November 28, 2022

# SEC Proposes Mandatory "Swing Pricing" and Revised Liquidity and Reporting Requirements for Open-End Funds

## Significant Amendments Seek to Improve Liquidity Risk Management Programs to Better Prepare Open-End Funds for Stressed Conditions, Improve Transparency in Liquidity Classifications and Mitigate Dilution of Shareholders' Fund Interests by Requiring Certain Open-End Funds to Use Swing Pricing.

## SUMMARY

On November 2, 2022, the Securities and Exchange Commission (the "SEC") voted 3-2 to propose significant amendments to rules 22e-4 and 22c-1 under the Investment Company Act (dealing with liquidity risk management and pricing of shares, respectively), as well as amendments to related reporting and disclosure forms.[1] According to the release, the SEC determined to review the effectiveness of the existing tools of open-end management investment companies ("open-end funds") for managing liquidity and limiting shareholder dilution following the March 2020 economic shock resulting from the onset of the COVID-19 pandemic, which led to significant market volatility, spread widening and investor redemptions from funds, and also resulted in liquidity concerns.[2] Following this review, the SEC is proposing amendments "to enhance funds' liquidity risk management to help better prepare them for stressed market conditions and to require the use of swing pricing for certain funds in certain circumstances to limit dilution."[3]

Consistent with current rule 22e-4, amended rule 22e-4 would apply to open-end funds other than money market funds, and the requirements relating to classifying the liquidity of a fund's investments and maintaining the requisite highly liquid investment minimum would not apply to exchange-traded funds ("ETFs") that are in-kind ETFs.[4] The mandatory swing pricing and related requirements of amended rule

22c-1 would apply to open-end funds other than money market funds and ETFs. As proposed, and subject to the foregoing, the amendments would, among other things:

- Eliminate the "less liquid" investment category from the existing liquidity classification framework under rule 22e-4 and treat all such investments as illiquid, subject to the 15% limit on illiquid investments;
- Require funds to classify all portfolio investments daily instead of monthly, and require that funds incorporate stress into their liquidity classifications by assuming the sale of a set stressed trade size equal to 10% of each portfolio investment (a so-called "vertical slice");
- Require funds to determine and maintain a highly liquid investment minimum ("HLIM") equal to at least 10% of net assets, eliminating the current exclusion for funds that primarily invest in highly liquid investments;
- Amend provisions governing the designation of investments as "illiquid" and the calculation of applicable liquidity minimums and illiquidity limits;
- Require a fund subject to mandatory swing pricing to implement swing pricing whenever it has net redemptions in any amount or net purchases in excess of 2% of the fund's net assets;
- Specify when and how a fund subject to mandatory swing pricing would adjust its net asset value ("NAV") and impose a specific framework for calculating the swing factor price adjustment;
- For funds subject to mandatory swing pricing, require that purchase and redemption orders be received by a fund, its transfer agent or a registered clearing agency by an established cut-off time (i.e., the pricing time, which is typically 4 p.m. ET) to receive the applicable day's price (a "hard close"); and
- Impose significantly expanded reporting and disclosure obligations on funds, including adding new reporting items to Form N-PORT, mandating monthly (rather than quarterly) filing of Form N-PORT reports (including for closed-end funds) and making substantial portions (including aggregate liquidity classification information, which is not currently made publicly available) of each monthly report publicly available (rather than making only information for the third month of each fiscal quarter publicly available).

If adopted as proposed, the amendments would result in sweeping changes to the distribution, operation and reporting of open-end funds, with the potential to impose significant costs on these funds and their shareholders. The SEC is seeking comment from the public on the proposal, including responses to 261 specific questions included in the 433-page proposing release. Comments are due 60 days after the date of publication of the proposed amendments in the Federal Register, notwithstanding the significant changes that would be necessary if the amendments are adopted as proposed.[5]

## BACKGROUND

In 2016, the SEC adopted rule 22e-4 under the Investment Company Act, requiring most open-end funds, including most ETFs but excluding money market funds, to adopt and implement liquidity risk management programs, to address concerns that open-end funds investing in less liquid securities may not be able to meet redemption requests without diluting remaining investors' interests in such funds.[6] Rule 22e-4 currently requires, among other things: (1) assessment, management and periodic review of a fund's

liquidity risk; (2) classification of the liquidity of each of a fund's portfolio investments into one of four prescribed categories—ranging from highly liquid to illiquid investments—including at-least-monthly reviews of these classifications; (3) determination and periodic review of a highly liquid investment minimum for certain funds; (4) a 15% limitation on illiquid investments; and (5) board oversight. An open-end fund subject to these requirements must also report the liquidity classifications of its holdings confidentially to the SEC on Form N-PORT and must immediately report to the SEC on Form N-RN and to the fund's board if its portfolio becomes more than 15% illiquid or if it breaches a threshold for non-highly liquid investments set as part of its liquidity management plan for seven consecutive days.

