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| asset management group

January 13, 2016

Mr. Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release – Comments on Swing Pricing Proposal

File No. S7-16-15

Dear Mr. Fields:

The Asset Management Group (the "**AMG**") of the Securities Industry and Financial Markets Association ("**SIFMA**") appreciates the opportunity to provide comments to the United States Securities and Exchange Commission (the "**Commission**" or "**SEC**") on the Commission's proposal to permit swing pricing by open-end funds on an optional basis (the "**Swing Pricing Proposal**" or "**Proposal**").[1] While the Proposal is part of a broader rulemaking, which also includes proposed requirements for open-end funds to adopt liquidity risk management programs, this letter addresses only the AMG's comments on swing pricing. Our comments on liquidity risk management programs, reporting, and related aspects of the rulemaking are provided in a separate letter.[2]

The AMG is the voice for the buy side within the securities industry and broader financial markets, which serves millions of individual and institutional investors as they save for retirement, education, emergencies, and other investment needs and goals. The AMG's members represent U.S. asset management firms whose combined assets under management exceed $30 trillion. The clients of AMG member firms include, among others, registered investment companies, separate accounts, ERISA plans, and state and local government pension funds. Our members, in their capacity as fiduciaries for the

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[1] 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, 2015) (the **"Proposing Release"**).

[2] Letter from Timothy W. Cameron, Head, and Lindsey Weber Keljo, Vice President & Assistant General Counsel, SIFMA AMG, to Brent J. Fields, Secretary, SEC (Jan. 13, 2016) (the **"Liquidity Comment Letter"**).

millions of investors they serve, are deeply committed to ensuring the Commission's continuing ability to fulfill its three-fold mission: investor protection; maintenance of fair, orderly, and efficient markets; and facilitation of capital formation. We believe that the AMG offers a valuable and unique perspective on the areas where the Commission has requested comments. Our members represent a significant and representative cross section of the registered open-end investment companies that are the subject of the Proposal. Our response to the Commission's request for comment brings together the practical experience and insight of investment, operations, finance, legal, and other relevant personnel from across the broad range of our member organizations.

I. Introduction and Executive Summary

A. The Swing Pricing Proposal

On September 22, 2015, the Commission proposed a multi-layered set of reforms that seeks to promote effective liquidity risk management throughout the open-end fund industry.[3] As one of these reforms, the Commission is proposing amendments to rule 22c-1 under the Investment Company Act of 1940 (**"1940 Act"**) that would permit an open-end fund other than a money market fund or exchange-traded fund (**"mutual fund"**) to use **"swing pricing,"** the process of adjusting a fund's net asset value per share (**"NAV"**) in a manner intended to effectively pass on the costs stemming from shareholder purchase or redemption activity to the shareholders associated with that activity. The Proposal is designed "to promote *all* shareholders' interests and promote practices that seek to ensure that a fund's shares are purchased and redeemed at a fair price."[4] As the Proposing Release notes, swing pricing has been used effectively in certain foreign jurisdictions, in particular Europe, to mitigate shareholder dilution associated with other shareholders' capital activity, and now represents the trend in European open-end funds.[5]

B. Summary of SIFMA AMG Position

We support the concept of swing pricing as a potential tool that mutual funds may use to mitigate potential dilution by passing on purchase and redemption costs to the transacting shareholders, rather than having those costs borne by remaining shareholders. We also support the Commission's goals of promoting all shareholders' interests and ensuring that mutual fund shares are purchased and redeemed at a fair price. We agree with the Commission that swing pricing practices in Europe have been viewed as successful and effective as a means of mitigating shareholder dilution associated with other shareholders' capital activity.

However, because of operational processes in the United States that differ significantly from those in Europe, we believe that swing pricing currently poses significant implementation

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[3] These reforms are part of a broader set of initiatives to address the impact of open-end fund investment activities on investors and the financial markets in light of the increasingly complex composition and operations of the asset management industry. The broader context of the Swing Pricing Proposal, including the other Commission initiatives, are described in the Liquidity Comment Letter.

[4] Proposing Release, *supra* note 1, at 62328 (emphasis in original).

[5] *Id.* at 62327.

challenges in the U.S. Unlike in Europe, most funds in the U.S. must calculate and disseminate NAV at a time before they have received fund flow information from most distribution channels. Accordingly, most U.S. funds will not, even based on reasonable inquiry, have sufficient information about fund flows at the time NAV is struck to determine whether the swing threshold has been breached and thus NAV should be adjusted. This determination is important to the proper functioning of swing pricing, because the swing threshold is the point at which a fund estimates that net purchases or net redemptions are likely to cause material dilution, and thus the point at which the goals of swing pricing – protection of the fund against dilution and fairness to all shareholders – outweigh the potential disadvantages – performance volatility, increased tracking error, and lack of transparency to shareholders.

We believe that these operational impediments pose a threshold feasibility challenge to funds wishing to use a swing pricing option, and that the Commission should make it a priority in connection with its swing pricing rulemaking to address and help resolve the feasibility issue.

With respect to the content of the Proposal, we recommend a number of changes to the rule as proposed that would align the rule more closely with the practices that have proven successful in Europe, and thus take full advantage of the experience and lessons learned from swing pricing in Europe.

The following is a summary of our recommendations:

- Swing pricing requires that funds have access to timely information on net inflows and outflows sufficient to permit a reasonably accurate assessment of when a fund's swing threshold would be exceeded before NAV is determined and published. To achieve an operational framework in the U.S. that provides fund flow information within this time frame, we request the Commission's assistance in exploring and implementing options for making the necessary industry-wide operational changes.

- The swing pricing option requirements for the determination of the swing factor should follow practices used in Europe, which have worked effectively and gained investor acceptance. In particular: (1) in determining the swing factor, the rule should permit but not require consideration of market impact costs and (2) the Commission should make clear that the swing factor may be determined on a periodic basis, rather than calculated anew each day that the swing factor is applied.

- Swing pricing should not be used to determine asset-based performance fees payable to the fund adviser.

- The rule should include a safe harbor making clear that (1) a determination that the swing threshold has been exceeded or (2) application of the swing factor determined in accordance with the method set forth in the policy, in either case made on reasonable inquiry, will not subject the fund, the manager, or any individual involved in the determination to any liability, absent knowing or reckless behavior. The safe harbor should also provide that funds will not face any liability for not adopting a swing pricing policy. Finally, the rule should make clear that where NAV is "swung" based on reasonable inquiry, a later determination that the swing threshold was not met will not constitute an "error" subject to the fund's error correction policy.

- If a swing pricing option is adopted, there should be at least a one-year period following adoption before the swing pricing option is available, in order to permit a level playing field between organizations that have implemented swing pricing in Europe and those for which it would be a new process.

We generally support the Commission's proposed disclosure and reporting-related amendments.

II. Description of the Proposed Swing Pricing Option

A. Option to Adopt Swing Pricing Policies and Procedures

Under proposed rule 22c-1(a)(3), a mutual fund would be permitted to establish and implement policies and procedures (a **"swing pricing policy"**) that would require the fund to adjust its current NAV on any day that a stated percentage of net purchases or net redemptions (the **"swing threshold"**) is exceeded, by applying a **"swing factor"** determined in accordance with the swing pricing policy to all purchase and sale orders received on that day.

The rule defines the term "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 [proposed rule 22c-1(a)(3)]."[6] The operative provision of rule 22c-1(a)(3) states that, notwithstanding the other provisions of rule 22c-1(a) – which requires that fund shares be sold at a price based on NAV next computed after a transaction order is received – a fund "may use swing pricing to adjust its 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, provided that it has established and implemented swing pricing policies and procedures in compliance with [the proposed rule]."

B. Required Elements of a Swing Pricing Policy

Under the Proposal, a fund's swing pricing policy must include the following elements:

1. Mandatory NAV Adjustment under the Policy

The policy must require the fund to adjust its NAV per share by the swing factor once the level of net purchases into or net redemptions from the fund has exceeded the fund's swing threshold (based on reasonable inquiry, as discussed below, and excluding purchases or redemptions in kind).[7] That is, while adopting a swing pricing policy is optional, once a fund adopts such a policy it must use swing pricing when the swing threshold specified in the Policy is exceeded, unless the Board approves termination or suspension of the policy.

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[6] Proposed rule 22c-1(a)(3)(v)(C).

