THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 50 No. 6 March 22, 2017

# THE SEC'S "SWING PRICING" RULE

*The SEC's amended rule will permit (but does not require) an open-end fund to use "swing pricing" to adjust its NAV under certain circumstances to effectively shift the costs stemming from shareholder purchases or redemptions onto purchasing or redeeming shareholders. The authors discuss the essential elements of the amendments to the rule, including the swing threshold, the swing factor, the role of the fund's board, and the additional financial and other required disclosures.*

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On October 13, 2016, the Securities and Exchange Commission adopted amendments to Rule 22c-1 under the Investment Company Act of 1940 to permit open-end funds, but not exchange-traded funds ("ETFs") and money market funds, to use, under certain circumstances, "swing pricing" to adjust the fund's net asset value ("NAV") per share to effectively shift the costs stemming from shareholder purchases or redemptions onto purchasing or redeeming shareholders (the "Swing Pricing Rule").[1] There is much subjectivity in many of the decisions funds and advisers will need to make with respect to the Swing Pricing Rule, such as whether *sufficient* information about a fund's daily cash flow has been obtained to justify a swung price.

This article is intended to provide a summary of the Swing Pricing Rule.[2] We suspect that the extended

[1] Investment Company Swing Pricing, Investment Company Act Rel. No. 32316 (Oct. 13, 2016), *available at* https://www.sec.gov/rules/final/2016/33-10234.pdf (the "Swing Pricing Release"). For additional background on the rule as proposed, *see* Open-End Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, Investment Company Act Rel. No. 31835 (Sept. 22, 2015), *available at* https://www.sec.gov/rules/proposed/2015/33-9922.pdf (the "Proposing Release"). The liquidity rule, new Rule 22e-4 under the Investment Company Act, and the Swing Pricing Rule were

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both proposed in the Proposing Release, but were adopted in separate releases. An article on the liquidity rule by the present authors appears in the January 25, 2017 issue of this publication.

[2] The Swing Pricing Rule was adopted by a 2-to-1 vote (Commissioner Piwowar voting against). Commissioner Piwowar voted against the Swing Pricing Rule because he had investor protection concerns, including the potential for: (1) harmful gaming behavior (*e.g.*, timing purchases and redemptions based on the likelihood that a fund would adjust its NAV); (2) funds to artificially enhance returns by swinging in an amount greater than the costs of redemptions or subscriptions; and (3) funds to conceal from investors the true

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**RSCR Publications LLC** Published 22 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $1,197 per year in U.S., Canada, and Mexico; $1,262 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call (937) 387-0473 or visit our website at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@gmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail shimmelfarb@comcast.net. To submit a manuscript for publication contact Ms. Himmelfarb.  ISSN: 0884-2426. 

compliance date of November 19, 2018 recognizes the extensive effort even the best-resourced firms will have to make to implement, if they choose, swing pricing.[3]

The Swing Pricing Rule permits, but does not require, an open-end fund (but not an ETF or money market fund), under certain circumstances, to use swing pricing to adjust its current NAV per share for the purpose of mitigating dilution of the value of its outstanding redeemable securities caused by shareholder purchase or redemption activity. To do so, it must establish and implement swing pricing policies and procedures in compliance with provisions of the rule, as discussed below.[4]

A fund electing to apply swing pricing must adopt policies and procedures that provide for the fund to adjust its NAV by an amount designated as the "swing factor"[5] once the level of net purchases into or net redemptions from the fund exceed a specified percentage of the fund's NAV, known as the "swing threshold."[6] A fund's swing pricing policies and procedures also must include an upper limit on the swing factor used, which may not exceed *two percent* of the fund's NAV per share.[7]

The Swing Pricing Rule requires that the swing threshold be the same for both purchases and redemptions, even though the SEC acknowledged that the impact of subscriptions may be different from that of redemptions.[8] The SEC explicitly rejected commenters' suggestions to adopt asymmetrical swing pricing, whereby a fund sets different swing thresholds for net redemptions versus net subscriptions.[9] As a result, a fund electing to adopt swing pricing would have to adjust its NAV whenever net purchases or net redemptions exceed the swing threshold.[10] Funds utilizing swing pricing are required to exclude any purchases and redemptions that are made in-kind in determining whether the fund's level of net purchases or net redemptions has exceeded the fund's swing threshold.[11]

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costs they will incur upon the purchase and sale of their fund shares. *See* Commissioner Michael S. Piwowar, Statement at Open Meeting on Investment Company Liquidity Risk Management Programs, Investment Company Swing Pricing, and Investment Company Reporting Modernization Releases (Oct. 13, 2016).

