November 15, 2022

SEC Proposes Overhauled Open-End Fund Liquidity Framework Including Mandatory Swing Pricing

On November 2, 2022, the SEC issued a release (the "Release") proposing amendments to its current rules for registered open-end funds[1] regarding liquidity risk management programs, swing pricing, and various reporting forms (the "Proposals"). The Release states that "[t]he proposed amendments are designed to improve liquidity risk management programs and better prepare funds for stressed conditions and improve transparency in liquidity classifications" and also "to mitigate dilution of shareholders' interests in a fund by requiring any open-end fund, other than a money market fund or exchange-traded fund, to use swing pricing" under certain conditions.

The Release explains that, in light of the market stress experienced in March 2020 in connection with the onset of the COVID-19 pandemic, the SEC staff has reviewed the effectiveness of funds' current tools for managing liquidity and limiting dilution and is proposing amendments to funds' liquidity risk management programs "to help better prepare them for stressed market conditions."

If adopted as proposed, the Proposals would amend Rule 22e-4 under the 1940 Act (the "Liquidity Rule"), Rule 22c-1 under the 1940 Act, and certain reporting and disclosure forms under the 1940 Act. Specifically, the Proposals would:

- Change how open-end funds, other than money market funds and in-kind ETFs,[2] classify the liquidity of their investments and require such funds to determine and maintain a minimum amount of highly liquid assets of at least 10% of net assets;
- Require open-end funds, other than money market funds and ETFs, to use swing pricing and to implement a "hard close"[3] to facilitate swing pricing; and
- Provide for more frequent, timelier, and more detailed public reporting of fund information, including information relating to funds' liquidity and use of swing pricing.

These and other aspects of the Proposals are discussed in detail below. The final section of this Alert includes some preliminary observations regarding the Proposals.

The Existing Regulatory Framework

I. Liquidity Risk Management

In 2016, the SEC adopted the Liquidity Rule to require open-end funds (including ETFs but not money market funds) to adopt and implement liquidity risk management programs.[4] The Liquidity Rule requires (i) assessment, management, and periodic review of a fund's liquidity risk, (ii) classification of the liquidity of a fund's portfolio investments into one of four prescribed buckets – highly liquid, moderately liquid, less liquid and illiquid – including at-least-monthly reviews of these classifications, (iii) determination and periodic review of a highly liquid investment minimum ("HLIM") for certain funds, (iv) a 15% limitation on illiquid investments, and (v) board oversight. Funds also are subject to related reporting

[1] This Alert refers to "open-end management investment companies" as open-end funds or funds, excluding money market funds.
[2] In-kind ETFs are not subject to the current rule's classification requirements or highly liquid investment minimum requirements and, therefore, would not be subject to the proposed amendments to these provisions. In-kind ETFs are subject to certain of the proposed amendments, however, such as amendments to the calculation of the 15% limit on illiquid investments.
[3] As described below, a hard close requirement would provide that a direction to purchase or redeem a fund's shares is eligible to receive the price established at the current day's NAV, provided that the fund, its designated transfer agent, or NSCC's Fund/SERV receives the direction before the time as of which the fund calculates its NAV. Purchase and redemption orders received after the time the fund has established for determining the day's NAV would receive the next day's NAV.
[4] The Liquidity Rule is described in Ropes & Gray's October 2016 Alert and March 2018 Alert.

requirements, including reporting to the SEC on Form N-RN and to a fund's board if its portfolio holdings are more than 15% illiquid or it breaches its established HLIM for seven consecutive calendar days.

II. Swing Pricing

In 2016, the SEC also amended Rule 22c-1 to permit, but not require, an open-end fund (other than an ETF or a money market fund) to implement swing pricing.[5] Swing pricing allows a fund to adjust its price above or below the fund's per-share NAV "to effectively pass on the costs stemming from shareholder purchase or redemption activity to the shareholders associated with that activity." In the release adopting the 2016 amendments, the SEC stated, "we believe that providing funds the option to use swing pricing as another anti-dilution tool is likely to benefit investors and may complement or be an alternative to the tools currently available to funds." The Release observes that, "[i]n the time since the adoption of [amended Rule 22c-1], no U.S. funds have implemented swing pricing."

Proposed Amendments to Funds' Liquidity Risk Management Programs

I. Overview

The Proposals would amend the Liquidity Rule to provide additional standards for making liquidity determinations, amend certain aspects of the liquidity categories, and require more frequent liquidity classifications, as discussed below.