[7] Proposed rule 22c-1(a)(3)(i)(A).

2. Swing Threshold

The policy must specify the fund's swing threshold – defined as "the amount of net purchases into or net redemptions from a fund, expressed as a percentage of the fund's net asset value, that triggers the initiation of swing pricing"[8] – based on consideration of four specified factors: (1) historical fund flows in normal and stressed markets; (2) the fund's investment strategy and portfolio liquidity; (3) the fund's holdings of cash and cash equivalents, borrowing arrangements, and other funding sources; and (4) transaction costs in the relevant markets.[9]

The policy must provide for the periodic review of the swing threshold using the same factors, no less frequently than annually.[10]

3. Swing Factor

The policy must specify how the swing factor – defined as "the amount, expressed as a percentage of the fund's net asset value and determined pursuant to the fund's swing pricing procedures, by which a fund adjusts its net asset value per share when the level of net purchases into or net redemptions from the fund has exceeded the fund's swing threshold"[11] – shall be determined, and whether the swing factor would be subject to any upper limit.[12] These determinations must take into account the following specified considerations: (1) near-term costs expected to be incurred as a result of net purchases or redemptions, including (a) market impact costs, (b) spread costs, (c) transaction fees and charges, and (d) borrowing costs; and (2) the value of assets purchased or sold on the swing day as a result of net purchases or sales, if that information would not already be reflected in that day's NAV.[13]

C. Board Approval and Oversight Requirements

1. Board Approval of Policy, Material Changes, and Termination or Suspension

The fund's board of directors, including a majority of independent directors, must approve the swing pricing policy (including the fund's swing threshold, the method for determining the swing factor, and any upper limit on the swing factor), as well as any material change thereto, and any decision to suspend or terminate the swing pricing policy.[14]

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8 Proposed rule 22c-1(a)(3)(v)(D).

9 Proposed rule 22c-1(a)(3)(i)(B).

10 Proposed rule 22c-1(a)(3)(i)(C).

11 Proposed rule 22c-1(a)(3)(v)(B).

12 Proposed rule 22c-1(a)(3)(i)(D).

13 *Id.* The phrase "near-term" is meant to reflect that investing proceeds from net purchases or satisfying net redemptions could involve costs that may not be incurred by the fund for several days. *See* Proposing Release, *supra* note 1, at 62337.

14 Proposed rule 22c-1(a)(3)(ii)(A).

2. Board Designation of Responsible Persons

The board must designate the fund's adviser or officers responsible for administering the swing pricing policy (provided that the determination of the swing factor must be reasonably segregated from the portfolio management function).[15]

D. Recordkeeping

A fund would be required to abide by certain recordkeeping requirements relating to its swing pricing policies and procedures and any NAV adjustments made pursuant to these policies and procedures.[16]

E. Standard of Care for Swing Threshold Determination

In determining whether the fund's level of net purchases or net redemptions has exceeded the fund's swing threshold, the person(s) responsible for administering the fund's swing pricing policies and procedures would be permitted to make such determination on the basis of information obtained after reasonable inquiry.[17] The proposed rule does not include any other provisions relating to standard of care or addressing errors in application of the swing policy.

III. Background and Objectives of the Proposal

A. Potential Benefits of Swing Pricing

The main goal of swing pricing is to mitigate potential dilution of fund shareholders.[18] Swing pricing accomplishes this goal by adjusting NAV in a manner designed to effectively pass on to purchasing or redeeming shareholders more of the costs stemming from their trading activity.[19] The Proposal also has an important fairness component. It is designed "to promote all shareholders' interests and promote practices that seek to ensure that a fund's shares are purchased and redeemed at a fair price."[20] In order to accomplish these goals, the proposed swing pricing rule would impose conditions intended to ensure

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15 Proposed rule 22c-1(a)(3)(ii)(B).

16 Proposed rule 22c-1(a)(3)(iii).

17 Proposed rule 22c-1(a)(3)(i)(A).

18 The Commission is proposing rule 22c-1(a)(3) "[b]ecause we believe that swing pricing could be a useful tool in mitigating potential dilution of fund shareholders." Proposing Release, *supra* note 1, at 62328.

19 *Id.* at 62274.

20 *Id.* at 62328. In this respect, the Commission emphasizes that, as the Commission previously stated in the release accompanying adoption of rule 38a-1, the mutual fund pricing requirements are "critical to ensuring fund shares are purchased and redeemed at fair prices and that shareholder interests are not diluted." *See* Compliance Programs of Investment Companies and Investment Advisers, Release Nos. IA-2204, IC-26299 (Dec. 17, 2003), 68 Fed. Reg. 74714, 74718 (Dec. 24, 2003); *see also* Proposing Release, *supra* note 1, at 62328 n.424.

that a fund's use of swing pricing would be "an effective tool to prevent fund dilution and promote fairness among all its shareholders."[21]

As discussed in the Proposing Release, swing pricing has been successfully used as an anti-dilution tool by funds in Europe, specifically as a means to "mitigate shareholder dilution associated with other shareholders' capital activity."[22] Survey information cited by the Commission, as well as updated information published subsequent to the Proposal, has confirmed a strong directional trend towards the adoption of swing pricing among major market participants organized in Luxembourg, which is a significant jurisdiction for the organization of UCITS funds, the European analogue to U.S. registered mutual funds.[23] The Proposal is designed to provide a similar option for U.S. funds, based on the success and investor acceptance of the experience the Commission has observed in Europe.[24]

While the primary purpose of swing pricing, as described both in the Proposing Release and in reports on swing pricing in Europe, is to serve as a tool for mitigating dilution by passing on transaction costs to the transacting shareholders, the Proposing Release identifies other potential benefits as well. The Commission believes that swing pricing more generally may be another tool to manage liquidity risks for mutual funds.[25] In addition, the Commission believes that swing pricing could also help deter redemptions motivated by any first-mover advantage, explaining that if remaining shareholders understood that redeeming shareholders would bear the estimated costs of their redemption activity, it would reduce their incentive to redeem quickly because there would be less risk that they would bear the costs of other shareholders' redemption activity.[26]

B. Potential Disadvantages of Swing Pricing

The Commission recognizes that swing pricing has potential disadvantages as well as potential benefits. The potential disadvantages of swing pricing identified in the Proposing Release are:

- increased performance volatility and potential tracking error caused by the NAV adjustments;

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[21] Proposing Release, *supra* note 1, at 62328.

[22] *Id.* at 62286.

[23] *See* Association of the Luxembourg Fund Industry, Swing Pricing: Survey, Reports & Guidelines (Feb. 2011), *available at* http://www.alfi.lu/sites/alfi.lu/files/files/Publications_Statements/Brochures/ALFI_Swing_Pricing.pdf (**"ALFI Report"**); *see also* Association of the Luxembourg Fund Industry, Swing Pricing: Survey Update 2015 (Dec. 2015), *available at* http://www.alfi.lu/sites/alfi.lu/files/ALFI-Swing-Pricing-Survey-2015-FINAL.pdf ("**2015 Update**"); Association of the Luxembourg Fund Industry, Swing Pricing: Guidelines (Dec. 2015), *available at* http://www.alfi.lu/sites/alfi.lu/files/Swing-Pricing-guidelines-final.pdf (**"2015 Guidelines"**).

[24] "We believe that the swing pricing policies contemplated by the proposed rule, which are similar to those used by some foreign funds, could mitigate dilution arising from shareholders' purchase and redemption activity." Proposing Release, *supra* note 1, at 62329.

[25] *Id.* at 62286.

[26] *Id.* at 62329.

- lack of transparency to investors (because the precise impact of swing pricing on particular purchase and redemption requests would not be known to them in advance); and

- adverse impact on small shareholders that are not significantly contributing to dilution (application of a swing factor would affect all purchasing and redeeming shareholders equally, regardless of whether the size of an individual shareholder's purchases or redemptions alone would create material trading costs for the fund).[27]

With respect to performance volatility and tracking error, the Proposing Release identifies a number of potential negative consequences. Performance volatility and tracking error resulting from swing pricing could:

- result in investors incorrectly perceiving the short-term relative performance of a fund;

- potentially cause market distortions if investors were to incorrectly rate the performance of funds that use swing pricing compared to funds that do not, and shift their invested assets from funds that use swing pricing to funds that do not as a result of this perception; and

- activate alerts in monitoring systems that follow fund performance, which could in turn trigger purchases or redemptions in automated fund advisory services whose algorithms are driven by fund performance.[28]

C. Mitigation of Potential Harm through Partial Swing Pricing

While recognizing these potential disadvantages, the Commission states that it has designed the Proposal to maximize the relative advantages and respond to potential concerns associated with swing pricing.[29] The primary provision that the Proposal includes as a means of combatting these disadvantages is the provision permitting only partial swing pricing – adjustment of NAV **only** when the swing threshold has been exceeded – rather than "full" swing pricing. Under partial swing pricing, NAV adjustments are triggered only when net capital activity reaches a threshold that the fund has determined indicates material dilution.[30] Limiting NAV adjustments to days when capital activity would otherwise cause

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27 *Id.* at 62330.

