



Consultation Paper for introduction of Swing Pricing

1. Objective

The objective of this consultation paper is to solicit public comments / views on the proposal to introduce swing pricing mechanism to ensure fairness of treatment of entering, exiting and existing investors in Mutual Fund schemes, particularly during market dislocation.

2. Background

2.1. In February 2018, International Organization Of Securities Commissions (IOSCO) published its final report on 'Open-ended Fund Liquidity and Risk Management – Good Practices and Issues for Consideration', which referred to swing pricing as one of the tools for liquidity risk management by open-ended funds.

2.2. As per the said IOSCO report, swing pricing mechanism is elaborated as follows¹:

2.2.1. Swing pricing refers to a process for adjusting a fund's net asset value (NAV) to effectively pass on transaction costs stemming from net capital activity (i.e., flows into or out of the fund) to the investors associated with that activity during the life of a fund, excluding ramp-up period or termination. In a liquidity-challenged environment, quoted bid/ask spreads and overall trading cost can widen and may not be representative of the executed prices that can be achieved in the market.

2.2.2. In such circumstances, swing pricing can be a useful mechanism to:

- contribute to protect the interests of existing investors, specifically from the dilution of their holdings; and
- contribute to protect the value of the investors capital.

2.2.3. It is also a useful mechanism to protect remaining investors when:

- one or more large investors choose to redeem in "normal times" where their actions would have material market impact costs;
- more active trading takes place; and/or
- funds hold illiquid assets.

2.2.4. Swing pricing has two forms.

- The first (the "full" swing pricing) is whereby the NAV of a fund adjusts up or down every calculation day regardless of the size of investor dealing.
- The second method (the "partial" swing pricing) is only invoked when the net inflow or outflow is greater than a pre-determined threshold (often

¹ <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD591.pdf>



referred to as the “swing threshold”), which is usually set in terms of a percentage or percentage of AUM.

- 2.2.5. The implementation of a swing price mechanism is appropriate where there is a material cost for accessing liquidity. The trading of frequent (and large) amounts of fund shares, as well as the corresponding underlying assets, imposes costs on the fund that results in inequitable outcomes since long-term investors subsidise those who trade more actively. The same effects are true for funds that hold more illiquid assets. Consequently, the externalities can become significant.
- 2.2.6. Swing factors are often limited in magnitude in the fund prospectus (e.g. a cap of 2%). Although, as pointed out by the Association of the Luxembourg Fund Industry (ALFI), beyond the fund prospectus, it is advisable that an asset manager has in place further swing pricing policy documents to highlight a number of other characteristics and parameters of the swing pricing mechanism
- 2.2.7. For partial swing, NAV is calculated in the normal manner and then swung by a pre-determined amount (the swing factor) if the net inflow/outflow is above the swing threshold.

2.3. NAV adjusted for swing factor generally becomes applicable for all the transacting investors (exiting or entering) and irrespective whether they are large or small investors and whether they triggered the threshold at individual level or not.

2.4. The adjustment of Net Asset Value (NAV) of scheme with swing factor is elaborated below:

Flows beyond the threshold	Impact
Scenario 1: Net inflows more than swing threshold	NAV will be adjusted upwards
Scenario 2: Net outflows more than swing threshold	NAV will be adjusted downwards

Illustration

Consider a scheme having NAV of Rs 100, swing factor of 1%, and Swing threshold of 5% (5% of net inflow or net outflow from the scheme), following is NAV adjusted for swing pricing for three scenarios



Scenario	Direction of price swing	NAV adjusted for swing pricing
Case 1: A net inflow of 10% (more than 5%) of the total AUM	↑	Rs. 101
Case 2: A net outflow of 10% (more than 5%) of the total AUM	↓	Rs. 99
Case 3: A net inflow / outflow of 2% (less than 5%) of the total AUM is received	↔	Rs. 100

3. Global practices

Swing pricing is a common anti-dilution measure employed by UCITS- regulated funds in several EU jurisdictions, such as Ireland and Luxembourg, since a number of years. Regulations permitting such swing pricing were introduced in the U.S., effective November 2018.

