February 14, 2023

Via Electronic Submission

Ms. Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: File No. S7-26-22: Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting, Investment Company Act Release No. 34746

Dear Ms. Countryman:

The LSTA[1] appreciates the opportunity to comment on the proposed amendments to the rules for open-end management investment companies ("open-end funds")[2] regarding liquidity risk management ("LRM") programs and swing pricing (the "Proposed Rule").[3]

As a preliminary matter, we are concerned that the Securities and Exchange Commission (the "Commission") has not provided sufficient time for thoughtful feedback on the Proposed Rule. The LSTA recently joined several other financial industry trade associations in submitting a letter expressing its concerns regarding the Commission's unreasonably short comment periods for a plethora of proposed rules. The Commission has provided only 60 days, since publication in the Federal Register, for comment on the Proposed Rule, which proposes extensive and complex changes to the existing LRM and pricing regime for open-end funds, including potentially forcing the liquidation of certain existing funds and thus eliminating a valuable product for retail investors.

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[1] The LSTA is a not-for-profit trade association that is made up of a broad and diverse membership involved in the origination, syndication, and trade of commercial loans. The nearly 600 members of the LSTA include commercial banks, investment banks, broker-dealers, hedge funds, mutual funds, insurance companies, fund managers, and other institutional lenders, as well as law firms, service providers and vendors. The LSTA undertakes a wide variety of activities to foster the development of policies and market practices designed to promote just and equitable marketplace principles and to encourage cooperation and coordination with firms facilitating transactions in loans. Since 1995, the LSTA has developed standardized practices, procedures, and documentation to enhance market efficiency, transparency, and certainty. For more information, visit www.lsta.org.

[2] "Open-end funds" includes mutual funds and exchange-traded funds ("ETFs").

[3] *Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting*, Investment Company Act Release No. 34746 (Nov. 2, 2022) (the "Proposing Release").

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As a result of the short comment period for the Proposed Rule and the flood of additional complex rule proposals from the Commission, this letter solely addresses the aspects of the Proposed Rule regarding the removal of the "less liquid investment" category from the liquidity classifications (and, more specifically, the impact of its removal on open-end loan funds (described below)). Accordingly, we are not able to address certain aspects regarding swing pricing and the "hard close;" although, we also have concerns regarding those aspects of the Proposed Rule. We also believe the Commission fails to comprehensively address the costs of the proposal and we briefly address the potential costs in this letter.

I. Introduction

We understand and agree with the Commission's objectives for open-end funds' LRM programs – to ensure that funds are able to satisfy redemption requests, including in stressed conditions, in a timely manner without materially diluting remaining investors. In that regard, we believe that the 2016 adoption of Rule 22e-4 "to promote effective liquidity risk management" throughout the open-end fund industry has been effective at accomplishing its goal to reduce "the risk that funds will be unable to meet their redemption obligations and mitigating dilution of the interests of fund shareholders."[4] We strongly believe, however, that the proposed elimination of the less liquid investment category and categorizing such assets as illiquid is unnecessary and unwarranted, and urge the Commission to reconsider this change, which would have material negative consequences for investors in open-end funds that invest predominately in loans (and may adversely impact certain multi-asset funds too). These consequences include significant market disruption and fire sales in the short term, while, in the long term, the elimination of a viable and useful investment product used by retail investors for more than two decades. This change would also significantly harm corporate borrowers. By failing to fully appreciate the impact of the Proposed Rule, the Commission has significantly underestimated its potential costs, and has offered insufficient evidence of benefit (especially considering the resilience displayed by open-end loan funds during March 2020, discussed below). Accordingly, we urge the Commission not to move forward with the Proposed Rule as drafted, but rather consider a more tailored approach that retains the less liquid investment category while achieving the same goal of ensuring orderly redemptions through materially less disruptive means.[5]

II. Executive Summary

A. The LSTA's comment letter focuses on "open-end loan funds," including ETFs, which are open-end funds that invest in broadly syndicated institutional leveraged term loans ("BSL Loans"). Open-end loan funds represent almost ten percent of the market for BSL Loans.[6] BSL Loans are purchased by non-bank lenders such as collateralized loan

[4] *Investment Company Liquidity Risk Management Programs*, Investment Company Act Release No. 32315 (Oct. 13, 2016) (adopting Rule 22e-4 under the Investment Company Act) (the "2016 Rulemaking").

[5] The Commission has understandably assumed that longer average settlement times for loan purchases and sales means that there is no ability to execute faster settlement in distinct cases where faster settlement is required. This is not the case, as explained below.

[6] As of December 2022, open-end loan funds held approximately 9% of outstanding BSL Loans.

obligations ("CLOs"), open-end loan funds, separately managed accounts, insurance companies and other institutions. BSL Loans are large loans to companies that are rated by nationally recognized statistical rating organizations and that trade actively in the secondary market.[7] There is approximately $1.4 trillion of outstanding BSL Loans[8] and more than $820 billion of loans traded in the secondary market in 2022.[9]

B. It is axiomatic that open-end loan funds must meet investor redemptions in a timely fashion without diluting remaining investors; the LSTA and its members agree with the Commission on this foundational principle.

C. The Commission expresses concern that "average" settlement times for BSL Loans pose the risk that open-end loan funds will not meet investor redemption requests in a timely manner, or that extended settlement will impose borrowing costs that dilute the interests of remaining investors. The Commission cites average settlement times of 23 days to support this contention.[10] In fact, when buyside parties are selling, the median settlement time is much shorter: nine days over the long-term and much shorter than that in stressed conditions.

