OPINIONS

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SEC's Reforms to Mutual Funds Will Hurt Investors

US regulator's proposals for mandatory swing pricing are ill-founded and unworkable

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Mutual funds have been foundational to American retail investing for almost a century. They democratised investing, presenting the first effective way for the middle classes to pool assets to achieve market returns. But the US Securities and Exchange Commission has proposed a reworking of how mutual funds are priced, bought, and sold—which threatens to permanently damage these products.

The SEC wants to require swing pricing for all mutual funds, which would involve funds having to "swing" their daily share price, changing the net asset value any time transactions, such as large redemptions, cross a threshold mandated by the SEC. Unlike in Europe, where swing pricing is optional, the SEC wants to push funds into a one-size-fits-all regime without addressing the immense operational challenges of implementing such a policy.

As part of this aggressive proposal, the agency will force funds to implement a "hard close" for orders at 4pm Eastern Time. Any orders that haven't reached the fund by that time won't be accepted and priced until the next day. This dramatic change is ostensibly so that funds can apply swing pricing based on flows. Yet it will require brokers and retirement plans to impose far earlier cut-off times for orders, meaning investors will lose full access to trading at today's price during normal market hours.

This may just sound like an efficiency question. In reality, it's reworking the fund market's entire plumbing. If an order reached your broker (and not the fund) only a few hours before the cut-off, it wouldn't receive today's price. Instead, it would be pushed to tomorrow's. For those millions of Americans who use mutual funds to save for college or retirement—100mn, according to our data—this would cause huge confusion. And it would discriminate against Americans by time zones. Its inherent unfairness has already drawn bipartisan criticism from Congress.

The SEC claims that mandatory swing pricing will address dilution: the idea that redeeming shareholders imposes costs on those remaining in the fund. But this is the nature of a collective investment—everyone enters and exits at some point. Furthermore, we estimate that the actual amount of daily dilution is on average just hundredths to tenths of a basis point, far too small to incentivise redemptions and barely a blip compared with the long-term returns investors receive from funds.

The more likely reason for the proposal is that the SEC is trying to appease central bankers, who for years have complained that open-ended funds are riskier than banks because the so-called “liquidity mismatch problem” makes them susceptible to runs.

Unfortunately, destabilising runs in the banking sector in recent weeks confirm that policymakers’ narrow focus on open-ended funds has been misplaced. And there is scant evidence that mandatory swing pricing will do much to change investors’ responses to economic turmoil. These could range from a dash-for-cash due to financial uncertainty, to a lack of liquidity in the short-term funding markets, to a credit crisis, or to sharp changes in macroeconomic conditions. Making markets more resilient to the challenges that arise in these situations should be the highest priority for central bankers and the SEC.

The proposal is not supported by data and barely addresses the costs or benefits to investors. Funds themselves would also incur significant costs, with the “hard close” necessitating system upgrades for all users including custodians and transfer agents. It also unnecessarily risks disrupting the US capital markets as investors move into other products. It is ironic that the SEC is sending the US in this direction when the promotion of sound retail investor participation in capital markets seems to be a big goal elsewhere in the world, such as the EU’s retail investment strategy.

The SEC should tread very carefully: its unworkable proposal is bad news for the country’s 100mn mutual fund investors.

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