Stradley Ronon

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Client Alert | Investment Management

SEC Proposes Extensive Changes to Open-End Fund Liquidity Framework

On Nov. 2, 2022, the Securities and Exchange Commission (the SEC) proposed amendments to its current rules for open-end management investment companies (open-end funds) regarding liquidity risk management programs and swing pricing (the Proposal).[1] The Proposal follows the 2016 adoption of Rule 22e-4 under the Investment Company Act (the Liquidity Rule)[2], which requires open-end funds to adopt and implement liquidity risk management programs, and subsequent amendments adopted by the SEC in 2018 that were designed to improve the reporting and disclosure of liquidity information by open-end funds.[3] The Proposal, which would make the current optional swing pricing framework mandatory, would fundamentally change how funds are priced, and make other significant related changes, including imposing a "hard close" on the process used to submit investor orders to funds.

According to the SEC, the amendments in the Proposal are intended to better prepare open-end funds for stressed conditions, improve transparency in liquidity classifications, and mitigate dilution of shareholders' interests. The SEC noted that the proposed amendments are informed by its evaluation of data regarding how the liquidity framework has operated over the last several years, including in March 2020 at the onset of the COVID-19 pandemic.[4]

The Proposal represents a sweeping overhaul of fund liquidity risk management programs, pricing and relationships with their intermediaries, and reporting to the SEC. If the SEC adopts many elements of the Proposal, it would be imposing requirements on funds that have previously been rejected as costly, unnecessary, and unworkable. This Alert summarizes the Proposal and addresses some key observations and issues to consider throughout.

The Proposal

The SEC's proposed amendments focus on four main areas: (1) amendments to the liquidity risk management program requirements; (2) the required use of swing pricing for all open-end funds, excluding exchange-traded funds (ETFs) and money market funds (MMFs) (collectively, excluded funds); (3) the required use of a "hard close" by all open-end funds, other than excluded funds; and (4) increased frequency of reporting fund information on Form N-PORT by open-end funds.[5]

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1 Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting, Investment Company Act Release No. 34746 (Nov. 2, 2022).

2 Investment Company Liquidity Risk Management Programs, Investment Company Act Release No. 32315 (Oct. 13, 2016).

3 Investment Company Liquidity Disclosure, Investment Company Act Release No. 33142 (June 28, 2018).

4 In particular, the SEC highlights official sector interventions, including the Secondary Market Corporate Credit Facility, which supported market liquidity by purchasing in the secondary market corporate bonds issued by investment grade U.S. companies, as well as U.S.-listed ETFs whose investment objective is to provide broad exposure to the market for U.S. corporate bonds.

5 The N-PORT amendments would apply to all open-end funds (excluding MMFs), registered closed-end funds, and ETFs organized as unit investment trusts.

I. Amendments Concerning Funds' Liquidity Risk Management Programs

The SEC noted that the proposed amendments to the liquidity risk management framework are intended to better prepare funds for future stressed conditions by providing additional standards for making liquidity determinations, amending certain aspects of the liquidity categories, and requiring more frequent liquidity classifications, as detailed below.

Move from 4 to 3 Buckets, and Change in Definitions for Each. The Liquidity Rule currently requires a fund to classify its investments into one of four different liquidity categories. The proposed amendments include a number of changes to the categories, such as modifying the definitions and eliminating the less liquid category, as highlighted in the chart below:

Liquidity Classifications and Related Terms	Current	Proposed
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>U.S. dollars</u>* held by a fund and any investment that the fund reasonably expects to be convertible to *<u>U.S. dollars</u>* 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 less without the conversion to cash significantly changing the market value of the investment.	*<u>Any investment that is neither a highly liquid investment nor an illiquid investment.</u>*
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.	*<u>Removed.</u>*
Illiquid Investment	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 *<u>convertible to U.S. dollars</u>* in current market conditions in seven calendar days or less without significantly changing the market value of the investment *<u>and any investment whose fair value is measured using an unobservable input that is significant to the overall measurement</u>*.[6]

[6] This "unobservable input" addition is drawn from the "level 3" standard under the US GAAP fair value hierarchy.

