

MEMO# 30333

October 21, 2016

SEC Permits Mutual Funds to Use Swing Pricing

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TO: ACCOUNTING/TREASURERS MEMBERS No. 34-16
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UNIT INVESTMENT TRUST MEMBERS No. 14-16
VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 26-16 RE: SEC PERMITS
MUTUAL FUNDS TO USE SWING PRICING

The SEC adopted rule amendments last week that permit, but do not require, mutual funds to use swing pricing.[\[1\]](#) On the same day, the SEC adopted new enhanced fund reporting and liquidity requirements.[\[2\]](#)

The SEC's adoption of the rule amendments permitting swing pricing finalizes the package of reforms first proposed in September 2015.[\[3\]](#) The SEC believes that swing pricing could be an effective tool to assist mutual funds ("funds")[\[4\]](#) in mitigating potential shareholder dilution, and may be an additional tool to manage a fund's liquidity risk. Funds that opt to use swing pricing also must make certain disclosures on Form N-1A, financial statements filed on Form N-CSR, and Form N-CEN.

I. Swing Pricing Amendments

A. Description of Swing Pricing

Many types of pooled investment vehicles, including U.S. mutual funds, “mutualize” portfolio transaction costs among fund shareholders. Because of this mutualization, sizable net redemption and purchase activity, and the transaction costs that often follow, have the potential to dilute the value of existing investors’ fund shares, absent some means of apportioning transaction costs to those redeeming or purchasing fund shareholders.

Outside the U.S., some funds use swing pricing to allocate transaction costs to redeeming and purchasing shareholders in certain circumstances. In effect, swing pricing involves a second step in the valuation process, whereby a fund measures daily net purchase or redemption activity, and, when the pre-determined activity threshold is exceeded, adjusts (or “swings”) the net asset value (“NAV”) upward (in the case of a net purchase of fund shares, so that transacting shareholders bear the transaction costs from resulting fund purchases of portfolio securities) or downward (in the case of a net redemption of fund shares, so that transacting shareholders bear the transaction costs from resulting fund sales of portfolio securities).

B. Summary of ICI’s Comment Letter

ICI’s comment letter on the SEC’s original liquidity proposal included detailed comments on the proposed swing pricing amendments.[\[5\]](#) The ICI letter:

- Urged the SEC to carefully explore the potential benefits, disadvantages, and operational challenges of swing pricing;
- Noted that ICI members do not share a uniform view on the desirability of swing pricing; and
- Explained how fundamental differences in U.S. and European fund operations create serious challenges to implementing swing pricing in the U.S., which must be addressed before swing pricing could be implemented in the U.S.

C. Summary of Rule 22c-1 Amendments

The Rule 22c-1 amendments permit, but do not require, funds to use swing pricing. The Release notes that fund complexes may decide to use swing pricing for certain funds within the complex but not others, or establish different swing thresholds for different funds within the complex.[\[6\]](#)

The key provisions of these Rule 22c-1 amendments are as follows:

- *Policies and Procedures:* A fund that chooses to use swing pricing must establish and implement swing pricing policies and procedures to mitigate dilution. Those policies and procedures must provide that the fund adjust its NAV per share by a single or multiple swing factors[\[7\]](#) once the level of net purchases into or net redemptions from the fund exceeds an applicable swing threshold.[\[8\]](#)

In determining whether the fund’s level of net purchases or net redemptions has exceeded the applicable swing threshold(s), the administrator may make such determination based on receipt of sufficient information about the fund investors’ daily purchase and redemption activity (“investor flow”) to allow the fund to reasonably estimate whether it has crossed the swing threshold(s) with high

confidence.[\[9\]](#)

The amendments also stipulate that for “master-feeder” fund structures, only the master fund may use swing pricing.[\[10\]](#)

