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What You Need to Know About the SEC's New Swing Pricing Rule

SEC Adopts Final Amendments to Rule 22c-1 to Allow Swing Pricing for Open-End Funds

On October 13, 2016, the U.S. Securities and Exchange Commission (SEC) adopted amendments to Rule 22c-1 under the Investment Company Act of 1940 (1940 Act) that will permit registered open-end funds (with the exception of exchange-traded funds and money market funds) to use “swing pricing,” a method of adjusting net asset value per share (NAV) to pass on the costs of purchase or redemption activity to the shareholders associated with that activity (the Swing Pricing Rule), along with amendments to Rule 31a-2 under the 1940 Act to require funds to keep certain records relating to swing pricing. The SEC also adopted amendments to Form N-1A and Regulation S-X, and added a new item to Form N-CEN, all of which address a fund’s use of swing pricing.¹

This Fund Alert provides an overview of the key components of the Swing Pricing Rule and related recordkeeping and disclosure amendments, with a focus on how the final rules compare against the SEC’s initial swing pricing proposal.² The effective and compliance dates for the various elements of the rulemaking are described at the end of this Fund Alert. Notably, in a departure from the SEC’s initial proposal, the effective date of the Swing Pricing Rule has been delayed until 24 months after publication of the Adopting Release in the Federal Register.³

I. SEC Concerns and Considerations Regarding Swing Pricing

Rule 22c-1 under the 1940 Act, the SEC’s “forward pricing” rule, requires each open-end fund, as well as its principal underwriters and dealers, to sell and redeem fund shares at a price based on current NAV next computed after receipt of an order to purchase or redeem fund shares. Forward pricing was designed to address the risk of shareholder dilution posed by the “backward pricing” method used prior to the adoption of Rule 22c-1.⁴ However, forward pricing does not typically take into account the transaction costs (including trading costs and changes in market prices) that may arise when a fund buys or sells portfolio investments in connection with shareholder purchases or redemptions.⁵

The SEC expressed concerns about the risk of shareholder dilution that can result from such transaction costs, along with the risk that a fund would be unable to meet its obligations to redeeming shareholders or other obligations under applicable law (while mitigating investor dilution) as a result of liquidity risk.⁶ According to the SEC, in times of liquidity stress, shareholders might be incentivized to redeem quickly to avoid further losses (i.e., to obtain a first-mover advantage). Furthermore, the SEC suggested that a fund experiencing large outflows as a result of redemptions might be exposed to predatory trading activity in the securities it holds.⁷

The SEC acknowledged that fund boards do currently have the option of imposing redemption fees as a way to address these concerns. In the Adopting Release, the SEC specifically noted

that Rule 22c-2, the redemption fee rule, “is not limited to the context of market timing and expressly contemplates that a fund board of directors may approve a redemption fee in order to ‘eliminate or reduce so far as practicable any dilution of the value of the outstanding securities issued by the fund,’ and thus the rule can also be used to mitigate dilution arising from shareholder transaction activity generally.”⁸ The SEC also made clear that a fund board, consistent with its obligations under Rule 22c-2, “may determine that it is appropriate to approve a redemption fee that would apply for an indefinite time period after purchase of the security – that is, whenever an investor redeems from the fund – in order to reduce dilution.”⁹ In addition, it said, a fund board might impose a redemption fee only on a subset of redemptions that the board determines are more likely to result in such costs or dilution, such as all redemptions exceeding a certain size (e.g., over \$100,000 or \$250,000) or on such large redemptions if advance notice is not provided.¹⁰ While redemption fees imposed on redemptions exceeding a certain size might potentially implicate the senior security concerns of section 18(f)(1) of the 1940 Act, the SEC said, there is exemptive relief from section 18(f)(1) for redemption fees imposed under Rule 22c-2.¹¹

However, notwithstanding these comments, the SEC acknowledged that redemption fees are viewed as unpopular with investors and intermediaries and entail their own operational complexities.¹² The SEC also noted that in-kind redemptions are another way to reduce transaction costs by reducing the need for cash transactions, but acknowledged that logistical and operational issues exist in that context as well.¹³ Given the foregoing, the SEC explained that it was seeking to provide funds the option to use swing pricing as another anti-dilution tool which may complement or be an alternative to the tools currently available to funds.¹⁴ The SEC also expressed its belief that swing pricing may be an additional tool to manage a fund’s liquidity risk.¹⁵