D. For the more than 20 years that open-end loan funds have been in existence, they have timely met investor redemption requests, while mitigating dilution. They have implemented LRM programs that include liquidity modeling and the appropriate setting of a highly liquid investment minimum ("HLIM") and have employed effective management strategies and a suite of tools including active cash management and establishing committed lines of credit (which have been used only periodically, for brief periods and without incident and with limited cost to investors).[11] Further, LRM is not simply a redemption readiness exercise but also an ongoing component of effective portfolio management. These tools, among others, have protected open-end loan funds and their investors against dilution; redemptions have been met in timely fashion while providing investors with access to the asset class in a fund with daily liquidity.

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[7] These are distinct from "private credit" loans or "direct lending," which are typically smaller, are held closely by institutional lenders and do not trade actively (if at all) in a secondary market.

[8] Morningstar/LSTA Leveraged Loan Index.

[9] LSTA Trade and Settlement Study, January 2023.

[10] Proposing Release at 61 (noting that "[b]y July 2021, the average time to settle a bank loan par trade in the secondary market increased to a then seven-year high of T+23, and the median was at T+15").

[11] The LSTA surveyed fund managers that collectively manage nearly $59 billion of loans in open-end loan funds – comprising 60% of open-end loan fund assets under management - to collect information on the widespread use of these tools.

E. The ability to meet redemptions in a timely and non-dilutive manner has been tested repeatedly in stressed conditions, including during the global financial crisis and in March 2020, as well as in periods of more targeted fixed income withdrawals such as in a period of geopolitical stress in the summer of 2011 and a sudden interest rate policy shift in late 2018. In benign periods as well as times of significant global capital markets stress, open-end loan funds have met their shareholders' redemption requests. This two-decade run of successful redemption management is a function of both a large and liquid underlying asset class and the robust and highly effective LRM programs at open-end loan funds, as more formalized following the implementation of Rule 22e-4 under the Investment Company Act.

F. Despite this historical evidence, the Commission has indicated that it is concerned about open-end loan funds' ability to make timely payment on shareholder redemption requests without a dilutive sale of portfolio investments.[12] The Commission seems to disregard the many tools available to open-end funds, including those that have been successfully employed through extreme stressed conditions. The Commission argues, without support, that certain tools that have been effective in the past and the present would be ineffective – or even potentially unavailable – in the future.

G. The Commission does not offer a realistic alternative to the wholesale dissolution of a viable product. The Commission's proposed "solution" would require a reclassification that would cause open-end funds to classify loans as "illiquid," so that loan funds could no longer operate as open-end funds. This "solution" is worse than any perceived problem. The Commission's suggestion that open-end funds could convert to closed-end funds or "interval funds" (i.e., closed-end funds offering periodic repurchases) is a chimera; such a conversion would never be acceptable to investors. Instead, this "solution" would likely force open-end loan funds to liquidate en masse, and such liquidation would significantly disrupt the underlying market and deprive investors of exposure to loans in a structure with daily liquidity.

H. The costs of the proposal are profound and counter to all three parts of the Commission's mission.[13] In the near term, the forced liquidation of these funds would create a fire sale that would harm the very investors the Commission seeks to protect. The fire sale would also be disorderly and inefficient for the loan market generally. In the long term, the proposal would eliminate one of the few investments that allow retail investors to manage

[12] Notwithstanding the Commission's focus on open-end loan funds, while there have been pockets of *trading* liquidity stress in some asset classes in periods of dislocation like March 2020, *this has not been the case for BSL Loans*.

[13] *See* https://www.sec.gov/about/what-we-do.

interest rate risk. [14] In addition, it would result in the destruction of a $100 billion-plus source of capital[15] for US companies, an outcome that runs completely counter to the Commission's mission to facilitate capital formation.

I. Instead of drastic changes that would destroy a long-standing and well-functioning part of the capital markets, the LSTA requests that the Commission retain the less liquid investment category, which includes loans, and instead require, consistent with the Proposed Rule, that open-end loan funds maintain a HLIM of at least 10%. A mandatory HLIM, together with the many other tools that are available to manage liquidity, will even further enable open-end loan funds to meet redemption requests, including in stressed conditions, while mitigating dilution of remaining shareholders. This 10% HLIM requirement alone is greater than all but three of the 240 monthly outflows seen since 2003. The LSTA also continues to work towards further formalizing contractual expedited settlement, which will enhance LRM even more.

J. We believe that the new HLIM requirement should be sufficient, with the other requirements in Rule 22e-4 regarding LRM programs, to support the continuation of the less liquid investment category.

III. Comments

A. Open-end loan funds are an important component of a vibrant leveraged loan market that provides significant funding to U.S. companies.

According to Standard & Poor's, 67% of the North American companies it rates have a non-investment grade (sub-BBB-) rating. These include a range of companies such as United Airlines, Caesars Resorts, Univision, Charter Communications, DirecTV and Bass Pro Shops.[16] Most of these companies receive a substantial portion of their financing from the BSL Loan market. The primary investors in BSL Loans are CLOs (67% as of December 2022), open-end loan funds (9% as of December 2022) and "Other"[17] (24% as of December 2022). BSL Loans rival the high yield bond market in size; there is $1.4 trillion of loans in the Morningstar/LSTA

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[14] Because BSL Loans bear a floating interest rate (SOFR plus a spread), in a rising interest rate environment investors' returns increase as interest rates on the underlying loans increase and vice versa.

