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SEC Update

By Gary O. Cohen

SEC Adoption of Forward Pricing Rule 22c-1—Before Swing Pricing, There Was Backward and Forward Pricing of Mutual Fund Shares

The current proposal[1] of the Securities and Exchange Commission (SEC) to require swing pricing and hard close for mutual fund (fund) shares follows the SEC's requirement that fund shares be forward, rather than backward, priced.

It is illuminating to recall[2] the highly unusual circumstances involving President Lyndon B. Johnson and the Vietnam War (War) that precipitated the SEC's 1968 adoption of its forward pricing requirement.

Applicable Law

The Investment Company Act of 1940 (1940 Act) does not mandate a time or method for pricing fund shares for purchase or redemption. However, Section 22 authorizes the SEC to adopt rules for pricing fund shares to eliminate or reduce dilution of shareholder value or other unfair result to shareholders.

More specifically, Sections 22(a) and (c), read together, authorize the SEC to "prescribe, by rules . . . [a] method . . . for computing" a "minimum" purchase price and a "maximum" redemption price for fund shares,

- "so that the price in each case will bear such relation to the current net asset value of such security computed as of such time as the rules may prescribe" and
- "for the purpose of eliminating or reducing so far as reasonably practicable any dilution of the value of other outstanding securities of such company or any other result of such purchase, redemption, or sale which is unfair to holders of such other outstanding securities."

The legislative history of Sections 22(a) and (c) shows that the SEC, prior to the adoption of the 1940 Act, was aware of the implications of backward and forward pricing. This knowledge included the fact that backward pricing diluted the value of fund shares held by existing shareholders and forward pricing did not. The SEC's 1940 report to Congress on investment companies stated that, if fund shares were bought and redeemed based on the closing net asset value on the day the order was received, "no diminution in asset value could result as the investment company would always receive the current rather than the preceding day's asset value."[3]

Backward Pricing

Between the effectiveness of the 1940 Act and January 1969, the fund industry mostly[4] backward priced fund shares.[5] The price was based on a fund's net asset value *last,* rather than *next*, determined. So, for example, an investor could buy fund shares on Monday based on the fund's net asset value on the previous Friday.

If the securities markets were higher on Monday than Friday, a fund's net asset value would likely be higher on Monday than Friday. An investor, buying shares at a price based on Friday's lower net asset value, could realize an immediate increase in the value of the shares.[6] In fact, sellers of fund shares used this result as a marketing tactic to convince investors to buy fund shares.[7]

Forward Pricing

In 1968, Solomon "Sol" Freedman[8] was the Director of what is now the SEC's Division of Investment Management.[9] He jawboned against backward pricing and in favor of forward pricing. His rationale was that the immediate increase in value that an investor could enjoy under backward pricing diluted the value of fund shares owned by existing fund shareholders. He deemed backward pricing to be a gimmick to help the industry sell fund shares.

In 1967, Director Freedman had the Division begin developing a rule requiring forward pricing and a memo to the Commissioners recommending the adoption of the rule. The Division submitted its recommendation to the Commissioners in early fall of 1967. The Commissioners instructed the Division to submit the proposed forward pricing rule to two industry organizations, the National Association of Securities Dealers, Inc. (NASD), a forerunner of the Financial Industry Regulatory Authority (FINRA), and the Investment Company Institute (ICI).

The SEC Staff did so and stayed in contact with the two organizations off and on over the next few months. This contact included the SEC Staff's receipt of a letter from each organization in early 1968 and at least one meeting of the SEC Staff with the organizations thereafter.

The two organizations opposed mandatory forward pricing. They acknowledged that backward pricing diluted existing shareholders, but claimed that the amount of dilution was insignificant. They also argued that forward pricing would be more costly, as well as mechanically more complex, for funds that distributed their shares through dealers. The two organizations suggested rules that would revise, but continue to permit, backward pricing.

President Johnson

President Johnson, on the evening of Sunday, March 31, 1968, addressed the nation regarding the status of the War. At the time, the War was going badly for the United States. President Johnson persisted in claiming accelerating success for the United States. However, many in the United States believed that this was not so and that President Johnson was not telling the truth.[10] Moreover, many in the United States believed that the President was not conducting the War in a way that would most likely lead to peace. In particular, they protested the United States bombing of North Vietnam.

President Johnson began his address by announcing that he was halting the bombing of North Vietnam in anticipation of peace talks in Paris between South and North Vietnam.[11] He then shocked the world by announcing that he would not seek reelection as President.[12] Most viewed these announcements as major steps toward ending the War.

On Monday, the securities markets soared. A headline in the *New York Times* the next day read "Johnson's Peace Move Sets Off a Dramatic Surge in Market Prices."[13] The *Times* reported that: "[t]he New York Stock Exchange recorded the busiest session in its 176-year history"; "[a] record number of shares changed hands"; "[s]tock prices rocketed up"; and "bond prices [climbed] dramatically."[14] The *Times* observed that the Dow Jones Industrial Average had "the largest one-day advance" in four and a half years.[15]

Speculative money flowed into mutual funds at what turned out to be the lower price at the end of the previous Friday.[16] Back offices struggled to handle the buy transactions. Portfolio managers struggled to invest the new money.

