SEC PROPOSES SWING PRICING AND A HARD CLOSE FOR ALL MUTUAL FUNDS

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U.S. Asset Management and Investment Funds Alert

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SUMMARY

On 2 November 2022, the U.S. Securities and Exchange Commission (SEC) voted 3-2 to propose amendments (proposed amendments) to Rule 22c-1 under the Investment Company Act of 1940, as amended (1940 Act) that would require the adoption of swing pricing and a “hard close” by all open-end funds other than money market funds and exchange-traded funds (Open-End Funds).[1] If adopted as proposed, the proposed amendments would fundamentally alter the way investors have bought and sold Open-End Funds for decades. Investors would no longer receive the net asset value (NAV) per share for their transactions but instead could receive a price more or less than the NAV depending on whether a “swing factor” was applied to their transaction. This swing factor is the amount, expressed as a percentage of the Open-End Fund's NAV, that the Open-End Fund adjusts its per-share NAV, and would represent a good faith estimate of the transaction costs imposed on current shareholders of the Open-End Fund by the transacting shareholders.

The SEC previously adopted rules permitting, but not requiring, Open-End Funds to use swing pricing in 2016. The proposed amendments would now mandate the use of swing pricing even though the SEC acknowledged that no Open-End Fund has made use of swing pricing since that time due to challenges related to its use. Although the proposed amendments, if adopted, would not affect money market funds, the SEC has already proposed similar requirements for institutional money market funds. See the K&L Gates client alerts issued on 17 December 2021 and 10 January 2022 for a summary of the key aspects of these requirements.

The SEC proposed to require a “hard close” for Open-End Funds to facilitate the operation of swing pricing, which requires more reliable and timely information about fund inflows and outflows than Open-End Funds can obtain currently. The proposed “hard close” requirement would make a purchase or sale order for shares of an Open-End Fund eligible for a given day's price only if the Open-End Fund, its transfer agent, or a registered clearing agency receives the order before the time when the Open-End Fund calculates its NAV, which is typically as of 4:00 PM ET. In contrast, current practices permit executing an order at the current day's price as long as the order is received by an authorized intermediary by the Open-End Fund's pricing time. The SEC's Chief Economist and Director of the Division of Economic and Risk Analysis noted that the most significant cost of the proposed amendments, which would be borne by investors, would likely stem from the proposed hard close requirement.

The comment period for the proposed amendments will run 60 days from their publication in the Federal Register.

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SWING PRICING REQUIREMENT

In a proposal that would significantly alter a central characteristic of Open-End Funds, the proposed amendments would require Open-End Funds[2] to implement swing pricing. "Swing pricing" is the adjustment of an Open-End Fund's price above or below its NAV per share, which is intended to pass on the costs arising from shareholder purchase or redemption activity to the shareholders engaging in that activity and mitigate the dilution of existing shareholders' investment.

The proposed amendments would require Open-End Funds to establish and implement policies and procedures (Swing Pricing Policies): (1) providing that, if an Open-End Fund has net purchases exceeding a certain threshold or net redemptions in any amount (Swing Threshold), the Open-End Fund must apply a swing factor to adjust its NAV per share to mitigate dilution of its outstanding shares, and (2) specifying the process for determining the swing factor. Accordingly, when an Open-End Fund has net redemptions in any amount, the Open-End Fund would adjust its NAV per share downward, allocating the costs from redemption activity to the redeeming shareholders. When an Open-End Fund has net purchases exceeding a Swing Threshold, the Open-End Fund would adjust its NAV per share upward, allocating the costs associated with investing purchasers' proceeds to those purchasers. The Swing Pricing Policies must be administered by a swing pricing administrator (Swing Pricing Administrator) designated by the Open-End Fund's board of directors (board). Each of the components of swing pricing is explained in greater detail in the sections that follow. In addition, a diagram illustrating the process of swing pricing can be found here.