28 *Id.* The ALFI Report also comments on the potential increase in volatility, noting that swing pricing could increase the volatility of a fund's NAV in the short term, which could increase tracking error and could make a fund's performance deviate from the fund's benchmark during the period of volatility to a greater degree than if swing pricing had not been used. ALFI Report, *supra* note 23, at 24.

29 Proposing Release, *supra* note 1, at 62366.

30 Estimating the threshold at which "material dilution" will occur will require a complex and highly differentiated analysis that will, by necessity, vary for different funds. This is the case in Europe, where it is a common industry practice for funds within a fund complex each to have an individual swing threshold. Also for this reason, the Commission is not proposing a swing threshold floor. The Commission believes that different levels of net purchases and net redemptions would create a risk of dilution for funds with different strategies, shareholder bases, and other liquidity-related characteristics, and thus it would be difficult to determine a swing threshold floor that would be appropriate across the scope of funds that would be permitted to use swing pricing. *Id.* at 62335.

material dilution is designed to maximize the benefits of swing pricing while minimizing potential disadvantages. Partial swing pricing addresses the potential harms of swing pricing in a number of different ways.[31]

First, partial swing pricing is designed to minimize NAV volatility (and related tracking error) associated with swing pricing to the extent possible through a number of features of the proposed rule. The Commission states that "partial swing pricing," where NAV adjustment is tied to net capital activity that is likely to cause dilution, would significantly reduce the performance volatility potentially associated with swing pricing.[32]

Partial swing pricing is also designed to address transparency concerns raised by the fact that investors will not know the threshold.[33] "Although funds would not be required to disclose their swing threshold, the use of partial swing pricing as opposed to full swing pricing could give shareholders comfort that, under circumstances in which the fund is experiencing relatively low purchases or redemptions, the fund's NAV will likely not be adjusted."[34] In other words, shareholders should be able to assume, as a basis for their expectations on pricing and performance, that NAV will not be adjusted unless the board-determined swing threshold has been breached.[35]

Finally, the enforcement of a threshold by use of partial rather than full swing pricing is intended to address the concern for small shareholders, whose transactions themselves do not cause dilution. The Commission states that these concerns are partially mitigated by the fact that "shareholders could be assured that the same threshold level of net purchase and net redemption activity (as approved by the fund's board) would consistently trigger the use of swing pricing," absent a board-approved changed in

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31 The Commission recognizes that the Proposal does not specify a minimum floor for a fund's swing threshold, and thus the fund could, in theory, set a swing threshold representing a very low level of net purchases or net redemptions that would be similar to "full" swing pricing (adjusting the fund's NAV whenever there is any level of net purchases or net redemptions). However, the Commission does not anticipate that a fund would generally wish to set a very low swing threshold, because it believes that the fund would not want to incur the increased NAV volatility associated with full (or nearly full) swing pricing. *Id.* at 62335.

32 *Id.* at 62330. The Commission also states that swing pricing should have a minimal effect on longer-term performance volatility and longer-term tracking error. *Id.*

33 The Proposal would not require disclosure of the swing threshold, and European funds typically do not disclose this information, to avoid investors attempting to arbitrage and trade under the threshold over a number of days. *See* 2015 Update, *supra* note 23, at 12. The Commission is also concerned that disclosure of the swing threshold could be confusing or potentially misleading insofar as it could give an inaccurate view of funds' relative risks and benefits. *See* Proposing Release, *supra* note 1, at 62330–31.

34 Proposing Release, *supra* note 1, at 62331.

35 The Commission also has proposed disclosure and reporting requirements regarding swing pricing that are designed to improve transparency by helping investors understand risks associated with investing in funds that use swing pricing. Proposed disclosure and reporting requirements regarding swing pricing would assist shareholders in understanding whether a particular fund has implemented swing pricing policies and procedures and has used swing pricing. Information that will not be transparent to shareholders, in addition to the swing threshold, include comparisons among funds of swing factors and the frequency of NAV adjustments under different fund policies. *See* Proposing Release, *supra* note 1, at 62330 – 31.

the swing threshold.[36] In effect, the Commission is relying on a high level of certainty or "assurance" that swing pricing would only be triggered when the level of net purchase and net redemption activity that the board has determined creates a dilution issue is exceeded.[37]

D. Swing Pricing in Europe

1. The 2011 ALFI Survey

As discussed in the Proposing Release, many open-end funds in Europe currently use swing pricing as a means of protecting fund investors from the dilution impact of trading costs.[38] The main source of information about swing pricing in Europe cited in the Proposing Release is a report published by the Association of the Luxembourg Fund Industry (**"ALFI"**) in 2011 setting forth the results of the survey referred to above (the **"ALFI Report"** or the **"2011 Report"**).[39] The 2011 Report includes two parts. Part I sets forth the results of a survey on swing pricing practices conducted (the **"ALFI Survey"**), while Part II sets forth swing pricing guidelines (the **"ALFI Guidelines"**). As recognized by the frequent references in the Proposing Release to the ALFI Report as support for the Proposal, the ALFI Report

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[36] *Id.* at 62330. The Commission makes a similar point in connection with its discussion of board approval of the swing threshold: "Furthermore, the proposed approval requirements would serve to assure shareholders that the same level of net purchase or net redemption activity would consistently trigger the use of swing pricing, unless the fund's board and a majority of the fund's independent directors were to approve a change in the fund's swing threshold." *Id.* at 62339.

[37] Furthermore, the Commission believes that investors who purchase shares on a day that a fund adjusts its NAV downward would not create dilution for non-redeeming shareholders (even though the purchasing shareholders may be receiving a lower price than would be the case if the NAV were not adjusted downward). The Commission states that, in fact, these shareholders' purchase activity would provide liquidity to the fund, which could decrease the swing factor (and the extent of the NAV adjustment) by reducing the fund's liquidity costs. In the Commission's view, this could potentially help redeeming shareholders to receive a more favorable redemption price than they otherwise would have if there had been less purchase activity on that day, but would not affect the interests of non-redeeming investors. *Id.* at 62367.

[38] The European Commission's 2009 revised Undertakings for Collective Investment in Transferable Securities (**"UCITS"**) Directive does not specifically provide for swing pricing, but does provide that "[t]he rules for the valuation of assets and the rules for calculating the sale or issue price and the repurchase or redemption price of the units of a UCITS shall be laid down in the applicable national law, in the fund rules or in the instruments of incorporation of the investment company." Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations, and administrative provisions relating to undertakings for collective investment in transferable securities, 2009 O.J. (L 302/32) at Article 85, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:en:PDF.

[39] *See* ALFI Report, *supra* note 23. The Commission also relies, to a lesser extent, on a number of policy statements issued by major fund groups in Europe, which explain swing pricing to investors. *See, e.g.,* J.P. Morgan Asset Mgmt., Swing Pricing: The J.P. Morgan Asset Management approach in the Luxembourg domiciled SICAVs JPMorgan Funds and JPMorgan Investment Funds (April 2015), *available at* http://www.jpmorganassetmanagement.de/DE/dms/Swing%20Pricing%20[MKR]%20[IP_EN].pdf; Legg Mason Global Asset Mgmt., Swing Pricing Policy From 30 June 2014 (June 2014), *available at* http://services.leggmason.com/globalmdl/documents/D16500/D16572-LMGF-dilution-adjustment-info-en.pdf; BlackRock, Swing Pricing: The Dilution Effects of Trading Activity (Dec. 2011), *available at* http://www2.blackrock.com/content/groups/internationalsite/documents/literature/1111157589.pdf; Russell Investments, Swing pricing: An overview (Sept. 2008), *available at* http://www.openworldinvesting.com/files/PDFs/Overview_Brochures/Swing_Pricing_Overview_2008_09.pdf.

provides a wealth of information about swing pricing in practice as well as "best practices" and other lessons learned from the European experience.