Liquidity Classifications and Related Terms	Current	Proposed
		Note: The Proposal also includes an amendment 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.
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.

In addition to the changes highlighted above, the proposed amendments would also require a fund to classify all of its portfolio investments each business day instead of at least monthly and change the method for counting the number of days under the tests.[7]

Assumption of Stressed Trade Size Sales. Currently, when a fund makes a liquidity classification under the Liquidity Rule, it must be based on reasonably anticipated trading sizes. The Proposal would amend the Liquidity Rule to require a fund to assume the sale of a set stressed trade size when determining a liquidity classification for an investment by assuming a 10% sale of each investment in the fund.

Value Impact Standard. Currently, when a fund makes a liquidity classification, it must analyze whether a sale or disposition would "significantly change the market value of the investment" under the Liquidity Rule. In an attempt to prevent funds from over-estimating the liquidity of their investments, the SEC is removing discretion in applying the standard and, more specifically, defining what constitutes a significant change in market value, as detailed below:

National Securities/Foreign Exchange	Other Investments Calculation
If a security is exchange-traded, selling or disposing of more than 20% of the security's average daily trading volume, as measured over the last 20 trading days.	For other investments, such as fixed-income securities and derivatives, any sale or disposition that a fund reasonably expects would result in a decrease in sale price of more than 1%.[8]

Removal of Asset Class Classifications. Currently, the Liquidity Rule, subject to certain exceptions, allows a fund to classify and review its portfolio investments according to their asset class. At this time, the SEC understands that asset class classifications are not widely used by funds based on outreach. The SEC believes this method runs the risk of overestimating the liquidity of a fund's investments and could impair a fund's ability to adjust quickly in times of stress, in addition to being less compatible with its proposed value impact standard discussed above. Accordingly, the proposed amendments would remove the asset class method of classification from the Liquidity Rule.

Highly Liquid Investment Minimums for All Funds. The Liquidity Rule currently requires a fund to determine a highly liquid investment minimum if it does not primarily hold highly liquid investments. The proposed amendments, however, would: (1) remove the "primary exclusion" and (2) require all funds to determine and maintain a highly liquid investment minimum of at least 10% of the fund's net assets. In

[7] In particular, the measurement must include the day on which the classification is made. For example, under the new test, if a fund is classifying an investment on Monday, it is only highly liquid if convertible under the standard by Wednesday.

[8] In considering whether a sale is reasonably expected to result in a price decrease of more than 1%, the fund would be required to consider the size of the sale relative to the depth of the market for the instrument and generally should consider, among other things, the width of bid-offer spreads.

addition, consistent with the current Liquidity Rule, a fund would be required to consider a specified set of liquidity risk factors to determine whether its highly liquid investment minimum should be above 10%.[9] This change would result in many very liquid funds adopting unnecessary highly liquid investment minimums.

Key Observations
- **Many Funds Will Appear Less Liquid:** If the Proposal is adopted, many funds will appear to hold less liquid portfolios than they do today, with no change in the actual liquidity of the investments and without appropriate context. Many of the proposed changes by the SEC attempt to define liquidity with a level of precision that fails to reflect the inherent uncertainty of liquidity in the markets. The current approach better recognizes this uncertainty by providing more discretion and flexibility in the relevant definitions. - **Bank Loan Funds:** Over 90% of bank loan investments reported by open-end funds are classified as "less liquid." The elimination of the less liquid category would result in bank loans being considered illiquid investments under the Liquidity Rule, absent the ability to negotiate shorter settlement cycles for such investments, even though bank loan funds were able to meet redemption requests during March 2020. If adopted, certain bank loan funds would need to negotiate shortened settlement cycles for such investments or, alternatively, change their strategies, close funds, or consider using a closed-end fund or other investment vehicle structure.

II. Swing Pricing

The Proposal also includes proposed amendments to Rule 22c-1 under the Investment Company Act, which would require all open-end funds, other than excluded funds and feeder funds, to engage in swing pricing under certain conditions, among other amendments.