A comparison of the Proposals' proposed changes to liquidity classifications and related terms and concepts appears in the Appendix of this Alert.

II. Amendments to the Classification Framework

Replace Reasonably Anticipated Trade Size with Stressed Trade Size. Currently, when a fund makes a liquidity classification, it must determine whether trading varying portions of a position in a particular portfolio investment or asset class, in sizes that the fund would reasonably anticipate trading, is reasonably expected to significantly affect its liquidity.[6] This determination helps a fund analyze market depth. Funds are currently permitted to determine their own reasonably anticipated trading sizing based on a variety of factors, each of which may be weighed differently, such as flow history, flow trends of similar funds, and shareholder makeup and concentration.

The Proposals would amend the Liquidity Rule to require funds to assume the sale of a set stressed trade size. Specifically, in order to determine the liquidity classification of each investment, the amended Liquidity Rule would require a fund to measure the number of days in which the investment is reasonably expected to be convertible to U.S. dollars without significantly changing the market value of the investment, while assuming the sale of 10% of the fund's net assets by reducing each investment by 10%.

Establish a Minimum 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 (the "value impact analysis"). The value impact analysis is intended to capture the risk of dilution in cases of inadequate liquidity, while not requiring funds to account for every possible value movement. Funds are currently permitted to determine value impact in a variety of ways depending on the type of asset, vendor, model, or system used.

The Proposals would amend the Liquidity Rule to establish a minimum value impact standard that defines more specifically what constitutes a significant change in market value. The proposed definition of a significant change in market value would require a fund to consider the size of the sale relative to the depth of the market for the instrument, which would vary depending on the type of investment. Specifically (i) for shares listed on a national securities exchange or a foreign exchange, selling or disposing of more than 20% of the security's average daily trading volume would

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[5] *See* Ropes & Gray's November 2016 Alert.

[6] Using a small reasonably anticipated trade size to analyze market depth leads to a more liquid classification, as a smaller position can be sold more quickly without significantly affecting the investment's liquidity than a larger position. In contrast, using a larger reasonably anticipated trade size typically leads to less liquid classifications.

indicate a level of market participation that is significant[7] and (ii) for any investments other than shares listed on a national securities exchange or a foreign exchange, 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% would indicate a level of market participation that is significant.[8]

Remove Classification by Asset Class. Currently, a fund may classify and review its portfolio investments (including the fund's derivatives transactions) according to their asset class, unless the fund or its adviser has information about any market, trading, or investment-specific considerations that are reasonably expected to significantly affect the liquidity characteristics of that investment as compared to the fund's other portfolio holdings within that asset class. The Proposals would amend the Liquidity Rule to remove asset class-level classifications to provide "more precise liquidity classifications that appropriately reflect investments' liquidity characteristics."

III. Amendments to Liquidity Classification Categories

Eliminate the Less Liquid Investment Category and Amend the Illiquid Investment Category. Currently, funds may classify as "less liquid" those 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. The Proposals would amend the Liquidity Rule to eliminate the "less liquid investment" category. Investments that funds currently classify as "less liquid" would become "illiquid investments," absent changes to shorten the settlement time of those investments.

Currently, an investment is classified as "illiquid" if it cannot be sold or disposed of in seven calendar days or less without significantly changing the market value of the investment. The Proposals would amend the definition of "illiquid investments" under the Liquidity Rule to include those investments that a 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, as well as those investments whose fair value is measured using an unobservable input[9] that is significant to the overall measurement.

Amend the Moderately Liquid Investment Category. The Proposals would amend the Liquidity Rule to simplify the definition of "moderately liquid investment," in light of the other proposed changes to the classification categories, to mean any investment that is neither a "highly liquid investment" nor an "illiquid investment."

Amend the Definition of Convertible to Cash and References to Cash. The Proposals would amend the term "convertible to cash" under the Liquidity Rule to "convertible to U.S. dollars" and also make conforming amendments to the definition of this term under the Liquidity Rule to refer to the ability of a fund to sell or dispose of an investment and for it to settle in U.S. dollars.[10]

Specify the Method for Counting the Number of Days. Currently, the Liquidity Rule does not specify when to begin counting the number of days an investment would be convertible to U.S. dollars. The Proposals would amend the

[7] To determine average daily trading volume, the Proposals would require funds to measure the average daily trading volume over the preceding 20 business days. For example, for purposes of measuring average daily trading volume, the preceding 20 business days include those days where U.S. markets are open but where one or more international markets are closed, such as "Golden Week," a week in Japan including multiple Japanese public holidays. A fund would count these and any other trading days where shares were not traded as zero volume days for the relevant investment.