SEC Rationale and Prior Swing Pricing Rule

In the Proposing Release, the SEC acknowledged that a foundational feature of open-end mutual funds, as codified in Rule 22c-1 under the 1940 Act, is that "an order to purchase or redeem fund shares must receive a price based on the current NAV next computed after receipt of the order."[3] The SEC noted, however, that "there are circumstances in which the transaction activity of certain investors leads to costs that are distributed across all shareholders, unfairly reducing the value (or 'diluting') the interests of shareholders who did not engage in the underlying transactions," such as trading activity and changes to portfolio holdings to meet redemptions or invest proceeds.[4] The less liquid a fund's portfolio holdings are, the SEC stated, the greater the liquidity costs and the possibility of dilution, particularly in times of heightened volatility or wider bid-ask spreads. The SEC further stated that, in times of liquidity stress, fund shareholders may have an incentive to redeem their shares more quickly, giving a potential first-mover advantage to shareholders who redeem their shares early. This could create a situation where shareholders remaining in the fund would end up absorbing the costs and potential dilution from redemptions. The SEC also discussed its analysis of the market disruptions that occurred in March 2020, during which liquidity in certain types of funds deteriorated, which the SEC stated created the need for the proposed amendments.[5]

In 2016, the SEC adopted amendments to Rule 22c-1 permitting, but not requiring, Open-End Funds to use swing pricing (the 2016 Swing Pricing Rule).[6] The 2016 Swing Pricing Rule also permitted Open-End Funds flexibility to determine certain elements of the Swing Pricing Policies, such as one or more Swing Thresholds and corresponding swing factors. In the Proposing Release, the SEC reported that no Open-End Funds have used swing pricing since the adoption of the 2016 Swing Pricing Rule. The SEC acknowledged that implementing swing pricing creates operational challenges, largely because it is difficult for Open-End Funds to obtain sufficient information about fund flows to determine whether they need to use swing pricing on any particular day before

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finalizing their NAVs. The SEC noted that, although a minority of orders are made through an Open-End Fund's transfer agent, most are placed with financial intermediaries, who may not transmit final orders received on a given day to Open-End Funds until later in the evening or possibly the following day. Although industry participants convened working groups to explore potential solutions after the adoption of the 2016 Swing Pricing Rule, according to the SEC, "the industry has not developed an operational solution to facilitate the implementation of swing pricing, nor have individual market participants."[7] Notwithstanding the lack of implementation of the 2016 Swing Pricing Rule, and thus the lack of testing of its framework, the proposed amendments would require, with limited exceptions, all Open-End Funds to implement swing pricing by adopting Swing Pricing Policies and would further revise the framework for these policies from the 2016 Swing Pricing Rule.

Swing Threshold

A "swing threshold" is an amount of net purchases or net redemptions, expressed as a percentage of the Open-End Fund's NAV, that triggers the application of swing pricing. Under the proposed amendments, an Open-End Fund would be required to adjust its NAV if the Open-End Fund (a) has net redemptions in any amount or (b) has net purchases exceeding its inflow swing threshold (Inflow Swing Threshold), which by default is 2% of its net assets. This universal approach reflects a change from the 2016 Swing Pricing Rule, which permitted Open-End Funds to determine their Swing Thresholds after considering certain factors.

The proposed amendments would require an Open-End Fund to use swing pricing on any day when it experiences net redemptions.[8] In mandating swing pricing for all net redemptions, the SEC stated that "every net redemption can potentially involve trading or borrowing costs that dilute the value of the fund, as well as depletion of a fund's liquidity for remaining shareholders."[9] If an Open-End Fund's net redemptions exceed 1% of its net assets (the Market Impact Threshold), in setting the swing factor, the Open-End Fund must consider the market impact of selling a security. Market impact costs are the costs incurred when the price of a security changes as a result of trying to purchase or sell the security.

Under the proposed amendments, Open-End Funds would be required to apply swing pricing in the case of net purchases only when those purchases exceed the Inflow Swing Threshold. However, when swing pricing is applied in the case of net purchases, the swing factor must always account for market impact. This reflects the SEC's view that smaller levels of net purchases are less likely to result in dilution because, among other reasons, Open-End Funds are not required to invest cash proceeds within a specified period and therefore have greater latitude to avoid higher transaction costs and wider bid-ask spreads.

The proposed amendments permit the Swing Pricing Administrator to lower either the Market Impact Threshold or the Inflow Swing Threshold, including to 0% of net assets, if, in its judgment, it would help the Open-End Fund to reduce dilution. For example, according to the SEC, lower thresholds may be appropriate to reduce dilution in times of market stress, when Open-End Funds hold a larger amount of less liquid investments, or for Open-End Funds with a larger asset base. In order to prevent the adjustment of these thresholds to enhance an Open-End Fund's performance, rather than to mitigate shareholder dilution, the Swing Pricing Administrator would be required to report to an Open-End Fund's board the information and data supporting these thresholds. In addition, as further discussed below, the Swing Pricing Administrator cannot be an Open-End Fund's portfolio manager.

In order to determine whether an Open-End Fund has net purchases or net redemptions, and the amount of such purchases or redemptions, the proposed amendments maintain the 2016 Swing Pricing Rule's requirement that

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the Swing Pricing Administrator review investor flow information. The proposed amendments define "investor flow information" as information about investors' daily purchase and redemption activity, which may consist of individual, aggregated, or netted eligible orders, and excludes purchases or redemptions made in kind rather than in cash. Although the SEC anticipates the imposition of the hard close (discussed below) would likely decrease the need for the Swing Pricing Administrator to estimate flows, the proposed amendments would continue to permit the Swing Pricing Administrator to make determinations regarding flows and amounts based on reasonable, high-confidence estimates of investor flows.

Swing Factor

Once an Open-End Fund determines that it has net redemptions, or net purchases exceeding its Inflow Swing Threshold, it would be required to adjust its NAV per share by the amount of the swing factor, which is expressed as a percentage of NAV and determined in accordance with its Swing Pricing Policies. The proposed amendments would require the Swing Pricing Administrator to estimate in good faith, with supporting data, the costs an Open-End Fund would incur if it sold or purchased a pro rata amount of each investment in its portfolio equal to the amount of the day's redemptions or purchases, referred to as a "vertical slice" of the Open-End Fund's portfolio.[10] The proposed amendments would require that, in estimating the costs to purchase or sell the vertical slice, the Swing Pricing Administrator consider: (1) spread costs, (2) brokerage commissions and other costs associated with the purchases or sales, and (3) if applicable, the market impact.

By requiring the Open-End Fund to assume the purchase or sale of a vertical slice of its portfolio, the proposed amendments eliminate the Swing Pricing Administrator's ability to consider the selection of specific investments the Open-End Fund would purchase or sell to meet net purchases or redemptions since it would "more fairly reflect the costs imposed by redeeming or purchasing investors than an approach that focuses solely on the costs associated with the instruments that the fund expects to buy or sell."[11] The 2016 Swing Pricing Rule established an upper limit on the swing factor of 2% of NAV per share, which the proposed amendments would eliminate. The proposed amendments also would require Open-End Funds to report their swing factor adjustments publicly on Form N-PORT, which the SEC noted is intended to avoid incentives for Swing Pricing Administrators to overestimate costs in order to improve fund performance rather than merely avoid dilution.

Swing Pricing Administrator, Board Oversight and Recordkeeping

The proposed amendments would require Open-End Funds to appoint a Swing Pricing Administrator responsible for administering the Swing Pricing Policies. The Swing Pricing Administrator may be an Open-End Fund's investment adviser or one or more officers, and may be a single person or a group. A portfolio manager may not serve as Swing Pricing Administrator, either individually or as a member of a group; however, the portfolio manager may provide data or other input. This contrasts with the SEC's recent Rule 18f-4 under the 1940 Act, which has been interpreted to permit portfolio managers to serve as derivatives risk managers as long as they do not constitute a majority of the derivatives risk managers.

A fund's board, including a majority of its directors who are not interested persons of the fund, must approve the Open-End Fund's Swing Pricing Policies and designate the Swing Pricing Administrator. The board also would be required to review, at least annually, a written report prepared by the Swing Pricing Administrator.

In addition, the proposed amendments would require funds to maintain Swing Pricing Policies for at least six years in an easily accessible place, as well as written copies of the Swing Pricing Administrator's reports to the board for six years, the first two in an easily accessible place.

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Alternatives to Mandated Swing Pricing

In the Proposing Release, the SEC discussed two alternatives to swing pricing—liquidity fees and dual pricing—that would enable funds to pass on costs resulting from shareholder purchase or redemption activity to the shareholders engaging in that activity and requested comment on the use of such alternatives.

Liquidity Fee. In the first alternative, an Open-End Fund could apply a separate liquidity fee on transacting investors rather than adjusting its NAV per share. The SEC stated that this approach may have advantages over swing pricing, including greater cost transparency to transacting investors and avoiding the adjustment of the NAV per share for investors trading in the opposite direction of flows (for example, investors purchasing shares on a day when the Open-End Fund has net redemptions, who therefore receive a discount on NAV per share). However, the SEC stated that, while swing pricing can be applied by the Open-End Fund without reliance on intermediaries, liquidity fees may require more coordination with intermediaries, including requiring intermediaries to submit purchase and redemption orders separately, in contrast to their frequent use of omnibus accounts. In addition, such fees may not be available to a fund operating under stressed circumstances until they are remitted by the intermediary, which might cause the Open-End Fund to incur costs it might not otherwise have occurred.