Proposed Swing Pricing Requirement. Swing pricing is a process of adjusting a fund's current NAV when certain conditions are met in an attempt to pass on transaction costs stemming from shareholder inflows or outflows to the shareholders engaged in that activity. Swing pricing swings the NAV upward (in the case of a net purchase of fund shares, so that transacting shareholders bear the transaction costs from resulting fund purchases of portfolio securities) or downward (in the case of a net redemption of fund shares, so that transacting shareholders bear the transaction costs from resulting fund sales of portfolio securities). See Exhibit 1 for a diagram showing how swing pricing would work under the Proposal.

Rule 22c-1 currently makes the use of swing pricing optional. The SEC, however, noted that no U.S. funds have currently implemented swing pricing, in part due to a lack of timely flow information to operationalize this anti-dilution tool, in addition to cost concerns and unfamiliarity with the process.

The Proposal would amend Rule 22c-1 to require every open-end fund (other than excluded funds and feeder funds) to implement swing pricing policies and procedures that adjust a fund's current NAV per share by a swing factor if the fund has net redemptions or net purchases that exceed an identified threshold. The SEC believes that making swing pricing a requirement, rather than a permissive framework, would accrue benefits to investors that justify the implementation costs and would overcome the collective action problems that may have prevented swing pricing implementation.

In addition to making swing pricing mandatory rather than optional, the Proposal is much more prescriptive than the current approach with respect to certain elements of the swing pricing framework. For example:

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9 In addition to the changes discussed above, the proposed amendments would also require that, when determining the amount of assets a fund has classified as highly liquid that count toward the highly liquid investment minimum, the fund account for limitations in its ability to use some of those assets to meet redemptions. Specifically, in assessing compliance with the 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.

"Swing Threshold." The swing threshold determines whether fund flows necessitate adjustment of the fund's NAV. The current swing pricing framework allows funds to determine their own thresholds. The proposed amendments, however, would include specific requirements as to when a fund must use swing pricing to adjust its current NAV, which would differ depending on whether the fund has any net redemptions, or any net purchases above a specified threshold on a given day, as outlined below.

Net Redemptions	Net Purchases
- Swing factor must be applied regardless of the size of a fund's net redemptions. - A fund must include market impacts in its swing factor only if net redemptions exceed 1% of a fund's net assets (the market impact threshold). - Market impact costs are the costs incurred when the price of a security changes as a result of the effort to purchase or sell the security.	- Swing factor, including market impact costs, is only required for net purchases if the amount of net purchases exceeds 2% of the fund's net assets (the inflow swing threshold).

Although the proposed amendments identify a market impact threshold for net redemptions and an inflow swing threshold for net purchases, the amendments give discretion to swing pricing administrators to set lower thresholds if the administrator determines it is appropriate to mitigate dilution. To help address the risk that this discretion could be used in a misleading manner to boost performance, the SEC determined the amendments would require the administrator to include information and data supporting its determination to use lower thresholds in its written report to the board.

Determining Flows. Currently, some intermediaries do not provide order flow until after a fund has finalized its NAV, which can make it difficult to determine investor flow information on a given day. Accordingly, while the hard close proposal discussed below is an attempt to mitigate such an issue, the proposed amendments would continue to permit the swing pricing administrator to make swing pricing determinations based on reasonable, high-confidence estimates of investor flows. The swing pricing administrator, however, would also be required to review investor flow information on a daily basis to determine: (1) if the fund experiences net purchases or net redemptions; and (2) the amount of net purchases or net redemptions.

"Swing Factor." The swing factor determines the amount to adjust the fund's NAV. The proposed amendments also include a number of changes to how a fund calculates a swing factor, as compared to the current swing pricing framework. One particular change is to no longer allow a fund to consider the specific investments it would purchase or sell in connection with purchases or redemptions, respectively. Instead, the proposed amendments would require that a fund assume it purchased or sold a pro-rata amount of each investment in its portfolio equal to the amount of net purchases or net redemptions (i.e., a vertical slice).[10]

[10] The SEC proposed to remove the upper limit on the swing factor. Form N-1A currently requires funds that use swing pricing to disclose a fund's swing factor upper limit. Because the SEC proposed to remove the swing factor upper limit in the rule, they also proposed to remove the requirement to provide an upper limit on the swing factor from Item 6(d) of Form N-1A.

Calculating the swing factor would depend on whether the fund is in net redemptions or purchases, as highlighted below:

	Costs	Application
Net Redemptions = Swing Down	- spread costs; - brokerage commissions, custody fees and any other charges, fees and taxes associated with portfolio investment sales; and - if the amount of the fund's net redemptions exceed the market impact threshold, the market impact	Applied regardless of the size of net redemptions; however, market impact only applied if net redemptions exceed 1% of net assets (or lower threshold if set by administrator)
Net Purchases = Swing Up	- spread costs; - brokerage commissions, custody fees, and any other charges, fees, and taxes associated with portfolio investment purchases; and - the market impact	Only applied if net purchases exceed 2% of net assets (or lower threshold if set by administrator)

Board Responsibilities. Under the proposed framework, the fund's board, including a majority of the independent directors, must:

- Approve the fund's swing pricing policies and procedures;
- Designate the fund's swing pricing administrator;[11] and
- Review, no less frequently than annually, a written report prepared by the administrator.[12]

Money Market Funds. Although money market funds are excluded from the Proposal, institutional prime and institutional tax-exempt money market funds are subject to a separate problematic swing pricing proposal. That proposal includes similar requirements, although it does not require swing pricing for money market funds with net purchases and includes a different market impact standard. In commenting on the Proposal, SEC Commissioner Peirce stated that it is "stunning in light of the stone-cold reception" that the similar money market fund proposal received.

Key Observations
There are numerous concerns with respect to the swing pricing aspect of the Proposal, including investor confusion and the operational and informational issues that the SEC is attempting to fix simultaneously with the implementation of a hard close (which is discussed in Section III below). Without substantial changes to the way funds and intermediaries transact purchases and redemptions, the implementation of swing pricing by funds presents significant challenges. Further, as acknowledged by the SEC in its request for comments, the challenges and costs could create incentives for investors to move their assets to other investment vehicles, such as ETFs, which are excluded from the swing pricing requirement due to the way they transact with authorized participants.

III. Hard Close Requirement

Under the Proposal, all open-end funds required to implement swing pricing (which would exclude MMFs and ETFs) would also be required to implement a hard close. Currently, if an investor submits an order to an intermediary to purchase or redeem fund shares, that order will be executed at the current day's price as long as the intermediary receives the order before the time the fund has established for determining the value of its holdings and calculating its NAV, which is typically 4 p.m. ET. The fund, however, may not receive information about that order until after it calculates its NAV, which presents issues for implementation of

[11] Additionally, similar to the current rule, a fund's portfolio manager could not be designated as the swing pricing administrator.
[12] The SEC proposed to remove the requirement in the existing optional framework that the board approve the fund's swing threshold and the upper limit on the swing factor(s) used, as well as any changes to these items.

swing pricing due to funds lacking sufficient flow information. Accordingly, the Proposal would further amend Rule 22c-1 to provide that an investor would only be eligible to receive the current day's price for a sale or redemption of a fund's shares if the fund, its designated transfer agent or registered securities clearing agency[13] (collectively, designated parties) receives an eligible order prior to the time a fund calculates its NAV. Orders received by the designated parties after such time would receive the next day's price.[14]

Key Observations
- A large portion of the Proposal's discussion regarding the hard close requirement focused on the SEC's acknowledgement of the potential operational challenges it could impose. For example, currently intermediaries generally submit aggregated and, in some cases netted, orders in one or more batches, often after 4 p.m. ET. In addition, some intermediaries' systems do not initiate batch processing until a fund's final NAV is received or until final NAVs are received for all funds offered on their platforms, which is particularly common with respect to retirement plan recordkeepers. To comply with the proposed hard close requirement, funds and intermediaries would need to make significant changes to their business practices, including updating their computer systems, altering their batch processes, or integrating new technologies that facilitate faster order submission (i.e., before 4 p.m. ET), or be based on a determination to process fund orders at the next day's price as a matter of practice. - Another of the primary concerns with respect to the hard close aspect of the Proposal, which the SEC acknowledged, is that the requirement could be particularly problematic for retirement plan recordkeepers, a significant investor base for mutual funds. Retirement plans frequently effect transactions (e.g., plan loans, withdrawals, or rebalances) that require fund NAVs to finalize. A hard close rule would be expected to delay completion of such transactions. - To implement the changes, the SEC noted that intermediaries may want to set their own internal cut-off time for receiving orders that is earlier than the pricing time to ensure that they are able to process orders in compliance with the Proposal. The SEC acknowledged that this may cause some investors transacting through intermediaries to lose flexibility on when they may submit orders to receive the current day's price. For an example of the harm, an investor could suffer as a result of the inability to make investment decisions based on current market information and waiting more than 24 hours for a fund transaction to be processed, see Exhibit 2. - We are concerned that many intermediaries may not be willing to make the necessary changes to continue offering mutual funds as an investment option.

IV. Alternatives to Swing Pricing and the Hard Close Requirement

The Proposal requested comment on a number of alternatives to swing pricing and the hard close, which are highlighted below.

	Swing Pricing Alternatives
Liquidity Fees	The liquidity fee would be charged only to a transacting investor and would not affect the fund's price.
Dual Pricing	A fund using dual pricing would have one price for purchasing investors to reflect the cost of buying portfolio securities in the market and another price for selling shareholders, to reflect the proceeds the fund would receive from selling portfolio securities in the market.

13 Currently, NSCC is the only registered clearing agency for fund shares, which operates its Fund/SERV service for processing fund transactions.

14 In addition to the change discussed above, the Proposal would also amend Form N-1A to require disclosure, noting that if an investor places an order with an intermediary, the intermediary may have an earlier submission time than the fund to receive the next calculated NAV.

	Hard Close Alternatives
Indicative Flows from Intermediary	This approach would require that funds receive indicative flow information from intermediaries at a set time, requiring the intermediary to calculate an estimate of flows for a given day.
Fund Estimated Flows	This method would have funds estimate their flows for a given day to determine if a swing factor should be applied to that day's NAV and the amount of the swing factor.
Later Cut-Off Times for Intermediaries	For this alternative, investors would still have to submit their order before the pricing time to receive that day's NAV, but intermediaries would have additional time to provide those orders to the fund after the pricing time.

V. Reporting Requirements

The Proposal would require the filing of Form N-PORT on a monthly basis and would make more of those reports publicly available, as described further in the chart below. Because these reporting requirements would apply to mutual funds, ETFs, and closed-end funds, the obligations would extend to a broader universe of funds than many of the other changes in the Proposal.

N-PORT	Current	Proposed
Filing Frequency Increased from 4 to 12 times/year	- Filers file for each month of a fiscal quarter 60 days after the end of the quarter.	Filers would file 30 days after the end of each month.
Public Disclosure Increased from 4 to 12 times/year	- Only information for the 3rd month of a fiscal quarter is made public (within 60 days after the end of the fiscal quarter).	Information for each month would be made public 60 days after the end of the month. [15]

VI. Conclusion

Public comments on the Proposal are due 60 days after publication in the Federal Register. It is likely that the industry will focus on a number of key issues in the significant and harmful Proposal during the comment period, including the operational challenges and costs presented with respect to implementing swing pricing and a hard close, particularly for intermediaries such as retirement plan recordkeepers, a significant investor base of mutual funds. Additionally, Commissioners Hester M. Pierce and Mark T. Uyeda raised a number of important concerns in their dissenting statements.[16] The industry should carefully consider their statements in developing comments on the Proposal.

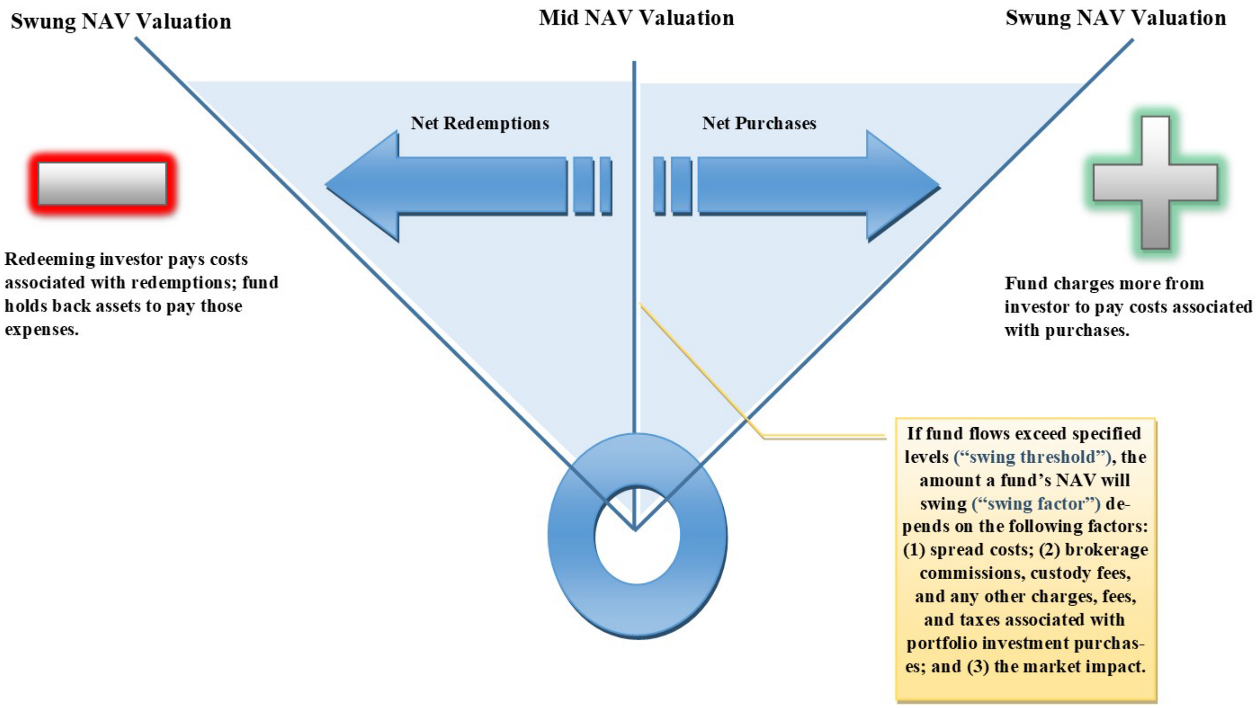
We expect that these comments, like prior comments on similar SEC proposals, will demonstrate that the SEC should pursue market-driven alternatives supported by data rather than changes to funds supported by bank regulators following the extraordinary market volatility caused by the COVID-19 pandemic.[17] For example, the SEC should instead pursue enhancements to the fixed income markets more generally, rather than making changes to funds that add costs and take away features that benefit fund investors.

[15] Certain information would remain nonpublic under the Proposal (e.g., liquidity classifications for individual portfolio investments).

[16] Hester M. Peirce, Commissioner, SEC, Closing Act: Statement on Proposed Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting (Nov. 2, 2022); Mark T. Uyeda, Commissioner, SEC, Statement on Proposed Rule: Open-End Fund Liquidity Programs and Swing Pricing; Form N-PORT Reporting (Nov. 2, 2022).

[17] For example, prior comments on the Liquidity Rule, swing pricing, and the hard close, as well as market events relating to March 2020, clearly explain why any benefits of the requirements in the Proposal are far outweighed by the costs.