[8] In considering whether a sale is reasonably expected to result in a price decrease of more than 1%, the Proposals would require a fund to consider the size of the sale relative to the depth of the market for the instrument. As part of that analysis, the Release states that a fund generally should consider, among other things, the width of bid-offer spreads.

[9] These inputs are Level 3 measurements under U.S. GAAP.

[10] The Release states that the amendment from "convertible to cash" to "convertible to U.S. dollars" reflects the codification of SEC statements in the adopting release for the Liquidity Rule and that the amendment is intended "to promote the ability of funds to meet redemptions without diluting the interests of the remaining shareholders and increase consistency in how funds classify the liquidity of investments, including in foreign investments and foreign currencies."

Liquidity Rule to specify that funds must count the day of classification when determining the period in which an investment is reasonably expected to be convertible to U.S. dollars. For example, in order for a fund to classify an investment as highly liquid on Monday, it would need to reasonably expect that the investment could be sold and settled to U.S. dollars by Wednesday at the latest.

IV. Frequency of Classifications

Currently, funds must review their liquidity classifications at least monthly in connection with reporting on Form N-PORT, and more frequently if changes in relevant market, trading, and investment-specific considerations are reasonably expected to materially affect one or more of their investments' classifications. The Proposals would amend the Liquidity Rule to require a fund to classify all of its portfolio investments each business day instead of at least monthly.

V. Highly Liquid Investment Minimums

Determination of the HLIM. Currently, a fund must establish an HLIM if it does not primarily hold assets that are highly liquid investments. Funds that are subject to the HLIM requirements must (i) determine an HLIM considering several factors, (ii) review the HLIM at least annually, and (iii) adopt policies and procedures to respond to a shortfall of the fund's highly liquid investments below the required HLIM.

The Proposals would amend the Liquidity Rule to require all funds to determine and maintain an HLIM of at least 10% of the fund's net assets, which is equivalent to the stressed trade size. The Proposals would therefore remove the exclusion for funds that primarily invest in highly liquid investments (the "primarily exclusion") and subject all funds to the HLIM requirements under the Liquidity Rule. As such, all funds would be required to (i) consider a specified set of liquidity risk factors[11] to determine whether their HLIMs should be above 10%, (ii) review HLIMs at least annually; and (iii) adopt shortfall policies and procedures.

Calculation of the HLIM. Currently, a fund is required to identify the percentage of the fund's highly liquid investments that it has posted as margin or collateral in connection with derivatives transactions that the fund has classified as less than highly liquid. In addition, funds are required to exclude highly liquid assets that are posted as margin or collateral in connection with non-highly liquid derivatives transactions when determining whether the fund primarily holds highly liquid assets.

The Proposals would amend the Liquidity Rule to require that, when determining the amount of assets a fund has classified as highly liquid that count toward the HLIM, 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 HLIM, a fund would be required to (i) 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[12] and (ii) subtract any fund liabilities.[13]

VI. Limit on Illiquid Investments

Currently, a fund is prohibited 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 that are assets. The Proposals would amend

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[11] The Release states that the liquidity risk factors funds must consider in determining an HLIM under the current Liquidity Rule and the associated guidance the SEC provided in the Liquidity Rule's adopting release regarding these factors are appropriate for a fund to take into account for these purposes.
[12] The Release states that the Liquidity Rule currently refers to a "pledge" of margin or collateral, rather than "posting." The Release explains that use of the term "post" is more commonly used within the industry and by other regulators to refer to instances where a party provides margin or collateral to its counterparty to meet the performance of its obligation under one or more derivatives transactions as a result of a change in the value of such obligations since the trade was executed or the last time such collateral was provided (commonly referred to as variation margin) or is provided to secure potential future exposure following default of a counterparty (commonly referred to as initial margin).
[13] "Fund liabilities" is defined in Rule 6.04 of Regulation S-X and would include, for example, investment liabilities and amounts payable for investment advisory, management, and service fees.

the Liquidity Rule's limitation on illiquid investments 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.

Swing Pricing

I. Proposed Swing Pricing Requirement

The Proposals would amend Rule 22c-1 ("Proposed Rule 22c-1") to require all registered open-end funds, except for money market funds and ETFs (the latter, "excluded funds"), to engage in swing pricing under certain conditions. The Release states that by 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."

