MEMO# 34960

February 16, 2023

ICI Files Comment Letter on the SEC's Liquidity, Swing Pricing, Hard Close, and Form N-PORT Proposal

[34960]

February 15, 2023

TO: ICI Members
Investment Company Directors
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
Variable Insurance Products Advisory Committee SUBJECTS: Disclosure
Operations
Transfer Agency RE: ICI Files Comment Letter on the SEC's Liquidity, Swing Pricing, Hard Close, and Form N-PORT Proposal

Attached please find ICI's comment letter on the SEC's liquidity, swing pricing, hard close, and Form N-PORT proposal, which we filed last night. The contents of the letter are summarized below.

Introduction

The proposal would radically change the liquidity risk management requirements for open-end funds (i.e., mutual funds and ETFs), impose on mutual funds a "hard close" on orders (typically at 4:00 p.m. (ET)), and mandate that mutual funds use swing pricing.[[1]] We are quite concerned that adoption of this proposal would not only fundamentally alter the management and operation of open-end funds and pricing of mutual funds but also how investors purchase and sell mutual funds. American retail investors could no longer be able to access certain funds and strategies that have successfully served their financial needs for decades.

The Commission has failed to ground such consequential changes in thorough evidence and careful study, analysis, and testing of proposed solutions, a prerequisite to fulfill its mandate to act in the public interest and for the protection of investors. We therefore cannot support this proposal and urge the Commission to undertake a more fulsome examination to identify any deficiencies in funds' current liquidity risk management practices and design well-calibrated solutions.

In addition to separately evaluating the proposed liquidity-related amendments (Section 2), the proposed hard close and swing pricing amendments for mutual funds (Section 3), and the proposed Form N-PORT reporting requirements (Section 4), we include the following appendixes:

- Appendix A contains ICI's economic analysis of the proposed liquidity, swing pricing, and hard close amendments and its evaluation of the proposal's economic analysis.
- Appendix B provides a history of the liquidity and dilution provisions of the Investment Company Act.
- Appendix C outlines the types of costs that would result from the proposed swing pricing and hard close amendments.

Proposed Liquidity-Related Amendments (Section 2)

The proposed changes to the liquidity framework would adversely and detrimentally affect portfolio management while also creating a distorted view of funds' liquidity risks. Our research indicates that some funds used by today's investors would no longer be able to comply with the new requirements and fully pursue their investment objectives and strategies. We therefore oppose many of its elements and offer tailored recommendations designed to improve funds' liquidity risk management practices where appropriate.

- We strongly object to the collective changes to the bucketing requirements, which would cause the exercise to be even less useful as a liquidity risk management and informational tool; compromise fund performance and investment operations by creating unnecessary constraints on portfolio management; limit investor access to investment strategies and asset classes; and add unwarranted compliance costs and burdens to all funds.
- Collectively, these changes would cause some funds—including some US large cap 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 utility and 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 rule's 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 would harm funds by removing 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 would lead to a significant migration of (currently) liquid investments into the illiquid bucket.

- Requiring daily bucketing would generate unjustified costs and burdens for funds (particularly smaller and highly liquid 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 (provided the current bucketing requirements are kept in place), 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).

Further, with respect to the liquidity proposal we:

- Explain why the rule's current bucketing requirements are ill-suited for smaller funds and how the proposed amendments (e.g., the daily bucketing requirement) would make matters worse. We recommend that the SEC ensure that any rule requirements are informed by the unique and varied characteristics of smaller funds, without diminishing investor protection.
- Discuss how bank loan funds have managed liquidity successfully for decades and recommend rule changes that could further strengthen their practices (e.g., mandating a minimum 10% HLIM and enhancing the rule's liquidity risk factors to address funds' longer-settling investments).
- Recommend that the SEC:
- Amend Rule 17a-7 (the cross trading rule) to permit fixed-income cross trading, subject to appropriate guardrails.
- Propose and adopt an interfund lending/borrowing exemptive rule.
- Recommend that the SEC retain existing guidance that is not superseded by any final amendments (e.g., most of the SEC staff's 2018 liquidity FAQs).