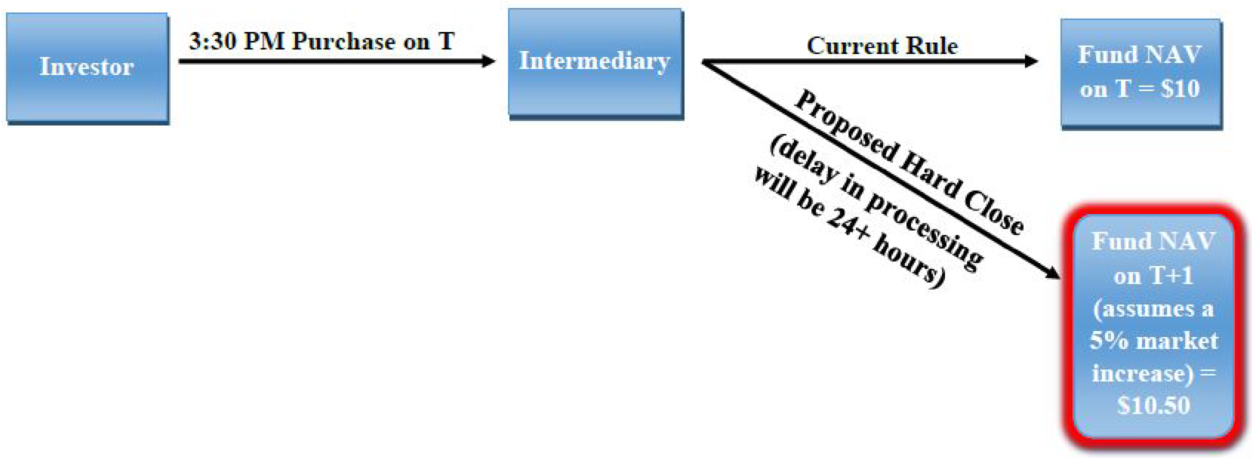
Exhibit 1

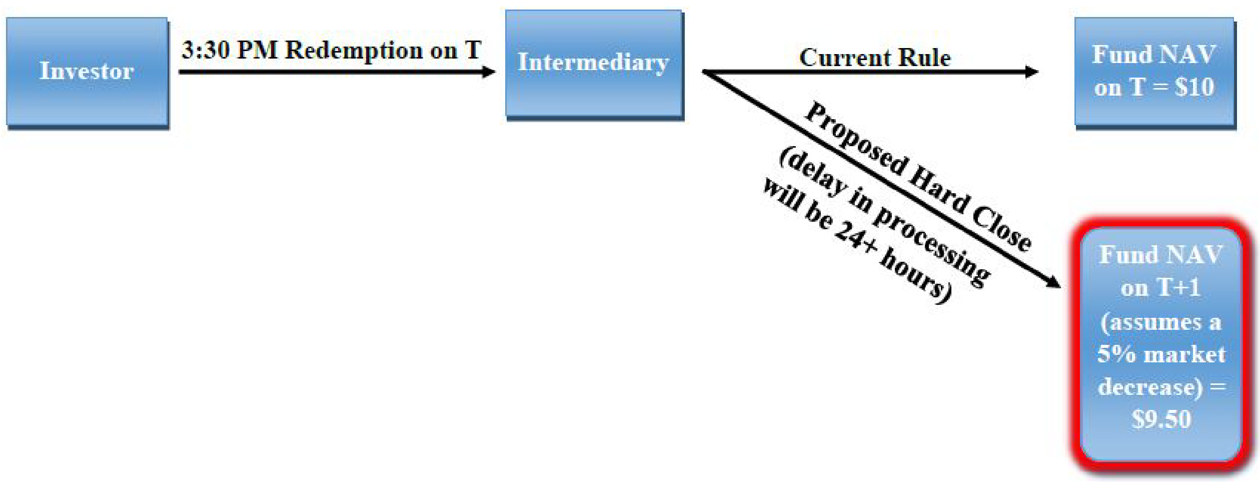


Swung NAV Valuation
Mid NAV Valuation
Swung NAV Valuation
Net Redemptions
Net Purchases
Redeeming investor pays costs associated with redemptions; fund holds back assets to pay those expenses.
Fund charges more from investor to pay costs associated with purchases.
If fund flows exceed specified levels ("swing threshold"), the amount a fund's NAV will swing ("swing factor") depends on the following factors: (1) spread costs; (2) brokerage commissions, custody fees, and any other charges, fees, and taxes associated with portfolio investment purchases; and (3) the market impact.

Exhibit 2

Example of Investor Harm Under Proposed Hard Close:
Inability to Make Investment Decisions Based on Current Market Information





For more information, contact:

Brian Crowell
Partner
215.564.8082 | bcrowell@stradley.com

David W. Grim
Partner
202.507.5164 | dgrim@stradley.com

Jamie M. Gershkow
Partner
212.404.0654 | jgershkow@stradley.com

Geena Marzouca
Associate
202.507.6408 | gmarzouca@stradley.com

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