Mandatory Swing Pricing is Not a Panacea

Background

The Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO) plan to publish consultations this summer discussing liquidity management by open-ended funds (funds). Swing pricing is expected to be among a menu of liquidity management tools (LMTs) that the FSB and IOSCO present for use in addressing potential investor protection or financial stability risks some see as being posed by funds. As they consider proposing tools for adoption, policymakers should bear in mind the meaningful operational and market differences that exist across jurisdictions.

Swing Pricing is Unworkable in Many Places

Swing pricing is permitted in many jurisdictions, including the US, and is used in the UK and EU. However, its viability varies in practice due to the different legal, market, and operational conditions around the globe. While some policymakers have highlighted the European and British experience in advocating the tool's widespread adoption, no US fund to date has utilized it.[1] Additionally, funds in Japan do not use swing pricing.

These variations underscore the reality that swing pricing is not a good fit or even operationally workable in all jurisdictions. A comparison of the EU and US markets offers some key reasons why:

1 Market and Operational Differences Matter Significantly

- A fund's ability to receive accurate, complete, and timely daily flow information before calculating its daily net asset value (NAV) is crucial to the use of swing pricing. While EU funds often have this degree of information, US funds do not because of the American market structure.
- For trade requests in the EU to be deemed "in good order," they generally must be accepted by the fund's transfer agent by the fund's closing time. This factor enables EU funds to have almost full visibility into their daily shareholder activity prior to NAV calculations, giving them timely information to set their swing factors.
- The US market, in contrast, often employs an agency model in which intermediary partners play a significant role in processing daily orders. Such arrangements allow intermediaries to make an initial good order determination up until the fund's closing time—even if the transfer agent doesn't receive the order until many hours later or even the next morning. Account structures in the US also increase trade processing times.
- Because US funds receive from their intermediaries many "good" trade orders well after they have calculated the day's NAV, they cannot apply swing pricing with the same level of confidence as their EU counterparts.

[1] In effect, swing pricing involves a second step in the valuation process, whereby a fund measures daily net purchase or redemption activity. When any pre-determined activity threshold (usually expressed as a percentage of the fund's net assets) is exceeded, the fund adjusts (or "swings") the per share net asset value upward (in the case of a net purchase of fund shares) or downward (in the case of a net redemption of fund shares) so that transacting shareholders bear the transaction costs from resulting fund portfolio activities.

❷ Shareholder Bases and Trading Practices Impact Processing Times

- Retail investors represent the vast majority of the US fund shareholder base, holding 94 percent of long-term fund assets. EU funds, on the other hand, are dominated by institutional buyers, with retail investors holding merely 27 percent of EU investment assets.[2]
- The substantially larger retail shareholder base in the US and the varied channels through which it invests make the US distribution process more complex and affects the timing to receive all daily shareholder activity.
- Moreover, US retail shareholders often invest in products with trading instructions denominated in shares or a percentage of holdings that require the fund's final NAV prior to submitting final orders. In contrast, most shareholder trades in the EU, regardless of type, are denominated in currencies that can be processed readily.

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Retail investors hold
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❸ Sufficient Time is Needed to Calculate and Disseminate NAVs after Trade Cut-Offs

- Market practices in the EU give funds considerable time after the close of trading to complete NAV calculation and dissemination.[3] In contrast, the time between trading cut-off and NAV publication in the US may be as little as two hours.[4]
- Even if sufficient information on shareholder activity were available to accurately estimate daily flows, it would still be much more difficult to apply swing pricing in the compressed US window.

Complex Markets Demand a Flexible Approach

The use of swing pricing in the EU is an important part of an *optional* toolbox of LMTs available to fund managers, and the European framework permits funds to set their own swing factors and thresholds periodically. This flexibility is critical to the success of swing pricing in the EU.

If IOSCO or the FSB favors the universal use of swing pricing or any other LMT, it would undermine the market for regulated investment funds in many countries. As market structures vary widely across jurisdictions, swing pricing might be a functional option in one region and unworkable in another—imposing new costs and a drastic overhaul of existing market structures. This would adversely affect the products that millions of individuals rely on to meet their financial goals, negating any investor protection goal and not presenting an effective answer to financial stability concerns.

It is important that the FSB and IOSCO do not promote or seek to mandate any single tool as the preferred LMT. A flexible approach will prove more valuable in practice than one-size-fits-all solutions.

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[2] See Investment Company Institute *2023 Investment Company Fact Book* and European Fund and Asset Management Association *2022 Fact Book*.

[3] For instance, in Luxembourg, the time available could exceed 8 hours. The final cut-off for fund trading may be mid-afternoon (about 2:30 p.m. Central European Time (CET)), though it may vary. Final NAV may be published as late as 11:00 p.m. CET.

[4] Trading cut-off is generally 4:00 p.m. ET, consistent with the NYSE market close. NAV publication typically occurs by 6:00 p.m. ET.