[15] The Commission's Proposed Rule referenced $200 billion of fund investments in loans as of January 2022. In contrast, following substantial redemption activity, Refinitiv Lipper counts open-end loan fund investments as $100 billion as of December 2022. In addition, the LSTA believes that the Commission's data may include multi-strategy funds that also hold positions in loans. We use $100 billion in our analysis of the cost of the Proposed Rule; to the extent that the Proposed Rule could cause the liquidation of $200 billion in loan investments, the impact on parties would be that much greater.

[16] Morningstar/LSTA Leveraged Loan Index.

[17] "Other" includes other types of funds and institutions including separately managed accounts, commingled accounts, insurance companies, hedge funds and more. *See* Refinitiv Lipper, Refinitiv.

Leveraged Loan Index[18] and more than $820 billion of loans traded in 2022.[19] While open-end funds hold a relatively small share of outstanding BSL Loans, they provide substantial secondary market liquidity because they are not restricted by the structural constraints imposed on other lenders like CLOs. This means that open-end loan funds provide an important source of liquidity to the secondary market and can support companies whose loans might not be a good fit for CLOs.

B. Buyside sale settlement times are shorter than the Commission cites, which helps explain why the open-end loan fund toolkit is so effective.

The Commission posits that because BSL Loan trades settle more slowly than those of other asset classes, open-end loan funds pose a risk that investor redemption requests may not be met in timely fashion (or that with increasing borrowing costs there is greater risk of dilution over extended settlement periods). To demonstrate the gap between the time to settle loan trades and the time to meet redemptions, the Commission cites 23 days as the average time to settle a loan.[20] This is incorrect as applied to the sale of loans by open-end funds. The average market settlement time *for all trades* and the time a loan fund needs to *sell and settle a loan trade to meet redemptions* are not the same. Many participants in the BSL Loan market may not have settlement urgency, such as CLOs while accumulating (purchasing) a portfolio prior to selling liabilities and taking possession of the assets. As noted, the Commission cited that the average time to settle for the entire market was 23 days in July 2021, however, this settlement time includes the settlement times for counterparties, such as CLOs, that may not share the need to settle as quickly.[21]

The more appropriate cohort of trade activities is buyside *sales* and, because loan settlement times do not follow a normal distribution, a more useful metric for the typical experience is the *median* time to settle.[22] Thus, we recommend that the Commission consider the "settlement gap" in the context of *median buyside sales*, as that more closely reflects the experience of open-end loan funds when they are selling to meet redemption requests. The long-term median buyside settlement time is nine days and it is shorter in times of market stress in light of the inherently higher settlement urgency. For example, in March 2020, the median buyside sale settlement time was seven days.[23] In turn, the tools that open-end funds can use to meet redemptions must *bridge a much shorter temporal gap than the Commission assumes*.

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[18] BSL Loans are distinct from private credit or direct lending which do not trade in a liquid market and are more likely to be held in a less liquid product such as an interval fund, BDC or balance sheet CLO.

[19] LSTA Trade & Settlement Study, January 2023.

[20] *See supra* note 10.

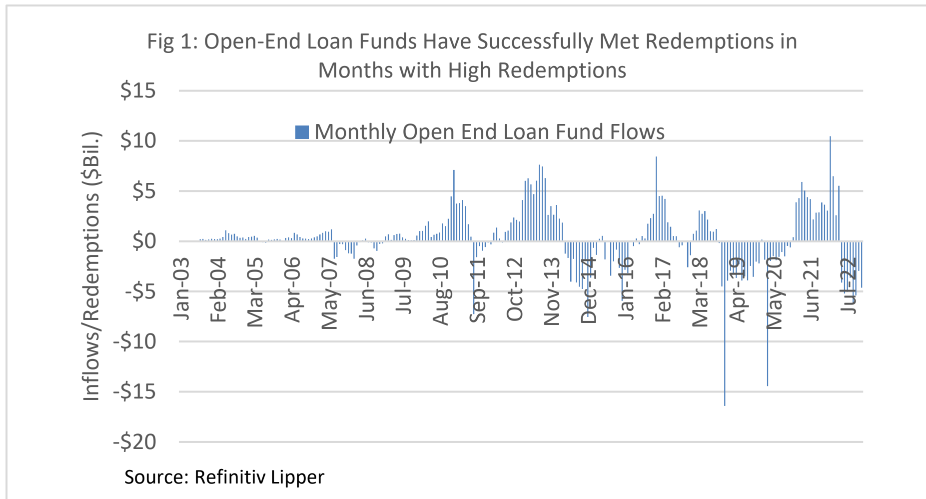
[21] *See id.*

[22] The Commission does cite the median as T+15. Proposing Release at 61.

[23] LSTA Trade & Settlement Study. Additionally, some open-end fund managers provided data indicating that their median settlement times in March 2020 were as short as T+3.

C. Open-end loan funds have successfully addressed redemptions through stressed conditions (including the recent COVID pandemic) using effective LRM and a robust suite of existing tools.

Open-end loan funds, offering daily liquidity, have been in existence for more than 20 years. In that time, there have been many periods of strong inflows and outflows as well as periods of capital markets stress such as 2008, 2011, 2014, 2018 and, most recently, 2020 (as illustrated by Figure 1 below). In all those situations, no open-end loan fund has ever failed to meet a redemption request.