Also in 2016, the SEC adopted rule 22c-1 under the Investment Company Act, permitting (but not requiring) open-end funds (except money market funds or ETFs) to use swing pricing under certain circumstances.[7] Swing pricing, as defined in the proposed amendments, is "the process of adjusting a fund's current net asset value per share to mitigate dilution of the value of its outstanding redeemable securities as a result of shareholder purchase and redemption activity."[8] The amount by which a fund adjusts its NAV per share is referred to as the "swing factor" and the amount of net purchases or net redemptions triggering when swing pricing must be applied, if any, is referred to as the "swing threshold."[9] According to the release, though commonly deployed as an anti-dilution tool in Europe, no U.S. funds have implemented swing pricing since the adoption of the rule, which the SEC attributes primarily to industry-wide operational obstacles to obtaining the fund flow information necessary to implement swing pricing.[10]

The SEC explains in the release that it was motivated to revisit its rules regarding fund liquidity and shareholder dilution by the economic disruptions arising out of the onset of the COVID-19 pandemic in March 2020.[11] Investors' concerns about the potential impact of the pandemic led many investors to move assets into cash and short-dated, near-cash investments, resulting in large-scale outflows from open-end funds that placed pressure on these funds to generate liquidity quickly in order to meet investor redemptions.[12] Combined with widened bid-ask spreads, the SEC believes that these outflows also likely contributed to significant dilution of the value of open-end funds' shares for remaining investors.[13] To address concerns regarding liquidity and dilution, the divided SEC voted 3-2 to propose the rule and form amendments discussed below.

Commissioners Peirce and Uyeda voted to oppose the proposed amendments. Both Commissioners raised concerns about the burden the mandatory imposition of swing pricing would place on open-end funds subject to the requirements and investors. Though recognizing that "[d]ilution may occur and is more likely in volatile times," Commissioner Peirce argued that the amendments, if adopted as proposed, "may cost fund investors more than the dilution does" and pointed to other solutions already available to address dilution, such as investors' ability to invest in ETFs or funds' ability to charge a simplified liquidity fee.[14] Both Commissioners also took issue with the SEC's reliance on the use of swing pricing in Europe as support for imposing swing pricing on funds in the U.S. given the differences between European and U.S.

funds' regulatory frameworks and markets, including differences in retirement plan systems between the two jurisdictions.[15] Commissioner Peirce also noted that the proposed "hard close" amendments to rule 22c-1 would likely have "cascading consequences," especially for retirement plan record-keepers, to the potential detriment of investors.[16] Commissioner Uyeda echoed these concerns, while also noting that the SEC "may be simply accelerating an existing trend where ETFs replace mutual funds as the low cost choice of investors."[17]

## OVERVIEW OF THE PROPOSED AMENDMENTS

The proposed amendments broadly fall into three categories—adjustments to the liquidity risk management framework, imposition of mandatory swing pricing and changes in reporting requirements—and would result in changes to rules 22e-4 and 22c-1 and Forms N-PORT, N-CEN and N-1A. The changes to Form N-PORT include mandating monthly rather than quarterly filing, together with additional reporting obligations. The SEC is also proposing that significant amounts of the monthly information be made publicly available. We discuss key elements of these proposed amendments below.

### A. AMENDMENTS TO FUNDS' LIQUIDITY RISK MANAGEMENT PROGRAMS (RULE 22E-4)

#### 1. Amendments to the Liquidity Classification Framework

The proposed amendments include a number of changes to the existing classification framework that would "provide additional standards for making liquidity determinations, amend certain aspects of the liquidity categories, and require more frequent liquidity classifications."[18] Specifically, the amendments would, among other things:

- Require funds to assume, when making liquidity classifications under the rule, the sale of a set stressed trade size equal to 10% of each portfolio investment, rather than the rule's current approach of assuming the sale of a reasonably anticipated trade size in current market conditions;
- Re-define the value impact standard, which requires funds making liquidity classifications to analyze whether a sale or disposition of an investment would "significantly change the market value" of that investment, to include specific factors dictating when a sale or disposition of shares listed on an exchange, on the one hand, and all other investments, on the other hand, would significantly change the market value of the investment;[19]
- Eliminate funds' ability to classify and review portfolio investments according to asset class by mandating that classifications be investment-specific;
- Remove the "less liquid" investment category, resulting in the classification of all such investments as illiquid,[20] and expand the scope of the illiquid investment category by specifically including investments whose fair value is measured using an unobservable input that is significant to the overall measurement;[21] and
- Require that funds classify all portfolio investments daily instead of monthly.[22]

These amendments would require most open-end funds to implement significant changes to their existing liquidity classification processes and, in some cases (including bank loan funds), cause open-end funds to

rebalance their portfolio holdings or change their strategies in order to comply with the changes, which could negatively affect some funds' performance.[23]

With respect to the proposed amendment that would require open-end funds subject to the classification requirements use a "stressed trade size" of 10% in making liquidity classifications, the SEC explains in the release that it has observed "wide variation" in funds' practices applying the existing "reasonably anticipated trade size" or "RATS."[24] Similarly, with respect to the proposed requirement that such funds classify all of their portfolio investments each business day instead of at least monthly, the SEC stated that it is concerned based on SEC staff observations of industry practice that funds are only equipped to classify their investments on a monthly basis to meet reporting requirements and are not prepared to review classifications intra-month, as may be required in response to stressed market conditions.[25] The SEC believes that daily classifications would assist liquidity risk program administrators in better monitoring and responding to changes in funds' liquidity.[26]

### 2. Highly Liquid Investment Minimums

Under current rule 22e-4, an open-end fund (other than a money market fund or in-kind ETF) must determine a highly liquid investment minimum and adopt and implement policies and procedures for responding to a shortfall in the fund's highly liquid investments below its established minimum if the fund does not primarily hold assets that are highly liquid investments.[27] The proposed amendments would now require all funds (other than money market funds and in-kind ETFs), including those that primarily hold highly liquid assets, to determine and maintain a highly liquid investment minimum of at least 10% of the fund's net assets (which the SEC notes is equivalent to the proposed "stressed trade size" discussed above).[28] Under the proposal, in assessing compliance with a fund's highly liquid investment minimum, the fund would be required to subtract (1) 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) any fund liabilities, as defined in rule 6.04 of Regulation S-X.[29]

### 3. Limit on Illiquid Investments

The SEC's proposal would amend the provision of rule 22e-4 limiting illiquid investments to 15% of a fund's net assets to provide that the value of margin or collateral that a fund could receive only upon exiting an illiquid derivatives transaction would itself be treated as illiquid for purposes of calculating the share of the fund's net assets invested in illiquid investments.[30]

## B. IMPLEMENTATION OF SWING PRICING AND RELATED AMENDMENTS (RULE 22C-1)

### 1. Mandatory Swing Pricing

The proposed amendments to rule 22c-1 would require all registered open-end funds (except money market funds and ETFs) to engage in swing pricing under certain conditions. The SEC states in the release that, "[b]y imposing the costs associated with net purchases or net redemptions on the shareholders who are

purchasing or redeeming from the fund at that time, swing pricing can more fairly allocate costs, reduce the potential for dilution of investors who are not currently transacting in the fund's shares, and reduce any potential first-mover advantages."[31] In determining to propose mandatory swing pricing, the SEC considered that funds may continue to choose not to implement swing pricing under a permissive framework due to "collective action problems" that make funds unwilling to be early adopters of the practice, including implementation costs and the unfamiliarity of U.S. investors with swing pricing.[32]