The ALFI Survey was conducted in 2010, following guidance on swing pricing issued by ALFI in 2006, and was designed to research what had happened in the industry since publication of the 2006 guidance. ALFI distributed the survey questions to the top 30 Luxembourg domiciled firms by assets under management (**"AUM"**), representing 77.73% of Luxembourg AUM as of the end of 2009, and also generally sent notice of the survey to all of its members. ALFI received a total of 19 responses, representing a wide geographic diversity in terms of their cultural center and location of corporate headquarters, and over half of Luxembourg AUM.

The ALFI Survey reported that of the 19 responses received, 13 fund firms were using swing pricing as an anti-dilution technique. This reflected a significant increase since 2006, which the ALFI Survey suggests may have been expected given the impact the 2008 credit crisis had on spreads (which widened significantly) and fund liquidity (volatility on flows). Nine firms had adopted swing pricing after the 2006 guidance, mainly around the time of the financial crisis. While the ALFI Survey noted some grey areas in adoption of swing pricing (such as reporting, disclosures and tax impact), responses indicated that the overwhelming majority of market participants who had adopted swing pricing had found it beneficial.

The ALFI Survey addressed all aspects of swing pricing practices and goes into considerable detail about the information received. For purposes of the Proposal and our recommendations, we found the following findings reported in the ALFI Survey to be the most relevant:

- Investor protection against dilution was recognized as the overwhelming aim of implementing swing pricing for many respondents.

- The majority of respondents used a partial swing approach, with a select few choosing the full swing method. The rationales for partial swing pricing varied, with some firms doing so to limit the frequency of NAV adjustments and thus reduce NAV volatility, while others believed their products had sufficient liquidity to manage small flows and were only concerned with material events triggering dilution.

- When asked whether, with the benefit of hindsight, the effort to implement swing pricing was worth it, the majority of firms were extremely positive about the effect. The main reasons for the positive reaction were investor protection, resultant performance, and positive client perception of the firm as protecting the long-term interests of the shareholders.[40]

- Most firms calculated the swing factor based on: (1) the bid-offer spread of the underlying portfolio of investments; (2) transaction costs; and (3) taxes.

- The most common frequency of the review of swing factors was quarterly. Some firms reviewed the swing factors as regularly as monthly, while, at the other extreme, several reviewed the swing factor

[40] The survey notes that one firm, which had recently implemented swing pricing, had found the process complex and drawn out, and wished to reserve judgment. *See* ALFI Report, *supra* note 23, at 7.

on a bi-annual basis. If market conditions became more volatile, factors tended to be reviewed more regularly.

2. The 2015 Update

Following the Commission's publication of the Proposal, ALFI issued a report on an updated survey on swing pricing (the **"2015 Update"**).[41] ALFI describes the reasons for the 2015 Update as follows:

> In 2015, swing pricing remains one of the most commonly discussed topics within the Luxembourg fund industry and increasingly in other jurisdictions. Since the formation of the original ALFI working group in 2006, the theory and practice has continued to evolve and be debated by market participants from across the asset management sector. Ultimately the goal was then, and remains today, to protect investors against the effects of dilution. This has led to a number of other jurisdictions considering or permitting the use of swing pricing within their domestic markets such as France in 2014.[1] More recently, industry participants in the United States have been debating whether it could be used as an effective dilution and liquidity management tool. This has led the SEC to issue a consultation proposal to amend the Investment Company Act to allow swing pricing. [2]
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> > [1] http://www.afg.asso.fr/index.php?option=com_content&id=5550%3Acharte-de-bonne-conduite-pour-le-swing-pricing-et-lesdroits-dentree-et-de-sortie-ajustables-acquis-aux-fonds-&lang=en
> >
> > [2] SEC announce proposals to amend the Investment Company Act to permit swing pricing September 22, 2015 http://www.sec.gov/news/statement/open-end-fund-liquidity-risk-management-programs--sept-22-2015.html[42]

The 2015 Update states that as a result of greater industry analysis and increased international focus, ALFI reconvened its swing pricing working group in the summer of 2015, with two main goals: (1) to launch a new broader survey in comparison to the 2011 survey in order to understand how asset managers are using the swing price mechanism currently and how this has developed since 2011; and (2) to provide updated guidance on best practices and trends in the industry.[43] For the 2015 survey, ALFI targeted the largest 65 asset managers exclusively, from whom 45 responses were received, representing more than double the responses received in 2011 and covering 69% of the Luxembourg market AUM. ALFI viewed this enhanced data set as providing a high level of comfort that the information received is representative of the industry as a whole.

The 2015 Update provides substantially more detailed information about how swing pricing is currently applied, common trends, emerging themes, and the challenges the industry faces in this regard. The following are the points from the 2015 Update that we believe are most relevant to the Proposal:

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[41] 2015 Update, *supra* note 23.

[42] *Id.* at 6. Note that while the 2015 Update refers to the Commission as proposing to amend the 1940 Act, the Proposal would amend a Commission rule, not the 1940 Act itself.

[43] Like the 2011 survey contained in the ALFI Report, the 2015 Update is accompanied by guidelines, this time in a separate document, which were also revised to take into account developments since the 2011 Report. *See* 2015 Guidelines, *supra* note 23.

- The trend observed in 2011 towards greater adoption of swing pricing in the industry has continued. A greater number of participants responded to the survey and a greater number of those responding have implemented swing pricing. Half of the sample population who responded but were not applying swing pricing stated they were in the process of evaluating it and wanted to understand more about the key principles, drivers, and theories.

- The overwhelming majority of respondents that apply swing pricing (97%) use partial swing pricing, either exclusively or in addition to the full swing pricing method. The main reason stated for using partial swing pricing was to prevent the NAV volatility created by full swing pricing – consistent with the comments received in 2011. Another commonly stated reason was targeting material dilution in situations where cash levels are held to manage smaller redemption flows.

- With respect to determination of the swing factor, the 2015 Update provides data on three significant points:

  i. Eighty percent of asset managers who operate swing pricing use a pre-determined swing factor to apply the swing adjustment;

  ii. When considering the constituent components of swing factors, all asset managers calculate these based on a combination of (i) bid-offer spread impacts, (ii) transaction costs and (ii) transaction taxes associated with purchasing or selling portfolio investments. Within this population, 80% use all three components in their factors; only 10% include market impact costs in their swing factors.[44]

  iii. With respect to frequency of review of swing factors, almost half of asset managers (47%) continue to review swing factors on a quarterly basis, 20% review factors monthly, and 13% routinely operate both a monthly and quarterly review. At the extremes, one respondent reviews factors on a weekly basis, while one asset manager does so "even upon each NAV swing for variable swing factors."[45] At the other end of the spectrum one asset manager performs a review every six months. The majority of asset managers (80%) have the ability to update swing factors when required depending on prevailing market conditions.

- The most commonly applied threshold is 1% or less, with over half of all responses at threshold intervals of 3% or less. Ten respondents apply a single threshold across all products, while 19 differentiate thresholds by fund, with a clear bias to differentiating specific to each individual fund or asset class.

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44 The 2015 Update notes that "[t]his topic is a recurring theme in the comments section of the survey, and several respondents raised interest in understanding more about how these costs might be incorporated into the calculation." 2015 Update, *supra* note 23, at 10.

45 *Id.* at 12.

IV. General Comment on the Swing Pricing Proposal

A. The Commission's Request for General Comments

The Commission has asked for comments generally on the swing pricing process as contemplated by the proposal, as well as specific comments on various aspects of the rule. With respect to the request for general comments, we wish to respond to three questions in particular: (i) whether commenters agree that swing pricing could be a useful tool for U.S. registered funds in mitigating potential dilution of fund shareholders; (ii) what types of operational challenges would arise with swing pricing as opposed to external fees; and (iii) whether the proposed swing pricing framework, in particular the use of partial swing pricing, responds as effectively as possible to the potential concerns associated with swing pricing, including price volatility and lack of transparency. Our responses to requests for specific aspects of the Proposal are addressed below in connection with the discussion of those aspects.

We believe the answers to these three questions pose a threshold feasibility issue that must be addressed before funds will be able to use swing pricing in the U.S.