Dual Pricing. In the second alternative, an Open-End Fund could use dual pricing, quoting one price for incoming shareholders reflecting the cost of buying portfolio securities, and one for redeeming shareholders reflecting the proceeds the Open-End Fund would receive from the sale of securities. The SEC acknowledged that dual pricing could create additional operational complexities for Open-End Funds accustomed to a single share price, including with respect to order processing systems, intermediary analyses, and the requirement that financial intermediaries submit purchase and redemption orders separately.

HARD CLOSE REQUIREMENT

In order to support the proposed implementation of swing pricing, the proposed amendments would amend Rule 22c-1 under the 1940 Act to require Open-End Funds to implement a “hard close.” The proposed hard close requirement would mandate that an investor's order to purchase or sell shares of an Open-End Fund is eligible to receive an Open-End Fund's daily price only if the Open-End Fund, its transfer agent, or a registered clearing agency receives an eligible order before the time the Open-End Fund calculates its NAV, which is typically as of 4:00 PM ET. This is in contrast to current practice, where investors receive an Open-End Fund's daily price as long as the intermediary receives the order before the time the Open-End Fund calculates its NAV, but an Open-End Fund might receive these orders from the intermediary later in the evening or the next day. Under the proposed amendments, orders received later in the evening or the next day would no longer be eligible to receive that day's price, and those orders would instead receive the next day's price. The SEC believes a “hard close” is necessary to facilitate swing pricing since the application of the swing factor is dependent on access to timely investor flow information. The SEC stated this change would have potential added benefits of modernizing and improving order processing and helping to prevent late trading.

In the Proposing Release, the SEC acknowledged that Open-End Funds and financial intermediaries would need to make significant changes to their business practices related to processing transactions, including updating their computer systems or adopting new technology. The SEC noted that the hard close also could result in intermediaries imposing earlier cut-off times for orders to be placed to receive the current day's price, to ensure that intermediaries have sufficient time to transmit their order flows to the Open-End Fund before its pricing time.

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In addition, the SEC acknowledged that, in certain circumstances, the hard close requirement could cause investors to receive the next day's NAV per share for their order and to receive their shares a day later. However, the SEC stated that, as most Open-End Fund investors are long-term investors, it did not believe that most Open-End Fund orders are time sensitive and that investors wishing to place orders close to an Open-End Fund's pricing time could place orders with the Open-End Fund's transfer agent. The SEC also noted that the hard close requirement could extend the completion times for certain types of transactions. For example, the hard close requirement could require changes to asset allocation systems since some of those systems cannot determine the exact number of shares to buy or sell until the NAV per share is determined. The SEC also acknowledged that the hard close requirement may pose particular challenges to retirement plan record-keepers due to the way order processing works for such plans and likely would require changes in how certain transactions in retirement plans, such as 401(k) loans, are processed.

Alternatives to a Hard Close

The Proposing Release included three potential alternatives to the hard close requirement for Open-End Funds. The SEC requested comments regarding whether indicative flows, estimated flows, or later cutoff times would be able to generate sufficient investor flow information to effectively apply swing pricing for Open-End Funds.

Indicative Flows. This approach would require that intermediaries (e.g., broker-dealers, banks, and retirement plan record-keepers) calculate an estimate for what they anticipate the given flows for a particular day to be, either before the Open-End Fund's pricing time or a set time thereafter (e.g., by 4:30 PM ET or 5:00 PM ET). In order to calculate the indicative flow information, the SEC noted that intermediaries could generate estimated flow based on, among other things, the actual flows that they have received before the pricing time and the prior day's price, as well as any indicative historical information that is available if the indicative flow information is provided to the Open-End Fund before the pricing time. Alternatively, intermediaries could provide summary net-flow information, and the Open-End Fund could apply the prior day's NAV to ascertain estimated net flows. The SEC noted that this approach would provide intermediaries with more flexibility in providing final flow information and may not require the same degree of changes necessary to comply with the hard close requirement. However, the SEC questioned whether this approach would accurately provide flow information to Open-End Funds during times of market stress.

Estimated Flows. The SEC also considered allowing Open-End Funds to estimate their flows for the day for the purposes of determining whether to apply a swing factor to the day's NAV and the amount of the swing factor. In order to estimate flows for a given day, Open-End Funds could generate models that incorporate the information available to them, as well as historical order flow information. The SEC noted that this approach may be less costly than either a hard close or relying on indicative flows. However, like the indicative flow approach, the SEC also questioned whether this approach would accurately provide flow information to funds during times of market stress and also noted that it would be less effective at preventing late trading and reducing operational risk than the proposed hard close requirement.

