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SEC Proposes Reworking Mutual Fund Liquidity Framework, including Mandating Swing Pricing

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The Securities and Exchange Commission (the "SEC") recently proposed a set of amendments to various rules and forms under the Investment Company Act of 1940, as amended (the "1940 Act"), that would fundamentally alter the liquidity framework applicable to most open-end funds (the "Proposal").[1] The Proposal was approved by a vote of three to two, with Commissioners Peirce and Uyeda dissenting. If adopted, the Proposal would:

- amend Rule 22c-1 to require open-end funds, except for money market funds and exchange-traded funds ("Covered Funds"), to use swing pricing and institute a "hard close" for transacting in fund shares;
- amend Rule 22e-4, which relates to the adoption and implementation of liquidity risk management programs, to require the open-end funds subject to the Rule to determine and maintain a highly liquid investment minimum of at least 10% of net assets, establish new minimum standards for making liquidity determinations, revise the current liquidity categories and require daily liquidity classifications; and
- require more frequent and detailed reporting of monthly portfolio holdings, liquidity risk management and the use of swing pricing to the SEC and the public.

SEC Concerns and Objectives

The SEC describes the Proposal as a response to lessons learned during the relatively brief period of market stress experienced at the outset of the COVID-19 pandemic in March 2020. The SEC asserts in the Proposing Release that some mutual funds were not prepared for sudden market stress and began to "explore emergency relief

requests or suggest a need for government intervention in an effort to withstand or alleviate liquidity stress, address dilution, and improve overall market conditions."[2] In light of these events, the SEC reviewed the effectiveness of funds' current tools for managing liquidity and limiting dilution, including liquidity risk management programs, the option to use swing pricing for certain funds, the ability to impose purchase or redemption fees and the ability to redeem in kind. As a result of its review, the SEC concluded that it identified weaknesses in funds' liquidity risk management programs that can cause delays in identifying liquidity issues in stressed periods and cause funds to overestimate the liquidity of their investments. The SEC recognized that anti-dilution tools such as redemption fees and swing pricing are rarely, if ever, used. However, the SEC noted its desire to provide funds with "well-functioning tools for managing through stress without significantly diluting the interests of their shareholders."[3]

Swing Pricing

The most significant element of the Proposal is the requirement for Covered Funds[4] to implement swing pricing under specified conditions, as part of the proposed amendment to Rule 22c-1 under the 1940 Act that would replace the current optional implementation framework with a mandatory one.

Current Swing Pricing Framework. In 2016, the SEC amended Rule 22c-1 to permit certain open-end funds to use swing pricing, which is the process of adjusting the price of a fund's net asset value ("NAV") per share to effectively pass costs associated with shareholder purchase or redemption activity onto the transacting shareholders. Since then, no U.S. open-end fund has opted to implement swing pricing. Despite the lack of adoption, the SEC states in the Proposing Release that it believes swing pricing is an "important and effective tool for dynamically addressing" dilution and notes that some academics and market participants have suggested that it has provided significant benefits to long-term investors in other jurisdictions. The SEC states that funds in the United States are not incentivized to use swing pricing as a result of operational hurdles, implementation costs and lack of investor familiarity.[5] The SEC reasons that a regulatory requirement, rather than a permissive framework, would overcome these collective action problems.

Conditions Requiring Swing Pricing. The Proposal would require Covered Funds to establish and implement swing pricing policies and procedures that adjust the fund's current NAV per share by a "swing factor" (discussed below) if the fund has (i) net

redemptions or (ii) net purchases exceeding 2% of the fund's net assets (the "inflow swing threshold").[6]

Determining Flows. Under the Proposal, the fund board must designate a "swing pricing administrator"[7] to review flow information to determine the extent of net purchases or net redemptions.[8]

Swing Factors. The swing pricing administrator would be charged with determining the swing factor by making good-faith estimates, supported by data, of the costs the fund would incur if it purchased or sold a pro rata amount of each investment in the portfolio equal to the amount of net purchases or net redemptions (i.e., a "vertical slice"). If the fund has net purchases exceeding the inflow swing threshold, such good-faith estimates must include spread costs, brokerage commissions, custody fees and any other charges, fees and taxes associated with portfolio investment purchases and the market impact factor (discussed below). If the fund has net redemptions, the same requirements would apply except that the market impact would only be included in the swing factor if net redemptions exceed 1% of the fund's net assets (the "market impact threshold").[9]

The SEC expressed some concern that fund managers may have incentives to overestimate costs when calculating swing factors to improve fund performance. As a result, under the Proposal, funds would be required to report their swing factor adjustments publicly on Form N-PORT.