B. Overview

While we agree that swing pricing, and specifically partial swing pricing, would, in concept, be a useful tool for U.S. mutual funds in mitigating potential dilution of fund shareholders, we believe this will require substantial changes to the current operational processes in existence in the U.S. There are three components to our belief that changes are necessary.

First, we agree with the Commission's determination to propose only partial swing pricing, and not full swing pricing. We believe the Commission has correctly weighed the potential benefits to funds and shareholders against the potential harm that can result from swing pricing, and has correctly determined that partial swing pricing is essential to that balance.

Second, partial swing pricing requires that net cash flows for a fund be known, or reasonably estimated, before determining whether to adjust the fund's NAV on a particular day. This key requirement for partial swing pricing generally cannot be satisfied under current U.S. operational processes. Based on the operational processes that currently dictate the timing of NAV calculation and fund flow determination for mutual funds in the U.S., as further described below, NAV is calculated and published before the fund has or can obtain information about fund flows sufficient to reasonably estimate net capital activity.[46]

Finally, we believe that determination of whether the swing threshold has been breached – and thus whether adjusting NAV for transacting shareholders is a fair and effective tool for combatting dilution – is an important component of swing pricing, and thus availability of the information necessary to make this determination needs to be addressed.

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[46] This is recognized in the Proposing Release. *See* Proposing Release, *supra* note 1, at 62340 – 42. Similarly, the ALFI Guidelines define partial swing pricing as the adjustment of NAV "only when a predetermined net capital activity (i.e. the swing threshold) is exceeded." ALFI Report, *supra* note 23, at 13. The ALFI Report also states that swing pricing generally operates "once the net capital activity is calculated." *Id.* at 14.

C. Availability of Fund Flow Information in the U.S.

As described below, the operational impediment to implementation of swing pricing in the U.S. is that most funds do not currently have substantially complete fund flow information before they are required to strike and publish NAV.

1. Timing of NAV Calculation

Rule 22c-1 generally requires open-end funds to compute NAV at least once each business day, at a time or times designated by the fund's board, and requires fund shares to be purchased or sold at a price based on the NAV next calculated after the purchase or sale order is received by the fund or its designated agent. Commission rules do not dictate when NAV must be calculated, although funds in the U.S. almost universally calculate NAV either at the time of the close of regular trading on the New York Stock Exchange (usually 4:00 pm Eastern Time), or simply at 4:00 pm. (We will refer to the pricing time generally as 4:00 pm.)[47]

Commission rules also do not require dissemination of share prices (NAV), either through Nasdaq or otherwise. However, the vast majority of mutual funds release their daily share prices through Nasdaq, a practice expected and relied on by investors, intermediaries, and advisers. As prices are received by Nasdaq, they are instantaneously transmitted to wire services and other subscribers, such as market data vendors and brokerage houses. Although Nasdaq will accept NAV information until it closes at 8:00 pm Eastern Time, investors expect pricing information to be available earlier, and most large intermediaries require earlier NAV submissions. As a consequence of this practice, funds must calculate NAV and deliver it to Nasdaq within the short period of time (often as little as two hours) between 4:00 pm, when the markets typically close and the information necessary for valuing securities can be collected,[48] and their deadline for transmitting the final NAV to Nasdaq.

2. Timing of Receipt of Fund Flow Information

Investors in U.S. mutual funds typically do not submit orders directly to the funds, but to any one of several different types of intermediaries.[49] All order information for a particular fund is ultimately submitted to the fund's transfer agent, which acts as the master recordkeeper for the fund and keeps track of shares sold and redeemed and cash flowing into and out of the fund. Investors who deal directly with the fund by telephone or via the internet typically submit their order information to the fund's transfer agent. The vast majority of fund investors (approximately 80%), however, invest through other

[47] Money market funds calculate NAV at other times and often at multiple times throughout the day.

[48] Rule 2a-4 states that this price must reflect the current market value of the fund's securities, as long as market quotations for those securities are readily available. Other assets should be priced at fair value, determined in good faith by a fund's board of directors.

[49] Amendments to Rules Governing Pricing of Mutual Fund Shares, Release No. IC-26288 (Dec. 11, 2003), 68 Fed. Reg. 70388 (Dec. 17, 2003) (the **"Hard Close Release"**).

intermediaries such as broker-dealers, fund platforms, and retirement plans, which form a network of intermediaries that process and record the transactions.[50]

Instead of submitting individual purchase and redemption orders each day (which could run into thousands of transactions), intermediaries typically net orders received from investors against each other and submit a single file containing net or omnibus purchase or redemption order information to the fund's transfer agent. A substantial portion of purchase and redemption orders are routed to fund transfer agents through the National Securities Clearing Corporation (**"NSCC"**), the registered clearing agency that operates several automated systems for processing fund orders. One such system is Fund/SERV, which is the industry standard for automated clearing and settlement of mutual fund purchase and redemption orders (**"Fund/SERV"**). Fund/SERV provides a central processing system that collects order information from clearing brokers and others, sorts incoming order information according to fund, and transmits the order information to each fund's transfer agent.[51] A related NSCC service is its Defined Contribution Clearance & Settlement service (**"DCC&S"**), which standardizes, centralizes, and automates the processing of mutual fund transactions from defined contribution plans and their recordkeepers and administrators, utilizing Fund/SERV and other NSCC systems.

Under rule 22c-1, although purchase and redemption orders must be submitted to retail dealers and other intermediaries by 4:00 pm in order to receive that day's price, the Commission's rules permit those intermediaries to forward the order information to Fund/SERV or the fund transfer agent through the NSCC Systems (or other means) at a later time.[52] These intermediaries, which include broker-dealers, fund platforms, and retirement plan recordkeepers and administrators, typically process orders received before 4:00 pm in the early evening hours before submitting them to Fund/SERV, DCC&S, or the transfer agent, a process that is typically completed throughout the night and, for some channels (including defined contribution plans), into the next morning.

Much of this information is not received by the fund's transfer agent until a stated time the next morning. Only then would the transfer agent have a complete set of information to determine net capital activity, including whether there have been net inflows or outflows, and the level of such net flows.[53]

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50 Investment Company Institute, Background Information About 12b-1 Fees (Feb. 2003), https://www.ici.org/policy/regulation/fees/ref_12b1_fees.

51 Hard Close Release, *supra* note 49, at 70388 – 89.

52 Hard Close Release, *supra* note 49, at 70389. *See also* SEC Staff Interpretive Position Relating to Rule 22c-1, Release IC-5569 (Dec. 27, 1968) (rule 22c-1 "contemplates that the time of receipt of the order by the retail dealer is controlling" for purposes of determining the price obtained by the dealer); *Charles Schwab & Co.*, SEC No-Action Letter (July 7, 1997) (the time an order was received by a person designated in the fund's prospectus will be deemed the time the order was received for purposes of rule 22c-1).

53 In recognition of how this process works, rule 2a-4 permits this information about capital activity (number of shares outstanding) to be reflected in NAV calculated on the day following receipt of the order (that is, if the orders are received for pricing on Day 1, capital activity that is not known by the transfer agent until the following day would be reflected on Day 2). In accordance with Rule 2a-4, funds typically reflect fund flows for orders placed on a particular business day on the following day.

3. Contrast with Operational Processes in Europe

By contrast, in Europe the timing of NAV calculation relative to order cut-off, and thus receipt of fund flow information, is entirely different, and indeed reversed. Generally, the order cut-off is around mid-day, and distribution channels operate to provide the vast majority of fund flow information to the funds before NAV is struck and disseminated. Therefore, European funds either have actual details or accurate estimates on fund flow information prior to the time they strike and publish their NAVs.

C. The Importance of the Swing Threshold

The swing threshold is a fundamental component of the rule. As explained above, use of the swing threshold is critical to the Commission's determination that the benefits of swing pricing outweigh the disadvantages. Furthermore, the swing threshold represents the point at which management and the board have determined that material dilution is likely and it is fair to charge that amount to transacting shareholders, even small investors whose transactions on their own would not have a material dilutive effect.

Both as contemplated in the proposed rule and as practiced in Europe, funds spend a considerable amount of time and take a highly differentiated approach to determining the appropriate threshold. The proposed rule requires consideration of a number of specific factors. In Europe, as indicated by the 2015 Update, approximately two-thirds of the respondents reported differentiating swing thresholds by fund "with a clear bias to differentiating specific to each individual fund or asset class."[54] In light of the importance of the swing threshold and the thoughtful analysis that funds devote to it, it is appropriate to be concerned about the reliability of information on which it is determined whether or not the threshold has been breached.

D. The Commission's Proposed Solutions

The Proposing Release recognizes both that partial swing pricing requires the net cash flows for a fund to be known, or reasonably estimated, before determining whether to adjust the fund's NAV on a particular day, and that receipt of fund flow information may not be complete by the time the fund strikes NAV.[55] For this reason, the proposed rule builds in a provision for estimates and permits the decision of whether the swing threshold has been breached to be made "on the basis of information obtained after reasonable inquiry."[56]

The Proposing Release also provides guidance, in the form of two proposed solutions, for how funds may obtain more information before NAV is determined. First, the Commission suggests that a fund may wish to arrange for interim feeds of flows from its transfer agent or distributor in order to reasonably estimate its daily net flows for swing pricing purposes. Second, the fund may wish to implement formal or informal policies to encourage effective communication channels between the persons charged with

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[54] 2015 Update, *supra* note 23, at 12.

[55] *See* Proposing Release, *supra* note 1, at 62341.

[56] Proposed rule 22c-1(a)(3)(i)(A).

implementing the fund's swing pricing policy, the fund's investment professionals, and personnel charged with day-to-day pricing responsibility. [57]

We support adoption of a "reasonable inquiry" standard. As discussed below, we believe this goes a long way toward providing funds the assurance they need that applying the swing factor in a situation when final fund flow information indicates that the threshold was not breached will not be considered an "error," or otherwise subject the fund or its employees to liability.

"Reasonable inquiry," however, is not a substitute for obtaining information. And, while we appreciate the Commission's suggested solutions for obtaining the information, we are not optimistic that they will be effective without changes to current industry-wide operational systems, including Fund/SERV, DCC&S, and other NSCC systems. [58]

The current operational processes that govern fund flows are based on a complex infrastructure that has been developed to address the existing regulatory requirements, over the course of decades and at substantial expense. In addition, as a result of centralized and automated processing, which is highly beneficial to investors and funds, the systems that support the current operational processes are deeply interconnected. Additional inquiries to selected intermediaries are not likely to change the fundamental way orders are received and processed or related information flows. Many fund organizations distribute through dozens or even hundreds of separate intermediaries. Even assuming a willingness among some intermediaries to cooperate as best they could, individual efforts are unlikely to result in the level of fund flow information most funds will want to have in order to use swing pricing.

E. SIFMA AMG Recommendation

We recognize the advantages of swing pricing in concept and many of our members have used it successfully in Europe. Because implementation of swing pricing in the U.S. faces the operational difficulties described above, we request that, as the Commission moves forward with its consideration of a swing pricing rule, the Commission take the initiative to assist the industry in resolving the operational difficulties.

We expect that review of industry comments on the Proposal will suggest a number of ways this process can be undertaken. Following this review, one method that suggests itself, and has proven helpful to the Commission and other regulators in the past in the face of new and complex issues, is the holding of a roundtable where all major participants, including intermediaries and shareholder groups as well as funds and managers, can discuss their views with the SEC staff in an interactive forum. We also suggest that

[57] Proposing Release, *supra* note 1, at 62341.

[58] We urge the Commission not to underestimate either the extent of the operational challenges or the difficulties in resolving them. For example, in connection with addressing the swing factor, the Proposing Release states that "persons administering the fund's swing pricing policies and procedures may (to the extent that net purchases or net redemptions cannot be ascertained or reasonably estimated until close to the time that the fund must strike its NAV) have limited time to determine the swing factor each day the fund's net purchases or net redemptions exceed the swing threshold." *Id.* at 62337. This statement indicates an assumption that receipt of fund flow information precedes NAV determination, although the window may be small, whereas the reality is that NAV determination now comes first.

such a roundtable should address the problem of fund dilution from shareholder transactions more generally and, in addition to swing pricing, might include alternatives such as redemption or purchase fees.[59]

In this connection, we note that one element of the timing sequence that creates the issue – receipt of orders by intermediaries up until the pricing deadline – is not an easy one to solve. As indicated above, both rule 2a-4 and rule 22c-1 expressly contemplate this timing, and existing practices are now both deeply entrenched across the industry and expected by investors. For example, one possible step towards a solution, cutting off orders before 4:00 pm, is likely to encounter resistance from both investors and intermediaries. We do not believe there is currently a consensus in the industry that would support an early cut-off in order to facilitate swing pricing.

Another possibility, requiring orders to be received by the fund (or its transfer agent) by 4:00 pm in order to receive the current day's price, rather than permitting receipt by 4:00 pm by intermediaries (sometimes called a "hard close"), has been considered and rejected in the past. In 2003, in the wake of the so-called "late trading" scandals that were revealed in September of that year,[60] the Commission proposed changing these processes through amendments to rule 22c-1 to impose a "hard close" on receipt of fund trades.[61] The Commission determined not to adopt the proposed "hard close" amendments. Reaction from many types of market participants demonstrated the difficulties, and adverse impact on fund investors, that would result from the proposal. The hard close proposal received particularly strong opposition from the SPARK Institute, an educational trade council affiliated with the Society of Professional Administrators and Recordkeepers, which brings together members of banks, insurance companies, mutual fund managers, third party administrators, and benefit consultants providing services to 401(k) and other participant-directed defined contribution retirement plans. The SPARK Institute stated that it believed that adopting a hard 4:00 pm close for mutual fund orders would have a significant adverse impact on American workers participating in 401(k) and other defined contribution retirement plans, and this impact would not be justified by potential benefits to participants as long-term investors.[62] Accordingly, rule

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59 The Commission discusses the possible use of redemption fees (or purchase fees) as an anti-dilution tool in the Proposing Release, but expresses concern that implementing such fees would require coordination with the fund's service providers, which could entail operational complexity. *Id.* at 62327 – 28. Since, as discussed above, swing pricing also would entail operational complexity, we believe that a broad range of possible solutions should be considered.

60 ''Late trading'' refers to the illegal practice of permitting a purchase or redemption order received after the 4:00 pm pricing time to receive the share price calculated as of 4:00 pm that day. Hard Close Release, *supra* note 49, at 70388.

61 *See* Hard Close Release, *supra* note 49.

62 Letter from Robert G. Wuelfing, The SPARK Inst., Inc., to Jonathan G. Katz, Sec'y, SEC (Feb. 6, 2004), *available at* http://www.sec.gov/rules/proposed/s72703/s7-27-03-110.pdf; *see also* Letter from Robert G. Wuelfing, The SPARK Inst., Inc., to William H. Donaldson, Chairman, SEC (Nov. 14, 2003) (describing adverse consequences of hard close for retirement plan participants), *available at* http://www.sec.gov/rules/proposed/s72703/s72703-15.pdf; Letter from Robert G. Wuelfing, The SPARK Inst., Inc., to Paul F. Roye, Dir., Div. of Inv. Mgmt., SEC (Oct. 31, 2003) (describing trade processing procedures typically employed by recordkeepers and other plan service providers), *available at* http://www.sec.gov/rules/proposed/s72703/s72703-4.pdf.

22c-1 continues to permit pricing based on intermediary receipt of orders up until 4:00 pm, and the fund distribution system in the U.S. continues to be built around this framework.[63]

Many of our Members strongly support swing pricing and are committed to working with market participants to make the structural and informational changes necessary to permit it to function. Realistically, these changes may not be possible without Commission support. For that reason we recommend that the Commission not stop at considering adoption of a swing pricing option rule, but also lend its leadership to industry efforts that would enable funds to use it as intended prior to the effective date of the rule.

We note, however, that there is no consensus within the industry on how best to proceed. Because of the important role the swing threshold plays in implementation of partial swing pricing and the severity of the operational impediments described below, 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.

V. Comments on the Proposed Rule

The Commission has asked for comments on a broad range of specific questions relating to each aspect of the Proposal.

A. Calculating the Swing Factor

1. The Commission's Proposal

Under the proposed rule, a fund's swing pricing policy must require the fund to adjust its NAV by an amount designated as the "swing factor" each time the fund's net purchases or net redemptions have exceeded the fund's swing threshold. The policy must also specify how the swing factor will be determined.