[3] Rather than being immediately allowed (as proposed), the Swing Pricing Rule will have a two-year extended effective date to provide fund intermediaries and service providers a reasonable amount of time to evaluate and implement the operational changes necessary to conduct swing pricing. Swing Pricing Release, at 17-18. The Swing Pricing Rule's compliance date of November 19, 2018 is the same as the Swing Pricing Rule's effective date.

[4] Rule 22c-1(a)(3). Any fund (a "feeder fund") that invests, pursuant to Section 12(d)(1)(E) of the Investment Company Act, in another fund (a "master fund") may not use swing pricing to adjust the feeder fund's NAV per shares; however, a master fund may use swing pricing to adjust the master fund's NAV. Rule 22c-1(a)(3)(iv).

[5] "Swing factor" means "the amount, expressed as a percentage of the fund's [NAV] and determined pursuant to the fund's swing pricing policies and procedures, by which a fund adjusts its

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[NAV] per share once a fund's applicable swing threshold has been exceeded." Rule 22c-1(a)(3)(v)(B).

[6] "Swing threshold" means "an amount of net purchases or net redemptions, expressed as a percentage of the fund's [NAV], that triggers the application of swing pricing." Rule 22c-1(a)(3)(v)(D).

[7] Rule 22c-1(a)(3)(i)(C). The proposal placed no limit on the swing factor.

[8] Swing Pricing Release, at 50.

[9] *Id.*

[10] *Id.*

[11] Rule 22c-1(a)(3)(i)(A). The SEC noted that although redemptions in-kind are excluded from the swing threshold, any such redemptions would still receive the swung NAV if the fund were to swing price on that day. Swing Pricing Release, at 20 n.61.

## 1. DETERMINING THE FUND'S SWING THRESHOLD

Under the Swing Pricing Rule, a fund's swing pricing policies and procedures must provide that the fund is required to adjust its NAV once the level of net purchases or net redemptions from the fund has exceeded its swing threshold.[12] In determining whether a fund has exceeded such threshold, the person(s) responsible for administering the fund's swing pricing policies and procedures will be permitted to make this determination based on receipt of sufficient information about fund shareholders' daily purchase and redemption activity to allow the fund to reasonably estimate whether it has crossed the swing threshold with high confidence.[13]

The person(s) in charge of swing pricing — and not the fund's board — will determine when the swing threshold is reached. A fund must adopt policies and procedures that specify the process for how the fund's swing threshold is determined, which must consider:

- the size, frequency, and volatility of historical net purchases or net redemptions of fund shares during normal and stressed periods;
- the fund's investment strategy and the liquidity of the fund's portfolio investments;
- the fund's holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources; and
- the costs associated with transactions in the markets in which the fund invests.[14]

[12] Rule 22c-1(a)(3)(i)(A).

[13] *Id.* The SEC acknowledged that full information about shareholder flows is not likely to be available to funds by the time the funds need to make the decision as to whether the swing threshold has been crossed. Swing Pricing Release, at 55. In response to comments on this topic, the SEC confirmed that a fund may determine its shareholder flows have crossed the swing threshold based on receipt of sufficient information, including reasonable estimates if necessary, about the fund shareholders' daily purchase and redemption transaction activity to allow the fund to reasonably estimate, with high confidence, whether it has crossed the swing threshold. Swing Pricing Release, at 55-56; *see also* Rule 22c-1(a)(3)(i)(A).

[14] Rule 22c-1(a)(3)(i)(A)-(B). The SEC noted that the Swing Pricing Rule does not prohibit funds from considering other factors that the fund believes may be relevant in determining the swing threshold. Swing Pricing Release, at 42-43.