Proposed Rule 22c-1 would require every open-end fund other than an excluded fund to establish and implement swing pricing policies and procedures that adjust the fund's current NAV per share by a "swing factor" if the fund has either (i) net redemptions (no threshold) or (ii) net purchases that exceed a specified threshold (2% of the fund's net assets).

- Proposed Rule 22c-1 would retain the provision in current Rule 22c-1 that bars feeder funds in a master-feeder fund structure from using swing pricing. Instead, if net purchases into or redemptions from the master fund by one or more feeder funds (or any other investors in the master fund) trigger the application of swing pricing under Proposed Rule 22c-1, the swing factor would be applied at the level of the master fund.
- Consistent with current Rule 22c-1, Proposed Rule 22c-1 would exclude ETFs from the swing pricing requirement because, among other reasons, (i) in connection with creation unit transactions, ETFs often impose fees that are intended to defray operational processing and brokerage costs to prevent possible shareholder dilution and (ii) swing pricing could impede the effective functioning of an ETF's arbitrage mechanism.[14]

II. Amendments to Swing Threshold Framework

Currently, Rule 22c-1 permits a fund to determine its own swing threshold for net purchases and net redemptions based on a consideration of certain factors the rule identifies. Proposed Rule 22c-1 would specify when a fund must use swing pricing to adjust its current NAV depending on whether the fund has any net redemptions or has net purchases above a specified threshold on a given day.

- In the case of net redemptions, Proposed Rule 22c-1 would require a fund to always apply swing pricing. However, the types of costs the swing factor must take into account would depend on the size of net redemptions. Proposed Rule 22c-1 would require a fund to include market impacts in its swing factor only if net redemptions exceed 1% of the 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.
- In the case of net purchases, Proposed Rule 22c-1 would require swing pricing – including market impact – only if the amount of net purchases exceeds 2% of the fund's net assets (the "Inflow Swing Threshold").

While Proposed Rule 22c-1 specifies a Market Impact Threshold that would apply to net redemptions and an Inflow Swing Threshold that would apply to net purchases, the Proposed Rule 22c-1 would permit the fund's swing pricing

[14] In addition, notwithstanding Section 18(f)(1) of the 1940 Act, a fund with a share class that is an ETF would be subject to the swing pricing requirement only with respect to any share classes that are not ETFs. Thus, a fund with an ETF share class would exclude the ETF's share class flow information when determining whether and how to apply swing pricing and would not adjust the NAV of the ETF share class by the swing factor in computing the share price of that class.

administrator (the "Administrator")[15] to use smaller thresholds than those specified in the proposed rule in either of these instances, as the Administrator determines is appropriate to mitigate dilution.

The Release observes that, in having the option to set a lower Market Impact Threshold for net redemptions and Inflow Swing Threshold for net purchases, the Administrator "would have discretion that it potentially could use to enhance fund performance in a misleading manner by adjusting the fund's NAV more frequently or more substantially than is needed to address dilution." Accordingly, to mitigate this risk, under Proposed Rule 22c-1, the Administrator would be required to include in its written reports to the fund's board the information and data supporting its determination to use lower thresholds. Additionally, consistent with current Rule 22c-1, Proposed Rule 22c-1 would continue to require that administration of swing pricing must be reasonably segregated from portfolio management of the fund and may not include portfolio managers.

III. Determining Flows

Consistent with current Rule 22c-1, Proposed Rule 22c-1 would provide that the Administrator must review investor flow information to determine if a fund has net purchases or net redemptions and the amount of net purchases or net redemptions.

For purposes of Proposed Rule 22c-1, investor flow information would mean information about a fund investors' daily purchase and redemption activity. Investor flow information may consist of individual, aggregated, or netted eligible orders and would exclude any purchases or redemptions that are made in-kind and not in cash.

In recognition of the fact it is difficult to determine investor flow information on a given day because some intermediaries do not provide order flow until after the fund has finalized its NAV, current Rule 22c-1 permits an Administrator to make swing pricing determinations based on receipt of sufficient investor flow information to allow the fund to reasonably estimate whether it has crossed a swing threshold with high confidence.