Under the existing swing pricing framework, a fund may determine its own swing threshold for net purchases and net redemptions, based on a consideration of certain factors identified in rule 22c-1.[33] The proposed amendments, however, would specify when a fund must use swing pricing to adjust its current NAV by a swing factor that requires the fund to make good faith estimates of the transaction costs of selling or purchasing a pro rata amount of its portfolio investments (or a "vertical slice") to satisfy that day's redemptions or to invest the proceeds from that day's purchases.[34] In the case of net redemptions, the proposed rule would require a fund that is subject to swing pricing to always apply swing pricing (i.e., to apply swing pricing without a swing threshold), because every net redemption can potentially involve trading or borrowing costs that dilute the value of the fund, as well as depletion of the fund's liquidity for remaining shareholders.[35] This appears to be mandated even if a fund has or would have cash available to satisfy its net redemptions. In the case of net redemptions in excess of 1% of the fund's net assets, the fund would be required to consider market impact costs when determining the appropriate swing factor.[36] In the case of net purchases, engaging in swing pricing (including determining market impact costs for purposes of calculating the swing factor) would be required if the amount of net purchases exceeds a swing threshold equal to 2% of the fund's net assets.[37]

The proposal would permit a fund's swing pricing administrator to set a market impact threshold that is lower than the mandatory 1% of net assets in the case of net redemptions and 2% of net assets in the case of net purchases if appropriate to mitigate dilution.[38] The proposed amendments would also remove the current 2% upper limit on the swing factor and remove the requirement that the fund's board review and approve the fund's swing threshold and the upper limit on the swing factor(s) used.[39]

The proposal would require that open-end funds subject to swing pricing establish and implement board-approved swing pricing policies and procedures. In addition, a fund's board would be required to designate a swing pricing administrator and review, no less frequently than annually, a written report prepared by the administrator.[40] The administrator would be the fund's investment adviser, an officer, or group of officers designated as responsible for administering the fund's swing pricing policies and procedures, but cannot be the fund's portfolio manager(s) and would be required to be reasonably segregated from portfolio management.[41] The swing pricing administrator would 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, determined on the basis of "reasonable, high confidence estimates."[42]

The proposal provides that in determining the swing factor, the "swing pricing administrator must make 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 its portfolio equal to the amount of net purchases or net redemptions."[43] The SEC notes in the release that these procedures and requirements are intended to address risks that swing pricing administrators would use swing pricing mechanics to improve fund performance.[44]

### 2. Hard Close Requirement

To facilitate the receipt of timely flow information and operationalize the proposed swing pricing requirement, the proposed amendments provide that, in order to receive the current day's price for a purchase or redemption order, a fund, its designated transfer agent or a registered securities clearing agency (each of the foregoing, a "designated party") must receive an "eligible order" before the pricing time the fund has established for determining the value of its holdings and calculating its NAV (typically 4:00 p.m. ET).[45] Orders received after the pricing time would receive the next day's price.

Consistent with the current rule, the "pricing time" would be established by the fund's board of directors and would be defined as the time or times of day as of which the fund calculates the current NAV of its redeemable shares.[46] Under the proposal, an "eligible order" would mean a direction to purchase or redeem a specific number or value of fund shares, and would also include exchange orders.[47] The proposed rule would also specify that eligible orders are irrevocable as of the next pricing time after a designated party receives the order.[48]

The SEC acknowledges in the release that the proposed hard close requirement would require changes to existing order-processing practices, which in turn would result in the incurrence of costs. The SEC discusses in the release the potential effects of the proposal on order processing, intermediaries, investors and certain transaction types.[49] Notably, the SEC seems to recognize the risk that the hard close requirement would potentially result in the migration of retirement plans from mutual funds to alternative investment options, requesting comment on whether this aspect of the proposal would cause retirement plan providers to replace mutual funds as plan investment options with ETFs or collective investment trusts, and asks how this would affect investors.[50]

## C. ALTERNATIVES TO SWING PRICING AND HARD CLOSE REQUIREMENTS

In the proposing release, the SEC explains that it has considered several alternatives to the proposed swing pricing requirements that could help ensure that costs stemming from shareholder purchase or redemption activity are borne by the shareholders engaged in such activities. These alternatives could be used independently or in combination with each other, and some, like the swing pricing requirement, would be dependent on investor flow information.[51] The SEC seeks comment on specific aspects of these alternative approaches, which include:

- ***Liquidity Fees***: A liquidity fee would be applied as a separate charge to a transacting investor without changing the fund's price per share.[52]
- ***Dual Pricing***: A fund that uses dual pricing would quote separate prices for incoming shareholders (reflecting the cost of buying portfolio securities in the market) and for outgoing shareholders (reflecting the proceeds the fund would receive from selling portfolio securities in the market), thus limiting dilution by ensuring that transaction costs are borne by transacting investors, though at the risk of imposing potentially significant operational burdens on funds and intermediaries.[53]

The SEC has also considered, and requests comment on, alternatives to the "hard close" requirement, including:

- ***Indicative Flows***: Funds would receive information about the day's estimated flows from intermediaries by an established time before or after a fund's pricing time, with final order information coming by the next morning, thus preserving flexibility for funds and intermediaries at the risk of leaving funds with less reliable flow information at pricing time.[54]
- ***Estimated Flows***: Funds would use their own data and models to estimate their flows for the day for the purposes of determining whether to apply a swing factor to the day's NAV and the amount of the swing factor. The SEC noted that this approach may not be as reliable as the indicative flows approach because funds lack the same breadth of data available to intermediaries closer to the market.[55]
- ***Later Cut-Off Times for Intermediaries***: Establishing later cut-off times for intermediaries to submit order flow information (e.g., by 6:00 or 7:00 p.m. ET for a fund with a 4:00 p.m. ET pricing time) could lessen the burden on intermediaries to comply with the proposed hard close requirement while continuing to give funds the necessary order flow information to implement swing pricing.[56]

Although the SEC voted to propose the swing pricing and hard close requirements, dissenting commissioners Peirce and Uyeda both noted the advantages of certain of the above alternatives in their statements opposing the SEC's proposal. Commissioner Peirce noted that "a simplified liquidity fee could apply to all redemption orders and be processed as part of a transaction, without the need for the [SEC] to upend the current order flow regime."[57] Commissioner Uyeda mentioned that he "look[ed] forward to public comments, especially with respect to the alternatives described."[58]

## D. SEC FORM AMENDMENTS

### 1. Amendments to Form N-PORT

Currently, registered management investment companies and ETFs organized as unit investment trusts file, on a quarterly basis with a 60 day delay, reports on Form N-PORT about their portfolios and each of their portfolio holdings (including information on liquidity classifications) as of month-end, and the information for the third month of each quarter is generally made publicly available (subject to certain information remaining nonpublic, such as liquidity classifications for individual portfolio investments).[59] To facilitate "more timely" provision of information to both the SEC and the public,[60] the proposed amendments to rule 30b1-9 and Form N-PORT, however, would require that registered funds (including closed-end funds) subject to Form N-PORT reporting obligations file Form N-PORT reports within 30 days of month-

end, and provide for much of the reported information to become publicly available 60 days after month-end.[61]

The proposed amendments to require monthly, rather than quarterly, filings on Form N-PORT stand in stark contrast to the current requirements of the form, which reflect revisions by the SEC in 2019 to address SEC and industry concerns regarding the various risks associated with making such information public, including cybersecurity risks relating to collection by the SEC of large amounts of recent, sensitive and non-public data as well as concerns about predatory trading such as front running.[62] The SEC has apparently determined that the need for more timely fund portfolio data outweighs the risk of the SEC receiving substantial amounts of sensitive and non-public data from funds and a potential future cybersecurity incident, citing to the SEC's "additional experience in receiving and maintaining sensitive portfolio data on the EDGAR system,"[63] and is satisfied that evolution in market practices are sufficient to address the prior concerns about predatory trading practices.[64]

In addition, the proposed amendments would, among other things, (1) require an open-end fund subject to rule 22e-4 to include in its monthly reports on Form N-PORT information regarding the aggregate percentage of its portfolio represented in each of the three proposed liquidity categories and (2) add a new reporting item to Form N-PORT related to swing pricing, which would require information about the number of times an open-end fund applied a swing factor during the month and the amount of each swing factor applied.[65] Information provided in response to these two new items would become public.[66] However, liquidity classifications for individual portfolio investments and certain other information reported on Form N-PORT would remain non-public.[67]

### 2. Other Form Amendments

The proposal also includes additional amendments to Forms N-PORT, N-CEN and N-1A to make conforming changes to other proposed amendments and to identify and provide certain information about service providers funds use to fulfill the requirements of rule 22e-4.[68] In particular, the proposed amendments to Form N-CEN would require open-end funds subject to rule 22e-4 to:

- name each liquidity service provider;
- provide identifying information, including the legal entity identifier and location, for each liquidity service provider;
- identify if the liquidity service provider is affiliated with the fund or its investment adviser;
- identify the asset classes for which that liquidity service provider provided classifications; and
- indicate whether the service provider was hired or terminated during the reporting period.[69]

The above proposed amendments to Form N-CEN are intended to allow the SEC and other interested persons to track certain liquidity risk management practices, as liquidity classification services have become more widely used.[70]

## E. SEC REVIEW OF RELATED EXEMPTIVE ORDERS, NO-ACTION LETTERS AND OTHER STATEMENTS

In the release, the SEC proposes to rescind an exemptive order that relates to rule 22e-4 on the basis that the order's representations, conditions and relief are predicated on rule 22e-4 in its current form.[71] In addition, the SEC notes that Division of Investment Management staff is reviewing no-action letters and other statements addressing compliance with rules 22e-4 and 22c-1 to determine which guidance should be withdrawn in connection with any adoption of the proposal.[72] The SEC includes in the release a non-exhaustive list of the no-action letters and other staff statements that are the subject of the staff's review.[73]

## F. TRANSITION PERIODS

If the amendments are adopted as proposed, they would provide for transition periods after their effective date.

- The SEC proposes a compliance date of 24 months after the effective date of the amendments for (i) the proposed swing pricing requirement in proposed rule 22c-1 and related reporting requirements on Forms N-PORT and N-1A, and (ii) the "hard close" requirement in proposed rule 22c-1 and related reporting requirements on Form N-1A.[74]
- The SEC proposes a compliance date of 12 months after the effective date of the amendments for all other aspects of the proposals, including (i) the proposed amendments to rule 22e-4 and (ii) the related proposed amendments to Forms N-PORT and N-CEN, except the swing pricing-related disclosure on Form N-PORT.[75]

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## ENDNOTES

[1] Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting, SEC Release Nos. 33-11130; IC-34746 (November 2, 2022) ("Proposing Release"), *available at* https://www.sec.gov/rules/proposed/2022/33-11130.pdf. *See also* SEC Fact Sheet: Open-End Fund Liquidity Risk Management and Swing Pricing (November 2, 2022), *available at* https://www.sec.gov/files/33-11130-fact-sheet.pdf.

[2] Proposing Release at 11.

[3] *Id.* at 11-12.

[4] *Id.* at 39, n.69, where the SEC notes that in-kind ETFs do not present the same kind of liquidity risks as other funds because the redeeming shareholder typically bears the direct costs associated with its liquidity needs. An "In-Kind ETF" is defined in the proposed amendments as "an ETF that meets redemptions through in-kind transfers of securities, positions, and assets other than a *de minimis* amount of U.S. dollars and that publishes its portfolio holdings daily." Proposed rule 22e-4(a).

[5] Industry groups have raised concerns regarding the limited comment period. *See, e.g.,* Comment Letter of the Loan Syndications and Trading Association ("LSTA") et al. (November 16, 2022), *available at* https://www.lsta.org/app/uploads/2022/11/SEC-Comment-Letter-from-LSTA-et-al.-2022.11.16.pdf (requesting that the SEC "extend the comment period . . . by 90 days"). The Investment Company Institute is one of the six other trade associations that joined the LSTA in signing the letter, which also requested extension of the comment period on the SEC's "outsourcing by investment advisers" rule proposal. *Id.*; Outsourcing by Investment Advisers, SEC Release No. IA-6176 (Oct. 26, 2022), *available at* https://www.sec.gov/rules/proposed/2022/ia-6176.pdf.

[6] For a discussion of key elements of current rule 22e-4, see our firm publication dated October 27, 2016.

[7] For a discussion of key elements of current rule 22c-1, see *id.*

[8] Proposed rule 22c-1(d).

[9] Proposing Release at 18.

[10] *Id.*

[11] *Id.* at 33.