Despite the perceived benefits, however, commenters on the proposed rule expressed significant concerns that the infrastructure is not in place to allow funds to accurately determine if a swing threshold has been reached. It remains to be seen if the final rule as adopted will enable a feasible solution.¹⁶

II. Overview of New Rule 22c-1(a)(3)

To address the concerns described above, the SEC proposed – and has now adopted – a new paragraph (a)(3) of Rule 22c-1, which will provide an exception to the forward pricing rule to permit “swing pricing” under certain circumstances.¹⁷ Rule 22c-1(a)(3) defines swing pricing as “the process of adjusting a fund’s current net asset value per share to mitigate dilution of the value of its outstanding redeemable securities as a result of shareholder purchase and redemption activity, pursuant to the requirements set forth in [the rule].”¹⁸



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A fund using swing pricing will adjust its NAV by a “swing factor” when the level of net redemptions from the fund has exceeded the fund’s “swing threshold.” The swing threshold is intended to “generally reflect the estimated point at which net purchases or net redemptions would trigger a 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,”¹⁹ and the swing factor is intended to “reflect... the costs associated with the potential shareholder purchase or redemption activity.”²⁰

The swing pricing option is available to all open-end funds other than exchange-traded funds and money market funds.²¹ A feeder fund in a master-feeder arrangement may not use swing pricing to adjust the feeder fund’s NAV, but the master fund may use swing pricing to adjust the master fund’s NAV.²²

III. Implementing a Swing Pricing Policy Under the Final Swing Pricing Rule

A. Optional Adoption of Swing Pricing Policies and Procedures

Under Rule 22c-1(a)(3), an open-end fund (other than an exchange-traded fund or money market fund) will be permitted, but not required, to use swing pricing to adjust its current NAV to mitigate dilution of the value of its outstanding redeemable securities as a result of shareholder purchase and redemption activity, provided that it has established and implemented swing pricing policies and procedures in compliance with Rule 22c-1(a)(3) (Swing Pricing Policy or Policy).

B. Required Elements of a Swing Pricing Policy

1. Swing Threshold. A fund’s swing threshold is the amount of net purchases into or net redemptions from

the fund, expressed as a percentage, which triggers the initiation of swing pricing.²³ In contrast to the proposed rule, the final rule permits a fund to set multiple escalating thresholds, each associated with a different swing factor.²⁴

A fund's Swing Pricing Policy must specify the process for how the fund's swing threshold(s) will be determined, taking into consideration:

- 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.²⁵

If a fund has more than one swing threshold, each should be established using the same factors discussed above.²⁶

Like the proposed rule, the final rule does not impose a minimum floor for a fund's swing pricing threshold(s). However, the SEC stated in the Adopting Release that it "believe[s] that, after considering the swing threshold factors, a fund would be unable to set the swing threshold at zero."²⁷

2. *Swing Factor.* The Policy must specify the process for how the fund's swing factor(s) shall be determined, including the establishment of an upper limit on the swing factor(s) used, which may not exceed two percent of NAV, and the determination that the factor(s) used are reasonable in relationship to the costs discussed below.²⁸ The imposition of this two percent upper limit for a fund's swing factor is new in the final version of the rule.

In determining the swing factor(s) and the upper limit, the person(s) responsible for such determination may take into account 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 is used, including spread costs, and transaction fees and charges²⁹ arising from asset purchases or asset sales resulting from those purchases or redemptions, and any borrowing-related costs associated with satisfying

redemptions.³⁰ If a fund has multiple swing factors, each should be established using these same factors.³¹

In response to comments on the proposed rule, the final rule does not require (or permit) the consideration of market impact costs associated with the fund trading portfolio assets, or consideration of the value of assets purchased or sold by the fund as a result of net purchases or net redemptions that occur on the day swing pricing is used, if that information would not be reflected in the fund's current NAV computed that day.³² The SEC also confirmed in the Adopting Release that a fund's swing factor(s) may be determined on a periodic basis, rather than calculated anew each day that the swing factor is applied, as long as developments such as significant market developments prompt a quicker re-evaluation.³³

3. *Reasonableness Requirement.* Unlike the proposed rule, the final rule includes an explicit requirement that any swing factor used must be reasonable in relation to the costs incurred by the fund.³⁴