- The "hard close provision" (discussed below) in Proposed Rule 22c-1 is intended to result in funds generally having flow information in a timely manner and, therefore, to greatly reduce the need for estimating fund flows.
- Nevertheless, the Release acknowledges that "some estimation may still be required." For this reason, Proposed Rule 22c-1 would continue to permit the Administrator to make swing pricing determinations based on "reasonable, high confidence estimates" of fund flows.

IV. Swing Factors

In General. To determine the swing factor, Proposed Rule 22c-1 would require a fund's Administrator to 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 to satisfy the amount of net purchases or net redemptions (*i.e.*, a "vertical slice").

Because a fund would need to calculate its costs based on the purchase or sale of a vertical slice of its portfolio, instead of selecting specific investments or borrowing to meet redemptions, Proposed Rule 22c-1 would remove borrowing costs from the swing factor calculation.

Under Proposed Rule 22c-1, calculating a swing factor would differ depending on whether the fund is experiencing net purchases or net redemptions.

- In the case of net redemptions, the good faith estimates must include, for selling a *pro rata* amount of each investment in the fund's portfolio to satisfy the amount of net redemptions (i) spread costs, (ii) brokerage commissions, custody fees, and any other charges, fees and taxes associated with portfolio investment sales and (iii) if the amount of the fund's net redemptions exceeds the Market Impact Threshold, the market impact.

[15] The Administrator is the investment adviser, officer, or officers responsible for administering a fund's swing pricing policies and procedures. The Administrator may consist of a group of persons.

- In the case of net purchases, swing pricing would be applied only if the amount of the fund's net purchases exceeds the Inflow Swing Threshold. In such cases, the good faith estimates must include, for purchasing a *pro rata* amount of each investment in the fund's portfolio to invest the proceeds from the net purchases (i) spread costs, (ii) brokerage commissions, custody fees, and any other charges, fees and taxes associated with portfolio investment purchases and (iii) the market impact.

The Release notes that, in calculating the swing factor, fund managers may have incentives to over-estimate costs to improve fund performance, which would be misleading. To mitigate this risk, Proposed Rule 22c-1 would require funds to report their swing factor adjustments publicly on Form N-PORT.

The Release also notes that the methodology used to calculate a fund's spread costs may differ depending on how the fund values its portfolio holdings because some funds may value portfolio holdings at the bid price or the mid-market price when determining their NAVs.

- If a fund values its portfolio holdings at the bid price, it would not need to include spread costs in its swing factor when the fund has net redemptions. In contrast, if the fund has net purchases exceeding 2%, the fund would need to include spread costs, which would reflect the full bid-ask spread.
- If a fund values its portfolio holdings using mid-market pricing, it would need to include spread costs in its swing factor any time it applies swing pricing. When a fund using mid-market pricing has net redemptions, or net purchases exceeding 2%, the spread cost component of its swing factor would reflect half of the bid-ask spread.

<u>Addition of Market Impact</u>. Current Rule 22c-1 does not permit a fund to include market impact costs in its swing factor calculation. As noted above, Proposed Rule 22c-1 would require a fund to include market impact cost in its swing factor if the amount of net redemptions exceeds the Market Impact Threshold or if the amount of net purchases exceeds the Inflow Swing Threshold. The market impact component of the swing factor would reflect good faith estimates of the market impact costs of selling (in the case of net redemptions) or purchasing (in the case of net purchases) a vertical slice of a fund's portfolio to satisfy the amount of net redemptions or net purchases.

- The fund would estimate market impacts for each investment in its portfolio by first estimating the market impact factor, which is 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.
- Next, the fund would multiply the market impact factor by the dollar amount of the investment that would be purchased or sold if the fund purchased or sold a *pro rata* amount of each investment in its portfolio to meet the net redemptions or net purchases.
- Because securities held by mutual funds may have similar characteristics and would likely incur similar costs if purchased or sold, Proposed Rule 22c-1 would permit the 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.

<u>Other Differences from Current Rule 22c-1</u>. Current Rule 22c-1 specifies that a swing factor may not exceed 2% of a fund's per-share NAV. Proposed Rule 22c-1 does not require an upper limit on the swing factor, and would remove the current Rule 22c-1 requirement for the board to review and approve a fund's swing threshold and the upper limit on the swing factor(s) used.[16]

[16] Under Proposed Rule 22c-1, the fund's board would be required to (i) approve the fund's swing pricing policies and procedures, (ii) designate the Administrator and (iii) review, no less frequently than annually, a written report prepared by the Administrator.

Hard Close Requirement

I. Overview

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 NAV, provided the intermediary receives the order before the time the fund has established for determining the value of its holdings and calculating its NAV (usually 4:00 p.m. Eastern time). The fund may not receive information about that order until much later, sometimes as late as the next morning.

The Proposals include additional amendments to Rule 22c-1 to require a "hard close" for funds that are required to implement swing pricing. Specifically, the proposed hard close requirement would provide that a direction to purchase or redeem a fund's shares is eligible to receive the price established at the current day's NAV, provided that the fund, its designated transfer agent, or a registered securities clearing agency (collectively, "designated parties")[17] receives an eligible order before the time as of which the fund calculates its NAV. Purchase and redemption orders received after the time the fund has established for determining the day's NAV would receive the next day's NAV.

The Release says that to implement the proposed swing pricing requirement, "mutual funds need sufficient net order flow information to determine whether to apply a swing factor, and the size of that swing factor, before they finalize that day's price." Among other things, the proposed hard close requirement "would facilitate the more timely receipt of order flow information by requiring that the fund, its transfer agent, or a clearing agency receive all orders that are eligible to receive that day's price before the fund computes its NAV."

II. Pricing Requirements

Under Proposed Rule 22c-1, an eligible order to purchase or redeem would receive the price for the next pricing time after a designated party receives the order. Proposed Rule 22c-1 would define the terms "pricing time" and "eligible order." Eligible orders would receive a price based on the current NAV as of the next pricing time, which would include an adjustment to the NAV to include the swing factor, as applicable.

Proposed Rule 22c-1 would not alter the requirement for a fund's board of directors to establish a "pricing time," which would be defined as the time or times of day as of which the fund calculates the current NAV of its shares pursuant to Rule 22c-1 (usually 4:00 p.m. Eastern time). The price of a fund's shares would normally be finalized several hours after the pricing time, giving funds time to calculate the current NAV, apply any swing factor, and finalize and publish the fund's share price.

- For purposes of the proposed hard close requirement, an "eligible order" to purchase or redeem fund shares would have to supply certain information about the size of an investor's intended trade. This requirement is intended to assist swing pricing by providing funds with data to calculate investor flows. Proposed Rule 22c-1 would define "eligible order" to mean a direction (i) to purchase or redeem a specific number or value of fund shares or (ii) to purchase the fund's shares using the proceeds of a contemporaneous order to redeem a specific number of shares of another registered investment company (*i.e.*, an exchange);
- Proposed Rule 22c-1 would require, to receive that day's share price, that a designated party must receive the eligible order before the pricing time; and
- Proposed Rule 22c-1 would specify that eligible orders are irrevocable as of the next pricing time after a designated party receives the order.

[17] A fund's designated transfer agent is a registered transfer agent designated as such in the fund's registration statement filed with the SEC. Currently the only registered clearing agency for fund shares is NSCC, which operates its Fund/SERV service for processing fund transactions.

Other Amendments to Rule 22c-1

Proposed Rule 22c-1 would retain the requirements of the current rule concerning the frequency and time of determining the NAV, but would reorganize and reword those provisions. Specifically, Proposed Rule 22c-1 would use the phrase "based on the current net asset value of such security established for the next pricing time," instead of "based on the current net asset value of such security which is next computed" in current Rule 22c-1. This amendment would codify in the text of Rule 22c-1 that orders received after the pricing time, but before calculation of the NAV is complete, do not receive same-day pricing. In addition, the Proposals would delete the provision in current Rule 22c-1 that allows funds not to calculate their current NAV on days in which changes in the value of the fund's securities will not materially affect the current NAV.

Amendments to Form N-1A

Form N-1A currently requires funds that use swing pricing to disclose a fund's swing factor upper limit. Because Proposed Rule 22c-1 would not include an upper limit on a fund's swing factor, the Proposals do not include a requirement to provide an upper limit on the swing factor from Item 6(d) of Form N-1A.

Item 11 of Form N-1A also currently requires a fund to describe how it prices its shares. Item 11(a), in particular, requires that funds state when they calculate their NAV and that the price at which a purchase or redemption order is effected is based on the next NAV calculated after an order is placed. The Proposals would amend this disclosure to also require, if applicable, that funds disclose that, if an investor places an order with a financial intermediary, the financial intermediary may require the investor to submit its order earlier than the fund's pricing time to receive the next-calculated NAV.

Reporting Requirements

Currently, open-end funds, closed-end funds, and ETFs registered as unit investment trusts (excluding money market funds and small business investment companies) are required to file monthly information with the SEC on Form N-PORT within 60 days after the end of each fiscal quarter, and the public only has access to such information for the third month of each quarter. The Proposals would require reports on Form N-PORT to be filed within 30 days of month-end, and such reports would be made public 60 days after month-end. The Release states that the information reported on Form N-PORT that is currently nonpublic (such information includes liquidity classifications for individual portfolio investments), even in the report for the third month of the quarter that is otherwise publicly available, will remain nonpublic under the Proposals.

The Proposals would require an open-end fund that is subject to classification requirements in the Liquidity Rule to provide information regarding the aggregate percentage of its portfolio represented in each of the three proposed liquidity categories, which would be publicly available, with such percentages adjusted to give effect to other aspects of the Proposals. Specifically, a fund would 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. The Proposals also would require a fund to increase its reported amount of illiquid assets by the amount of collateral available upon exit of illiquid derivatives transactions.[18] The Release states that this public disclosure framework is similar to that previously adopted by the SEC in 2016 and then later replaced by the SEC with narrative liquidity disclosure in shareholder reports in 2018.[19] The Release notes that one week before issuing the Release, on

[18] The Release states that, in certain situations, the adjustments to the high liquid and illiquid categories could result in the amounts of a fund's investments in all three categories not summing to 100% of assets. For example, the reduction in the reportable amount of highly liquid assets may be greater than the increase in the reportable amount of illiquid assets, resulting in the percentages of the fund's assets in each category summing to an amount below 100%. Funds would be required to increase their reported amounts of moderately liquid investments if necessary to make the amounts the fund reports sum to 100%.

[19] *See* Ropes & Gray's March 2018 Alert.

November 2, 2022, the SEC adopted amendments that remove the requirement to disclose narrative disclosure on the operation and effectiveness of a fund's liquidity risk management program in shareholder reports.[20]

The Proposals also would introduce conforming and technical amendments to Forms N-PORT and N-CEN relating to, among other things, (i) funds' use of swing pricing, (ii) the proposed amendments to the Liquidity Rule, (iii) certain entity identifiers, and (iv) whether and which liquidity service providers are used, for what purpose and for what period.

Withdrawal of Commission Staff Statements

The Release states that the SEC staff will review no-action letters and other statements addressing compliance with the Liquidity Rule and Rule 22c-1 to determine which letters and other staff statements, or portions thereof, should be withdrawn in connection with any adoption of the Proposals. The Release provides a preliminary list of no-action letters and other SEC staff statements that would be withdrawn if the Proposals are adopted as proposed.

Transition Periods

The Release states that if the Proposals are adopted as proposed, they would provide for a transition period after the effective date.

- The Release proposes a compliance date of 24 months after the effective date of the Proposals for all open-end funds except money market funds and ETFs with respect to (i) the proposed swing pricing requirement and related reporting requirements on Form N-PORT and (ii) the proposed "hard close" requirement in Proposed Rule 22c-1 and related reporting requirements on Form N-1A.
- The Release proposes a compliance date of 12 months after the effective date of the Proposals for all other aspects of the Proposals, including (i) the proposed amendments to the Liquidity Rule and (ii) the related reporting requirements on Forms N-PORT and N-CEN, except the swing pricing-related disclosure on Form N-PORT.

Comment Deadline

The Release states that comments on the Proposals should be received by the SEC no later than 60 days after publication of the Release in the *Federal Register*. As of the date of this Alert, the Release has not been published therein.

Preliminary Observations

The Proposals would impose sweeping and costly changes on the fund industry. These include (i) mandating swing pricing and "hard close" requirements that would fundamentally change the way open-end funds operate and interact with shareholders and intermediaries, (ii) requiring open-end funds with significant percentages of assets (*e.g.*, bank loans) that would be reclassified from "less liquid" to "illiquid" to restructure or liquidate and (iii) implementing dramatic changes to recently developed Liquidity Risk Management Programs. The Release cites the market volatility of March 2020 as the impetus for the Proposals, noting that, absent Federal Reserve intervention, future stressed periods may be more protracted or severe. The Release speculates that large outflows during March 2020 likely contributed to the dilution of interests for remaining shareholders and notes the extent of those outflows. The Release does not include any specific examples of funds that were unable to meet redemptions requests or otherwise manage their liquidity during the March 2020 market stress, but instead cites the SEC's more general view that "funds should be better prepared for stressed conditions" and "have well-functioning tools for managing through stress" as its rationale for the Proposals.