The final rule also permits (but does not require) a fund to set multiple escalating swing thresholds, each associated with a different swing factor, and whichever threshold is triggered on a given day would then determine the single swing factor that would be used to adjust the fund's NAV on that day.[15]

## 2. CALCULATING THE FUND'S SWING FACTOR

The Swing Pricing Rule requires that a fund's swing pricing policies and procedures (1) provide that, once the fund's level of net purchases or net redemptions has exceeded a swing threshold, the fund must adjust its NAV by an amount designated as the "swing factor" for that threshold[16] and (2) specify the process for how the swing factor will be determined. The person(s) responsible for administering swing pricing, as described below, and not the fund's board, determine the swing factor. In doing so, they may take into account only the "near-term"[17] 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 is used, including:

- spread costs;
- transaction fees and charges arising from asset purchases or asset sales to satisfy those purchases or redemptions; and
- borrowing-related costs associated with satisfying redemptions.[18]

A fund's swing pricing policies and procedures also must include an upper limit on the swing factor used, which may not exceed two percent of the fund's NAV per share.[19] The fund would be required to take into account the same set of considerations when determining the swing factor upper limit as it must take into account when determining the swing factor itself.[20]

[15] Swing Pricing Release, at 51.

[16] Rule 22c-1(a)(3)(i)(A).

[17] "Near-term" is meant to reflect that investing proceeds from net purchases or satisfying net redemptions could involve costs that may not be incurred for several days, but that costs that are "significantly removed in time" from the purchases or redemptions could not be taken into account. Swing Pricing Release, at 72-73.

[18] Rule 22c-1(a)(3)(i)(C).

[19] *Id.*

[20] *Id.*

A fund's policies and procedures must also include a specific determination that the swing factor(s) used are reasonable in relationship to the fund's costs in meeting net shareholder subscriptions and redemptions.[21] The SEC noted that swing factors could vary from fund to fund depending on facts and circumstances.[22] The SEC also noted that a fund's policies and procedures for determining the swing factor should discuss how each of the considerations a fund is required to take into account will be used in determining the swing factor.[23]

## 3. ROLE OF THE FUND'S BOARD

Much of the day-to-day implementation of a fund's swing pricing falls to the fund's adviser or the person(s) administering swing pricing. Nonetheless, the fund's board has significant responsibilities. The fund's board of directors, including a majority of the independent directors, must:

- approve the fund's swing pricing policies and procedures;
- approve 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;
- designate the fund's investment adviser, officer, or officers responsible for administering the swing pricing policies and procedures, which *may not* include portfolio managers, with such administration of swing pricing reasonably segregated from portfolio management of the fund; and
- review, no less frequently than annually, a written report prepared by the person(s) in charge of swing pricing administration that describes:
  - — its 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;
  - — any material changes to the fund's swing pricing policies and procedures since the date of the last report; and
  - — its review and assessment of the fund's swing threshold(s), swing factor(s), and swing factor upper limit considering the required factors of the Swing Pricing Rule, including the information and data supporting the determination of the swing threshold(s), swing factor(s), and swing factor upper limit.[24]

Consistent with the proposal, a fund's board must approve the two core elements of a fund's swing pricing program — the swing threshold(s) and the swing factor upper limit. The Swing Pricing Rule, however, does not require the board to approve material changes to the policies and procedures, as the board will provide its ongoing oversight by reviewing the written annual report.[25]

## 4. RECORDKEEPING

Funds are required under the Swing Pricing Rule to maintain the swing pricing policies and procedures adopted by the fund that are in effect, or at any time within the past six years were in effect, in an easily accessible place, and shall maintain a written copy of the report provided to the board for six years (the first two in an easily accessible place).[26] In addition, the SEC expanded Rule 31a-2(a)(2) under the Investment Company Act, which requires a fund to keep records evidencing and supporting each computation of a fund's NAV, to reflect the NAV adjustments based on a fund's swing pricing policies and procedures.[27] Such records are required to be preserved for at least six years from the date that the NAV adjustment occurred (the first two in an easily accessible place).

## 5. FINANCIAL STATEMENTS AND PERFORMANCE REPORTING

The Swing Pricing Rule addresses the impact of swing pricing on financial statements and other financial disclosures. The SEC clarified that for funds that utilize swing pricing, the statement of assets and liabilities would continue to be presented as currently required by Regulation S-X Rule 6-04.19 and U.S. Generally Accepted Accounting Principles or "GAAP."[28] The SEC further explained that for funds that implement

[21] *Id.*

[22] Swing Pricing Release, at 70.

[23] *Id.*

[24] Rule 22c-1(a)(3)(ii).

[25] Swing Pricing Release, at 85-86.