[12] *Id.* at 21-22. In a recent progress report, the Financial Stability Board ("FSB") discussed how its analysis of the March 2020 market turmoil and resulting redemption pressures faced by open-end funds has resulted in new insights into liquidity management challenges for these funds, including informing enhancements that could be made to the FSB's 2017 policy recommendations on mitigating vulnerabilities in open-end funds stemming from liquidity mismatches. Among other things, the FSB notes that its 2017 recommendations dealing with liquidity management tools should be strengthened to achieve (i) greater utilization of anti-dilution mechanics to pass on to redeeming investors the costs of redemptions, including any significant market impact of asset sales to meet those redemptions; (ii) greater and more consistent use of anti-dilution mechanics in both normal and stressed market conditions and (iii) increased awareness among investors of the objectives and operation of anti-dilution mechanics. *See* FSB, Enhancing the Resilience of Non-Bank Financial Intermediation (November 10, 2022), at pp. 8-10, *available at* https://www.fsb.org/wp-content/uploads/P101122.pdf.

[13] Proposing Release at 22. The SEC notes in the release that it "do[es] not have specific data about the dilution fund shareholders experienced in March 2020 because funds do not report information about their trading activity and the prices at which they purchase and sell" shares. *Id.* at 22, n.40. The SEC bases its assumption regarding dilution of shareholders in U.S. open-end funds during

**ENDNOTES (CONTINUED)**

March 2020 on the increased utilization of swing pricing by European funds experiencing similar market conditions. *Id.*

[14] Commissioner Hester M. Peirce, Closing Act: Statement on Proposed Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting (November 2, 2022) ("Peirce Statement"), *available at* https://www.sec.gov/news/statement/peirce-statement-open-end-funds-110222.

[15] *Id.* ("The Commission finds confidence in Europe's experience with swing pricing. Swing pricing, however, is voluntary there and we have different intermediary structures between funds and their investors, different regulatory frameworks and investor base, and the European mutual fund sector does not depend as much as the U.S. mutual fund sector on pension plans.")(internal citations and quotations omitted); Commissioner Mark T. Uyeda, Statement on Proposed Rule: Open-End Fund Liquidity Programs and Swing Pricing; Form N-PORT Reporting (November 2, 2022) ("Uyeda Statement"), *available at* https://www.sec.gov/news/statement/uyedar-statement-open-end-funds-110222 ("[W]hile some European funds may use swing pricing, their experience does not appear analogous to ours due to the fundamental differences in our markets and retirement plan systems."). In the release, the SEC specifically requests comment on whether retirement plan sponsors or others would remove mutual funds as investment options if swing pricing is required. Proposing Release at 129.

[16] Peirce Statement.

[17] Uyeda Statement. The proposals, if adopted, would also likely accelerate the movement of fund assets held by qualified plans into collective investment trust offerings. *See also* note 52, *infra*, and related discussion.

[18] *See generally* Proposing Release at 41-77.

[19] Specifically, with respect to equity securities listed on a national securities exchange or foreign exchange, selling or disposing of more than 20% of the security's average daily trading volume (as measured over 20 business days) would indicate a level of market participation that is significant. For other kinds of investments, such as investments in fixed-income securities and derivatives, a significant change in market value would be any sale or disposition that the fund reasonably expects would result in a decrease in sale price of more than 1%. *See id.* at 50-52.

[20] As discussed in more detail in the release, the most common type of investment currently included in the "less liquid" category is bank loans. According to the SEC, this proposed change, if adopted, could cause bank loan funds to contract for expedited settlement of underlying investments (which would involve costs) or, alternatively, could cause advisers employing significant bank loan strategies to change their strategies, close funds or consider using a closed-end fund or other investment vehicle structure not subject to rule 22e-4. *See generally id.* at 60-63.

[21] The proposal would require funds to classify investments whose fair value is measured using an unobservable input that is significant to the overall measurement as "illiquid," even when there is a liquid market for such investments. *See id.* at 64.

[22] *Id.* at 41.

[23] *See, e.g.*, *id.* at 45, 63 (describing the potential impacts of the proposed stressed trade size and elimination of the "less liquid" category changes, respectively, on funds).

[24] *Id.* at 44.

[25] *Id.* at 75-76. The SEC notes in the release that, based on its review of Form N-PORT filings, "[m]ost funds did not report reclassifications of their portfolio investments despite extraordinary liquidity constraints in March 2020." *Id.* at 75.

[26] *Id.*

**ENDNOTES (CONTINUED)**

27 *See* 17 C.F.R. § 22e-4(b)(1)(iii).

