Mutual Funds to SEC: We Can’t Swing Prices

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When proposing new rules, the US Securities and Exchange Commission often plays catch-up to the changing technological or market times. Not so when it comes to the practice of swing pricing, part of its new proposed rules for liquidity management.by US registered investment funds.

Nothing short of a revolutionary change in operational capabilities would be needed for swing pricing, warn some of the nation’s largest mutual fund complexes and influential trade groups in recent responses to the concept paper issued by the SEC late last year. Just because some of their European peers have been handling it doesn’t mean that swing pricing is doable in the US in the near future.

Although the mutual fund industry’s concerns about swing pricing was only a fraction of the recommendations on how the SEC should change its proposals, it represented the most extreme disagreement with the agency’s stance. “Without significant changes to fund and intermediary operations and sizeable investment to modify associated systems, swing pricing is not feasible in the US,” says Payton Swaffield, chief income investment officer for Boston-headquartered Eaton Vance Management in a letter to the SEC. That stance was shared by the Washington DC mutual fund trade group Investment Company Institute (ICI) and the New York-based Asset Managers Forum (AMF) of the Securities Industry and Financial Markets Association among others.

The regulatory agency wants fund managers to ensure they have sufficient liquid assets available to address market stresses and to cope with heavy redemptions. The optional implementation of swing pricing — that is an adjusted NAV to neutralize the impact on long-term investors of large purchase or redemption orders — depends on the fund’s ability to know when net transactions exceed a pre-set threshold percentage of the NAV. Policies defining the “swing factor” for triggering and

calculating the adjusted pricing are dependent on additional factors such as the types of assets a fund holds, access to cash and lending agreements, as well as what type of transaction cost or market impact factors it considers. Whatever the policies, they must be approved by the fund board and reviewed annually.

Most fund investors in the US purchase their shares through intermediaries. To implement swing pricing, the fund must determine whether the swing pricing threshold has been reached and the NAV must be adjusted. This requires accurate daily fund flow information from those intermediaries. However, those fund intermediaries in turn must know the NAV of a fund before they can value their orders to calculate daily net flows, explains Swaffield.

The Global Association of Risk Professionals (GARP) was the only respondent to the SEC's proposals to provide the agency with a detailed roadmap of the necessary changes to the mutual fund industry's current operating requirements, based on the recommendations of a buy-side swing pricing committee. Its participants represented the creme de la creme of the mutual fund industry: AllianceBernstein, BlackRock, Deutsche Asset Management, Goldman Sachs Asset Management, JP Morgan Asset Management, Neuberger Berman, Nuveen Fund Advisors, MFS Investment Management, Oppenheimer Funds and Western Asset Management.

However, as GARP notes, adjusting data flows to enable swing pricing would require changes to systems and processes for not only mutual fund managers, but also their transfer agents and financial intermediaries such as banks, broker-dealers, retirement plan recordkeepers and trust companies as well as the National Securities Clearing Corporation (NSCC). While noting the potential merits of swing pricing for investors, neither the AMF nor the ICI made any specific suggestions on how to adapt current workflow, instead focusing on the more general operation concerns related to swing pricing.

"We note, however, that there is no consensus within the industry on how to proceed. Because of the important role the swing threshold plays in implementation of partial swing pricing and the severity of the operational impediments, a number of our members believe that the Commission should not adopt a final swing pricing rule until these matters are addressed in a manner that would permit implementation of swing pricing broadly across the industry," say Timothy Cameron, head of the AMF, and Lindsay Weber Keljo, vice president of the AMF in their letter to the SEC.

Operational Conundrum

Swing pricing has been implemented in Europe for at least five years, predominantly by Luxembourg domiciled UCITS-eligible funds. Based on surveys conducted by the Association of the Luxembourg Fund Industry (ALFI), its popularity is growing. So far, European regulators have taken a hands-off approach, leaving professional organizations such as ALFI to come up with voluntary best practice guidelines.

Why can't US mutual funds implement swing pricing now? In a nutshell, current deadlines for communications between funds and their intermediaries make it impossible for funds to know — in time to set a "swung" NAV — whether net purchases or redemptions exceed the thresholds they set. This is largely because most fund investors purchase their shares through intermediaries, such as banks and broker-dealers

David Oestreicher, chief legal counsel for T. Rowe Price Associates in Baltimore, details the timing glitches as follows: Under the SEC's Rule 22c-2, all fund purchase and redemption orders must be received by banks and broker-dealers by 4 p.m. EST for investors to receive that day's net asset value. Fund intermediaries have no trouble sending the fund's transfer agent files containing whatever they can muster as net purchase and redemption information.

However, the files transmitted by 4 p.m. do not include final complete order flow information. That level of detail typically doesn't arrive on the fund transfer agent's desk until late on the same evening or the following morning, when it is transmitted through either the FundServ platform or the DCC&S platform long after the fund's NAV is officially struck at 6 p.m. Both platforms are operated by the NSCC, a subsidiary of US clearing and settlement infrastructure Depository Trust & Clearing Corporation.

"Because funds do not have a complete understanding of fund flow information until after they strike their NAV, we are not sure it will be possible to accurately determine whether or not the swing threshold is breached," explains Oestreicher. "Consequently, funds will be using imperfect and incomplete information to adjust their NAVs as they will need to rely on interim information or estimated flows from their intermediaries. Our experience with SEC Rule 22c-2 tells us that it will not be easy to collect this information from all intermediaries in a timely manner."

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What to Do

European funds — particularly those domiciled in Luxembourg — have been able to implement swing pricing because of their prevalence of institutional investors that don't use intermediaries, plus their extended time to calculate NAVs. The funds don't have to rely on information from financial intermediaries and, because their window for purchase and redemption transactions typically closes at noon, they have three hours from the time they have the order flow information to when they have to strike the NAV. "This timing allows for swing pricing to operate with minimal risk of NAV errors due to the misapplication of a swing factor," says Oestreicher, whose firm's SICAV funds in Luxembourg do use swing pricing.