Eleven out of twenty six jurisdictions which are part of IOSCO have made available provisions of swing pricing in their jurisdiction, which include US, UK, Singapore, France and Switzerland amongst others. Regulatory practices in few jurisdictions are elaborated as under:

3.1. **United States:**

The Securities and Exchange Commission (SEC) adopted rule amendments to allow open-ended funds (except money market funds or Exchange Traded Funds (ETFs)) to use swing pricing. To use swing pricing, a fund must establish and implement swing pricing policies and procedures that adjust a fund's NAV under certain circumstances. Before doing so, the fund's board, including a majority of independent directors, must have approved policies and procedures².

USA SEC rules on swing pricing specify that the determination of a fund's swing factor must take into account only the near-term costs expected to be incurred by the fund as a result of net purchases or net redemptions that occur on the day the swing factor is used. These near-term costs are limited to spread costs, transaction fees and charges from purchasing or selling assets, and borrowing-related costs associated with satisfying redemptions and specifically exclude consideration of impact costs. USA SEC rules require that administration of

² <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD591.pdf>



the swing pricing policies and procedures must be reasonably segregated from portfolio management of the fund and may not include portfolio managers (although portfolio managers may provide data or other input used by those responsible for administering the policies and procedures). SEC rules also do not require a fund to disclose its swing threshold.

3.2. Luxembourg:

Swing pricing has been permitted in Luxembourg for more than 15 years and has proven to be an efficient mechanism to protect existing investors from dilution associated with investor purchases and redemptions. A survey by the ALFI found that two out of three managers who manage a combined \$1,900 billion (€1,747 billion pricing.) of net assets – or 54% of total assets under management in Luxembourg funds – apply swing. The survey highlights a trend towards greater adoption of the mechanism, with a number of asset managers applying swing pricing to a varied range of fund types and asset classes. The majority of asset managers apply swing pricing on equity, fixed income, and multi-asset fund in addition to fund-of-funds and sharia-compliant funds³.

The Luxembourg Swing Pricing Survey, Reports & Guidelines provides that the following should be considered when determining the swing factor: (i) the bid-offer spread of a fund's underlying portfolio assets; (ii) net broker commissions paid by the fund; (iii) custody transaction charges; (iv) fiscal charges (e.g., stamp duty and sales tax); (v) any initial charges or exit fees applied to trades in underlying investment funds; and (vi) any swing factors or dilution amounts or spreads applied to underlying investment funds or derivative instruments.

3.3. Hong Kong

In Hong Kong, swing pricing is permitted for Securities and Futures Commission (SFC)-authorised funds provided that clear disclosures are set out in the funds' offering documents including information on how the swing pricing measure works, under what circumstances it is triggered and the effect on the NAV upon subscription or redemption as a result. In general, an SFC-authorised fund may apply swing pricing measures in order to mitigate the effect of transaction costs in meeting the subscription or redemption requests and to safeguard the interest of those investors remaining in the fund. In making such decisions, the fund manager generally takes into account various factors such as the type of fund,

³ <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD591.pdf>



costs of transacting the underlying investments, administrative costs, implementation considerations and/or the fund's cash management strategy⁴.

3.4. France

The Code of Conduct for asset managers using Swing Pricing and variable anti dilution levies (ADLs), issued by the French Asset Management Association – AFG, states that: *Investors must be given individual notification when ADLs are introduced for a fund, and must be given the option to redeem their investment free of charge*⁵.

3.5. United Kingdom (UK)

A study by UK Financial Conduct Authority (FCA) captioned “Swing pricing and fragility in open-ended mutual funds” (published in May 2019) on open-ended corporate bonds schemes of UK based Asset Management Companies found that NAV adjustment factor is significantly higher when portfolio illiquidity is higher and during periods of stress. In fact, illiquidity of a fund's holdings appears as an important determinant of a fund's dilution adjustment factor⁶.

