# SEC PROPOSES SWING PRICING FOR INSTITUTIONAL MONEY MARKET FUNDS

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## I. INTRODUCTION

On 15 December 2021, the Securities and Exchange Commission (the SEC) proposed amendments to Rule 2a-7 under the Investment Company Act of 1940, as amended (the 1940 Act) (the Proposed Rule), which governs the structure and operation of money market funds. One key element of the Proposed Rule is a requirement that institutional prime and institutional tax-exempt money market funds (Institutional MMFs) adopt swing pricing policies so that redeeming investors bear the liquidity costs of their redemptions.[1] The Proposed Rule reflects the SEC's concern over market stresses experienced in response to the Covid-19 Pandemic in March 2020 and it is the SEC's belief that such measures will improve the resiliency of Institutional MMFs.

Swing pricing is a process of adjusting a fund's current net asset value (NAV) such that the transaction price effectively passes on costs stemming from shareholder redemptions to redeeming shareholders. As the SEC notes in its proposing release, fund trading activity associated with meeting redemptions may impose costs, including trading costs and costs associated with depleting a fund's daily or weekly liquid assets. These costs are currently borne by the remaining investors in the fund, diluting these investors' interests in the fund. In the SEC's view, this potential for dilution can create incentives for shareholders to redeem quickly to avoid losses, particularly in times of market stress.

Optional swing pricing was first adopted for open-end funds, other than MMFs and exchange-traded funds, when the SEC adopted Rule 22c-1(a)(3) in 2016 as part of its implementation of Rule 22e-4. There are, however, important differences between swing pricing in the Proposed Rule and Rule 22c-1.[2] If adopted as proposed, the

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swing pricing provisions of the Proposed Rule would be mandatory for these funds and implemented within 12 months from the effective date of the amendment.

## II. KEY REQUIREMENTS FOR SWING FACTOR IMPLEMENTATION

The SEC now proposes to require Institutional MMFs to adopt swing pricing policies and procedures to adjust a fund's current NAV per share by a "swing factor," which would be expressed as a percentage discount to a fund's NAV. Swing pricing policies and procedures would have to be approved by a majority of the fund's independent directors and reviewed annually. The swing factor would be implemented by a board-designated "swing pricing administrator" who must be reasonably segregated from the portfolio management of the Institutional MMF and make annual reports to the board. The swing pricing administrator's annual report to the board would be required to include:

1. the administrator's review of the adequacy of the fund's swing pricing policies and procedures and the effectiveness of their implementation;
2. any material changes to the fund's swing pricing policies and procedures since the date of the last report; and
3. the administrator's review and assessment of the fund's swing factors and market impact threshold, including the information and data supporting the determination of the swing factors and the swing pricing administrator's determination to use a smaller market impact threshold, if applicable.

The swing pricing administrator would also be responsible for the Proposed Rule's record keeping requirements. Specifically, the swing pricing administrator must maintain a written copy of both the swing pricing policy and the reports provided by the swing pricing administrator to the board for six years, the first two being in an easily accessible place. Finally, each Institutional MMF would be required to report, in its Form N-MFP filing, the number of times the fund applied a swing factor over the course of the reporting period, and each swing factor applied.

## III. WHEN A SWING FACTOR MUST BE APPLIED

The swing factor would be required to be applied when the fund has net redemptions during a pricing period. Unlike swing pricing for open-end funds under Rule 22c-1, the Proposed Rule would require Institutional MMFs to apply swing pricing only in periods of net redemptions and not during periods of net subscriptions. Under the Proposed Rule, the "pricing period" is defined as the period of time in which an order to purchase or sell securities issued by the fund must be received to be priced at the next computed NAV. This definition is designed to address Institutional MMFs that calculate their NAV multiple times each day. For example, if an Institutional MMF strikes a NAV as of 12:00 p.m. and 4:00 p.m., the fund would determine if it had net redemptions for each pricing period that day and, if so, apply swing pricing for the corresponding NAV calculation. As described in the SEC proposing release, a fund may estimate shareholder flow information to determine whether the fund has net redemptions for a pricing period and to determine the amount of net redemptions, provided that the swing pricing administrator receives sufficient shareholder flow information to be able to make a reasonable estimate.

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Consistent with the approach for open-end funds under Rule 22c-1, if the Institutional MMF has multiple share classes, the fund must calculate net redemptions in the aggregate (i.e., not with respect to each share class) when determining whether to apply the swing factor.

## IV. CALCULATION OF THE SWING FACTOR

As noted above, the swing factor, if adopted as proposed, would be expressed as a percentage discount of the NAV and would reflect spread costs and certain other transaction costs of selling a vertical slice of the fund's portfolio. In other words, the swing factor is designed to estimate the costs the fund would incur, as applicable, by selling a pro rata amount of each security in its portfolio to satisfy the amount of net redemptions for the pricing period. This "vertical slice" is designed to ensure that the adjusted NAV incorporates the costs of selling the Institutional MMF's less liquid holdings, which may protect remaining shareholders from dilution. The vertical slice methodology is also designed to discourage investors from redeeming quickly during periods of market stress to seek to avoid potential costs from a fund's future sale of less liquid securities. The swing factor would not be capped to avoid the creation of a de facto redemption gate.

