

November 16, 2016

SEC Adopts Optional Swing Pricing Rule

In an October 13, 2016 [release](#) (the “Release”) the SEC amended Rule 22c-1 to permit, but not require, an open-end fund (other than an ETF or a money market fund) to implement “swing pricing.”¹ Swing pricing allows a fund to adjust its NAV to pass on to purchasing or redeeming shareholders the costs incurred arising from their purchases or sales.

Background. Existing Rule 22c-1 under the 1940 Act, also known as the forward pricing rule,² requires funds to sell and redeem fund shares at a price based on the current NAV next computed after receipt of an order to purchase or redeem (the “next-determined NAV”). The Release states that when a fund trades portfolio assets due to purchase or redemption orders, the costs associated with this trading activity can dilute the value of the existing shareholders’ interests in the fund. Dilution occurs when the next-determined NAV paid by purchasing shareholders (or to redeeming shareholders) does not reflect the transaction costs to buy portfolio assets to invest proceeds from purchasing shareholders (or to sell portfolio assets to pay redeeming shareholders). Instead, these costs are borne by existing fund shareholders.

Existing Rule 22c-2 permits a fund’s board of directors/trustees (“Board”) to 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.” Moreover, funds are permitted to redeem shareholders in kind instead of with cash to mitigate potential shareholder dilution. The Release notes that redemption fees and redemptions in kind are not broadly utilized by funds and, in recent years, a number of fund complexes have removed redemption fees for a variety of reasons, including the administrative burdens they engender and the imprecision with which they achieve their intended goal. Therefore, the SEC stated, “we believe that providing funds the option to use swing pricing as another anti-dilution tool is likely to benefit investors and may complement or be an alternative to the tools currently available to funds.”

Swing Pricing and Related Policies and Procedures

As amended, Rule 22c-1 permits a fund to use swing pricing under certain circumstances. Before a fund can use swing pricing, a fund must establish and implement swing pricing policies and procedures containing the elements described below. A fund may adopt swing pricing procedures as part of the liquidity risk management program it will be required to adopt under Rule 22e-4.³

Swing Thresholds and Swing Factors. A “swing threshold” is an amount of net purchases or net redemptions, expressed as a percentage of the fund’s NAV, that triggers the application of swing pricing. A “swing factor” is the amount, expressed as a percentage of the fund’s NAV, that a fund adjusts its per-share NAV once a “swing threshold” has been exceeded. As a refinement to the Proposing Release, the Release permits a fund to have multiple escalating swing thresholds, each associated with a different swing factor.⁴ A fund’s policies and procedures are

¹ On May 20, 2015, the SEC issued a proposing release (the “Proposing Release”) regarding the matters covered in the Release.

² The SEC adopted Rule 22c-1 in 1968 “to eliminate or reduce so far as reasonably practicable any dilution of the value of outstanding redeemable securities of registered investment companies” through the sale (redemption) of such securities at a price below (above) their NAV.

³ In a separate October 13, 2016 [release](#), the SEC adopted Rule 22e-4, covering fund liquidity risk management, and published new, related disclosure and data reporting requirements. Rule 22e-4 and related disclosure and reporting changes are the subject of separate Ropes & Gray Alert (available [here](#)).

⁴ The rationale for this refinement is that multiple thresholds and swing factors will allow a fund to mitigate shareholder dilution more effectively if the costs of managing shareholder activity increase as purchases/redemptions increase.

required to state that the fund must adjust its per-share NAV by a single swing factor, or by multiple swing factors that may vary based on the swing threshold crossed, once the level of net purchases into or net redemptions from the fund exceeds the applicable swing threshold.

Determination of Swing Thresholds. A fund's policies and procedures must specify the process for determining the fund's swing threshold(s), based upon the consideration of the following non-exhaustive list of factors:

- 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, and borrowing arrangements and other funding sources; and
- The costs associated with transactions in the markets in which the fund invests.

