# Statement on Open-End Fund Liquidity Risk Management Programs and Swing Pricing

## Commissioner Daniel M. Gallagher

**Sept. 22, 2015**

Thank you, Chair White. Before getting started, I would like to thank the staff from the Division of Investment Management for all their hard work on today's release, especially Dave Grim, Diane Blizzard, Sarah ten Sietoff, Sarah Buescher, Melissa Gainer, Naseem Nixon, and Amanda Wagner. In addition, I want to recognize the foundational work done by former director Norm Champ. And of course I want to recognize the hard work of the staff from the Office of the General Counsel and the Division of Economic and Risk Analysis.

Today's set of proposals is the second of a series of Commission initiatives intended to improve our regulatory program for the asset management industry. Back in May, I was pleased to support the Commission's proposals to modernize and enhance the information reported to the Commission and investors. Those proposals, if adopted, will enhance our ability to monitor for risks by updating and streamlining the types of data to be reported in important and developing areas such as fund investments in derivatives. We would also be able to harness the power of technology through the tagging of reported data. As I noted then, the rules would further enhance our current and already robust oversight of the industry at a time when false claims are being made by bank regulators and other self-described experts that our regulatory program is deficient and that the industry and its participants pose systemic risks.

The proposals before us today are an excellent example of a Commission initiative that focuses on our core responsibilities – what I often refer to as the basic "blocking and tackling." While our earlier proposals focused on improving data reported to the Commission and disclosed to investors, today's proposal focuses on an important operational risk in the open-end fund world – namely, that of liquidity risk.

Over the years, I have spoken a number of times about the critical need to monitor and address potential liquidity issues in the U.S. capital markets.[1] While most of my statements have focused on liquidity issues in the corporate and municipal bond markets, liquidity considerations also play an important role in the context of open-end funds. Indeed, a hallmark feature of open-end funds distinguishing them from other types of pooled investment vehicles is the fund investor's ability to redeem shares back to the fund for the investor's proportional share of the fund's net asset value. This feature is enshrined in Section 22(e) of the Investment Company Act, which essentially requires open-end funds to honor redemption requests within seven days after tender of the fund's securities.

Investors have been well served by the addition of new products designed to meet their demand for exposures to a broader universe of asset classes and strategies. While funds in the days of old focused their investment strategies on more traditional asset classes such as large-cap equities, more recently, fund offerings have expanded into new asset categories and

strategies of varying liquidity profiles, including bonds and so-called alternative investments. The proposals before us today preserve the availability of these new options for investors. Rather than prohibit these types of funds, which would be the wrong course, the proposals would ensure that funds investing in less-liquid assets are able to maintain liquidity for investors that is not only required by the Investment Company Act, but that investors have come to expect in choosing to invest in these products.

I am particularly pleased to see that the proposals include a scaled compliance period for smaller funds. I pushed for a scaled compliance period for the May proposals, and to my knowledge, that marked the first time an investment company-related rulemaking contained an accommodation for small funds. A scaled compliance period allows smaller funds a longer period to implement necessary changes to their systems and procedures. I hope and expect that the Commission will continue to recognize the challenges faced by smaller funds in future investment company rulemakings.

I am also pleased to see that we are allowing a comment period longer than the 60-day period that is typically given for most proposals. A longer comment period helps ensure that we receive thoughtful comment, and shows that we are serious about soliciting and considering comments, particularly in rulemakings of significant impact.

Although I support issuing today's proposals for public comment, I have reservations about two aspects of the proposals – namely, the three-day liquid asset minimum and the use of swing pricing.

In the case of the three-day liquid asset minimum, funds would be required to establish a minimum amount of their assets that must be held in cash or assets convertible to cash within three business days. Although Section 22(e) generally requires funds to pay redemption proceeds within seven days, the rule would require all funds to determine their "three-day bucket" and limit their portfolios accordingly. The theory behind the "three-day bucket" is that most funds as a practical matter must meet redemptions within three business days as a result of Rule 15c6-1 under the Exchange Act.

