MEMO# 34856

February 1, 2023

ICI Draft Comment Letter on the SEC's Liquidity, Swing Pricing, Hard Close, and Form N-PORT Proposal; Comments Due By February 8

[34856]

TO: Accounting/Treasurers Committee
Chief Risk Officer Committee
Disclosure Working Group
Liquidity Rule Implementation Working Group
Operations Committee
SEC Rules Committee
Small Funds Committee
Transfer Agent Advisory Committee RE: ICI Draft Comment Letter on the SEC's Liquidity, Swing Pricing, Hard Close, and Form N-PORT Proposal; Comments Due By February 8

Attached please find ICI's draft comment letter on the SEC's liquidity, swing pricing, hard close, and Form N-PORT proposal. We would appreciate it if you could consolidate your firm's comments and provide them to us (matt.thornton@ici.org, joanne.kane@ici.org, kenneth.fang@ici.org, and jason.nagler@ici.org) by February 8, COB. Comments are due to the SEC by February 14. There are still some sections to be fleshed out, but in the interest of time we want to get this draft to you for review. We welcome your comments on the whole letter, and especially on the matters that we have bracketed.

The contents of the draft letter are briefly summarized below.

Proposed Liquidity Amendments

The proposed changes to the liquidity framework would adversely and detrimentally affect portfolio management while also creating a distorted view of funds' liquidity risks. We therefore oppose many of its elements.

- We strongly object to the collective changes to the bucketing requirements, which harmfully increase their level of prescription and would cause the exercise to be even less useful as a liquidity risk management and informational tool, while disrupting investment operations.
- Collectively, these changes would cause some funds—including large US equity funds

whose portfolios are highly liquid—to breach the 15% illiquid investments limit, even in ordinary market conditions. Fund managers would have to reassess the use of the open-end fund for these and other strategies.

- The proposed 10% size assumption is arbitrary and utterly disconnected from funds' actual experiences in times of stress. Instead, each fund should determine its own stressed trading size figure for bucketing purposes, based on its specific liquidity risk factors (most prominently, its flows in stressed conditions).
- The proposed day counting provision is unnecessary and flatly at odds with the rule text and the proposing and adopting releases.
- The proposed value impact standards are overly rigid; fail to account for the wide range of investments and their differing trading characteristics; and produce anomalous results that would impede portfolio management and confuse investors.
- Eliminating asset class classification removes an effective means of (i) expeditiously reclassifying investments in stressed market conditions and in response to significant events; (ii) addressing gaps in vendor coverage; and (iii) classifying some or all investments in a practical and cost-effective manner.
- The removal of the "less liquid" bucket and the expansion of the "illiquid" bucket effectively eliminates open-end bank loan funds and leads to a significant migration of (currently) liquid investments into the illiquid bucket.
- Requiring daily bucketing results in unjustified costs and burdens for funds (particularly smaller funds) with little benefit.
- We strongly object to public reporting of funds' aggregated bucketing information each month. Such information by its nature is subjective, forward-looking, and hypothetical and risks misleading and confusing investors. The proposed bucketing changes make this output even worse by distorting funds' liquidity risk profiles, including by unfairly misrepresenting the liquidity of larger funds and producing anomalous results.
- With respect to the highly liquid investment minimum (HLIM) requirements, we:
- Support eliminating the "primarily highly liquid fund" exemption, which would significantly increase the number of funds subject to these requirements.
- Oppose a mandatory 10% minimum HLIM for all funds as arbitrary and unnecessary, but support it for funds primarily holding longer-settling investments (e.g., bank loans).

Proposed Swing Pricing and Hard Close Amendments

We strongly oppose the 4:00 pm (ET) hard close on mutual fund orders and mandatory swing pricing for mutual funds. Neither fund experience nor the proposal's economic analysis establishes that such costly measures are warranted.

Implementing a hard close would require significant systems rebuilds across the industry, affecting the entire fund ecosystem, including intermediaries, retirement plan recordkeepers, administrators, custodians, transfer agents, and the industry utility (DTCC). The hard close would negatively affect mutual fund investors. Most of these investors would not be able to execute fund trades as they do today throughout normal market hours (i.e., until 4 pm ET), and some may face cut-offs as early as 10:00 am ET.

With respect to swing pricing, the Commission does not fully appreciate the critical differences between the European and US fund markets. Apart from our operational concerns with mandating swing pricing in the US, the SEC's proposed swing pricing amendments fundamentally differ from and are inferior to European regulatory frameworks and the SEC's 2016 swing pricing amendments (which permit, but do not require, mutual funds to use swing pricing). We recommend that the SEC mostly retain the 2016 amendments in their current form, with further amendments to reduce the legal risk associated with swing pricing (e.g., by adding a safe harbor from liability) and improve the board-related provisions.

Overall, the swing pricing and hard close proposal seriously errs in requiring that (i) all mutual funds adopt an extraordinary anti-dilution measure, and (ii) such measure be the same for each fund (i.e., mandatory swing pricing). For most mutual funds, dilution is de minimis, and adoption of extraordinary anti-dilution measures for these funds is unnecessary and unjustifiable based on their potential costs and burdens on investors. For the small sub-set of funds where dilution is significant, the relative merits of various anti-dilution measures (e.g., swing pricing and liquidity fees) differ by fund.

In lieu of what the SEC has proposed, we recommend the following two-step approach for mutual funds:

- A fund's liquidity program administrator must assess the fund's dilution.
- A fund that determines that its dilution is significant generally would be required to adopt an "anti-dilution measure." We envision defining "anti-dilution measure" broadly to include swing pricing (the 2016 version, as we recommend amending it herein), liquidity fees (broadly understood), possibly other alternatives included in the proposal, and any other measure that a fund reasonably believes would reduce dilution below a significant level. A fund adopting an anti-dilution measure then would assess periodically the operation, adequacy, and effectiveness of that measure and make any changes as necessary and appropriate.

We further recommend exploring the key provisions in this framework (e.g., how to assess dilution, and permissible "anti-dilution measures") in a concept release. Carefully considering these provisions would be critical, and thoughtful input from all affected stakeholders would be indispensable to that process.

Proposed Form N-PORT Amendments

We also have serious concerns with certain of the proposed changes to the disclosure framework. The changes would impose substantial burdens on Form N-PORT filers, requiring them to produce more detailed information, some of which is unnecessary, in a substantially compressed timeframe. In addition, the changes would provide for more frequent public disclosure of sensitive fund holdings information, which would harm certain funds and their shareholders.

- We recommend that the SEC provide Form N-PORT filers with at least 45 days after the end of a month to file Form N-PORT. The time would allow such funds to properly review and file the information and reduce the opportunities for the misappropriation of sensitive information.
- We urge the Commission not to require more frequent public disclosure of portfolio holdings. The current quarterly disclosure approach appropriately balances the interest in public transparency against the need to protect sensitive portfolio management positions and strategies.
- We strongly oppose requiring more frequent filing of Regulation S-X-compliant Schedule of Investments information. The proposed requirement would impose excessive costs on funds and their shareholders with no clear benefits. If the SEC determines to proceed with requiring additional holdings information monthly in a

reader-friendly format, there are other less costly and equally effective ways of providing the information, including:

- Creating a tool on the SEC's website for shareholders to extract existing Form N-PORT Part C information; or
- Permitting funds to post simplified and unstructured Form N-PORT holdings on a fund's or adviser's website.

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