Market Impact Determinations. As noted above, the Proposal would require funds to estimate the market impact of purchases and sales of a vertical slice of the fund's portfolio. First, the fund would estimate the market impact factor for each investment: the percentage change in the value of the investment if it were purchased or sold, per dollar of the amount of the investment that would be purchased or sold. The fund would then multiply the market impact factor by the dollar amount of each investment in the "vertical slice" that would be purchased or sold to meet the net purchases or net redemptions. The Proposal would permit the swing pricing administrator to estimate costs and market impact factors for each type of investment with the same or substantially similar characteristics and apply those estimates to all investments of that type rather than analyze each investment separately.

Reduction of Market Impact Thresholds or Inflow Swing Thresholds. The Proposal permits the fund's swing pricing administrator to use smaller market impact thresholds or inflow swing thresholds than the rule identifies so long as the swing pricing administrator determines it is appropriate to mitigate dilution.[10]

Board Responsibilities and Reporting. A fund's board of directors, including a majority of the directors who are not "interested persons" of the fund, must: (i) approve the fund's swing pricing policies and procedures; (ii) designate the fund's swing pricing administrator; and (iii) review, no less frequently than annually, a written report prepared by the swing pricing administrator that describes (a) the swing pricing administrator's review of the adequacy of the fund's swing pricing policies and procedures and the effectiveness of their implementation, including their effectiveness at mitigating dilution; (b) any material changes to the fund's swing pricing policies and procedures since the date of the last report; and (c) the swing pricing administrator's review and assessment of the fund's swing factors, considering the requirements related to determining the swing factors, including the information and data supporting the determination of the swing factors and, if the swing pricing administrator implements either an inflow swing threshold lower than 2% of the fund's net assets or a market impact threshold lower than 1% of the fund's net assets, the information and data supporting the determination of such threshold.

Hard Close

The Proposal would also require Covered Funds to implement a hard close at the time the fund has established for calculating its NAV (typically, 4:00 p.m. Eastern time). Many shareholders do not hold their Covered Fund shares directly, but rather hold them through so-called "omnibus" accounts that are maintained by an intermediary. Each day the market is open, the intermediary sends to the fund only one purchase or sale request, based on the net activity of the investors in the omnibus account for that day. Currently, so long as the intermediary receives a purchase or redemption order from an investor prior to 4:00 p.m., then that order will be executed at the current day's NAV even if the fund receives the order from the intermediary after 4:00 p.m. In practice, funds often receive order information from intermediaries significantly past the 4:00 p.m. pricing deadline. Under a hard close framework, an order to purchase or redeem shares will be executed at the current day's NAV only if received by the fund, its designated transfer agent or a registered securities clearing agency (i.e., NSCC) before the fund's pricing time on that day. Otherwise, the order will be executed based on the fund's NAV for the following day.

Because orders are typically processed by intermediaries before the information reaches funds, it will likely fall upon the intermediaries (rather than the funds) to determine how to implement the hard close framework most efficiently.

Amendments concerning Liquidity Risk Management Programs

The Proposal would amend Rule 22e-4, which governs open-end funds' liquidity risk management programs, by establishing new minimum standards for making liquidity determinations, revising the current liquidity categories and requiring daily liquidity classifications.

Establishment of Minimum Standards for Making Liquidity Determinations. Under Rule 22e-4, funds are required to classify each portfolio investment based on the number of days in which the fund reasonably believes the investment would be convertible to cash, sold or disposed of without significantly changing its market value. When engaging in these classifications, the fund assumes a reasonably anticipated trade size in current market conditions. Currently, Rule 22e-4 permits considerable discretion in how funds determine the classification of investments, and classification is generally permitted to be done by asset class. The Proposal seeks to provide objective minimum standards to prevent funds from overestimating the liquidity of their investments, including in times of stress. Specifically, the Proposal would:

- require funds to assume the sale of a set stressed trade size (10% of the fund's net assets by reducing each investment by 10%), rather than a reasonably anticipated trade size in current market conditions which is set at the discretion of the fund;
- establish definitions for when a sale significantly changes a security's market value (for shares listed on a national securities exchange or a foreign exchange, any sale or disposition of more than 20% of the average daily trading volume of those shares, as measured over the preceding 20 business days; for any other investment, any sale or disposition that the fund reasonably expects would result in a decrease in sale price of more than 1%); and
- remove classification by asset class.

Amendments to Liquidity Classification Categories. The Proposal would eliminate the "less liquid" liquidity classification category under current Rule 22e-4, which comprises investments that the fund reasonably expects to be able to sell or dispose of in seven calendar days or less without significantly changing the market value of the investment, but that are reasonably expected to settle in more than seven calendar days. Such investments would be reclassified as illiquid investments. Under the Proposal, illiquid investments would also include investments whose fair value is

measured using an unobservable input that is significant to the overall measurement (i.e., Level 3 investments).

