FORsights

Funds Face New Liquidity & Swing-Pricing Requirements

On November 2, 2022, the SEC issued a 444-page proposal that would significantly change liquidity risk management and pricing practices for open-end management investment companies, including:

- **Updating the classification of investment liquidity and requiring a minimum of 10% of highly liquid assets**
- **Requiring the use of swing pricing[1] and implementing a hard close**
- **Timelier, more frequent (monthly), and more detailed public reporting of fund information**

The changes would not apply to money market funds (MMFs)[2] or certain exchange-traded funds (ETFs). If adopted, the final rule would have a two-year compliance date for the swing rule changes and allow one year to implement the liquidity updates. Comments are due 60 days after Federal Register publication.

Background

There are several kinds of open-end funds, including traditional mutual funds, MMFs, and ETFs. Open-end funds offer investors daily liquidity but may invest in assets that cannot be liquidated quickly without significantly affecting market prices. Without effective liquidity risk management, a fund may not be able to make timely payment on shareholder redemptions, and asset sales to pay redemptions may result in the dilution of shareholders' interests. Even when a fund manages its liquidity effectively, transaction costs associated with meeting redemption requests or investing the proceeds of subscriptions can create shareholder dilution. These concerns are heightened in times of stress or for funds invested in less liquid investments. The SEC points to the market disruptions of March 2020 as a recent reminder that liquidity can deteriorate rapidly and significantly. The large outflows open-end funds faced during March 2020, combined with the widening bid-ask spreads funds encountered when purchasing or selling portfolio investments at that time, likely contributed to dilution of the value of funds' shares for remaining investors.

[1] Swing pricing is the process of adjusting the price above or below a fund's net asset value (NAV) per share to effectively pass on the costs stemming from shareholder purchase or redemption activity to the shareholders associated with that activity, rather than diluting other shareholders.

[2] In December 2021, the SEC issued proposed updates for MMFs. See our related **FORsights**™ article, "**Changes Ahead for Money Market Funds**?"

Liquidity

Current Guidance

In 2016, the SEC adopted Rule 22e-4 that required open-end funds to adopt and implement liquidity risk management programs, including:

- Assessment, management, and periodic review of a fund's liquidity risk
- Classification of the liquidity of each of a fund's portfolio investments into one of four prescribed categories and at-least-monthly classification reviews
- Determination and periodic review of a highly liquid investment minimum for certain funds
- Limitation on illiquid investments
- Board oversight

The liquidity classifications of holdings must be reported at least monthly on Form N-PORT. The four liquidity categories are based on the number of days the investment could reasonably be converted into cash or sold without significantly changing its market value—highly liquid, moderately liquid, less liquid, and illiquid. Funds must have a minimum level of highly liquid investments and a 15% maximum limit on illiquid investments. Funds have discretion in determining this classification; investments can be classified individually or by asset class and the asset class composition can be determined by the fund.

A fund must immediately report to the fund's board and on Form N-RN if the portfolio becomes more than 15% illiquid, or if a fund breaches the minimum highly liquid investment level established as part of its liquidity risk management program for seven consecutive days.

Proposed Changes

Most open-end funds would be required to incorporate stress into their liquidity classifications by assuming the sale of a stressed trade size, which would be 10% of each portfolio investment, rather than the current "reasonably anticipated trade size in current market conditions." Funds would no longer be allowed to apply liquidity classifications by asset class; instead, a fund would apply its stressed trade size to each investment to determine its liquidity classification. All funds would be required to maintain a minimum amount of highly liquid assets of at least 10% of net assets. Daily liquidity classifications also would be required.

The proposal reduces the liquidity categories from four to three by removing the less liquid investment category and treating those investments as illiquid (the most common type of less liquid investment is bank loans). The definition of illiquid investment would be updated to include investments whose fair value is measured using an unobservable input that is significant to the overall measurement.

A prescriptive calculation is required for the highly liquid investment minimum calculation and the 15% limit on illiquid investments. A fund also would be required to reduce the amount of highly liquid assets that count toward the fund's highly liquid investment minimum by the amount of the fund's liabilities. Funds would no longer be able to offset highly liquid assets used as collateral for non-highly liquid derivative transactions. A fund also would be required to treat the collateral posted for an illiquid derivative transaction as illiquid in determining if a fund is in compliance with the illiquid investment limitation. (Currently, a fund is only required to disclose the percentage of a fund's highly liquid investments that are posted as collateral for derivatives classified as less than highly liquid).

More fund investments will be subject to the 15% limit on illiquid investments.[3]

The [Appendix](#) has a summary of proposed category changes.