[26] Rule 22c-1(a)(3)(iii).

[27] Swing Pricing Release, at 96-97.

[28] Swing Pricing Release, at 98.

swing pricing, Regulation S-X will require the dollar amounts received for shares sold and paid for shares redeemed that are disclosed in a fund's statement of changes in net assets to be based on the transactional NAVs used to process investor subscriptions and redemptions, including those processed using swung NAVs during the reporting period.[29]

The impact of swing pricing must be reflected in a fund's financial highlights,[30] and the per share impact of amounts retained by the fund due to swing pricing should be included in the fund's disclosures of per share operating performance.[31] In response to comments, Item 13 of Form N-1A was amended to: (1) 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 and (2) specifically require that the per share impact of amounts related to swing pricing be disclosed below the total distributions line in a fund's financial highlights.[32]

The SEC also adopted, as proposed, the requirement for a fund that adopts swing pricing policies and procedures to disclose in a footnote to its financial statements: (1) the general, methods used in determining whether the fund's NAV per share will swing; (2) whether the fund's NAV per share has swung during the period; and (3) a general description of the effects of swing pricing on the fund's financial statements.[33]

## 6. ADDITIONAL DISCLOSURE REQUIREMENTS

Along with the disclosure requirements noted above, funds are also required to make the following disclosures related to swing pricing.

*Form N-1A*. Item 6, as amended, will require a fund that uses swing pricing to explain in the fund's summary prospectus the use of swing pricing, including its meaning, the circumstances under which the fund will use it, and the effects of swing pricing on the fund and investors. Funds that use swing pricing will also have to disclose the swing factor upper limit it has set with respect to the fund's use of swing pricing, but not the fund's swing threshold.[34] Interestingly, a fund is permitted to voluntarily disclose its swing threshold, although the SEC cautions against doing so.[35]

*Form N-CEN*. Adopted substantially as proposed, a fund (other than an ETF or money market fund) is required to disclose whether it engaged in swing pricing during the reporting period, and if so, the swing factor upper limit set by the fund.[36]

## 7. EFFECTIVE AND COMPLIANCE DATE

The effective date of the Swing Pricing Rule is November 19, 2018. The compliance date for the amendments to Form N-1A discussed in the Swing Pricing Release is the same as the effective date of Swing Pricing Rule, as the SEC takes the view that a fund should disclose the use of swing pricing to investors before it is used.[37] Likewise, the additional disclosures regarding swing pricing within the financial statements related to the Regulation S-X amendments should be included in any financial statements in which swing pricing is implemented on or after the effective date.[38] The Swing Pricing Release notes that only the funds using swing pricing are required to provide the Form N-1A and financial statement disclosure amendments.[39] With regard to Form N-CEN, as with the amendments to Form N-1A, the compliance date for the new reporting requirements related to swing pricing will be the same as the effective date of Swing Pricing Rule.[40]

## CONCLUSION

The adoption of the Swing Pricing Rule, along with the adoption of the liquidity rule and the changes to

[29] Swing Pricing Release, at 102.

[30] Item 13 of Form N-1A; *see also* Swing Pricing Release, at 103.

[31] FASB ASC 946-205-50-7 requires specific per share information to be presented in the financial highlights for registered investment companies, including disclosure of the per share amount of purchase premiums, redemption fees, or other capital items. Swing Pricing Release, at 103 n.325.

[32] Swing Pricing Release, at 103.

[33] Swing Pricing Release, at 107-08; *see also* Rule 6-03(n) of Regulation S-X.

[34] Item 6(d) of Form N-1A. The SEC shared commenters' concerns regarding unfair trading, gaming, and other negative fund and market impacts that could occur if swing pricing thresholds were shared with the public. Swing Pricing Release, at 115.

[35] Swing Pricing Release, at 39.

[36] Item C.21 of Form N-CEN.

[37] Swing Pricing Release, at 118.

[38] *Id.*

[39] *Id.*

[40] *Id.*

modernize and enhance fund reporting, are the first part of a series of transformative reforms proposed to enhance the SEC's oversight and regulation of the asset management industry. Since whether to engage in swing pricing is voluntary, it remains to be seen how many funds and fund groups take advantage of the Swing Pricing Rule. For funds subject to frequent, sizable redemptions or purchases and a heightened risk of dilution, the rule may provide a useful way to mitigate shareholder dilution. ■