Calculation of the swing factor takes place in two stages. First, an Institutional MMF would calculate, based on its swing pricing policies and procedures, a good faith estimate of the costs the fund would incur if it sold a pro rata amount of each security in its portfolio to satisfy the amount of net redemptions for the pricing period. This estimate must include spread costs such that the fund is valuing each security at its bid price.[3] Similarly, this estimate must include brokerage commissions, custody fees, and any other charges, fees, and taxes associated with portfolio security sales.

The second stage of the swing factor calculation is designed to capture market impact costs and would only be required if net redemptions exceed a market impact threshold during the pricing period. The "market impact threshold" is defined as 4% of the fund's NAV divided by the number of pricing periods the fund has in a business day, or such smaller amount of net redemptions as the swing pricing administrator determines.[4] As part of the Proposed Rule, the SEC also requested comments pertaining to the calculation of the "market impact threshold" and whether it is operationally feasible to calculate such threshold prior to the determination of a fund's NAV. Specifically, the SEC requested feedback on whether the threshold should be defined on a fund-by-fund basis rather than as a set percentage of net redemptions and whether the swing pricing administrator, or potentially a fund's board, would have the ability to establish either a smaller or larger market impact threshold.

The additional market impact costs would be based on a good faith estimate of the percentage decline in the value of each security if it were sold under current market conditions, based on the dollar amount of the security that would be sold. This estimate would then be multiplied by the dollar amount of the security that would be sold if the fund sold a pro rata amount of each security in its portfolio to meet the net redemptions for the pricing period. This process would be repeated across the vertical slice in order to obtain the total market impact cost of the redemptions.

In recognition of the difficulty of producing timely, good faith estimates of the costs at each stage of the swing factor calculation, Institutional MMFs would be permitted to estimate costs and the market impact factor for each type of security with the same or substantially similar characteristics in the fund's portfolio and apply those estimates to all securities of that type, rather than analyze each security separately. Additionally, the SEC noted that it would be appropriate for the market impact factor to be zero in the case of daily and weekly liquid assets

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because of their shorter maturities. As the Proposed Rule would separately increase daily and weekly liquid asset requirements to 25% and 50% of a portfolio, respectively, a substantial portion of each Institutional MMF's portfolio would likely be presumed to have a market impact factor of zero. The SEC also solicited comments on whether a market impact factor of zero for a MMF's daily and weekly liquid assets is reasonable and, if not, what methodology MMFs should use to determine the market impact factor for such short-term securities.

## V. THE PRESIDENT'S WORKING GROUP 2020 WHITE PAPER AND PRIOR INDUSTRY REACTIONS TO SWING PRICING

In December 2020, the President's Working Group on Financial Markets published a white paper entitled "Overview of Recent Events and Potential Reform Options for Money Market Funds" (the White Paper).[5] The White Paper reviewed the effect of the early stages of the Covid-19 Pandemic on financial markets in March 2020 and proposed a series of potential regulatory reforms designed to improve the resilience of MMFs and broader short-term funding markets, including the application of swing pricing for MMFs. The White Paper noted a number of potential benefits of the implementation of swing pricing in MMFs, including insulating MMFs from runs by internalizing the liquidity costs of investors' redemptions. The White Paper also noted that mutual funds have been reticent to adopt swing pricing under Rule 22c-1 because implementation would require substantial reconfiguration of current distribution and order-processing practices. MMFs are likely to suffer from similar barriers. In addition, the White Paper indicated that MMFs that strike NAV multiple times each day would face particular logistical hurdles in adopting swing pricing, which as detailed in the White Paper, would have applied to all MMFs, not just Institutional MMFs as in the Proposed Rule.

On 12 April 2021, the Investment Company Institute (ICI) published a response to the White Paper that was critical of the proposal to implement swing pricing in MMFs. The ICI indicated that, in its view, swing pricing is not likely to achieve the SEC's stated regulatory goals. The ICI noted that MMFs presently have the ability to institute liquidity fees, which the ICI believed are better suited to cause investors to internalize the cost of redemptions in situations of market stress without the risk of altering the NAV of a fund in situations where a fund's liquid assets are sufficient to cover redemptions.[6] If adopted as proposed, the Proposed Rule would eliminate liquidity fees for MMFs; however, in its response to the White Paper, the ICI indicated support for leaving the ability to institute liquidity fees in place but separating the implementation of such liquidity fees from any applicable liquidity thresholds. In the Proposed Rule, the SEC also requested comments regarding whether it should adopt a liquidity fee framework instead of a swing pricing framework, including whether a liquidity fee framework should be adopted without the link to weekly liquid asset thresholds. The SEC's requests for comments in this area also touched on the operational implications of the proposed swing pricing framework and the implications if the SEC were to instead adopt a simplified liquidity fee framework.

In addition, the ICI suggested that many of the attributes that currently make Institutional MMFs attractive (i.e., multiple settlements per day and same-day settlement) might have to be removed to accommodate swing pricing due to the timing and complexity of correctly applying a swing pricing mechanism multiple times a day and still accommodating same day settlement and meeting the Federal Reserve's current cutoff time for Fedwire instructions.