At the core of the recommendations of GARP's swing pricing committee is keeping the 4 p.m. EST time for when redemptions and subscriptions must be received by financial intermediaries to receive that day's net asset value. The objective in maintaining the same transaction window is to minimize impact on the investors. However, the committee wants the SEC to require providers of fund flows to deliver "estimated" trade flows to funds by 6 p.m. EST. On this new schedule, NAVs would be published at 8 p.m. EST, rather than 6 p.m. EST — a time that was once linked to deadlines in print publications, and which are no longer relevant in the online world . If purchase or redemption thresholds are breached, fund managers could rely on the "estimated flows" executed on trade date to come up with the swing price by 8 p.m. EST, says Richard Apostolik, president and chief executive of the Jersey City, New Jersey based GARP.

Seeking Safe Harbor

But even GARP, the ICI and others acknowledge that fixing operational glitches is just one obstacle to implementing swing pricing in the US. Another is liability. The SEC says that the fund management firm can implement swing pricing based on a "reasonable inquiry" of fund flow information to determine whether the swing threshold has been exceeded. The SEC never explains what means by "reasonable" and it does not explain what a fund should do if it ultimately finds out that the swing price was incorrect. Current fund practice is for a funds to correct inaccurate NAVs and reimburse shareholders experiencing "material" economic loss due to the errors.

The ICI, AMF, and GARP, among others, urged the SEC to more clearly define what "reasonably inquiry" means and provide the fund management firm with a safe harbor if it has made a good faith effort to provide a correct swing price. "In particular, we would ask that the SEC expressly provide in any adopting release that if a fund adopts swing pricing policies and procedures that comply with the final rule amendments, applies them reasonably, and any NAV misstatements that occur are due solely to limitations in the fund flow information that the fund reasonably has available to it, that such misstatements would neither necessitate order reprocessing nor expose the fund, its manager or its board to any type of liability," says David Blass, general counsel of the ICI. Without that assurance, funds would simply "eschew" swing pricing to avoid the potential risks and costs that could result.

The SEC should also follow ALFI's guidelines and give fund management firms more flexibility in whether they should implement swing pricing and what thresholds and inputs to use. "The degree of potential dilution that funds encounter is not uniform, and in many cases is *de minimis* — e.g., particularly for those funds with stable shareholder bases, relatively staid fund flows and relatively low transaction costs for buying and selling portfolio assets," says Blass.

When it comes to determining what should be considered when calculating the swing factor, Blass urges the SEC not to require fund managers to include the market impact of a large purchase or redemption order. Instead, they should be allowed to use their own inputs. "Under this approach, a fund's swing pricing methodology initially may capture only those variables that it may estimate with greater confidence, such as transaction costs (more narrowly understood) and certain other fees," says Blass in citing a recent study conducted by ALFI that market impact was only used in 10 percent of funds which implemented swing pricing.

SIFMA's AMG agrees that the SEC should follow ALFI guidelines which suggest funds' cost consideration may include bid/offer spreads, net broker commissions paid by the fund, custody fees, fiscal charges such as stamp duty and sales tax, any initial charges or exiting fees applied to trades and any swing factors or dilution amounts of spreads in underlying investment funds or derivative instruments.

Fairness Factor

Operational and legal problems aside, there is still one fundamental flaw with the concept of swing pricing. It may not pass the "fairness" test. Fund management firms have a fiduciary obligation to treat all investors fairly, but swing pricing may penalize those investors making "first moves" in large purchases or redemptions. "No requirement appears to exist for fund sponsors and fund boards to balance the conflicting interests of continuing shareholders (benefiting from low swing thresholds and high swing factors) versus transacting shareholders (benefiting from high swing thresholds and low swing factors)," says Swaffield from Eaton Vance.

Because the SEC's proposal imposes no explicit duty on fund sponsors or fund boards to limit adjustments from NAV to amounts that are reasonable in relation to fund costs associated with the trading activity requiring swing pricing, the transacting shareholders would end up unfairly exposed to undisclosed and uncapped transaction costs. Even worse, fund managers have an incentive to adopt aggressive swing pricing policies, such as low swing thresholds and high swing factors, says Swaffield. That is because they can use adjusted NAVs to measure fund performance and determine performance-based fees.

Ironically, the investors the SEC wants to protect with swing pricing also don't think it's such a great idea. "The symmetry of the SEC's proposal would disadvantage certain shareholders, both new and existing," says Niels Holch, executive director of the Coalition of Mutual Fund Investors, a Washington, D.C. advocacy group.

Here is why: On a day in which net purchase orders exceed the swing threshold, the fund could adjust the NAV upward for both purchases and redemptions. On a day when the net redemption orders exceed the threshold, the NAV would be adjusted downward for both purchases and redemptions.

What does that mean for investors, beyond the big transactors? On the day when net purchases are above the swing threshold, all purchasing investors would buy shares at the higher NAV, incurring extra cost for making the mistake of buying shares on the same day as a large investor. At the same time, redeeming investors would benefit from a windfall over what the adjusted NAV should have been on that day. Conversely, on a day when net redemptions exceed the swing threshold, causing a "swing" downward in the NAV, investors buying shares would benefit by buying shares at a discount from the actual NAV. Any investor redeeming shares that day would receive less than the unadjusted NAV.

The SEC has already said that it views swing pricing as an optional, not mandatory part of its new liquidity management regime for registered funds. Even those who believe there are potential long-term benefits to investors concede that the number of challenges in implementing swing pricing in the US will make require a lot of money and time before swing pricing becomes common practice among US funds.