The Proposal would also simplify the definition of moderately liquid to mean any investment that is neither a highly liquid investment nor an illiquid investment. In addition, the Proposal specifies that the time period in which an investment is reasonably expected to be convertible to U.S. dollars would determine the liquidity classification of the investment.

Appendix A contains a table with the primary proposed changes to the liquidity classification framework of Rule 22e-4.

Frequency of Classifications. The Proposal would require a fund to classify all of its portfolio investments each business day instead of at least monthly.

Highly Liquid Investment Minimums. The Proposal would remove the exclusion in current Rule 22e-4 for funds that primarily hold assets that are highly liquid investments from the requirement to determine a highly liquid investment minimum and require all funds subject to Rule 22e-4 to determine and maintain a highly liquid investment minimum of at least 10% of the fund's net assets. In addition, the Proposal would require that, in assessing compliance with a fund's highly liquid investment minimum, the fund would be required to: (1) subtract the value of any highly liquid assets that are posted as margin or collateral in connection with any derivatives transaction that is classified as moderately liquid or illiquid; and (2) subtract any fund liabilities.

Limit on Illiquid Investments. Rule 22e-4 currently prohibits a fund from acquiring any illiquid investment if, immediately after the acquisition, the fund would have invested more than 15% of its net assets in illiquid investments. The Proposal would amend this provision of Rule 22e-4 to provide that the value of margin or collateral that a fund could only receive upon exiting an illiquid derivatives transaction would itself be treated as illiquid for these purposes because it would not be convertible to U.S. dollars within the required time frame.

Form N-PORT

The Proposal also would modify timing and disclosure requirements with respect to funds[11] that file reports on Form N-PORTs. Specifically, the Proposal would require funds to file reports with the SEC within 30 days of month-end, with most of the data

in such reports becoming public 60 days after month-end. Currently, while funds filing on Form N-PORT provide monthly information to the SEC, funds file these reports on a quarterly basis within 60 days of fiscal quarter-end, and the public only has access to information for the third month of each quarter. Current items that are nonpublic, including individual portfolio investment liquidity classifications, would remain nonpublic.

The Proposal would also require funds to report on Form N-PORT the percentage of the fund's assets that fall into each of the three modified liquidity categories of Rule 22e-4. A fund would be required to reduce its reported amount of highly liquid assets by the amount of highly liquid assets that it posts as margin or collateral for derivatives transactions that are not highly liquid and by the amount of the fund's liabilities as well as increase its reported amount of illiquid assets by the amount of collateral available upon exit of illiquid derivatives.

Compliance Dates

If adopted, the swing pricing and hard close requirements would be effective 24 months after the effective date of the amendments, and the liquidity rule and reporting changes would be effective 12 months after the effective date.

Reaction from the Industry

The Proposal and the swing pricing mandate, in particular, have been met with significant and swift negative feedback from the industry. Investment Company Institute President and CEO Eric Pan expressed unease about whether implementation of swing pricing is even feasible for the industry, noting that the proposal faces insurmountable operational hurdles and risks confusing investors and upending mutual funds' longstanding and equitable share pricing methodology.[12] SEC Commissioner Peirce similarly noted that swing pricing may cost fund investors more than the dilution does.[13]

Critics are also particularly concerned about retirement plan recordkeepers' ability to adhere to the hard close requirement. In addition, critics have cited that the reclassification of securities with extended settlement times as illiquid would dramatically affect mutual funds that invest in bank and floating rate loans, which may necessitate significant changes in their investment strategies in order to continue to

operate in an open-end fund structure, their conversion to a closed-end fund structure or their liquidation.

Funds, intermediaries and trade groups will have limited time to submit their comments, given a short comment period (comments are due 60 days after publication of the release in the Federal Register) with year-end holidays falling during the period.

Appendix A

Proposed Changes to Rule 22e-4's Liquidity Classifications

Liquidity Classifications and Related Terms	*Current Rule 22e-4*	*Proposed Rule 22e-4*
	Definitions	
Highly Liquid Investment	Any cash held by a fund and any investment that the fund reasonably expects to be convertible into cash in current market conditions in three business days or less without the conversion to cash significantly changing the market value of the investment.	Any U.S. dollars held by a fund and any investment that the fund reasonably expects to be convertible to U.S. dollars in current market conditions in three business days or less without significantly changing the market value of the investment.
Moderately Liquid Investment	Any investment that the fund reasonably expects to be convertible into cash in current market conditions in more than three calendar days but in seven calendar days or	Any investment that is neither a highly liquid investment nor an illiquid investment.

	less, without the conversion to cash significantly changing the market value of the investment.	
Less Liquid Investment	Any investment that the fund reasonably expects to be able to sell or dispose of in current market conditions in seven calendar days or less without the sale or disposition significantly changing the market value of the investment, but where the sale or disposition is reasonably expected to settle in more than seven calendar days.	Removed.
Illiquid Investment Convertible to Cash / U.S. Dollars	Any investment that the fund reasonably expects cannot be sold or disposed of in current market conditions in seven calendar days or less without the sale or disposition significantly changing the market value of the investment.	Any investment that the fund reasonably expects not to be convertible to U.S. dollars in current market conditions in seven calendar days or less without significantly changing the market value of the investment and any investment whose fair value is measured using an unobservable input that is significant to the overall measurement.
Convertible to Cash / U.S. Dollars	The ability to be sold, with the sale settled.	The ability to be sold or disposed of, with the sale

		or disposition settled in U.S. dollars.
	Related Concepts	
Assumed Trade Size	Sizes that the fund would reasonably anticipate trading	10% of the fund's net assets by reducing each investment by 10%
Value Impact Standard	Significantly changing the market value of the investment	Significantly changing the market value of an investment means: (1) For shares listed on a national securities exchange or a foreign exchange, any sale or disposition of more than 20% of average daily trading volume of those shares, as measured over the preceding 20 business days. (2) For any other investment, any sale or disposition that the fund reasonably expects would result in a decrease in sale price of more than 1%.

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1. Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting, Investment Company Act Release No. 34736 (Nov. 2, 2022) (the "Proposing Release"). ↩

2. The SEC itself states that it does not have specific data about the dilution fund shareholders experienced in March 2020 but notes that many European funds increased their use of swing pricing and the size of their swing factors during that period. *Proposing Release* at n. 40. ↩

3. *Id.* at 33. ↩

4. Exchange-traded funds ("ETFs") and money market funds ("MMFs") would not be required to implement swing pricing. In addition, feeder funds relying on Section 12(d)(1)(E) of the 1940 Act may not use swing pricing to adjust the feeder fund's NAV per share; however, a master fund must use swing pricing to adjust the master fund's NAV per share. ↩

5. *Id.* at 35. ↩

6. The Proposing Release justifies applying swing pricing regardless of the size of net redemptions by noting that swing pricing may help reduce any potential first-mover advantage associated with redeeming before other investors. In contrast, the Proposing Release acknowledges that low levels of net purchases are less likely to result in dilution but that higher levels of net purchases are more likely to result in dilution absent appropriate tools for mitigating it. ↩

7. The swing pricing administrator is defined in the Proposing Release as the fund's investment adviser or officer(s) responsible for administering the fund's swing pricing policies and procedures. The Proposing Release specifies that the swing pricing administrator may consist of a group of persons. The administration of swing pricing must be reasonably segregated from portfolio management of the fund and may not include portfolio managers. This concept is similar to the requirement under Rule 22e-4 with respect to the administrator for a fund's liquidity risk management program. ↩

8. In recognition of the challenges of this determination, as some intermediaries do not provide order flow until after the fund has finalized its NAV, the Proposal permits the swing pricing administrator to make swing pricing determinations based on sufficient investor flow information to allow the fund to estimate reasonably whether it has crossed a swing threshold with high confidence. In addition, the hard close requirement of the Proposal, discussed below, is designed to result in funds generally having flow information in a timely manner and reduce the need for estimation. ↩

9. The market impact threshold recognizes that there may be operational challenges and complexities to estimating market impact costs and that market impacts are likely to be minimal or even negligible when redemptions are not significant. ↩

10. Because this discretion could potentially be used to enhance fund performance in a misleading manner, the swing pricing administrator would be required to include in its written reports to the board the information and data supporting its determination to use lower thresholds. ↩

11. The universe of funds required to file Form N-PORT is unchanged in the Proposal and would continue to include open-end funds, registered closed-end funds and ETFs registered as unit investment trusts, and exclude MMFs and small business investment companies. As a result, all funds that are N-PORT filers would be subject to the increased filing frequency of the N-PORT, not merely open-end funds. ↩

12. ICI News Release, Swing Pricing Proposal from SEC Could Severely Harm Savers, Nov. 2, 2022 (releasing ICI President and CEO Eric Pan's statement on the Proposal). ↩

13. SEC Commissioner Hester M. Peirce, Closing Act: Statement on Proposed Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting, Nov. 2, 2022. ↩

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