The SEC's Swing Pricing and Liquidity Proposal: What You Should Know

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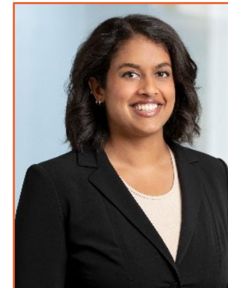

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SEC's Swing Pricing and Liquidity Proposal

Introduction and Key Features

Introduction

- In November 2022, the SEC proposed significant revisions to its rules governing mutual fund swing pricing and liquidity risk management
- The rulemaking is generally intended to accomplish the following objectives:
  - To reduce the potential "dilutive" effect on non-transacting shareholders when mutual funds purchase and sell portfolio holdings in response to shareholder inflows and outflows
  - To standardize mutual fund liquidity management practices in a manner more attuned to severe market stress events and address perceived "liquidity mismatch" in mutual funds
- The rulemaking was significantly influenced by the COVID-related market disruptions that occurred in March 2020

Key Features

- Mandated swing pricing (excluding MMFs and ETFs)
- Hard close (excluding MMFs and ETFs)
- Changes to liquidity risk management rule (including ETFs)
- Reporting and disclosure changes (including CEFs and ETFs but excluding MMFs)
- Comments are due by February 14, 2023

Mandatory Swing Pricing and “Hard Close”

Features and Effects

Background

- Swing pricing is an anti-dilution tool that could enable mutual funds to allocate portfolio transaction costs to the shareholders that generate those costs
- In October 2016, the SEC amended Rule 22c-1 to permit, but not require, mutual funds (excluding ETFs and MMFs) to use swing pricing
- Since 2016, no mutual fund in the U.S. has opted to use swing pricing, in part because of operational challenges
  - Swing pricing requires funds to estimate shareholder purchases / redemptions by their pricing times; intermediated market structure in the U.S. makes this difficult
- Although swing pricing has been widely used in Europe, swing pricing is not required for European funds, but rather is a discretionary anti-dilution tool

Swing Thresholds

- Under the proposal, a fund would need to adjust its NAV by a “swing factor” if, on a given day:
  - The fund has net redemptions; or
  - The fund has net purchases exceeding its “inflow swing threshold” (2% of net assets or a lower threshold that the swing pricing administrator (SPA) determines)
- The SPA would need to determine net redemptions or net purchases based on “reasonable, high confidence estimates” of investor flows
- Funds currently have more discretion to set their own swing thresholds, provided they take into account certain enumerated factors
  - Factors include the size, frequency and volatility of historical net purchases / redemptions

Swing Factor Determination

- The swing factor is the amount that is added to the purchase price or subtracted from the redemption price of fund shares
- Under the proposal, the SPA would calculate the swing factor based on selling / purchasing a vertical slice of the fund's portfolio (*i.e.*, a pro rata amount of each portfolio investment) equal to the amount of net purchases / redemptions
  - Must consider spreads, brokerage commissions, custody fees and any other associated charges/fees/taxes
  - Must consider "market impact" costs when net redemptions / purchases exceed certain thresholds (generally 1% of net assets if net redemptions or 2% of net assets if net purchases)
- Market impact costs "are the costs incurred when the price of a security changes as a result of the effort to purchase or sell" a security

Swing Factor Determination

- The swing factor may be determined on a periodic basis
  - But would need to be determined more quickly if developments would otherwise prevent the swing factor from reflecting the costs of purchasing or selling (as applicable) a vertical slice of the fund's portfolio
- No upper limit on swing factor (current rule imposes a 2% upper limit)

Board Responsibilities and SPA

- Board responsibilities
  - Approve swing pricing policies and procedures
  - Designate SPA
  - Review SPA's annual written report
- Swing pricing administrator (fund's adviser, officer or officers)
  - Reasonable segregation from fund portfolio management; may not include PMs
- The proposal would not materially change board responsibilities under the rule, although a board would no longer have to approve a fund's swing threshold or any changes to the fund's swing threshold

Swing Pricing Proposal – Alternatives

- The SEC described several alternatives to swing pricing, signaling the potential for some changes to the proposal:
  - A static liquidity fee
  - A dynamic liquidity fee
  - A liquidity fee triggered on days when the fund faces significant anticipated trading costs
  - Dual pricing, in which the fund would have a price for gross redemptions that is different from its price for gross purchases on the same day
  - A "simplified version of swing pricing" – NAV adjusted only for spread costs and only on days with estimated net outflows

Hard Close

- To overcome the operational issues related to swing pricing, the SEC would mandate a “hard close” for mutual funds
  - Purchase / redemption order eligible for a given day’s price only if a fund, TA, or registered clearing agency (NSCC) receives an “eligible order” before time fund calculates NAV (generally 4:00 pm ET)
- The hard close represents a significant departure from current industry practices, which permit a shareholder to receive a given day’s price as of a fund’s pricing time (generally 4:00 pm ET), if they submit their order to their broker before the fund’s pricing time, even if the broker transmits that order to the fund or its TA after the time the fund calculates its NAV