Swing Pricing

Current Guidance

In 2016, the SEC adopted Rule 22c-1 **permitting** registered open-end funds (except MMFs or ETFs), under certain circumstances, to use swing pricing. For funds choosing to use swing pricing, the fund's NAV is adjusted by a specified amount (swing factor) once the level of net purchases into or net redemptions from the fund has exceeded a specified percentage of the fund's NAV (swing threshold). The swing factor would include only the near-term costs expected to be incurred by the fund from that day's net purchases/net redemptions and cannot exceed 2% of the NAV per share. A fund that uses swing pricing must adopt pricing policies and procedures that specify the process for determining the fund's swing factor, upper limit, and swing threshold, which must be approved by the fund's board. An annual written review is required on the adequacy and effectiveness of the fund's swing-pricing policies and procedures.

Although this tool is frequently used by European funds, no U.S. funds have implemented this policy, primarily due to operational challenges.

Proposed Changes

Amended Rule 22c-1 would **require** an open-end fund—other than an MMF or ETF—to adopt swing pricing. The current exception for feeder funds in a master-feeder fund structure would continue to apply. A fund would be required to establish and implement swing-pricing policies and procedures to adjust a fund's NAV by a swing factor on any day it has net redemptions that exceed 1% of net assets or net purchases that exceed 2% of net assets. The swing factor would reflect bid-ask spread and a good faith estimate of the transaction costs of selling or purchasing a vertical slice of the fund's portfolio.

Hard Close

Many mutual funds use prices as of 4 p.m. ET to value a fund's underlying holdings to calculate the day's NAV. Typically, investors may place orders to purchase or redeem mutual fund shares with the fund's transfer agent or with intermediaries as late as 3:59 p.m. ET for execution at that day's NAV. When the transfer agent or an intermediary receives an order before the pricing time, that order typically receives that day's price. An investor who submits an order after the pricing time must receive the next day's price. However, the majority of mutual fund orders are placed with intermediaries, such as broker-dealers, banks, and retirement plan record-keepers who often do not transmit flow details to the fund's transfer agent or the clearing agency until after the fund has finalized its NAV calculation. Often, the fund's transfer agent or the clearing agency will not receive a significant portion of orders until after midnight. Without actual or estimated inflow or outflow information, it is impossible to determine if swing pricing should be applied.

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[3] The SEC estimates, using Form N-PORT data, that approximately 200 funds during March 2020 would have had illiquid investments over the 15% limit if this proposed change had been in effect.

To address the previous operational challenges of implementing swing pricing, the proposal would require a hard close for funds. An investor's order to purchase or redeem a fund's shares would be eligible for a given day's price only if the fund, its transfer agent, or a registered clearing agency receives the order before the time as of which the fund calculates its NAV, typically 4 p.m. ET.

The SEC acknowledges that fund and intermediaries would need to make significant changes to their business practices, update computer systems, alter batch processes, and integrate new technologies to facilitate faster order submission. Retirement plan record-keepers would face particular challenges with adhering to the proposed hard close requirement.

New Disclosures & Monthly Reporting

Currently, registered management investment companies (open-end funds (other than MMFs), registered closed-end funds, and ETFs registered as unit investment trusts) are required to file periodic reports on Form N-PORT about their portfolios and each of their portfolio holdings as of month-end. Funds file these reports on a **quarterly basis with a 60-day delay**, and the public has access to information for the third month of each quarter.

Under the proposal, all registered investment companies that report on Form N-PORT would be required to file **monthly within 30 days of month-end** and reports would be publicly available 60 days after month-end.

The proposal would require additional disclosures for open-end funds on Form N-PORT, including the percentage of a fund's assets that fall into each of the three liquidity categories as well as the frequency and amount of swing-pricing adjustments.

Conclusion

The asset management team at Forvis Mazars has more than 50 years of experience providing accounting, tax, and consulting services to various types of investment holdings, including conventional debt and equity investments, loans, businesses, alternative investments, and other unique assets. As of August 2022, Convergence Optimal Performance ranked Forvis Mazars as a top 25 accounting and audit firm to registered investment advisors. Forvis Mazars also was ranked in the top 20 by assets under management. We have experience providing services to fund complexes with net assets ranging from a couple million to several billion dollars. Our experience allows us to provide tailored services to help meet your unique needs. For more information, visit forvismazars.us.

Contributors

Debbie Scanlon
Partner
debbie.scanlon@us.forvismazars.com

Anne Coughlan
Director
anne.coughlan@us.forvismazars.com

Appendix

The tables below highlight the primary proposed changes to liquidity classification framework.

Rule 22e-4	Current	Proposed
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	Removed

	expected to settle in more than seven calendar days.	
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.

Rule 22e-4	Current	Proposed
Related Concepts		
Assumed Trade Size	Sizes that the fund would reasonably anticipate trading.	10% of the fund's net assets by reducing each investment by 10%.
Value Impact Standard	Significantly changing the market value of the investment	Significantly changing the market value of an investment means: (1) For shares listed on a national securities exchange or a foreign exchange, any sale or disposition of more than 20% of average daily trading volume of those shares, as measured over the preceding 20 business days. (2) For any other investment, any sale or disposition that the fund reasonably expects would result in a

		decrease in sale price of more than 1%.