The SEC believes that these factors reflect areas that "a fund would consider in establishing its swing pricing process and are consistent with factors that are considered by funds that use swing pricing in other jurisdictions." The SEC also noted that amended Rule 22c-1 would not prohibit a fund from considering other factors that the fund deems relevant. In permitting a fund to determine its swing threshold(s), the SEC acknowledged that there were potential dangers both if the amended rule were "overly prescriptive" or permitted "complete discretion." That said, with respect to the balance it had struck, the SEC stated that it believes that "evaluating all four factors will assist a fund in determining what level of net purchases or net redemptions would generally lead to the trading of portfolio assets that would result in material costs to the fund, and thus they are relevant to setting a fund's swing threshold."

Determination of Swing Factors. Amended Rule 22c-1 provides that, in determining the swing factor(s) and the upper limit on the swing factor(s) (which may not exceed 2% of the per-share NAV), the person(s) responsible for administering swing pricing (the "Administrator") 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(s) is (are) used. The near-term costs may include spread costs, brokerage commissions, custody fees, and any other charges, fees, and taxes associated with portfolio asset purchases and sales, arising from asset purchases or asset sales resulting from purchases or redemptions, and borrowing-related costs associated with satisfying redemptions (collectively, "Fund Costs"). A fund's policies and procedures must specify the process for determining the fund's swing factor(s), as well as include a determination that the swing factor(s) used is (are) reasonable in relationship to the Fund Costs.

- The Proposing Release included "market impact costs" associated with the fund trading portfolio assets as a cost to be considered in determining a swing factor. In the Release, the SEC eliminated the consideration of market impact costs in determining a swing factor because of its concerns that (i) many funds may not be able to readily estimate market impact costs, and (ii) subjective estimates of market impact costs could grant excessive discretion in the determination of a swing factor.
- With respect to the requirement, not found in the Proposing Release, that any swing factor used be reasonable in relation to the Fund Costs, the Release states this requirement merely makes the requirement explicit because "funds would have necessarily been evaluating the reasonableness of the swing factor and its relationship to costs."

Board Oversight of Swing Pricing

As amended, Rule 22c-1 requires a fund's Board, including a majority of its members who are not interested persons of the fund, to:

- 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 Administrator (which may be the fund's investment adviser or one or more fund officers, but must be reasonably segregated from portfolio management of the fund and may not include portfolio managers); and
- Review, no less frequently than annually, a written report prepared by the Administrator that describes:
 - the Administrator's 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
 - the Administrator's review and assessment of the fund's swing threshold(s), swing factor(s), and swing factor upper limit, including the information and data supporting the determination of the swing threshold(s), swing factor(s), and swing factor upper limit.

The SEC emphasized the importance of a Board's review and approval of a fund's determination of its swing threshold(s) in ensuring that the swing threshold(s) is (are) in the best interests of shareholders, noting that a Board can serve as an "important check on the discretion afforded" to the Administrator in determining the swing threshold(s).

Related Form N-1A Changes

A fund using swing pricing will be required to disclose in its Form N-1A the circumstances in which swing pricing will be used, the effects of swing pricing and the upper limit the fund has set on its swing factor. In the financial highlights and performance data sections of Form N-1A, a fund using swing pricing will be required to provide a general description of the effects of swing pricing on the fund's average annual total returns for the period(s) presented and to present performance information to show the effects, if any, of its use of swing pricing.

Effective Date

The effective date for amended Rule 22c-1 is 24 months after the date the Release is published in the Federal Register. The SEC stated that it was delaying the amended rule's effective date for 24 months to provide funds, intermediaries, and service providers time to work through operational issues. In addition, the SEC stated that delaying the amended rule's effective date may lead to the creation of industry-wide operational solutions in a more efficient manner. There is no compliance date, as there usually is for other rules, because the use of swing pricing, once amended Rule 22c-1 becomes effective, will be permissive rather than mandatory.

If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney.