve System. New Insights from N-CEN: Liquidity Management at Open-End Funds and Primary Market Concentration of ETFs. Jan 11, 2023. https://www.federalreserve.gov/econres/notes/feds-notes/new-insights-from-n-cen-liquidity-management-at-open-end-funds-and-pmc-of-etfs-20230111.html