3.6. Certain aspects of swing pricing

3.6.1. Discretion on swing pricing

In both USA and certain European jurisdictions where swing pricing is permitted such as Luxembourg, France and UK, its use is optional, subject to appropriate disclosures to investors.

3.6.2. Swing threshold

Internationally, in case of many fund houses (although not all cases), the thresholds are confidential, in order to prevent any attempt to avoid a price swing by subscribing / redeeming in an amount just below the threshold. USA SEC rules also do not require a fund to disclose its swing threshold.

3.6.3. Upper limit on swing factor

Certain European jurisdictions that permit swing pricing do not place an upper limit on the swing factor that a fund may set. Instead, funds that use swing pricing within those jurisdictions voluntarily limit the

⁴ <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD591.pdf>

⁵ <https://www.afg.asso.fr/wp-content/uploads/2020/12/guidepro-swingpricing-eng-201207web.pdf>

⁶ <https://www.imf.org/en/Publications/WP/Issues/2019/11/01/Swing-Pricing-and-Fragility-in-Open-end-Mutual-Funds-48729>



level of the swing factor to be applied, with such limits generally ranging from 1% - 3% as disclosed in the offer documents.

The USA SEC has placed an upper limit of 2% on the swing factor, noting the following: *we believe that it is appropriate to limit the swing factor that may be used to avoid placing an undue restriction or de facto gate on shareholders' ability to redeem their shares and to prevent potentially unfair treatment of shareholders and abusive practices*⁷.

3.6.4. Exit option to investors

The Code of Conduct for asset managers using Swing Pricing and variable anti-dilution levies, issued by the French Asset Management Association – AFG, states that: *Investors must be given individual notification when ADLs are introduced for a fund, and must be given the option to redeem their investment free of charge*⁸.

4. Pros and Cons of Swing Pricing

Potential benefits:	Potential drawbacks, limitations, and challenges:
- Swing pricing is a tool that allows asset managers to achieve a more equitable treatment of entering, existing and exiting investors. - Swing pricing could materially reduce risk of run on the fund and reduce first-mover advantages, if it is implemented in a manner that is likely to pass on the costs that redeeming investors impose on the	- To be effective, these policy measures must be implemented in a manner that fully reflects the costs that redeeming investors impose on the fund. This could present a challenge because liquidity costs may be difficult to ascertain in markets where secondary trading activity is typically thin and transparency is poor. - AMCs may find it challenging to determine appropriate parameters for swing pricing. This would be less attractive to investors who do not want to bear any risk of loss upon redemption.

⁷ <https://www.sec.gov/rules/final/2016/33-10234.pdf>

⁸ <https://www.afg.asso.fr/wp-content/uploads/2020/12/guidepro-swingpricing-eng-201207web.pdf>



Potential benefits:	Potential drawbacks, limitations, and challenges:
fund by ensuring that they bear those costs. • Swing pricing could reduce/mitigate the impact of redemptions on remaining investors by reducing dilution of the value of a fund's units and protecting remaining investors from the effects of others' redemption activities. • This option would also reduce redemption pressures in case of sudden surge in redemptions/demand for liquidity, because fund managers would be able to increase the cost of liquidity to be more in line with other sources of liquidity. • By reducing run risk and potential asset fire sales, swing pricing would protect the interest of entering, existing and exiting investors in an equitable manner. • By protecting remaining investors from dilutive impact of other investors' redemptions, mitigates first-mover advantage.	• AMCs may find it challenging to accurately determine the costs that redeeming investors impose on the fund and set the appropriate minimum size or swing threshold. There may well be a material residual cost that will be borne by remaining investors in stressed conditions. • There is also a risk that investors anticipate such a decision by the AMCs and decide to redeem preemptively, which would affect all the funds and not only the ones perceived as more susceptible to the application of swing pricing. • Risk of schemes resorting effectively to a discretionary exit load under swing pricing framework • There is a risk that small investors will have to bear a brunt of swing pricing because of subscription/redemption by large investors. For instance if swing threshold is triggered by a large investor, small investor will also get lower NAV.



Despite certain limitations, swing pricing has become a widely used anti-dilution tool. It has been adopted by funds as it protects the interest of entering, existing and exiting investors in an equitable manner.⁹ The framework proposed in this consultation paper also proposes various measures to mitigate the challenges of Swing Pricing.

5. Need for Swing Pricing in Indian Context

5.1. Developed markets have liquid bond market and Swing Pricing is largely used to adjust the bid-offer spreads and transaction costs.

5.2. In the Indian context, swing pricing is needed to address issues in addition to above costs of bid-offer spread and transaction costs, particularly arising during market dislocation in the mutual fund industry or in the underlying bond market. The secondary bond market in India is not as liquid as the equity market and can absorb only a limited amount of paper on any given day. Further, liquidity is concentrated in high quality paper and during market dislocation, very high risk aversion is observed and in terms of yield of bonds, spread over benchmark spike, particularly for relatively lower quality paper. Accordingly, swing pricing, an anti-dilution adjustment that seeks to protect investors in a fund from performance dilution as a result of significant outflows from the fund, particularly during market dislocation is relevant in Indian context.

5.3. Currently, there is a first mover advantage for those investors who do early redemptions. At an industry level, if the redemptions start to snowball (as there is a perceived first mover advantage at every stage), the perception turns into reality, thereby leading to even more redemption pressure. During market dislocation, complete cost of transaction, illiquidity cost amongst other costs may not be reflected in NAV and those investors who redeem when the scheme has liquidity buffer to meet the redemption requests get better NAV than those who redeem after the liquidity buffer held by the scheme is over.

5.4. There is a need for a mechanism that imposes certain cost on exiting investors (since they are contributing to a downward spiral in NAV) while incentivizing entering investors (since they are helping to stem the downward spiral in NAV). This happens as the NAV is adjusted downwards during times when net outflows

⁹ BlackRock (2011): "Swing Pricing: The Dilution Effects of Trading Activity." Also, recreated in "Fund structures as systemic risk mitigants, Appendix B (2014). In analysing a number of their UCITS funds between 2010 and 2011, BlackRock highlighted that without the operation of a swing pricing mechanism, the performance of many of their funds would have been impaired.



are more than the swing threshold and this lower NAV is offered to the entering investors during such times.

5.5. Secondary bond market is not as liquid as that of secondary equity market. Further, the valuation of bonds for NAV computation relies significantly on spread over benchmarks. Hence, during market dislocation, the yield spreads (typically computed based on historical spreads) may not fully capture the high level of risk aversion and to that extent may not fully reflect the “distress price” that a fund may realize if it needs to sell the bond on account of increasing redemption pressure.

5.6. As elaborated above, there are two forms of Swing pricing. Globally, many jurisdictions have adopted the “partial swing” method, making it optional for each scheme as:

- a. It lowers daily NAV volatility
- b. Having a threshold recognizes that smaller subscription or redemption can frequently be managed within existing cash levels/liquidity management tools.

6. Proposed framework of swing pricing

6.1. In view of above, keeping in mind regulatory practices followed by other jurisdictions as well as the Indian context, a hybrid model is proposed i.e. partial swing during normal times and a mandatory full swing during times of market dislocation.

6.2. At this stage, it is proposed to implement the framework of swing pricing only for open ended debt schemes. The proposed framework for swing pricing is as under:

During normal time

6.3. Applicability of swing pricing will be optional based on pre-determined minimum swing threshold and maximum swing factor. The same shall be disclosed in the scheme information document, along with details of swing pricing policies and procedures.