Mandatory swing pricing/hard close requirement. In 2016, the SEC adopted amendments to Rule 22c-1 that permit open-end funds (other than money market funds) to use swing pricing. As the SEC observes in the Release, "[i]n the time since the adoption of the rule, no U.S. funds have implemented swing pricing." While employed as an optional liquidity and dilution management tool in Europe, U.S. open-end funds have universally rejected swing pricing to date, citing a

[20] *See* Ropes & Gray's November 3, 2022 Alert.

range of operational issues and challenges. Beyond the sheer complexity (and accompanying risk of error and related liability) associated with implementing swing pricing, swing pricing requires a fund to have a precise sense of daily subscription and redemption activity to implement. In the current U.S. open-end fund environment, many investors place trades through fund intermediaries (*e.g.*, 401(k) plans and broker-dealers). If these investors place trades with their intermediaries by 4:00 p.m. Eastern time, they typically will receive that day's NAV and trade date, and the fund receives the trade order from the intermediary the next morning. The Proposals seek to address that operational hurdle by imposing a "hard close" requirement. While the Release acknowledges that the hard close requirement "would require changes in the ways funds and intermediaries process fund purchase and redemption orders" and "that retirement plan recordkeepers may face particular challenges with adhering to the proposed hard close requirement," in practice, the Proposals would require a complete overhaul of intermediaries' systems and processes.

Substantial portions of the Release are devoted to discussion of alternatives to swing pricing by which funds could "pass on costs stemming from shareholder purchase or redemption activity to the shareholders engaged in that activity" and alternatives to a hard close requirement by which a fund would be able to "generate sufficient investor flow information to determine whether to apply swing pricing on a given day." Ultimately, the Release concludes that the alternatives are inferior to the Proposals but, nevertheless, invites comments on alternatives.

Impact on Bank Loan Funds and Floating Rate Funds. The Proposals' elimination of the "less liquid" category and the corresponding expansion of the "illiquid" category would result in many extended settlement instruments being classified as illiquid. As a result, absent significant changes in the settlement practices for these investments, many funds that invest principally in bank loans or other extended settlement instruments would be required to change their strategies, convert to a new structure (*e.g*., closed-end fund) or close. The Release acknowledges that bank loan funds were able to meet redemption requests during March 2020, notwithstanding substantial outflows (approximately 13.4% of prior period assets), but notes that such funds may not be able to meet shareholder redemptions in future stressed conditions, especially as investments into this asset class increase.

Merging of Valuation and Liquidity in Classifications. The Proposals would amend the definition of an illiquid investment under the Liquidity Rule to include any investment whose fair value is measured using an unobservable input that is significant to the overall measurement. The Release notes that U.S. GAAP establishes a fair value hierarchy that categorizes into three levels the inputs to valuation techniques used to measure fair value, and that fair value measurements are categorized in accordance with this hierarchy. The highest-level measurements are those developed using quoted, observable inputs for identical assets and liabilities (Level 1), whereas the lowest-level measurements are those developed using unobservable inputs (Level 3). The Release states that "observability is a valuation concept and may not always correspond to liquidity" and that "it is unclear . . . whether a GAAP concept can translate into a liquidity classification bucket." In fact, the SEC has previously stated that liquidity and valuation are distinct concepts,[21] but the Proposals would intertwine the two concepts under the definition of illiquid investments.

Proposed N-PORT Filing Requirements Would Have An Impact Beyond Open-End Funds. The Proposals generally would impact open-end funds, excluding money market funds and ETFs.[22] However, the proposed amendments to the filing frequency of Form N-PORT – from 60 days after the end of each fiscal quarter to within 30 days after the end of the month – would impact all Form N-PORT filers, including open-end funds, closed-end funds, and ETFs registered as unit investment trusts. Accordingly, the new costs associated with monthly Form N-PORT filings would impact all registered investment companies required to make such filings.

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If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney contacts.

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[21] *See* Investment Company Liquidity Risk Management Programs, Rel. No. 33- 10233 (Oct. 16, 2016) at 57.
[22] *See* note 2, above (impacts on ETFs).

APPENDIX

Proposed Changes to Liquidity Classifications and Related Terms and Concepts

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 less, without the conversion to cash significantly changing the market value of the investment.	Any investment that is neither a highly liquid investment nor an illiquid 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	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.
	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 and (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%.