Then, over the next few days, the situation reversed. Money flowed out of the funds as savvy investors bailed out with their profits realized through backward pricing. Back offices struggled to handle the redemption transactions. Portfolio managers struggled to sell portfolio securities to generate cash to pay redeeming shareholders.

Industry executives called and wrote SEC Chairman Manuel "Manny" F. Cohen to complain about the great disruption to their operations that they were forced to bear. Ironically, they asked the Chairman how the SEC could permit such circumstances to develop. Chairman Cohen sensed that the industry tide against forward pricing had turned. He instructed Director Freedman to update and resubmit the Division's recommendation for a rule requiring forward pricing.

The Commissioners, working on an accelerated basis, proposed[17] a forward pricing rule on June 25, 1968, reviewed a Division memo analyzing public comments on the proposed rule in early fall, and adopted[18] the proposed rule on October 16, 1968, effective January 13, 1969.

SEC Rationale

The SEC expressed two reasons for adopting the forward pricing rule. The first reason was that the rule would eliminate or reduce dilution.

The SEC explained that backward pricing could involve "the sale of redeemable securities at a price below their net asset value,"[19] which could "have the effect of diluting the value of outstanding redeemable securities of registered investment companies."[20] The SEC also pointed out that backward pricing was a way for the industry to sell fund shares in that "[a]n investor may be encouraged to purchase securities in this manner by the practice of announcing the next sale price in advance of the time at which it becomes effective, thereby enabling the investor to time his purchase so as to obtain investment company securities at the lower of two known prices."[21] These statements reflected Director Freedman's views.

The SEC's second reason for adopting the forward pricing rule was that it would eliminate or reduce another unfair result to existing shareholders.

The SEC explained that backward pricing "allows speculators to buy large blocks of such securities"[22] and "hold such securities until the next net asset value is determined and then redeem them at large profits."[23] The SEC said that "[t]hese speculative trading practices can seriously interfere with the management of registered investment companies to the extent that (i) management may hesitate to invest what it believes to be speculators' money and (ii) management may have to effect untimely liquidations when speculators redeem their securities."[24] These statements reflected the industry executives' complaints of disruption following President Johnson's announcements.

Conclusion

The SEC Staff, in 1967, recommended that the Commissioners adopt a rule requiring that fund shares be forward priced for purchase and redemption. The industry opposed the recommendation. On March 31, 1968, President Lyndon B. Johnson announced that he would cease bombing North Vietnam in the War and not run for reelection. The announcements were viewed as positive steps toward ending the war. The securities markets soared the next day. Great amounts of speculative money flowed into funds based on backward pricing and, shortly after, flowed out in redemptions that realized profits from the backward pricing. These purchases and redemptions of fund shares caused great disruption in the industry, leading to the industry's acceptance of the SEC's adoption of a rule requiring forward pricing.

Mr. Cohen is of counsel at Carlton Fields, P.A., in Washington, DC. Mr. Cohen spent five years on the Staff of the SEC's IM Division, ultimately serving as assistant chief counsel, and has dealt with the Division as a private practitioner for more than 50 years. Mr. Cohen has served on *The Investment Lawyer*'s Editorial Board since the outset of the publication in 1986 and has published numerous articles in this publication over many years. He thanks his colleagues, Ann B. Furman and Edmund J. Zaharewicz, and his firm's librarian, Nicole Warren, for reviewing and contributing to this article. Mr. Cohen also thanks Allan S. Mostoff for reading and contributing to this article. Mr. Mostoff, a former Director of what is now the SEC's IM Division, was a Division official at the time of the events described in this article. The views expressed are those of Mr. Cohen and do not necessarily reflect the views of his firm, its lawyers or its clients.

NOTES

1 *Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting*, Securities Act Release No. 11130, Investment Company Act Release No. 34746 (Nov. 2, 2022) (proposing mandatory swing pricing and hard close), available at *https://www.google.com/search?q=sec+release+proposing+swing+pricing+and+hard+close&rlz=1C1GCEU_enUS865US865&oq=sec+release+proposing+swing+pricing+and+hard+close&aqs=chrome.0.69i59.15763j0j7&sourceid=chrome&ie=UTF-8#ip=1*. The date of this article is February 23, 2023.