28 Proposing Release at 78.

29 *Id.* at 84, 88.

30 *Id.* at 91.

31 *Id.* at 94-95.

32 *Id.* at 95-96.

33 *See* 17 C.F.R. § 22c-1(a)(3)(i)(B).

34 Proposing Release at 36, 104-07.

35 *Id.* at 106.

36 *Id.* 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. *Id.* at 106-07, 107 n.181.

37 *Id.* at 108. The SEC notes its view that smaller levels of net purchases are less likely to result in dilution than net redemptions because, while funds are required to pay redemptions within seven days, they are not required to invest cash inflows within a specified period. *Id.*

38 *See id.* at 107-09, 20.

39 *Id.* at 123.

40 Proposed rule 22c-1(b). *See also* 17 C.F.R. § 22c-1(a)(3)(ii)(C).

41 Proposed rule 22c-1(d). *See also* Proposing Release at 110.

42 Proposing Release at 113-14.

43 Proposed rule 22c-1(b)(2). *See also* Proposing Release at 116.

44 *See, e.g.*, Proposing Release at 109-10 (discussing the permissibility of using a lower market impact threshold for net redemptions and inflow swing threshold for net purchases and the ability to use lower-than-required thresholds to enhance fund performance) and 119 (discussing the potential incentive to over-estimate costs when calculating the swing factor to improve fund performance).

45 *Id.* at 132.

46 *Id.* at 135.

47 *Id.* at 136.

48 *Id.* at 137.

49 *Id.* at 139-150.

50 *See id.* at 155-56.

51 *Id.* at 158.

52 *Id.* at 159. It should be noted that funds currently have the option of charging fixed (i.e., a specified percentage) "liquidity" and other fees upon sales and redemptions of their shares, including to offset costs associated with investing proceeds of sales or funding redemptions, although very few funds do so.

53 *Id.* at 172-73.

54 *Id.* at 178-79.

55 *Id.* at 183-84.

**ENDNOTES (CONTINUED)**

56 *Id.* at 186-87.

57 Peirce Statement.

58 Uyeda Statement.

59 *See* SEC Form N-PORT.

60 Proposing Release at 38.

61 *Id.* at 200.

62 *See* Amendments to the Timing Requirements for Filing Reports on Form N-PORT ("Form N-PORT Amendments Release"), SEC Release No. IC-33384 (February 27, 2019), *available at* https://www.sec.gov/rules/interim/2019/ic-33384.pdf, at 4-12; Investment Company Liquidity Disclosure, SEC Release No. IC-33142 (June 28, 2018), *available at* https://www.sec.gov/rules/final/2018/ic-33142.pdf, at 7-13. *See also* our firm publication on the proposed amendments to Form N-PORT, dated July 11, 2018.

63 Proposing Release at 203-04.

64 *See id.* at 206-10. For example, the SEC states in the proposing release that "many funds, including actively managed funds, voluntarily provide their complete portfolio holdings on their websites on a monthly basis, typically lagged 30 days." *Id.* at 206-07.

65 *Id.* at 212-13, 221-22.

66 Proposed General Instruction F to Form N-PORT. In response to industry concerns about potential investor confusion (including due to lack of context) regarding the liquidity information, the SEC's 2019 amendments to Form N-PORT had replaced the requirement to report aggregate liquidity classification information on Form N-PORT with an obligation to include narrative disclosure regarding fund liquidity management programs in shareholder reports. *See* Form N-PORT Amendments Release at 4-5. As justification for its change of position on this subject, the SEC cites, among other things, the staff's determination that the narrative discussion in funds' shareholder reports resulted in a boilerplate recitation of the rule 22e-4 requirements rather than a tailored discussion of funds' liquidity risk management that took current market conditions into account. *See* Proposing Release at 212-17. The requirement to include the narrative discussion of fund liquidity management programs in shareholder reports was removed in recent amendments to shareholder reporting requirements adopted by the SEC. *See* Tailored Shareholder Reports for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements, Investment Company Act Release No. 34731 (October 26, 2022).

67 *Id.*

68 Proposing Release at 38, 230.

69 *Id.* at 230.

70 *Id.*

71 *Id.* at 232, n.335.

72 *Id.* at 232.

73 *Id.* at 233.

74 *Id.* at 234.

75 *Id.* at 235.

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