4. *Mandatory Application of Swing Factor to Adjust NAV.* A fund's Swing Pricing Policy must provide that the fund must adjust its NAV by the single swing factor or multiple factors that may vary based on the swing threshold(s) crossed once the level of net purchases into or net redemptions from the fund has exceeded the applicable swing threshold.³⁵ In determining whether the applicable swing threshold has been exceeded:

- the person(s) responsible for the determination 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; and
- purchases or redemptions that are made in kind and not in cash must be excluded.³⁶

For this purpose, investor flow information may consist of individual, aggregated, or netted orders, and may include reasonable estimates where necessary. Because the deadline by which a fund must strike its NAV may precede the time that a fund (or its pricing agent) receives final information concerning daily net flows from the fund's transfer agent, a fund engaged in swing pricing will likely need to develop processes and procedures to gather sufficient investor flow information from transfer agents that include transactions being conducted by intermediaries on

behalf of fund investors. According to the Adopting Release, this information could include actual transaction orders received by the transfer agent, as well as estimates of investor flows, which funds can use to reasonably estimate its aggregate daily net investor flows for swing pricing purposes.³⁷

If a fund, using reasonably designed policies and procedures, determined with reasonable high confidence that it should or should not apply swing pricing based on estimated information obtained after reasonable inquiry, the fund would not need to treat it as a pricing error if it later turned out, based on final data, that its determination that the swing threshold had or had not been crossed was incorrect.³⁸

However, the SEC emphasized in the Adopting Release that a fund “should not employ swing pricing if the fund is unable to obtain sufficient information about the fund shareholders’ daily purchase and redemption activity on the relevant date at the time it calculates the fund’s NAV.”³⁹ Although the SEC did not define what would be considered sufficient, it did look to Europe as an example, observing that “many funds in Europe that use swing pricing may typically receive as much as 90% of net purchase/redemption data prior to deciding whether to adjust the fund’s NAV by a swing factor.”⁴⁰

C. Approval and Oversight Requirements

1. Board Approval of Policy, Swing Threshold(s) and Swing Factor Upper Limit. Under the rule as adopted, a fund’s board, including a majority of the directors or trustees who are not interested persons of the fund (disinterested directors), must approve (i) the Swing Pricing Policy; (ii) the swing threshold(s); (iii) the upper limit on swing factor(s) used; and (iv) any changes to the swing threshold(s), or the upper limit or swing factor(s) used.⁴¹

2. Board Designation of Responsible Person(s). A fund’s board, including a majority of the disinterested directors, will be required to designate the fund’s investment adviser, officer or officers responsible for administering the Swing Pricing Policy. The administration of swing pricing must be reasonably segregated from the portfolio management function of the fund and, per the final version of the rule, may not include portfolio managers.⁴²

3. Board Review of Written Report from Responsible Person(s). A fund’s board, including a majority of the disinterested directors, will be required to review, no less frequently than annually, a written report prepared

by the person(s) responsible for administering the Swing Pricing Policy that describes:

- its review of the adequacy of the fund’s Swing Pricing Policy and the effectiveness of its implementation, including the impact on mitigating dilution;
- any material changes to the fund’s Swing Pricing Policy 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 requirements of Rule 22c-1(a)(3), including the information and data supporting the determination of the swing threshold(s), swing factor(s) and upper limit.⁴³

IV. Recordkeeping Requirements

A fund that adopts a Swing Pricing Policy will be required to maintain in an easily accessible place a written copy of the fund’s Swing Pricing Policy in effect at any time within the past six years.⁴⁴ The SEC has also adopted amendments to Rule 31a-2 under the 1940 Act that will require a fund that uses swing pricing to maintain records supporting swing pricing computations. More specifically, these amendments to Rule 31a-2 require a fund that adopts a Swing Pricing Policy to preserve records evidencing and supporting each computation of an adjustment to the fund’s NAV based on the fund’s Swing Pricing Policy. These records should generally include, at a minimum, the fund’s “unswung” NAV; the level of net purchases or net redemptions that the fund encountered (or 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).⁴⁵ These records will be required to be maintained for at least six years from the date that the NAV adjustment occurred (the first two in an easily accessible place).⁴⁶

V. Disclosure and Reporting Requirements

A funds that has adopted a Swing Pricing Policy will be required to disclose and report the following additional information:

A. Amendments to Form N-1A

A fund that has adopted a Swing Pricing Policy will be required to disclose the following information pursuant to Form N-1A:⁴⁷

- In its risk/return bar chart and table, if a fund applied its Swing Pricing Policy during any of the periods, it will be required to include a general description of the effects of swing pricing on the fund's annual total returns for the applicable periods presented.⁴⁸
- In discussing the purchase and sale of fund shares, a fund will be required to explain the fund's use of swing pricing, including its meaning, the circumstances under which the fund will use it, the effects of swing pricing on the fund and its investor and the upper limit set on the fund's swing factor. With respect to any portion of a fund's assets that is invested in other registered funds, the fund must disclose that NAV is calculated based on the NAVs of the funds in which it invests, and that the prospectuses for those funds explain the circumstances under which those funds will use swing pricing and the effects of using swing pricing.⁴⁹
- In its financial highlights, a fund will be required to disclose the per share impact of swing pricing, and the per share impact of amounts retained by the fund due to swing pricing will be required to be included in the fund's disclosures of per share operating performance. The fund will disclose its end-of-period NAV as adjusted pursuant to its Swing Pricing Policy on the last day of the reporting period, if applicable.⁵⁰

B. Financial Statement Disclosures Pursuant to Regulation S-X

A fund that has adopted a Swing Pricing Policy will be required to include certain information in its financial statements:⁵¹

- In its statement of changes in net assets, where funds are required to disclose the number of shares and dollar amounts received for shares sold and paid for shares redeemed, a fund will disclose the dollar amount based on the transactional NAVs used to process subscriptions and redemptions, reflecting swing pricing during the reporting period.⁵²
- In addition, a fund using swing pricing will be required to report in the notes to its financial statements (i) the general methods used to determine whether the NAV will swing; (ii) whether the NAV has swung during the year; and (iii) the general effects of swing pricing on the fund's financial statements.⁵³
- For funds that utilize swing pricing, the statement of assets and liabilities should continue to be presented as currently required by Regulation S-X Rule 6-04 and U.S. Generally Accepted Accounting Principles or "GAAP."⁵⁴

C. New Item on Form N-CEN

A new item on Form N-CEN will require funds, other than exchange-traded funds and money market funds, to disclose whether they engaged in swing pricing during that reporting period, and if so, the swing factor upper limit set by the fund.⁵⁵

VI. Effective and Compliance Dates

A. Swing Pricing

Although the SEC had not initially proposed a delayed effective or compliance date for Rule 22c-1(a)(3) because adoption of swing pricing would be optional, it ultimately decided to delay the effective date of Rule 22c-1(a)(3) until 24 months after the Adopting Release is published in the Federal Register.⁵⁶ This change was made in response to commenters who suggested that funds, service providers and intermediaries may need to work through operational issues, and believed that delaying the effectiveness of swing pricing would level the playing field among market participants and allow for the creation of industry-wide operational solutions in a more efficient manner.

B. Amendments to Form N-1A, Regulation S-X and Form N-CEN

In light of the delayed effective date for the amendments to Rule 22c-1(a)(3), the compliance date for the amendments to Form N-1A and N-CEN will be the same as the effective date for Rule 22c-1(a)(3). Likewise, 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. Only funds using swing pricing will provide these additional disclosures.⁵⁷

¹ Investment Company Swing Pricing, Release Nos. 33-10234, IC-32316 (Oct. 13, 2016) (Adopting Release), <https://www.sec.gov/rules/final/2016/33-10234.pdf>.

² See Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, Release Nos. 33-9922, IC-31835 (Sept. 22, 2015), 80 Fed. Reg. 62274 (Oct. 15, 2016) (Proposing Release), <https://www.federalregister.gov/d/2015-24507>.

³ Adopting Release, *supra* note 1, at 116-17.

⁴ *Id.* at 4, *citing* Pricing of Redeemable Securities for Distribution, Redemption and Repurchase and Time-Stamping of Orders by Dealers, Release No. IC-5519 (Oct. 16, 1968), 33 Fed. Reg. 16331 (Nov. 7, 1968) (Rule 22c-1 Adopting Release).

⁵ *Id.* at 4-5, citing Proposing Release, *supra* note 2, at 184-87.

⁶ Adopting Release, *supra* note 1, at 5.

⁷ *Id.* at 8-9.

⁸ *Id.* at 10.

⁹ *Id.*

¹⁰ *Id.* at 10-11.

¹¹ *Id.* at 11 n.30.

¹² *Id.* at 11.

¹³ *Id.* at 12.

¹⁴ *Id.* at 13.

¹⁵ *Id.* at 6.

¹⁶ One SEC Commissioner expressed concern that adopting a swing pricing threshold could result in sophisticated investors timing their purchases and redemptions based on the likelihood that a fund would adjust its NAV. He also expressed concern that funds could artificially enhance returns by swinging in an amount greater than the costs of redemptions or subscriptions. In his words, swing pricing grants regulatory approval for a fund to impose unpopular costs on investors in a non-transparent way. Ultimately, however, although Commissioner Piwowar voted against the rule's adoption, he did not boycott the meeting altogether, which would have made it impossible for the SEC to meet its three commissioner quorum requirement, and the rule was approved by a 2 – 1 vote. 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), <https://www.sec.gov/news/statement/piwowar-statement-open-meeting-101316.html>.

¹⁷ Adopting Release, *supra* note 1, at 5-6.

¹⁸ Rule 22c-1(a)(3)(v)(C).

¹⁹ Proposing Release, *supra* note 2, at 62334.

²⁰ *Id.* at 62337.

²¹ Rule 22c-1(a)(3).

²² Rule 22c-1(a)(3)(iv).

²³ Rule 22c-1(a)(3)(v)(D).

²⁴ However, it is important to note that a fund with multiple share classes must treat all classes the same; it is not permitted to selectively swing the NAV of certain share classes but not others. Adopting Release, *supra* note 1, at 53.

²⁵ Rule 22c-1(a)(3)(i)(B).

²⁶ Adopting Release, *supra* note 1, at 51.

²⁷ *Id.* at 45-46.

²⁸ Rule 22c-1(a)(3)(i)(C).

²⁹ Transaction fees and charges are defined as brokerage commissions, custody fees, and any other charges, fees and taxes associated with portfolio asset purchases and sales. Rule 22c-1(a)(3)(v)(E). The Adopting Release identified transfer taxes and repatriation costs for certain foreign securities or transaction fees associated with portfolio investments in other investment companies as examples of "other charges, fees and taxes associated with portfolio assets purchases and sales." Adopting Release, *supra* note 1, at 44 n.148.

³⁰ Rule 22c-1(a)(3)(i)(C).

³¹ Adopting Release, *supra* note 1, at 51.

³² Adopting Release, *supra* note 1, at 74-76.

³³ *Id.* at 83.

³⁴ Adopting Release, *supra* note 1, at 76-77.

³⁵ Rule 22c-1(a)(3)(i)(C).

³⁶ Rule 22c-1(a)(3)(i)(A).

³⁷ Adopting Release, *supra* note 1, at 54-55.

³⁸ *Id.* at 57 n.190, 110.

³⁹ *Id.* at 55-56 n. 184.

⁴⁰ *Id.*

⁴¹ Rule 22c-1(a)(3)(ii)(A) and (B).

⁴² Rule 22c-1(a)(3)(ii)(C).

⁴³ Rule 22c-1(a)(3)(ii)(D).

⁴⁴ Rule 22c-1(a)(3)(iii).

⁴⁵ Adopting Release, *supra* note 1, at 96-97. While most of these records were listed in the Proposing Release, back-testing data was added in the Adopting Release.

⁴⁶ Rule 31a-2(a)(2).

⁴⁷ Notably, the final rule will not require funds to publicly disclose their intraday flows or swing thresholds. Adopting Release, *supra* note 1, at 40.

⁴⁸ Form N-1A Item 4(b)(2)(ii) and Item 4(b)(2)(iv)(E).

⁴⁹ Form N-1A Item 6(d).

⁵⁰ Form N-1A Item 13, Instruction 2(d), (e).

⁵¹ Reg. S-X Rule 6-03(m); Adopting Release, *supra* note 1, at 97-111.

⁵² *Id.* at 102.

⁵³ Reg. S-X Rule 6-03(m).

⁵⁴ Adopting Release, *supra* note 1, at 100.

⁵⁵ Form N-CEN Item C.21.

⁵⁶ Adopting Release, *supra* note 1, at 116-17.

⁵⁷ *Id.* at 117-18.