Potential Impact

- Mandatory swing pricing and the hard close would likely:
  - impact the competitive landscape for mutual funds (vis-à-vis other pooled investment vehicles, including CITs);
  - significantly impact fund operations and impose significant costs;
  - cause intermediaries to establish cut-off times for share purchases / redemptions in advance of 4:00 pm ET (which would likely vary from intermediary to intermediary);
  - prevent some shareholders from transacting on a same-day basis (because of missed cut-off times, among other reasons); and
  - impact some distribution channels (*e.g.*, retirement) more than others

Liquidity Risk Management Framework

Liquidity Classifications, HLIMs, Illiquid Investment Limit

Background

- In the aftermath of the COVID-related market disruptions in March 2020, financial regulators have been focusing on potential liquidity mismatches (*e.g.*, between the ability to redeem mutual fund shares daily and the time it takes to liquidate portfolio holdings) and their potential to create systemic risk
- Although market liquidity was challenged during March 2020, no mutual fund was unable to satisfy shareholder redemption requests during that time
- The proposal would amend Rule 22e-4, which was adopted in 2016, and would generally increase the liquidity profile of mutual funds and make it more difficult to hold less liquid or illiquid investments

Liquidity Classification

- Mutual funds are subject to a 15% restriction on illiquid investments and are required to classify investments into four “buckets”:
  - Highly Liquid
  - Moderately Liquid
  - Less Liquid
  - Illiquid
- The proposal would expand the “illiquid” category to include: (1) the current “less liquid” category (*i.e.*, the “less liquid” category would be eliminated)*;* and (2) Level 3 investments
  - According to the SEC, bank loans make up the majority of investments in the less liquid category

Liquidity Classification

- Elimination of asset class classifications
  - Currently, funds are permitted to classify investments according to asset class
  - This flexibility would be eliminated under the proposal, such that investments need to be classified individually
- Discretionary "RATS" replaced with uniform 10% stressed trade size
  - In classifying an investment, funds would be required to assume the sale of 10% of the fund's net assets by reducing each investment by 10%
  - This would replace the current requirement to consider a "reasonably anticipated trade size" (or RATS) of a position (which permitted some discretion in choosing a fund's RATS)

Liquidity Classification

- Uniform price impact standard
  - Mutual funds are currently required to classify investments based on the time it takes to sell or dispose of the position without "significantly changing its market value"
  - This price impact standard would be defined as follows:
    - For shares listed on a national securities exchange or foreign exchange, any sale or disposition of more than 20% of the average daily trading volume of those shares, as measured over the preceding 20 business days
    - For any other investment, any sale or disposition reasonably expected to result in a decrease in sale price of more than 1%
- Daily classifications (currently no less frequently than monthly)
- Day counting method (include the day the liquidity classification is determined)

Mandated Highly Liquid Investment Minimum

- Under the proposal, mutual funds would be required to adopt a "highly liquid investment minimum" (HLIM) of at least 10%
  - Removes current exception for funds that "primarily" hold highly liquid investments
  - Retains exception for "In-Kind ETFs"

Potential Impact

- Liquidity risk management rule changes would:
  - Limit fund manager discretion in liquidity classifications
  - Put downward pressure on liquidity classifications, likely with fewer investments classified as highly liquid and more classified as illiquid
  - Make it more difficult, or potentially impossible, to offer certain investment strategies in an open-end fund wrapper
  - Impose costs and additional responsibilities

Reporting Changes

Forms N-PORT & N-CEN

Reporting – Form N-PORT Changes

- Swing factor reporting
  - Number of times applied during period
  - Amount of each swing factor applied
- Public reporting of aggregate liquidity classifications (currently non-public)

Reporting – Form N-PORT Filing Frequency

- File within 30 days of month end; publicly available 60 days after
  - The current requirement is to file monthly reports with the SEC 60 days after fiscal quarter-end, where only the report for the third month of every quarter is made public
  - Items that are non-public under the current rule, including individual portfolio investment liquidity classifications, would remain non-public
- Holdings report
  - Funds would need to provide a complete portfolio holdings report on Part F of Form N-PORT ten months of the year rather than just for the first and third quarters

Reporting – Form N-CEN Changes

- Liquidity classification service providers
  - Name
  - Identifying information
  - Affiliation information
  - The asset classes for which the liquidity service provider provided classifications
  - Whether the provider was hired or terminated during the period

Transition Periods and Timing

Transition Periods & Timing

- 24 months: Swing pricing and hard close; related disclosure updates
- 12 months: Liquidity risk management rule; related disclosure updates

Questions?

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