The most dramatic test case of March 2020 presented an enlightening natural experiment and the first significant test of the Commission's own 2016 Rulemaking. The global financial markets underwent unimaginable strain as the global economy effectively shut down in just one month. Open-end loan fund redemptions soared from $1.85 billion (2% of starting AUM) in February 2020 to $14.4 billion (15.7% of starting AUM) in March 2020.[24] Despite this unprecedented stress, open-end loan funds timely met each and every redemption request. To do so, open-end loan funds undertook a number of actions. The most obvious was to sell loan assets and, indeed, loan trading nearly doubled from $68 billion in February to $119 billion in March 2020. Clearly, the loan market had the capacity to absorb significant increases in trading activity and to settle those loan trades to meet redemptions.[25]

However, selling loans and settling those loan trades were not the only means for open-end funds to meet redemptions. In addition, they used a suite of time-tested tools and various portfolio management strategies such as modeling or maintaining certain levels of cash or cash equivalents.

First, open-end fund managers, in accordance with Rule 22e-4(b)(i), actively monitored and modeled their current and expected cash needs – putting into practice more robust programs

[24] Refinitiv Lipper.

[25] Loan prices did decline significantly in March 2020, but this is no different than any other asset class at the start of a multi-year global pandemic.

that were enhanced following the 2016 Rulemaking.[26] Unlike many other investments, BSL Loans generate substantial cash from frequent repayments and prepayments. For example, the average and median monthly loan repayment rates between January 2002 and October 2022 were 2.53% and 2.25%, respectively. *Even in March 2020, when companies were hoarding cash, the monthly loan repayment rate still was 0.96% of outstanding loans.*[27] While this might not appear to be a large percentage on its face, it was more than $11 billion in total and, on a market share basis, more than $1 billion of repayments to open-end funds *in a month in the face of severe market stress*. Clearly, loans provide reliable cash flow in ways that other investments do not; this alone helps address redemption requests and informs managers cash flow modeling.

Second, open-end loan funds have adopted HLIMs in accordance with Rule 22e-4(b)(iii), which averaged 4.5% in funds of managers surveyed. In addition to the HLIM, all funds surveyed employed a buffer above the stated minimum, which varies based on market conditions. While fund managers surveyed said that they largely met redemptions through loan sales, higher HLIMs helped ensure that fund managers had other sources of readily accessible cash with which to meet redemptions in an ordinary manner to avoid having to sell into a declining market, and to avoid dilution of remaining shareholders.[28]

Third, all fund managers surveyed had at least one – and often more than one – committed line of credit. Importantly, these lines do not create leverage; they are collateralized by the loans that have been sold and are only used to bridge the short time between the sale of loans and the settlement of those sales. As the Commission pointed out in the Proposing Release, some managers, using the tool as contemplated, drew upon their lines of credit in March 2020 demonstrating that the lines worked precisely as intended.

This reflects the fact that, as all managers surveyed confirmed, they have *committed* lines of credit, so lending institutions cannot simply reject a request for a draw, even in stressed financial conditions. These loans are typically provided by a syndicate of relationship banks and are renegotiated well in advance of their maturity, so fund managers and fund boards have clarity into whether the loan terms or amount will change. While the Commission believes that credit has become more difficult to obtain over time, managers surveyed stated that they continue to be able readily to obtain such loans. Accordingly, most managers increase or decrease their lines simply based on the size of their open-end loan funds, and without issue.

Finally, the Commission should not assume that such lines when drawn will be outstanding for 23, or even 15, days – the timeframe the Commission cites as the loan market's average and median settlement time for the whole loan market – but rather closer to the seven to nine days observed when an open-end loan fund is selling. This has two implications: First, it

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[26] A number of managers stated that they use analytical tools such as Blackrock's Aladdin system to measure and monitor cash flow needs.

[27] Pitchbook LCD.

[28] In addition to historical modeling, in the ordinary course, loan fund managers also engage with their institutional clients to understand upcoming redemption expectations to ensure that they have sufficient liquidity ahead of redemptions.

should help allay the Commission's concern that these lines are likely to be phased out because banks find them excessively risky. Second, the fact that the sale-settlement gap to bridge is short means that the lines are drawn very briefly and that, therefore, the interest cost borne by fund investors is modest.

In the cost-benefit analysis, the Commission observes that 48 open-end loan funds, excluding ETFs, had secured a line of credit. From this set of open-end loan funds, nine open-end loan funds used their line of credit and drew an average amount of $29.4 million ($265 million of total usage) for an average time of 114 days in 2021 (as the cumulative usage over the period). The Commission suggests open-end loan funds engaging in this financing to bridge the settlement gap may, in effect, impose additional financing cost on fund investors, which may increase dilution. Using the Commission's numbers, we calculated the dilution impact of the 2021 line of credit draws on fund investors. The cost of drawing on a typical line of credit for an open-end loan fund is approximately 1.2% over SOFR.[29] With SOFR averaging 0.04% in 2021, the typical *annual* cost of drawing on a line would be 1.24%. Thus, the cost of the entire industry drawing in 2021 would be the total drawn amount multiplied by the period drawn multiplied by the interest rate. In the Commission's numbers, this is $265 million * 0.31 years * 1.24% ***or $1.03 million***. Divided by the $99 billion of AUM in open-end loan funds (excluding ETFs) in 2021, use of credit lines created dilution of .001 cents per dollar of AUM of the overall market.[30]

In summary, using their existing set of LRM tools, including active cash management and modeling, the use of HLIMs and committed lines of credit bridging the gap between sale and settlement of loans when needed, fund managers successfully addressed redemptions in March 2020.[31] As the experience of March 2020 and many other periods of macroeconomic stress demonstrate, fund managers already have the tools that they need. Nevertheless, fund managers are still working to enhance their tools for the next stress event.

