CARLTON FIELDS

SEC Would Mandate Swing Pricing: Badly Upending Most Funds' Procedures

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In November 2022, the SEC published a proposal that would mandate "swing pricing" procedures for the purchase and redemption of shares of most open-end investment companies. The proposal, however, does not apply to exchange-traded funds, money market funds, or feeder funds in master-feeder arrangements.

The SEC discussed the market disruptions that occurred in March 2020, which caused reduced liquidity in certain types of funds and, according to the SEC, demonstrated the need for the proposed procedures. The basic aim of the swing pricing proposal is to pass costs resulting from shareholder purchase or redemption activity on to the shareholders engaging in that activity, thus reducing the possibility of unfair dilution of other shareholders' interests in the fund. (Although the SEC also proposed refinements to its requirements for fund liquidity risk management programs, those liquidity proposals are not within the scope of this article.)

The November 2022 swing pricing proposal is similar to, but also in important ways different from, both (a) the optional swing pricing procedures that the SEC authorized for most open-end investment companies in 2016, and (b) the mandatory swing pricing requirements that the SEC proposed for institutional money market funds in 2021. The substance of those 2016 procedures received a cold shoulder from the industry, as no funds have opted to implement them. The SEC's 2021 swing pricing proposal for money market funds also generated significant adverse comments from industry sources, and the SEC has not yet taken further action thereon.

The Terms of the SEC's Proposal

The types of funds to which the November 2022 swing pricing proposal applies (Funds), would be required to make extensive and fundamental changes in the way they price and implement purchases and redemptions of their shares. To summarize (very briefly), this would require Funds to:

- **Implement a "hard close" procedure** under which, in order to be effected at a given net asset value (NAV), a purchase or redemption order must be received by the Fund, its transfer agent, or a registered clearing agency (and not merely by some other authorized intermediary) by the time as of which the NAV is struck. This procedure is intended to provide more reliable and timely information about fund inflows and outflows than Funds currently can obtain. On the other hand, the SEC's Chief Economist and Director of the Division of Economic and Risk Analysis has expressed her view that the most significant costs of the proposal — which would be borne by investors — would likely stem from this hard close requirement.

- **Have a "swing pricing administrator"** who could be the Fund's investment manager or an individual or group of persons. However, no portfolio manager of the Fund may serve in a swing pricing administrator role, although a portfolio manager may provide input to the swing pricing administrator.

- **Adjust its NAV by a "swing pricing factor"** for any day when (a) it has net purchases that exceed 2% of its net assets (or such lower percentage as the swing pricing administrator determines, subject to certain conditions imposed by the proposal), or (b) it has any amount of net redemptions.

- **The "swing pricing factor" must reflect** the swing pricing administrator's good faith estimate, based on supporting data, of the costs the Fund would incur if it sold or purchased a pro rata amount of each investment in its portfolio (i.e., a "vertical slice" of the portfolio) equal to the amount of the day's net redemptions or purchases. For this purpose, the swing pricing administrator must consider:
    - brokerage commissions, spread costs (subject to certain exceptions), and certain other costs associated with purchases or sales of Fund portfolio assets; and
    - the market impact of such purchases or sales, except that market impact associated with a day's net redemptions need be considered only if those redemptions exceed 1% of the Fund's net assets (or such lower percentage as the swing pricing administrator determines, subject to certain conditions imposed by the proposal).

- **Report their swing factor adjustments publicly** on Form N-PORT.

A Fund's board, including a majority of its directors who are not interested persons of the Fund, would be required to approve the 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.

Alternatives to the SEC's Proposal

The SEC requested commenters to address whether any of three possible alternatives to its proposed hard close requirement would be able to generate sufficient investor flow information to effectively implement the swing pricing proposal:

1. requiring intermediaries (e.g., broker-dealers, banks, and retirement plan record-keepers) to provide Funds, either before the Fund's pricing time or a set time thereafter, with a daily estimate of the orders the intermediary will place with the Fund for that day;

2. allowing Funds to estimate their orders for each day by, for example, developing models that incorporate the information available to them, as well as historical order flow information; or

3. requiring intermediaries to provide their orders to a designated party within a limited time period (e.g., two or three hours) after a Fund's pricing time for the day.

The SEC also requested commenters to address two possible alternatives to swing pricing:

1. "liquidity fees" that Funds could assess at different rates for purchase and redemption transactions on a given day; or

2. "dual pricing" structures under which Funds could quote a NAV for purchases on a given day that differs from the NAV for redemptions on the same day.

Such liquidity fee or dual pricing arrangements could result in a more precise allocation of transaction-related costs, because they permit a different allocation of those costs as between Fund share purchasers on a given day and Fund share redeemers on that day.

Particular Issues for Variable Insurance Products

The November 2022 proposal has generated a decidely icey reaction from industry sources. It has been controversial even within the SEC itself, with the SEC's two Republican members having published written dissents from the proposal.

The proposal could have especially significant implications for underlying Funds that support variable insurance products. For example, the "hard close" component could be interpreted to overturn the long-standing SEC staff position that allows Fund share orders placed by insurance company separate accounts after a 4:00 p.m .closing time on a given day to nevertheless receive that day's 4:00 p.m. NAV, so long as the orders correspond to variable contract owner orders received prior to that time. Indeed, the SEC specifically requested comment on whether certain relief from the proposals' requirement would be appropriate for transactions in Fund shares by an insurance company separate account. In this regard, even if Fund swing pricing administrators were permitted to use estimates of the amount of Fund net purchases and redemptions for each day, it may be especially difficult for such administrators to reasonably make such estimates if (a) the Funds are unaffiliated with the insurance companies placing the orders, and (b) the orders continue to be submitted by the insurance companies after the 4:00 p.m. closing time each business day.

In any event, implementing the swing pricing procedures in the SEC's November 2022 proposal in its current form would require such fundamental changes in their operating procedures that insurance companies and underlying Funds will undoubtedly continue to strenuously resist this proposal.

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