- *Board involvement:* The fund’s board, including a majority of the independent directors, must approve: (i) the fund’s swing pricing policies and procedures;[\[11\]](#) (ii) the fund’s swing threshold(s) and the upper limit on the swing factor(s) used, and any changes to the swing threshold(s) or the upper limit on the swing factor(s) used; and (iii) the designation of the fund’s investment adviser or person(s) responsible for administering the swing pricing policies and procedures (the “administrator”).[\[12\]](#) The board also must review, no less frequently than annually, a written report prepared by the administrator.[\[13\]](#)

D. Recordkeeping Requirements

A fund must maintain its swing pricing policies and procedures and the board reports mentioned above for six years (the first two in an easily accessible place), under the amendments to Rule 22c-1. The SEC’s amendments to Rule 31a-2 under the Investment Company Act require a fund that uses swing pricing to preserve records evidencing and supporting each computation of an adjustment to the NAV of the fund’s shares based on the fund’s swing pricing policies and procedures.[\[14\]](#)

E. Operational and Legal Considerations in Implementing Swing Pricing

In response to comments from ICI and others about the existing operational hurdles associated with implementing swing pricing in the U.S., the Release states, “We also appreciate the extent of operational changes that will be necessary for many funds to conduct swing pricing and that these changes may still be costly to implement, but we were not persuaded by commenters who argued that these changes are insurmountable... .”[\[15\]](#) After summarizing these operational challenges, the Release makes several points, including the following:

- Although funds and intermediaries may incur costs in changing operational systems and developing new processes, these costs would only be incurred if funds elect to adopt swing pricing.
- The two-year delay in effectiveness[\[16\]](#) is meant to permit the industry to address such operational changes, and may also alleviate some of the competitive concerns raised regarding certain funds being better positioned to implement swing pricing.
- Certain funds with investors that primarily transact directly with the fund’s principal underwriter or transfer agent, or that are primarily distributed through affiliates or broker-dealers that could potentially provide timely flow data, and/or do not have a substantial number of investors transacting in retirement plans or insurance products, could more easily obtain sufficient net flow information.
- Larger fund complexes may have the leverage to negotiate operational solutions and the resources to implement swing pricing sooner, which may result in inefficient one-off solutions rather than coordinated industry-wide operational solutions.
- Even if only a limited number of funds adopt swing pricing immediately following the extended effective date, as funds begin to gain familiarity with the process, more funds may choose to adopt it over time.

The proposed amendments contemplated that funds may not have complete fund flow information at the time they must calculate and disseminate their NAVs, so those amendments would have permitted those responsible for implementing swing pricing to determine whether the swing threshold had been exceeded based on fund flow information obtained after a “reasonable inquiry.” ICI’s comment letter requested guidance and clarification regarding what constitutes “reasonable inquiry.” The Release provides further guidance on this point,[\[17\]](#) but does not require intermediaries to provide timely estimates of shareholder flows to funds that implement swing pricing.

ICI’s comment letter also requested guidance regarding what would constitute an “error” in the swing pricing context, given that a fund could misstate its NAV solely because it did not have access to complete flow information at the time it had to calculate and disseminate it. The Release addresses this subject,[\[18\]](#) stating in part that fund management, with oversight by the fund’s board of directors, is in the best position to tailor and oversee any error correction policies that may relate to swing pricing. It also states, “We believe that as long as the fund has followed reasonable practices, policies and procedures in gathering sufficient information in determining whether net investor flows (which may include reasonable estimates) have exceeded the applicable threshold used for swing pricing, such differences [in actual versus estimated net flows] would not in and of itself result in a determination of a NAV pricing error requiring reprocessing of transactions or a financial statement adjustment to the fund’s NAV.”[\[19\]](#)

The Release also notes that, two years after the amendments’ effective date, the SEC staff will review market practices associated with funds’ use of swing pricing and provide the SEC with the results of this review.

II. New Disclosure, Financial Statement and Performance Reporting Requirements

A. Form Amendments

Funds must provide swing pricing-related information on the following amended forms:

- *Form N-1A*: a fund that uses swing pricing must (i) report certain performance and financial information,[\[20\]](#) and (ii) explain the fund’s use of swing pricing, including what it is, the circumstances under which the fund will use it, its effects on the fund and investors, and the swing factor upper limit.[\[21\]](#)
- *Form N-CEN*: each fund must report whether it engaged in swing pricing, along with its swing factor upper limit.

B. Financial Statements

The final rule and form amendments include a number of changes regarding financial statement and performance reporting for funds that use swing pricing.[\[22\]](#)

The final amendments require disclosure of the GAAP NAV per share on the balance sheet.[\[23\]](#) The Release indicates that the GAAP NAV per share would include both the effects of swing pricing throughout the period as well as any trade date financial reporting adjustments for portfolio transactions and capital share transactions occurring on the balance sheet date. The Release notes that funds are not precluded from disclosing the swung NAV per share on the balance sheet, provided there is an explanation of the

differences between the two.

Swing pricing also affects the disclosure of capital share transactions included in the statement of changes in net assets. Regulation S-X requires funds to disclose the number of shares and dollar amounts received for fund shares issued, and paid for shares redeemed. The Release indicates that the dollar amount of issuance and redemption reported in the statement of changes in net assets should be based on the transactional NAVs used to process investor subscriptions and redemptions, including those processed using swung NAVs during the reporting period.[\[24\]](#)

The financial highlights reconcile the beginning and ending NAV per share and provide total return for the period. The final amendments require disclosure of the swung NAV per share, if applicable, as a separate line item below the ending GAAP NAV per share on the financial highlights. In addition, the final amendments require disclosure of the per share impact of amounts related to swing pricing be disclosed as a separate line item below the total distributions line in a fund's financial highlights. Accordingly, the cumulative effect of swing pricing throughout the year will be presented within the financial highlights' GAAP NAV per share roll-forward as a separate line item, and the impact of swing pricing as of the period end date, if any, would be disclosed by presenting the swung NAV.

Finally, a fund that adopts swing pricing must disclose its effects in the financial statement notes, specifically: (i) the general methods used in determining whether the fund's NAV per share will swing; (ii) whether the fund's NAV swung during the period; and (iii) a general description of the effects of swing pricing on the fund's financial statements.

C. Performance Reporting

Funds must calculate total returns based on the GAAP NAV, which will include the cumulative effects of swing pricing over the reporting period.[\[25\]](#) Additionally, funds must disclose in a footnote to the prospectus's annual total returns bar chart and average annual total returns table the general effects of swing pricing on the fund's returns, if a fund's swing pricing policies and procedures were applied during any of the periods presented.

III. Effective and Compliance Dates

Consistent with ICI's recommendation, the Rule 22c-1 swing pricing amendments will become effective 24 months after the Release is published in the Federal Register. Funds must comply with the new Form N-1A and Form N-CEN swing pricing items as of that same date. Funds must include the new swing pricing disclosures in any financial statements in which swing pricing is implemented on or after the effective date for the Rule 22c-1 amendments.

IV. ICI Activity in Connection with Recent SEC Rulemaking

The swing pricing amendments, together with the new liquidity and enhanced fund reporting requirements, will bring about significant changes for the fund industry. To assist members in analyzing and implementing them, ICI will:

- Host a one-day conference on November 17 in Boston, at which we will cover these new requirements (and include a separate swing pricing panel) in depth. We will be joined by senior SEC staff. Information about this event and registration can be found at www.ici.org/events/upcoming/conf_16_sec_rules.
- Devote panels to these subjects at ICI's Securities Law Developments Conference in Arlington, VA (outside Washington, D.C.) on December 6. We will be joined by senior

SEC staff. Information about this event and registration can be found at www.ici.org/events/upcoming/conf_16_seclaw.