D. Potential Enhancements to Open-End Loan Funds' Suite of LRM Tools

While the evidence clearly demonstrates that open-end loan funds can meet redemptions in periods of stressed conditions, our members nevertheless seek to be responsive to the Commission's concerns about the temporal gap between redemption requests and loan settlement times, and the potential costs imposed by such gap. Thus, the LSTA is working with our

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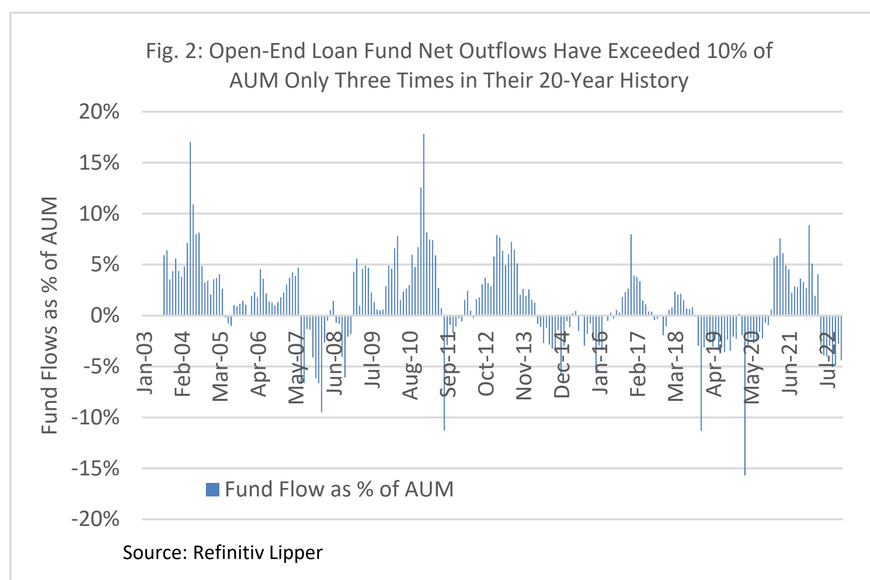
[29] Based on feedback from open-end fund managers.

[30] The low drawn cost is not purely a function of 2021's low interest rate environment. Doing the same analysis using the February 13, 2023 CME Term SOFR of 4.56% would increase dilution to only 0.0048 cents per dollar of AUM of the overall market. The Proposing Release does not provide the AUM of the funds that used their lines, so we are unable to determine the impact directly on the remaining shareholders. However, the market dilution of a drawn loan is so miniscule that it is difficult to conclude that the impact on remaining shareholders would have been material. Additionally, the undrawn cost (or annual fee) of a line of credit is low as well. A sample of these loans had an annual fee of 12.5 bps, according to Refinitiv's Loan Connector database. Even if the line of credit were as large as 10% of a fund's AUM, the ongoing cost to investors would be roughly 0.013 cents per dollar of AUM (and such costs are far more limited that the costs of a closed-end or interval fund structure, discussed below).

[31] In addition to the tools renumerated above, several fund managers also noted that they had received exemptions for interfund lending, another effective tool the Commission has endorsed for managing liquidity.

members to augment the already robust redemption toolkit that funds currently use. Specifically, we support the requirement included in the Proposed Rule, that open-end loan funds adopt a HLIM of 10%.[32] This, by itself, is more than the monthly outflows in all but three of the 240 months that Refinitiv Lipper has tracked the funds (see Figure 2 below).

1. **Minimum HLIM Requirement.** By including a HLIM of 10%, open-end loan funds have sufficient highly liquid assets (i.e., the ability to generate cash) to meet the *monthly* redemption amounts in almost 99% of the 240 months that open-end loan funds have existed (and been tracked by Refinitiv Lipper). While the 10% HLIM requirement is sufficient to meet the most extreme *monthly* redemptions, the 10% HLIM requirement is determined *daily* which ensures that the necessary liquidity is continually available and provides time for funds to sell additional assets, as necessary, to further meet redemption requests. Increasing a required HLIM past 10%, however, could create more problems than it would solve. Investors in open-end funds purchase these investments to invest in a particular asset class, including loans, and many funds state that they are 80% invested in their respective class, consistent with Rule 35d-1 (i.e., the "names rule"). If a HLIM, plus any buffer a manager uses to avoid going below its HLIM, were to approach 20% of net assets, the fund would have difficulty meeting its investment objective and providing investors with their desired exposure. For these reasons, we believe a required HLIM of 10% is appropriate.



2. **Expedited Settlement Arrangements.** Aside from the use of a HLIM, fund managers use additional tools to manage liquidity risk, in particular the gap between the sale and settlement of loan trades. One method managers may use is to contractually agree with one or more of their counterparties that their loan sale will settle on an expedited basis.[33] Specifically, the Commission included Questions 17

[32] To be clear, the LSTA's support for a 10% HLIM is limited to managers of open-end loan funds; we are not suggesting that a required 10% HLIM is necessary for any other type of open-end fund.

[33] Because the historical median buyside sale settlement times are nine days, funds are only looking to expedite the settlement time from nine days to three days, *not* 23 (or 15) days to three days.

and 18 in the Proposing Release on whether the proposed amendment may lead to the use of contractual expedited settlement and whether that ability is relevant to whether a loan is reasonably expected to be convertible promptly to U.S. dollars. We appreciate the acknowledgement that the ability to contract for expedited settlement may demonstrate liquidity of the asset class. Indeed, managers of open-end loan funds use expedited settlement mechanisms as one of the tools that enable them to manage their funds' liquidity to meet redemptions in stressed conditions.

Contractually expedited settlement arrangements enable funds to receive the cash from the sale of a loan in a much shorter period as compared to a typical loan trade. Managers can agree with one or more of their buyer counterparties at the time of the loan trade that it will settle on an expedited basis. A further explanation of how these arrangements work is included in Appendix 1.

The LSTA is now working with its members to standardize expedited settlement arrangements to enhance the ability of managers to more readily enter into these contractual arrangements. These arrangements will continue to be a useful tool for managers whose funds already have lines of credit and a required HLIM of 10% available to meet redemption requests in stressed conditions.

E. Removing the Less Liquid Investment Category and Recategorizing Loans as Illiquid Would Impose Significant Harms with Few Benefits

In the 2016 Rulemaking, the Commission recognized that loans demonstrated sufficient trading liquidity but had longer typical settlement times.[34] The Commission correctly concluded that these longer settlement times did not prevent funds from timely meeting redemption requests. As discussed above, that conclusion was validated most recently by the experience of March 2020, when open-end loan funds managed such requests in a manner that protected all investors by selling loans and settling expeditiously, as well as by using tools and strategies such as a HLIM, access to lines of credit and active cash management. Open-end loan funds have repeatedly demonstrated that they can meet significant redemption requests in periods of market stress.

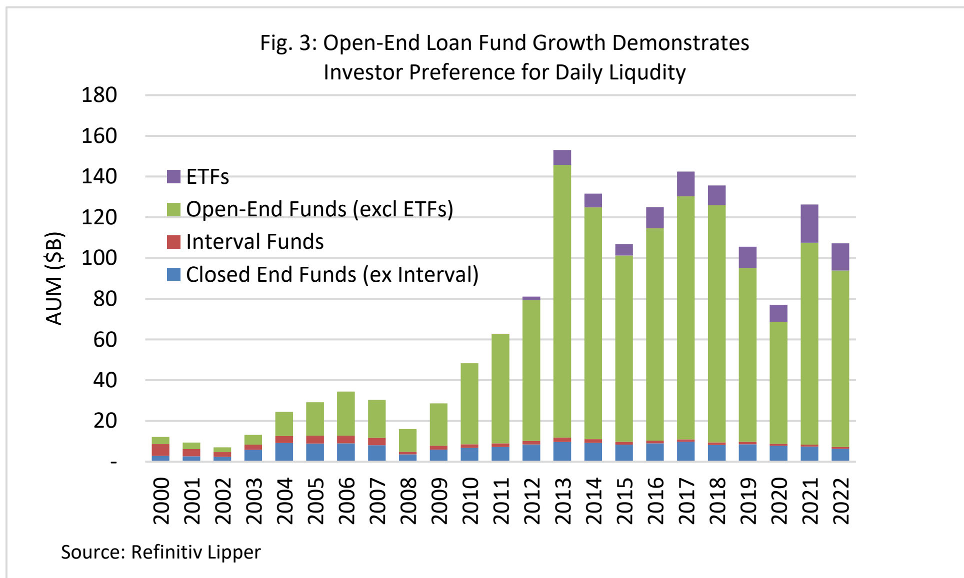
Notwithstanding this historical experience, the Commission proposes that loans be recategorized as illiquid assets. The Commission acknowledges that such a change could require open-end loan funds to "change those strategies, close funds, or consider using a closed-end fund or other investment vehicle structure that is not subject to rule 22e-4."[35] In fact, it is not realistic for funds to convert to closed-end or interval funds; instead, they likely would be forced to liquidate. This could create significant harm to investors both in the short term (as asset prices would fall when funds liquidate en masse) and in the long term (as investors – and particularly retail

[34] *See supra* note 4.

[35] Proposing Release at 63.

investors – would lose access to one of the few investments that effectively manages interest rate risk).

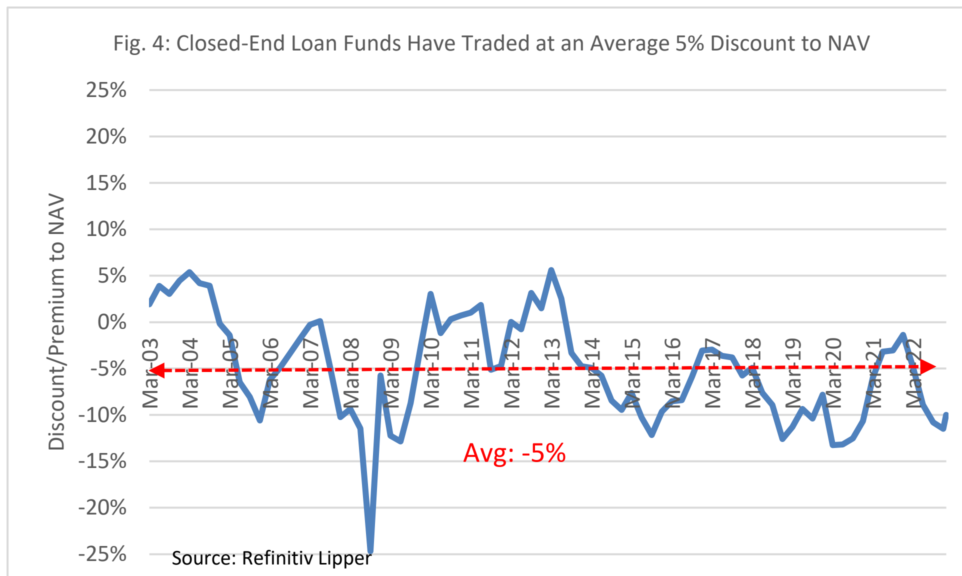
The growth of funds that hold liquid BSL Loans has come nearly exclusively in the form of open-end funds, illustrating investors' preference for BSL Loans in a vehicle that provides daily liquidity (see Figure 3 below). Managers believe that there would be very significant – likely existential – redemptions if investors believe open-end loan funds would be forced to convert to closed-end or interval funds.[36] Even beyond the anticipated onslaught of redemptions, conversion to a closed-end fund would require a shareholder vote. If shareholders did not vote, as is often the case, the fund likely would be forced to liquidate.



The rapid liquidation of the majority of open-end loan funds' BSL Loans would create a fire sale of loans, driving down their prices. In turn, fund investors that exit early (most likely the well-informed institutional accounts) would suffer the smallest NAV decline,[37] while later sellers (likely retail investors) would suffer more material price impairments. This activity would harm the very investors the Commission purports to protect through this rule – the remaining investors (likely retail investors) who are slow to redeem. Moreover, an extended implementation period would not ease the matter materially. Once investors realize that there will be liquidations, this, in itself, would create a "run on the bank."

[36] Some managers have noted that they have already received inquiries from large institutional accounts asking about the potential path of the regulation and flagging that they would likely exit the asset class.

[37] To be clear, the NAVs would be priced fairly but the rush to sell may drive down the asset prices.



Furthermore, even if a forced conversion of open-end loan funds to closed-end or interval funds were feasible, it would harm a number of constituencies and would be operationally and economically burdensome. Open-end loan funds are one of few means for retail investors to manage interest-rate risk in a product with daily liquidity. Even if open-end loan funds could be successfully converted to closed-end funds or interval funds without moving the price of the loans, investors still would be harmed. In the current environment, investors are able to access floating-rate loan returns *with daily liquidity*, which means that they can access their money daily at NAV; in turn, they do not require excessive returns on the loans in which the funds invest. This changes if they can no longer be in open-end funds and three different constituencies could be harmed.

1. **Investors forced into a closed-end fund**. If an open-end fund converted into a closed-end fund, its investors would suffer in two ways. Closed-end fund share prices often trade at a discount to NAV, which would create both immediate and longer-term harms. First, closed-end loan funds traded at an average discount to NAV of 5% between March 2003 and January 2023 (see Figure 4 above).[38] Assuming the historical 5% discount to NAV held, the conversion of $100 billion of funds to closed-end format would cost investors $5 billion on day one. Over the longer term, while investors may have access to cash by selling shares, they would be subject to greater price volatility as shares are generally thinly traded and share prices frequently delink from NAV. Thus, even if converting from an open-end fund to a closed-end fund were possible, investors would be harmed by a conversion.

2. **Investors forced into an interval fund**. If an open-end loan fund were converted into an interval fund investing in BSL Loans, investors would receive the same returns but only with periodic access to their invested capital. An investor would require an illiquidity premium to compensate for the loss of daily liquidity. The illiquidity premium in direct lending may be an illustrative example. According to Refinitiv LPC, yields on illiquid direct loans typically averaged 190 bps above (liquid) BSL Loans between 2013

[38] Refinitiv Lipper.

and 2022.[39] A significant portion of this is attributed to an illiquidity premium demanded by investors for locking up their money. However, BSL Loans do not currently require this premium, and so investors forced into an interval fund would have lower liquidity but without the compensating higher return prospects.

3. **Corporate borrowers**: Corporate borrowers are another constituency that would be harmed by the liquidation or conversion of open-end loan funds. Open-end loan funds provide $100 billion of liquidity and credit to corporate borrowers. In the short term, if there were massive redemptions and liquidations, secondary loan prices would fall in order to clear the market. In turn, loan yields would increase, the cost of borrowing would rise and many companies would find borrowing costs uneconomical.[40] In the longer term, it would be difficult to directly replace open-end loan funds with other investors at the same cost structure and with the same flexibility[41] Moreover, if open-end loan funds were replaced with interval funds, the very illiquidity premium that investors require would be paid by the borrower. As noted previously, Direct Loans typically yield 190 bps more than BSL Loans, due in large part to an illiquidity premium. If $100 billion of open-end loan funds converted to interval funds and borrowers' cost of capital on those loans ultimately increased 190 bps, that would total $1.9 billion of additional interest costs on borrowers per year.

The Commission does not appear to have weighed all the costs and benefits of the Proposed Rule. As we outline above, open-end loan funds have *already* demonstrated the ability to meet redemptions, without significant dilutive effects, in stressed conditions. Thus, the Commission's proposal of effectively shutting down an entire product class by eliminating the less liquid investment category demonstrates no obvious benefit other than one suggested by questionable assumptions belied by actual historical experience and conjecture about the harm of dilution to remaining investors. Conversely, the analysis above demonstrates that fund investors and corporate borrowers would be significantly harmed by an unconsidered elimination of open-end loan funds.

The LSTA supports more tailored measures to address liquidity risk and to enhance LRM programs in ways that permit the continued existence of open-end loan funds. We support the

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[39] Refinitiv LPC's Middle Market Connect, February 2023, Chart 9.