In determining the swing factor the fund would be required to consider two sets of costs, which together would represent an estimate of the combined near-term costs associated with purchase or redemption activity.[64]

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63 Another potential complexity in the timing issue arises because a substantial percentage of fund flows comes from defined contribution retirement plans, which hold approximately 27% of mutual fund assets. *See* Investment Company Institute, The U.S. Retirement Market, Third Quarter 2015 (Dec. 2015) (tables 20 and 24), http://www.ici.org/info/ret_15_q3_data.xls. Because plan contributions are often in the form of regular payments in stated dollar amounts, retirement plan platforms often will not provide net order information until they know NAV, as NAV will determine the number of shares subject to the order. Since whether NAV is swung will depend on the flows from these platforms, and the platforms will not provide that information until they know the NAV, this operational process has the potential to set up a classic "Catch-22" scenario, which would require modeling based on historical flows in order to provide reliable estimates.

64 The phrase "near-term" is meant to reflect that investing proceeds from net purchases or satisfying net redemptions could involve costs that may not be incurred by the fund for several days. For example, a fund could use cash to satisfy redemptions, which may result in minimal costs to the fund, but rebalancing the fund's portfolio to rebuild cash balances in the next several days could cause the fund to incur costs that would be borne by the existing shareholders. The rule text specifies that the costs to be considered are those that are expected to be incurred by the fund as a result of the net purchase or net redemption activity that occurred on

First, the Proposal would require the fund to consider any near-term costs that are expected to be incurred by the fund as a result of net purchases or net redemptions occurring on the day the swing factor is used to adjust the fund's NAV per share, including:

- any market impact costs;
- spread costs;[65]
- transaction fees and charges arising from asset purchases or asset sales in connection with those purchases or redemptions; and
- any borrowing-related costs associated with satisfying those redemptions.

Second, determination of the swing factor would require funds to consider the value of assets purchased or sold by the fund as a result of net purchases or net redemptions that occur on the day the swing factor is used to adjust the fund's NAV, if that information would not be reflected in the NAV computed that day.

The Commission defines the **"market impact costs"** that the swing factor must consider as costs that are incurred when the price of a security changes as a result of the effort to purchase or sell the security.[66] As further explained, market impacts are "the price concessions (amounts added to the purchase price or subtracted from the selling price) that are required to find the opposite side of the trade and complete the transaction."[67] The Commission recognizes that market impact cost cannot be calculated directly, but suggests that it can be roughly estimated by comparing the actual price at which a trade was executed to prices that were present in the market at or near the time of the trade.[68]

2. Comment on Swing Factor Determination

We believe that, as proposed, the required factors for determination of the swing factor are overly complex and subjective. We recommend that the Commission adopt an approach that is similar to the approach funds use in Europe and that is set forth in the ALFI Guidelines. In particular, we recommend

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the day the swing factor is used to adjust the fund's NAV; this specification is designed to help ensure that the costs to be taken into account are those that are directly related to the purchases or redemptions at issue. Thus, while the term "near-term costs" does not envision a precise number of days, the Commission believes that, in context, this term would not likely encompass costs that are significantly removed in time from the purchases or redemptions at issue. Proposing Release, *supra* note 1, at 62337.

65 The Commission defines **"spread costs"** as costs that are incurred indirectly when a fund buys a security from a dealer at the "asked" price (slightly above current value) or sells a security to a dealer at the "bid" price (slightly below current value). The difference between the bid price and the asked price is known as the "spread." Proposing Release, *supra* note 1, at 62327 n.416.

66 *Id.* at 62327 n.415.

67 *Id.*

68 *Id.* For this statement, the Commission cites to a 2003 concept release, Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs, Release Nos. 33-8349, 34-48952, IC-26313 (Dec. 18, 2003), 68 Fed. Reg. 74820 (Dec. 24, 2003).

that "market impact" should not be a required factor, and that the Commission should clarify the expectation that the swing factor may be determined on a quarterly or other periodic basis, with adjustments only as necessary to address significant market events.

Because market impact costs require estimates, and are thus difficult to quantify, we recommend that market impact costs be a permissible consideration for determining a fund's swing factor, but not a required consideration. This is consistent with the manner in which the swing factor is determined for European funds, and reflects the approach adopted by the ALFI Guidelines. Section 4 of the ALFI Guidelines (captioned "calculating the swing factor") states that in addition to bid offer spread, which is a key factor to be included in the swing factor, the following items should be considered:

1. Net broker commissions paid by the fund;

2. Custody transaction charges;

3. Fiscal charges (e.g., stamp duty and sales tax);

4. Any initial charges or existing fees applied to trades in underlying investment funds; and

5. Any swing factors or dilution amounts of spreads applied to underlying investment funds or derivative instruments.[69]

The ALFI Guidelines also address market impact. However, the ALFI Guidelines suggest consideration of market impact only in connection with illiquid securities (not as a general rule) and, more importantly, recognize that because of the difficulty of quantifying market impact, it is not a required consideration.[70] The 2015 Guidelines continue to describe market impact as an item that "could be considered."[71] In practice, however, the 2015 Update found that 90% of asset managers do not include market impact costs in their swing factors.[72]

We believe that, as the Proposal is designed to offer U.S. funds a tool similar to swing pricing as successfully used in Europe, the Commission should adopt the European practice to this critical aspect of swing pricing and not require market impact to be considered in determining the swing factor.[73]

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69 The ALFI Survey and the 2015 Update report that most firms calculate the swing factors based on: (1) the bid-offer spread of the underlying portfolio of investments; (2) the transaction costs; and (3) any taxes. ALFI Report, *supra* note 23, at 7; 2015 Update, *supra* note 23, at 10.

70 *Id.* at 16.

71 2015 Guidelines, *supra* note 23, at 12.

72 2015 Update, *supra* note 23, at 10.

73 The Commission recognizes this difference between its Proposal and the ALFI Guidelines. In stating that the proposed costs that a fund would be required to consider in determining its swing factor overlap significantly with costs considered in other jurisdictions, the Commission lists the costs set forth in Section 4 of the ALFI report, which do not include market impact. The Proposing Release states elsewhere that some European funds consider market impact in determining the swing factor, but does not provide a source for that statement. *Compare* Proposing Release, *supra* note 1, at 62336 n.494 (setting forth the considerations in the ALFI

In addition, we recommend that the final rule omit proposed rule 22c-1(a)(3)(i)(D)(2). This paragraph would require the fund to consider "the value of assets purchased or sold by the fund as a result of net purchases or net redemptions that occur on the day the swing factor is used to adjust the fund's net asset value per share, if that information would not be reflected in the current net asset value of the fund computed that day." We find this factor confusing and unclear, and do not believe it corresponds to anything required or commonly used in Europe. It also appears to require the swing factor to take into consideration factors specific to a particular day, and thus would undermine the practice of determining the swing factor on a quarterly or other periodic basis, as described below.

B. Periodic Determination of the Swing Factor

The Proposing Release acknowledges that it may be appropriate for funds to set a "base" swing factor, which would then be adjusted, as appropriate, if certain aspects required to be considered in determining the swing factor deviate from a range of pre-determined norms (for example, if spread costs generally exceed a certain pre-determined level).[74] The Release also requests comment on the extent to which funds may wish to incorporate into their swing pricing policies a formula or algorithm that includes the factors to be considered for determining the swing factor.[75] Finally, the Commission notes that a fund may wish to consider delineating in its policy the frequency with which the persons overseeing swing pricing would meet. For example, a fund's policies and procedures might specify that these persons shall meet periodically, such as monthly or quarterly, or more frequently if market conditions require.[76]

These statements are consistent with the practices identified in the ALFI Survey and continued in the 2015 Update. As described above, the most common frequency of the review of swing factors was quarterly; some providers reviewed these as regularly as monthly or even more frequently, while at the other extreme, one calculated them on a bi-annual basis (i.e., every six months). If market conditions became more volatile, factors tended to be reviewed more regularly. Finally, the Commission states that a fund's swing pricing policy may incorporate the use of reasonable estimates.[77]

We are concerned, however, that the required considerations could be viewed as inconsistent with quarterly review of the swing factor or use of base or algorithmic factors. For example, required consideration of (1) market impact costs and (2) the value of assets purchased or sold by the fund as a result of net purchases or net redemptions that occur on the day the swing factor is used to adjust the

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Guidelines) *with id.* at 62327 (stating that some European funds consider market impact in determining the swing factor).