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Finally, the ICI noted that swing pricing would create significant tax hurdles for MMFs. Presently, Treasury regulations permit MMF investors to use the "NAV method" for reporting their gains and losses from MMFs. This requires that investors track purchases, redemptions, and dividend reinvestments but does not require MMFs to report additional information to investors via IRS Form 1099-B. Additionally, investors in Institutional MMFs are not subject to the Wash Sale rule with respect to their purchase and redemption from Institutional MMFs and therefore may record a loss on their tax returns when they redeem shares of an MMF at a loss and subsequently acquire new shares in the same MMF through an automatic dividend reinvestment plan. Both the ICI in its comment letter and the SEC in the Proposed Rule acknowledged that these tax features would have to be revisited if swing pricing were to be implemented because investors would have reportable losses or gains as a result of the adjustment of the fund's NAV.

## VI. REQUESTS FOR COMMENT

The Proposed Rule will be published on SEC.gov and in the Federal Register. The comment period will remain open for 60 days after publication in the Federal Register. As noted above, the SEC has requested industry comments on many of the details related to swing pricing under the Proposed Rule, including the following:

4. The SEC requests comment on whether it should make swing pricing permissible but not mandatory for Institutional MMFs. Relatedly, should any Institutional MMFs be excluded from the proposed swing pricing requirement?
5. The SEC requests feedback on whether non-institutional MMFs should be permitted to adopt swing pricing policies.
6. Under the Proposed Rule, swing pricing would apply only in periods of net redemptions. The SEC seeks comment on whether swing pricing should also be implemented in periods of net subscriptions.
7. As proposed, the swing factor would be calculated by assuming the fund would sell a pro rata amount of each security in its portfolio. The SEC seeks comment on whether this method properly accounts for liquidity costs.
8. The SEC seeks comment about the proposed appointment of a swing pricing administrator. Specifically, the SEC would like to know who is likely to be appointed, how they could be segregated from the portfolio management functions, and whether they should be required to report to the Chief Compliance Officer.
9. The Proposed Rule would require Institutional MMFs that strike their NAV multiple times per day to determine whether they have net outflows during each pricing period. Consistent with the ICI response discussed above, the SEC requests alternative solutions that reduce complexity but treat investors fairly.
10. The SEC seeks comment on whether it should retain the ability for Institutional MMFs to institute liquidity fees as an alternative to swing pricing.
11. The SEC requests information about whether there are instances in which an Institutional MMF permits intermediaries to submit subscription or redemption requests after the fund's cut-off time and to receive the NAV calculated for that cut-off time, as long as the intermediary received the order prior to the fund's cut-off time. If so, when do such instances occur, and how frequently?

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12. The Proposed Rule would require the swing factor to include spread costs and other transaction fees even when the market impact threshold has not been reached. The SEC seeks information about why certain Institutional MMFs do not use bid prices when calculating NAV and alternatives for the calculation of the estimated cost of selling the vertical slice of a portfolio's assets.
13. The current proposed market impact threshold is net redemptions equaling 4% of NAV during a pricing period. The SEC seeks comment on whether this threshold should be adjusted and whether laying out a specific percentage is likely to encourage strategic redemption behavior.[7]

In any event, swing pricing, if implemented, will likely result in fundamental changes to the operations and services provided by Institutional MMFs. Most notably, as the ICI stated in its response to the White Paper, swing pricing would present significant operational hurdles to Institutional MMFs being able to continue to offer multiple settlements per day and same-day settlement. A comprehensive overview of the broader impacts of the Proposed Rule on MMFs can be found in our prior client alert entitled “SEC Proposes Another Round of Money Market Fund Reforms” that was published on 17 December 2021. That alert can be accessed by clicking here.

## FOOTNOTES

[1] Note that the SEC is not proposing to impose swing pricing requirements on government MMFs, retail prime MMFs, or retail tax-exempt MMFs because those funds are permitted to maintain a stable NAV.

[2] The most important distinction is that under the Proposed Rule, swing pricing is mandated for Institutional MMFs, while swing pricing for other open-end funds under Rule 22c-1 is optional. The adoption of Rule 22c-1 was discussed in greater detail in a previous client alert issued on 11 November 2016. The alert can be found here.

[3] The SEC noted that certain Institutional MMFs may already price portfolio securities at the bid price when striking their NAVs. As a result, the requirement to adjust the fund's current NAV by a swing factor when it has net redemptions that do not exceed the market impact threshold would generally affect institutional funds that use mid-market pricing to compute their current NAVs.

[4] The SEC arrived at the 4% threshold via a historical analysis of net redemptions from MMFs during a five year period. The analysis found that daily outflows of greater than 4% occur on approximately 5% of trading days.

[5] A copy of the White Paper can be found at the following link.

[6] The Proposed Rule would eliminate MMFs' ability to use liquidity fees in favor of swing pricing.

[7] The SEC suggested that, in lieu of a set percentage, Institutional MMFs could be required to set their own percentage based on the historical flows of each particular fund.

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