2 Portions of this article are based on the memory of the author who was on the Staff of what is now the Division of Investment Management at the time and assigned to lead the project. The author, among other things, drafted the proposed forward-pricing rule, supporting memorandum to the Commissioners, and the SEC's proposing and adopting releases titled, respectively, *Pricing of Redeemable Securities for Distribution, Redemption and Repurchase and Time-Stamping of Orders*, Exchange Act Release No. 8340, Investment Company Act Release No. 5413 (June 25, 1968)(proposing forward-pricing Rule 22c-1 under the Investment Company Act of 1940) [hereinafter SEC Release Proposing Forward Pricing Rule], available at *https://www.sec.gov/rules/final/1968/34-8429.pdf*, and *Pricing of Redeemable Securities for Distribution, Redemption and Repurchase and Time-Stamping of Orders*, Exchange Act Release No. 34-842, Investment Company Act Release No. 5519 (Oct. 16, 1968) (adopting forward-pricing Rule 22c-1 under the Investment Company Act of1940) [hereinafter SEC Release Adopting Forward Pricing Rule], available at *https://www.sec.gov/rules/final/1968/34-8429.pdf.*

Portions of this article are corroborated by a speech made by the then Director of what is now the Division of Investment Management. Solomon Freedman, Director, SEC Division of Corporate Regulation, Remarks Before the 20th Annual International Mutual Fund Dealers' Conference, Projections, Forward Pricing and Group Purchasing (Oct. 22, 1968), available at *https://www.sec.gov/news/speech/1968/102268freedman.pdf*. For information regarding the changed name of the Division, *see infra* n.9.

3 SEC, Report on Investment Trusts and Investment Companies, Pt. Three, Ch. III. at 870.

4 A few funds used forward pricing for purchases and redemptions. As one observer noted:

> Some investment companies have instituted a forward pricing system (also permissible under the NASD rule) under which shares are sold at prices computed upon the closing market prices after the order has been received, thus eliminating any possible dilution of the fund.

Greene, "The Uniform Offering Price of Mutual Fund Shares Under the Investment Company Act of 1940," 37 *U. Det. L.J.*, 369, 375 (1962).

5 The SEC has stated: "Prior to adoption of rule 22c-1, investor orders to purchase and redeem could be executed at a price computed before receipt of the order, allowing investors to lock-in a low price in a rising market and a higher price in a falling market." *Investment Company Swing Pricing,* Securities Act Release No. 10234, Investment Company Act Release No. 32316 at n.4 (Oct. 13, 2016)(adopting amendments to Rule 22c-1), available at *https://www.sec.gov/rules/final/2016/33-10234.pdf*.

6 Conversely, if the securities markets were lower on Monday than Friday, a fund's net asset value would likely be lower on Monday than Friday. An investor redeeming at a price based on Friday's higher net asset value could realize an immediate increase in the value of the shares.

7 *See* text accompanying *infra* n.21.

8 For information about Mr. Freedman, *see* "Soloman [sic] Freedman, S.E.C. Lawyer," 78*, N.Y. Times*, (March 22, 1988), at B5 (incorrectly spelling his first name with an "a" instead of an "o") [hereinafter Freedman Obituary], available at *Soloman https://www.nytimes.com/1988/03/22/obituaries/soloman-freedman-sec-lawyer-78.html*, and "Freedman Retires from SEC; Levy Named Division Head," *SEC News Digest* 1 (Sept. 11, 1972), available at *https://www.sec.gov/news/digest/1972/dig091172.pdf.*

9 When Mr. Freedman was Director, the name of the Division was the Division of Corporate Regulation. *See* Freedman Obituary, *id*. In 1972, the Division of Corporate Regulation was split into two Divisions, one of which was named the Division of Investment Company Regulation. "Casey Announces SEC Restructuring," *SEC News Digest*, Aug. 3, 1972, at 1, available at *https://www.sec.gov/news/digest/1972/dig080372.pdf.* In 1973, the name of the Division was changed to the Division of Investment Management Regulation. Anne Jones, a Republican, had the name of the Division changed to the Division of Investment Management after she became Director in 1975, because, as she told the author of this article, it sounded less regulatory. For information about Director Jones, *see* "The Open Door: Roles of Women in Securities Regulation, Barriers Broken: 1970s," SEC Historical Society, available at *https://www.sechistorical.org/museum/galleries/tod/tod04a_barriers_broken.php#fn23*.

10 One historian stated:

> LBJ had become the face of America's divisions. To those on the Right, Johnson had done too much, too quickly, overloading the system with big-government programs that trampled on individual liberties. Much of the Left viewed Johnson as the corrupt wheeler-dealer who had lied America into the disastrous, bloody Vietnam quagmire.

Matthew Dallek, "LBJ Announced He Wouldn't Run Again. Political Chaos Ensued," History Website (Sept. 10, 2018), available at *https://www.history.com/news/lbj-exit-1968-presidential-race.*

11 New York Public Radio Archives Collection (April 1, 1968), available at *https://www.wnyc.org/story/president-johnson-halts-bombing-in-vietnam/*. This site provides the tape recording, text, and summary of the President Johnson's speech.

12 *Id.*

13 *N.Y. Times* (Apr. 2, 1968) at 63 (banner headline).

14 *Id.*

15 *Id*.

16 "Hot Money Hits Funds; New Ones Proliferating," *N.Y. Times* (May 5, 1968) at F.1., and "Trading Fever Hits Washington; Mutuals [sic] in Demand," *Washington Daily News* (Apr. 2, 1968).

17 SEC Release Proposing Forward Pricing Rule, *supra* n.2.

18 SEC Release Adopting Forward Pricing Rule, *supra* n.2.

19 *Id*. at 2.

20 *Id*. at 3.

21 *Id*.

22 *Id*.

23 *Id*.

24 *Id.* at 3-4.

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