[40] The impact of supply exceeding demand (which would occur in a liquidation of open-end funds) was directly observed in the US loan market in 2022. Due to a confluence of events – Ukraine invasion, geopolitical tensions, inflation, interest rate hikes and a repricing of risk generally – loan prices dropped into the 92-cent range. This effectively pushed the secondary market yield up 217 bps to SOFR+6.25%. To compete with the secondary market, new issue all-in loan spreads (which include the impact of emerging with a discount) increased 190 bps to SOFR+6.04%. Because it was so uneconomic for companies, BSL Loan origination plummeted 63% between 2021 and 2022. The sudden sale of $100 billion of fund assets would almost certainly drive a substantially larger price dislocation before opportunistic buyers stepped in to buy. In turn, the costs of new capital for loan borrowers would likely increase more than 200 bps. *See* Morningstar/LSTA Leveraged Loan Index and Pitchbook LCD.

[41] As an example, CLOs are a significant investor in leveraged loans. However, they face constraints in the form of industry diversification, weighted average asset spread and weighted average rating factor, meaning that they cannot invest as flexibly as open-end loan funds.

Proposed Rule's requirement of a 10% HLIM for open-end loan funds. In addition, we are continually working with our members to develop additional anti-dilution tools to equip fund managers with options to address various liquidity scenarios; one such tool is the increased standardization of contractual expedited settlement arrangements, which could bolster fund managers' liquidity toolkits. We believe that these tailored enhancements, in addition to all the ways that open-end funds currently manage liquidity risk, provide many benefits and none of the harms that would result in shutting down open-end loan funds. We recommend that the Commission consider this approach, while continuing to permit the existence of the less liquid investment category.

IV. Conclusion

It is axiomatic that all open-end funds must meet redemption requests in a timely manner and protect all investors' interests while doing so. The Commission and the industry agree on this. Importantly, open-end loan funds have demonstrated their ability to meet redemptions in a wide range of economic and market environments without dilutive effects thanks to tools they have developed over decades. The fact that open-end loan funds met redemptions in the Global Financial Crisis *and* the Global Pandemic shows that their toolkit remained robust in different scenarios.

We support the requirement of a 10% HLIM for open-end loan funds to further strengthen a robust set of existing tools. We believe that the Commission should accept this approach, rather than eliminating the less liquid investment category and converting loans to illiquid investments. As demonstrated above, we believe eliminating the less liquid investment category would lead to widespread liquidations, harming investors, and borrowers. That would be far more costly than any perceived problem.

The LSTA appreciates this opportunity to comment and stands willing to provide additional information in person or in writing.

Sincerely,

Meredith Coffey
Executive Vice President – Research, Co-Head Public Policy

Elliot Ganz
Head of Advocacy, Co-Head Public Policy

Appendix 1

As we discussed in the body of our letter, open-end loan funds that invest in BSL Loans use expedited settlement mechanisms as one of the tools to enable them to meet redemption requests, including in stressed conditions. Managers can agree with their buyer counterparty at the time of the loan trade that the trade will settle on an expedited basis. The parties will then settle the loan trade by one of two methods – (i) as an assignment or (ii) as a participation – and in either case the selling fund receives the cash from the loan sale within a short, certain timeframe.

In an expedited settlement arrangement, an open-end loan fund selling its loan agrees with the buying dealer at the time of trade that the trade will settle as an assignment by a certain date after the trade is entered, e.g., two business days after the trade date, and, if that is not possible, the trade will settle as a participation on, e.g., the third business day following the trade date. The option to settle by participation is what effectively guarantees settlement within a few days. This is because, in a typical loan, a borrower has the ability to control which entities can join its loan syndicate. Most loan transfers require the borrower to consent to that transfer at the time of settlement of that trade by "assignment" (unless the buyer is an existing lender or an affiliate of an existing lender). In a typical loan trade, obtaining borrower consent can take many days; indeed, obtaining borrower consent is one of the significant reasons loan settlement times are as long as they are. Despite the delay in settlement, the vast majority of loan trades settle by assignment because when a loan trade settles as an "assignment" the buyer becomes a direct "lender of record" under the credit agreement in privity with the borrower.[42] In contrast, it is rare that borrower consent is required to settle a loan trade as a "participation." So long as certain requirements are met, the seller of a BSL Loan can settle that trade with a buyer as a participation any time after they enter into the trade and without obtaining consent. Therefore, in an expedited settlement arrangement where the seller agrees to the loan participation option at the time of trade, the open-end loan fund is guaranteed to receive the cash from the sale within a few days.

Settlements by participation are already common in the market, though they are done on an individually negotiated basis. The LSTA is working with its interested members to develop standardized agreements designed for use when an open-end fund is selling its loan(s) to meet redemptions. We believe this standardized approach will bring more consistency (and thus less operational risk) to this traditional settlement approach and will allow open-end loan funds to further formalize the understandings they have with dealers.

[42] When a loan is sold and settled as a participation, the buyer or "participant" receives economic exposure to the loan but does not become a lender of record. The trade counterparties typically execute a trade confirmation and then enter into a participation agreement which governs the relationship between the buyer/participant and the seller or "grantor." That participation agreement provides for the transfer of 100% beneficial ownership interest in the loan to the participant and the grantor retains bare legal title. The grantor continues to be the "lender of record" (i.e., a "lender" as defined in the credit agreement), so the participant has a direct relationship with the grantor and no direct relationship to the borrower. A participation generally is then elevated to an assignment as rapidly as is feasible.