- Engage our committees within ICI Operations to review the liquidity requirements and swing pricing amendments, identifying potential common practices and/or industry-sponsored solutions that could benefit compliance efforts by funds, intermediaries, and service providers.

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endnotes

[1] *Investment Company Swing Pricing*, SEC Release No. IC-32316 (Oct. 13, 2016)(the “Release”), available at www.sec.gov/rules/final/2016/33-10234.pdf. For a shorter summary of the new liquidity, swing pricing, and enhanced fund reporting provisions, see Institute Memorandum No. [30316](#), dated October 14, 2016.

[2] These new requirements regarding enhanced fund reporting and liquidity risk management are summarized in Institute Memoranda Nos. [30331](#) and [30334](#), respectively.

[3] *Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release*, SEC Release No. IC-31835 (Sept. 22, 2015), available at www.sec.gov/rules/proposed/2015/33-9922.pdf. Institute Memorandum No. [29367](#), dated September 28, 2015, provides a detailed summary of the proposal. We provide links to and summaries of ICI’s numerous comment letters on the liquidity and swing pricing proposal in Institute Memorandum No. [29643](#), dated January 14, 2016, and Institute Memorandum No. [29920](#), dated May 18, 2016.

[4] Money market funds and open-end ETFs are not permitted to use swing pricing.

[5] Letter from David W. Blass, General Counsel, Investment Company Institute, to Brent J. Fields, Secretary, Securities and Exchange Commission, dated January 13, 2016, at pp. 54-69 and Appendices D and E, available at www.sec.gov/comments/s7-16-15/s71615-54.pdf.

[6] Release at 20.

[7] The “swing factor” is the amount, expressed as a percentage of the fund’s NAV and determined pursuant to the fund’s swing pricing procedures, by which the fund adjusts its NAV per share once net purchases or redemptions exceed the applicable swing threshold. A fund must consider the following factors in setting its swing factor(s): (i) the establishment of an upper limit on the swing factor(s) used, which may not exceed two percent of the NAV per share; and (ii) the determination that the factor(s) used are reasonable in relationship to the applicable near-term costs. In setting the swing factor and

upper limit, the administrator (defined below) may consider only near-term costs expected to be incurred by the fund as a result of net purchases or net redemptions that occur on the day the swing factor(s) is used, including spread costs, transaction fees and charges arising from asset purchases or asset sales resulting from those purchases or redemptions, and borrowing-related costs associated with satisfying redemptions. The Release clarifies that “near-term costs” could involve costs that may not be incurred for several days. Release at 72.

The final amendments differ from the proposal in that they: (i) do not include consideration of “market impact costs” (ICI recommended removal of this item), or information about the value of assets purchased or sold by the fund as a result of the net purchases or net redemptions that occur on the day the swing factor is used; (ii) require funds to establish and disclose an upper limit on the swing factor, which may not exceed two percent; (iii) explicitly require that the swing factor be reasonable in relation to near-term costs; and (iv) permit use of multiple swing factors (ICI recommended this change).

[8] The “swing threshold” is the amount of net purchases or redemptions of fund shares, expressed as a percentage of the fund’s NAV, that triggers swing pricing. The amendments impose a partial swing pricing methodology (i.e., by requiring a threshold, a fund’s NAV per share will not swing on those days that net flows fall short of it), although they do not stipulate a minimum threshold amount. A fund must consider the following factors in setting its threshold: (i) the size, frequency, and volatility of historical net purchases or net redemptions of fund shares during normal and stressed periods; (ii) the fund’s investment strategy and the liquidity of its portfolio investments; (iii) the fund’s holdings of cash and cash equivalents, and borrowing arrangements and other funding sources; and (iv) the costs associated with transactions in the markets in which the fund invests. “[A] fund’s swing threshold should generally reflect the estimated point at which net purchases or net redemptions would trigger the fund’s investment adviser to trade portfolio assets in the near term, to a degree or of a type that may generate material liquidity or transaction costs for the fund.” Release at 45.