Later Cutoff Times. Under this approach, investors would continue to need to submit orders before the Open-End Fund's pricing time to be eligible to receive that day's price, but intermediaries would have additional time to provide those orders to a designated party after the pricing time, such as by 6:00 or 7:00 PM ET for a fund with a 4:00 PM ET pricing time. To provide time to assess the flows and determine whether to apply swing pricing, an Open-End Fund might push the time of publication of its price to a later time, such as 8:00 to 10:00 PM ET.

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RECEPTION TO THE PROPOSED AMENDMENTS

Commissioners Hester Peirce and Mark Uyeda voted against the proposal, with both noting in their statements the potential viability of alternatives discussed in the Proposing Release. During the SEC open meeting at which the proposed amendments were considered, one SEC commissioner even asked the director of the SEC's Division of Investment Management whether he thought there was something fundamentally broken with funds, implying that such sweeping proposed changes should only be predicated on solving a problem of comparable magnitude. In addition, the initial public reception to the proposed amendments has been vocal, and in many cases negative, with the Investment Company Institute issuing a statement that "[t]he swing pricing proposal faces insurmountable operational hurdles, risks confusing investors, and upending mutual funds' longstanding and equitable share pricing methodology."

POTENTIAL IMPLICATIONS

While it is difficult to predict what might ultimately be adopted by the SEC, if anything, the adoption of the proposed amendments or any of the potential alternatives proposed by the SEC are likely to lead to substantial operational changes by Open-End Funds and intermediaries. These changes will lead to the imposition of significant costs on Open-End Funds and intermediaries, which will be borne by shareholders of the Open-End Funds with the potential benefits somewhat uncertain.

The proposed amendments would also fundamentally alter the way investors have bought and sold Open-End Funds for decades. Investors would no longer receive the NAV per share they have come to expect for their transactions. Instead, at any time, investors could receive a price more or less than the NAV, which would occur without the investor actually knowing exactly how much the NAV will be adjusted at the time they enter their order. In addition, since no Open-End Fund has adopted the optional swing pricing framework, there will likely be challenges related to educating shareholders about this new framework for buying and selling shares, since it changes the way shareholders have historically bought and sold shares. It also may ultimately lead additional Open-End Funds to consider whether to convert to an exchange-traded fund structure, continuing a trend we are only starting to see occur, as exchange-traded funds are excluded from these proposed amendments.

FOOTNOTES

[1] At the same time, the SEC also proposed major changes to the liquidity risk management framework for open-end funds, proposing to amend Rule 22e 4 and fund reporting on Form N-PORT. These proposed changes will be the subject of a separate K&L Gates client alert.

[2] The proposed amendments also would prohibit any feeder fund that invests in a master fund pursuant to Section 12(d)(1)(E) of the 1940 Act from using swing pricing and would exempt from the swing pricing requirements any share class of a multiclass fund that is an exchange-traded fund, notwithstanding Section 18(f)(1) of the 1940 Act.

[3] Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting, Investment Company Act Release No. 34,726 (Nov. 2, 2022) at 13 [hereinafter *Proposing Release*].

[4] *Id*.

[5] The SEC stated that, at that time, there were widespread outflows in funds resulting in widening bid-ask spreads

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encountered by funds purchasing or selling portfolio investments to generate liquidity. The SEC also stated that this situation likely contributed to dilution for shareholders remaining in funds based on the SEC's observations about European funds, but the SEC acknowledged that it did not have specific data about any such dilution for U.S. fund investors. The SEC also stated that it heard from several fund managers during this period regarding liquidity concerns and the potential need for emergency relief.

[6] *See* Investment Company Swing Pricing, Investment Company Act Release No. 32,316, 81 Fed. Reg. 82084 (Nov. 18, 2016).

[7] Proposing Release, *supra* note 3, at 19.

[8] In contrast, the 2016 Swing Pricing Rule permits an Open-End Fund to use swing pricing when net redemptions exceed a certain threshold (or multiple thresholds) set by the Open-End Fund.

[9] Proposing Release, *supra* note 3, at 106.

[10] This is a change from the 2016 Swing Pricing Rule, which required that the swing factor take into account only the near-term costs expected to be incurred by the Open-End Fund as a result of net purchases or redemptions on the day the swing factor is used, as well as costs related to borrowing to satisfy net redemptions.

[11] Proposing Release, *supra* note 3, at 117.

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