74 *Id.* at 62337. The Proposing Release suggests that a fund could take a variety of approaches, including the "base" factor approach, in recognition that persons administering the fund's swing pricing policies and procedures may (to the extent that net purchases or net redemptions cannot be ascertained or reasonably estimated until close to the time that the fund must strike its NAV) have limited time to determine the swing factor each day the fund's net purchases or net redemptions exceed the swing threshold. *Id*.

75 *Id.* at 62337.

76 *Id.* at 62339.

77 *Id.* at 62337.

fund's NAV, if that information would not be reflected in the current NAV of the fund computed that day, appear to contemplate a more differentiated approach to calculating the swing factor.

Accordingly, we recommend that the Adopting Release clarify that quarterly or other periodic determination of the swing factor is permitted, with adjustments as the fund deems appropriate to address interim events.

C. Asset-Based Performance Fees

The Proposing Release states that if a fund using swing pricing pays "NAV-based performance fees" to its adviser, the fund's NAV for purposes of calculating performance fees should be the NAV as adjusted pursuant to its swing pricing policies and procedures.[78] We do not agree with this view. Instead, we believe that any asset-based performance fees should be based on the fund's assets, determined without regard to swing pricing adjustments.

We note first that the Proposing Release does not accurately state how performance fees are calculated. In the Proposing Release, "NAV" is defined as "net asset value per share."[79] However, section 205(b)(2) of the Investment Advisers Act of 1940 (**"Advisers Act"**) allows certain performance fees based on the asset value of the fund averaged over a specified period – not the net asset value per share.[80] And the SEC has not proposed to alter the determination of a fund's assets, which will continue to be calculated in accordance with section 2(a)(41) of the 1940 Act and reported in accordance with rule 6-04(1) – (9) of Regulation S-X. Calculation of performance fees to reflect swing pricing would require a recalculation of fund assets for this purpose on each day that swing pricing was implemented, and it is not clear how this calculation would be carried out for funds that base their advisory fees on total rather than net assets.[81]

We also note that ALFI's 2015 Guidelines recommend that the unswung NAV be used when calculating performance fees, noting that "[a]s performance fees are ordinarily crystallised on a specific date, the use of the swung price could significantly distort the performance fee calculation."[82]

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[78] Proposing Release, *supra* note 1, at 62341.

[79] *Id.* at 62276.

[80] As the Commission notes in the Proposing Release, performance fees could also be paid to a fund that is a qualified client under Advisers Act rule 205-3. *Id.* at 62341 n.532. Rule 205-3 does not specify any particular method for the calculation of performance fees.

[81] In addition, this interpretation may not be properly proposed. The Proposing Release was issued under the 1940 Act and the Securities Act of 1933, not the Advisers Act. Under the Administrative Procedure Act, a notice of proposed rulemaking shall include reference to the legal authority under which the rule is proposed. 5 U.S.C. § 553(b)(2). The Proposing Release does not include reference to any legal authority for rulemaking under section 205(b)(2) of the Advisers Act.

[82] 2015 Guidelines, *supra* note 23, at 26.

D. Error Correction; Need for a Safe Harbor

The use of estimates to calculate the swung NAV raises the question whether an NAV as so calculated would be considered an "error" and, thus, subject to the fund's NAV error correction procedures. The Commission's staff has long taken the view that NAV errors should be corrected when discovered, and fund sponsors should reimburse shareholders who have experienced a material economic loss due to the error.[83] In many cases, the standard protocol is that shareholders who benefit from an error are allowed to keep the money, while shareholders who were materially and negatively impacted are made whole.[84] In addition, sponsors generally make the fund whole if the sponsor was responsible for a material pricing error that led to the fund experiencing a loss. In addition to the expense of making the fund and some shareholders whole, while allowing positively affected shareholders to retain their gains, repricing results in administrative expense, as well as inconvenience for both the fund and its shareholders.

The Proposing Release requests comment on whether the Commission should provide guidance as to the circumstances in which a possible misapplication of a firm's swing pricing policy could result in a material NAV error (e.g., whether an error would occur when the fund makes estimates under its swing pricing policy that is applied correctly, but the information, such as final shareholder flows, subsequently changes to a material degree).[85] We believe that a use of swing pricing based on information obtained after reasonable inquiry should not be considered an error subject to a fund's error correction policy, even if there is a material change between the estimated information and the final information. To require error correction in such an event would inconvenience funds and their shareholders and place fund sponsors at financial risk, making swing pricing untenable for funds that must rely on the use of estimates.

Swing pricing determinations necessarily will require the use of judgment in determining swing thresholds and swing factors and the use of estimates in making swing pricing adjustments. However, the resulting records and reports may be subject to the liability provisions of section 34(b) of the 1940 Act, which provides that it shall be unlawful for any person to make any untrue statement of a material fact in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to this title or the keeping of which is required pursuant to section 31(a) of the 1940 Act.

Section 34(b) does not require that a violator act willfully,[86] and the Commission has ruled that scienter need not be found to establish a violation.[87] However, swing pricing determinations will be prepared

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83 Memorandum from Division of Investment Management to Chairman Levitt, SEC, at 17 (Sept. 26, 1994), *available at* https://www.sec.gov/divisions/investment/noaction/1994/mutualfundderivatives092694.pdf.

84 Barrington Partners, An Extraordinary Week: Shared Experiences from Inside the Fund Accounting System Failure of 2015, at 5 (Nov. 2015), *available at* http://mfdf.org/images/uploads/blog_files/SharedExperiencefromFASystemFailure2015.pdf. While it is possible to reclaim gains from clients who did not fully pull the proceeds from their accounts, this approach is generally not pursued due to cost and impact to a client relationship. *Id.*

85 Proposing Release, *supra* note 1, at 62340; *see also id.* at 62342 (requesting comment on whether the Commission should amend the proposed rule or provide guidance regarding pricing errors in the context of swing pricing).

86 *SEC v. Advance Growth Capital Corp.*, 470 F.2d 40, 52 (7th Cir. 1972). A person acts "willfully" under the securities laws if he intentionally did the wrongful acts; no knowledge that he is breaking the law is required.

quickly with limited information and will be readily subject to second-guessing with the benefit of hindsight. To protect funds and other persons with responsibilities under section 34(b) against undue risk under this demanding liability statute, therefore, we believe that the Commission should affirmatively provide that liability for violations of the 1940 Act and the rules thereunder will not attach for errors in swing pricing calculations unless the error is material and the fund or other person acted knowingly or recklessly. In addition, we believe the Commission should make it clear that the decision to adopt swing pricing is optional and no liability will attach to the decision not to adopt swing pricing.

E. Compliance Date

The Commission proposes that, as reliance on rule 22c-1(a)(3) would be optional, a compliance period would not be necessary. However, some fund managers already have extensive experience with swing pricing, while other fund managers will be approaching swing pricing for the first time and, hence, be at a disadvantage. In order to provide a level playing field, we believe the Commission should provide, at such time as the swing pricing rule is adopted and effective, for a compliance date that is one year after the effective date. This delay would provide a period sufficient to give all funds the opportunity to build the necessary systems, rather than giving a head start advantage to funds with experience in swing pricing through their European affiliates.

VI. Disclosure and Reporting

The Commission is proposing several disclosure- and reporting-related amendments. Among these are proposed amendments to Form N-1A to require disclosure regarding swing pricing, if applicable, and to specify financial and performance calculations when swing pricing is used. The Commission is also proposing amendments to Regulation S-X with respect to the treatment of swing pricing in financial statements.

We generally support the proposed amendments to Form N-1A, proposed Form N-CEN, and Regulation S-X.

Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000); *United States v. O'Hagan*, 139 F.3d 641, 647 (8th Cir. 1998).

[87] *Fundamental Portfolio Advisors*, Release Nos. 33-8251, 34-48177, IA-2146, IC-26099 (July 15, 2003).

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SIFMA AMG sincerely appreciates the opportunity to comment and your consideration of these views. We stand ready to provide any additional information or assistance that the Commission might find useful. In particular, we and our members would welcome the opportunity to work with the Commission and other industry representatives to study the changes that would be necessary to the current processes in order to create the infrastructure necessary to support swing pricing. Please do not hesitate to contact either Timothy Cameron at [redacted] or [redacted] or Lindsey Keljo at [redacted] or [redacted] with any questions.

Sincerely,

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