The final amendments differ from the proposal in that they, consistent with ICI’s recommendation, permit the use of multiple swing thresholds.

[9] Investor flow information may consist of individual, aggregated, or netted orders, and may include reasonable estimates where necessary. It excludes any in kind purchases or redemptions (these do not generate transaction costs).

[10] The Release states that a multi-class fund may not selectively swing the NAV of certain share classes but not others, and that funds structured to include ETFs as a share class would not be able to use swing pricing. Release at 53-54. It also indicates that when funds using swing pricing merge, the fund boards may want to consider whether to temporarily suspend a fund’s swing pricing policies and procedures ahead of the merger. Release at 95.

[11] In a change from the proposal, the board does not have to approve material changes to the policies and procedures.

[12] Administration of swing pricing must be reasonably segregated from the fund’s portfolio management function and may not include portfolio managers. The Release notes, however, that portfolio managers may provide appropriate inputs. Release at 94.

[13] The report must describe the administrator's (i) review of the adequacy of the fund's swing pricing policies and procedures and the effectiveness of their implementation, including the impact on mitigating dilution; (ii) any material changes to the fund's swing pricing policies and procedures since the date of the last report; and (iii) review and assessment of the fund's swing threshold(s), swing factor(s), and swing factor upper limit considering the applicable requirements, including the information and data supporting the determination of the swing threshold(s), swing factor(s), and swing factor upper limit. This reporting requirement was not part of the proposal.

[14] "For each NAV adjustment, such records should generally include, at a minimum, the fund's unswung NAV, the level of net purchases or net redemptions that the fund encountered (and estimated) that triggered the application of swing pricing, the swing factor that was used to adjust the fund's NAV, relevant data supporting the calculation of the swing factor, and any back-testing data used by the fund in assessing the swing factor (and its relationship to near term costs expected to be incurred by the fund as a result of net purchases or net redemptions that occur on the day the swing factor(s) is used)." Release at 96-97.

[15] Release at 18.

[16] See *infra*, Section III.

[17] Release at 55-58. The Release states that complete information is not necessary to make a reasonable high confidence estimate. It also suggests that: (i) a fund's reasonably estimated shareholder flows could include estimates for certain intermediary flows that are based on actual transaction orders received from investors prior to the fund's cut-off time; and (ii) where transaction orders are NAV dependent, the application of estimated fund prices (such as the prior day's NAV) to the current day's orders to derive estimated shareholder flow information could be conducted by intermediaries or fund transfer agents. Finally, the Release suggests that funds (and their intermediaries) may also wish to consider regular back-tests of their daily estimated net flows used in determining whether a swing threshold has been crossed based on complete or final data obtained later, and then update their estimation process over time.

[18] Release at 108-111.

[19] This is generally in accord with what ICI recommended.

[20] See *infra*, Section II.B and C, for a more detailed discussion of these amendments to Items 4 and 13 of Form N-1A.

[21] In addition to this amendment to Item 6, a fund investing in other open-end funds must include a statement that its NAV is calculated based on the NAVs of the other funds in which it invests, and (if applicable) that the prospectuses for those funds include swing pricing disclosure.

[22] See Release at 97-108 for a more complete description.

[23] The proposal would have required funds to disclose the "swung NAV" per share on the balance sheet. The swung NAV per share would be the NAV that investors transacted at on the last day of the financial reporting period and would not include the GAAP trade date adjustments.

[24] The proposal requested comment on whether the dollar amount retained by the fund attributable to swing pricing should be separately disclosed in the statement of changes in net assets. The final amendments do not require this disclosure.

[25] The proposal would have required funds to calculate and disclose total return as required by the financial highlights and Item 26 of Form N-1A based on the swung NAV. ICI and others commented that presenting total return based on the swung NAV could introduce volatility unrelated to fund performance and also could create comparability concerns (e.g., where a particular fund swings on the last day of the reporting period and a competitor fund does not).

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