However, there appears to be a potentially sizable portion of the industry that is not restricted by Rule 15c6-1, and therefore, would only be required to pay redemptions within seven days. I am uncomfortable with the "one-size-fits-all" three-day approach. On the flip side, there are funds that endeavor to pay redemption proceeds within a period of less than three days. In each of those cases, the "three day bucket" has limited relevance. Furthermore, for funds that invest solely in assets that can be settled in three days or less – for example, a fund that limits its investments to equity securities of S&P 500 companies – the "three-day bucket" has no functional value. Requiring such a fund to set its three-day bucket – whether it be at 1%, or 20% or even 90% – would be a meaningless exercise given that the entire portfolio would be comprised of assets settled in three days or less. I encourage commenters to weigh in on this requirement. For example, are there ways the rule can be more appropriately tailored? Should any final rule instead match up with the seven-day requirement statutorily mandated by Section 22(e)?

I am also concerned about the proposal to permit the use of swing pricing. In particular, I believe that swing pricing could cause disproportionate harm to retail investors. As proposed, funds opting to engage in swing pricing would be required to set one threshold that would

apply equally to both net redemptions and net purchases. Thus, if the applicable threshold is met because of trading by a large institutional investor, a small investor that had the unfortunate luck to trade in the same direction as the institutional investor that day would likewise bear the impact from the amended price. Also, many retail investors invest in funds through paycheck debits and other automatic payment schedules, and would thus run a continual risk of their purchase orders being placed on a day that the swing threshold is met.

Further, requiring funds to set a single swing threshold that would apply equally to both net purchases and net redemptions does not account for the variation among funds. I fear that this inflexibility greatly reduces the utility of swing pricing as a tool to mitigate dilution. Funds are in the best position to understand their portfolios, shareholder base and fund flows. If the Commission ultimately adopts final rules permitting swing pricing, those rules should give funds the flexibility to craft their swing pricing procedures as appropriate. For example, one fund may find it beneficial to adopt swing pricing only in the case of net redemptions. Another fund may find it beneficial to adopt swing pricing on both the purchase and redemption side, but may wish to adopt different thresholds for each side of net flows. And finally, we need to know if this radical shift in pricing is susceptible to disclosure that can be understood by retail investors.

As I noted earlier, today's proposal is the second of a series of upcoming rule proposals governing the asset management industry. While these are important proposals, we must also recognize that they involve significant costs that will ultimately be borne by investors in the form of higher expense ratios, and higher expense ratios in turn reduce shareholder returns.

The Commission must be mindful of the effect of these regulatory costs as it considers any rulemaking initiatives – not only because we are required by law to do so, but because these costs directly impact the bottom line for the many Americans who rely on funds to save for retirement, college, and other important financial goals. Our investor protection mandate should not be read to apply only in the direction of increasing burdens. We should actively seek to reduce burdens so that investors can make the most of their investment.[2]

As many of you know, this is likely my last open meeting as Commissioner. It has been an honor and a privilege to work with my fellow Commissioners and the staff over the last four years. While at times I may not have agreed with or otherwise seen eye to eye with some items that have come across my desk, I have consistently respected the hard work that Commission staff puts in every day and the contributions of my colleagues on the Commission. While it is normal to laud the staff in open meetings, and that is entirely appropriate, I would like to close by lauding my fellow Commissioners. Each of us has made real and sometimes significant sacrifices to take on this job. And each of you, like me, has experienced moments when the job seems thankless, at best. I know and respect each of you, as I have your predecessors, and I wish you all the best as you continue to serve the nation at this important time.

I have no questions.

[1] *See, e.g.*, Commissioner Daniel M. Gallagher, Speech, *A Watched Pot Never Boils: the Need for SEC Supervision of Fixed Income Liquidity, Market Structure, and Pension Accounting* (Mar. 10, 2015), *available at* https://www.sec.gov/news/speech/031015-spch-cdmg.html;

Commissioner Daniel M. Gallagher, Speech, *Remarks Regarding the Fixed Income Markets at the Conference on Financial Markets Quality* (Sept. 19, 2012), *available at* https://www.sec.gov/News/Speech/Detail/Speech/1365171491192.

[2] A couple of initiatives come to mind. For example, we should consider rules that would codify routine exemptive orders. One candidate is rule 15a-5 under the Investment Company Act, a rule we first proposed back in 2003, which would replace the commonplace manager-of-manager orders. We should also continue to review our various rules on the delivery of fund disclosure documents to investors to determine whether we have now reached an age where electronic delivery is appropriate.

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*Modified: Sept. 22, 2015*