Proposed Mandatory Hard Close and Swing Pricing Amendments (Section 3)

We strongly oppose the hard close on mutual fund orders (typically set by most funds at 4:00 p.m. ET) and mandatory swing pricing for mutual funds. Neither fund experience nor the proposal's economic analysis establishes that such costly measures are warranted. The harm and disruption for everyday mutual fund investors resulting from them would be far too high. Implementing a hard close would require significant systems rebuilds across the industry, affecting the entire fund ecosystem, including intermediaries such as broker-dealers and retirement plan recordkeepers, administrators, custodians, transfer agents, and the industry utility (DTCC). The cost, resources, and effort to build these systems would be enormous and lead to lost processing efficiencies.

The hard close would negatively affect mutual fund investors in several respects. These investors would not be able to execute fund trades as they do today throughout normal market hours, and many may face cut-offs as early as 10:00 a.m. ET if they wish to receive same-day pricing. In many cases, execution and prices received would be delayed by at least one day for these investors. These delays would create a new source of involuntary investment risk for investors, as they would be unable to promptly transact and receive same-day pricing (See Appendix A, Figure 4.1).

The Commission proposes to radically change how mutual funds are purchased and sold on the premise that swing pricing has been used successfully in Europe as an anti-dilution tool. Yet, the Commission does not fully appreciate or consider the critical differences between the European and US fund markets, which include the following:

- Europe's funds have significantly larger percentages of institutional investors.
- Most European funds have several hours between their cut-off time for receiving trades and calculating their NAVs. This sequencing and timing is critical to accurate application of swing pricing.
- The European market has a smaller percentage of its total assets in "NAV-dependent" products (i.e., products that require receipt of a fund's net asset value (NAV) before they may in turn calculate their values or perform other related transactions). In the United States, such products include funds of funds, variable insurance products, and Section 529 investment plans, and they compose a larger part of the US market.
- Most shareholder trades in Europe are denominated in currencies, which can be readily processed by funds and intermediaries without estimation.

Apart from our operational concerns with mandating swing pricing in the United States, the SEC's proposed swing pricing amendments fundamentally differ from European regulatory frameworks, which are permissive in application (i.e., European funds need not adopt swing pricing) and significantly more flexible in their specific provisions (e.g., European funds set their own thresholds based on fund-specific factors and are not required to include market impact in their swing factors). The swing pricing amendments that the SEC adopted in 2016—which permit, but do not require, mutual funds to use swing pricing—are in greater accord with European regulation and practice and far superior to the 2022 proposed amendments. We recommend that the SEC mostly retain the 2016 amendments in their current form, with further exploration, based on data and information, of amendments to facilitate the use of swing pricing (e.g., a safe harbor) 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 coupled with a hard close). For the large majority of 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 could be significant, the relative merits and shortcomings of various anti-dilution measures (e.g., swing pricing and liquidity fees) differ by fund.

We appreciate the proposal's consideration of anti-dilution alternatives. In fact, we believe that the SEC should examine some of these alternatives further through roundtables and other forms of information gathering, which could be followed by a concept release. In lieu of what the SEC has proposed, we recommend that the Commission explore through the means mentioned above the following two-step approach for mutual funds:

- A fund's adviser (or appropriate advisory personnel) must assess the fund's dilution.
- Subject to board oversight, a fund that determines that its dilution is significant would assess various "anti-dilution approaches." We envision defining "anti-dilution approach" broadly to allow a range of considerations and approaches, including swing pricing (the 2016 version, as we recommend amending it herein), liquidity fees

(broadly understood), other alternatives included in the proposal, and any other measure that a fund reasonably believes would address significant dilution in the interests of investors. A fund adopting an anti-dilution approach then would assess periodically its operation, adequacy, and effectiveness and make any changes as necessary and appropriate.

Carefully considering this approach (e.g., how to assess dilution, and permissible and feasible "anti-dilution approaches") in a full and open way would be critical, and transparent input from all affected stakeholders (including investors, service providers, and intermediaries) would be indispensable to that process.

Proposed Form N-PORT Amendments (Section 4)

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. To address our concerns, we offer the recommendations below:

- 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.

Matthew Thornton
Associate General Counsel

Joanne Kane
Chief Industry Operations Officer

Kenneth Fang
Associate General Counsel

Jason Nagler
Senior Director, Fund Accounting & Compliance

Notes

[[1]] Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting, SEC Release No. 33-11130, 87 Fed. Reg. 77172 (Dec. 16, 2022) (the "proposal"), available at https://www.govinfo.gov/content/pkg/FR-2022-12-16/pdf/2022-24376.pdf.