During market dislocation

6.4. Swing pricing framework shall be implemented in a phased manner. In first phase, it shall be mandated only during the times of outflow market dislocation across mutual funds as it is a high risk scenario. The rationale for mandating



swing pricing across mutual funds during market dislocation times is to mitigate following risks:

- a. Uncertainty of whether swing pricing will apply or not
- b. If it is not mandated uniformly, there will be race to the bottom among various mutual fund schemes.
- c. Small schemes may be at a relative disadvantage if a threshold based (e.g. net redemption as a percentage of net assets of the scheme) swing pricing applicability is specified.

Thus, mandating swing pricing during market dislocation will lead to better predictability, transparency and effectiveness of the said mechanism. This is considered appropriate since market dislocation will be declared based on industry level/market wide market dislocation and not scheme or fund specific stress.

- 6.5. During market dislocation, applicability of minimum swing factor will be as stipulated by SEBI which shall be risk-based. Beyond this, the Asset Management Company (AMC) can choose to levy higher swing factor if it considers such a factor to be in the best and equitable interest of its unitholders, based on pre-defined parameters viz. redemption pressure, current portfolio of the scheme as detailed in the scheme information document (SID). This will be subject to compliance to pre-disclosed cap on swing factor and minimum swing threshold.
- 6.6. SEBI will determine 'market dislocation' either based on Association of Mutual Funds in India (AMFI)'s recommendation or based on combination of various factors like net redemption build up at industry level, global market indicators, Indian market indicators as well as bond market indicators. Once market dislocation is declared, it will be broadcasted that swing pricing will be applicable for a certain period, which can be extensible.
- 6.7. It is proposed to mandate swing pricing for high risk open ended debt schemes during market dislocation, as these schemes carry high risk securities compared to other schemes which possibly have higher costs of liquidation.
- 6.8. Accordingly, swing pricing mechanism shall be mandated only for all open ended debt schemes that:



- have High or Very High risk on the risk-o-meter¹⁰ (as of the most recent period at the time of declaration of market dislocation) **AND**
- classify themselves in the cells A-III, B-II, B-III, C-I, C-II and C-III of Potential Risk Class (PRC) Matrix tabulated below:¹¹

Minimum swing factor for open ended debt schemes*			
Max Credit Risk of scheme→	Class A(CRV** ≥12)	Class B (CRV ≥10)	Class C (CRV <10)
Max Interest Rate Risk of the scheme ↓			
Class I: (MD≤1 year)	Optional	Optional	1.5%
Class II: (MD≤3 years)	Optional	1.25%	1.75%
Class III: Any Macaulay duration	1%	1.5%	2%
*: Scheme can levy higher swing factor, based on pre-defined parameters, redemption pressure and current portfolio of the scheme subject to a cap and minimum threshold **CRV: Credit Risk Value ¹²			

- 6.9. During the times of market dislocation, all schemes will give effect to swing pricing and certain minimum uniform swing factor shall be made applicable across the industry. However, when there is a scheme level stress, the fund manager shall determine whether to apply swing factor or not. Accordingly, it is proposed that the scheme performance (as reported under various regulations) be reported:
- 6.9.1. without taking into account the mandatory swing factor during market dislocation but
- 6.9.2. after adjusting NAV for the swing factor during normal times and adjusting NAV for the swing factor if additional discretionary swing factor is levied by the AMC during stress (if any)
- 6.10. When swing pricing mechanism is triggered and swing factor is made applicable (during normal time or market dislocation, as the case may be), both the entering and exiting investors shall get NAV adjusted for swing pricing.

¹⁰ SEBI circular SEBI/HO/IMD/DF3/CIR/P/2020/197 dated October 5, 2020

¹¹ SEBI circular SEBI/HO/IMD/IMD-II DOF3/P/CIR/2021/573 dated June 7, 2021

¹² SEBI circular SEBI/HO/IMD/IMD-II DOF3/P/CIR/2021/573 dated June 7, 2021



6.11. Swing Pricing shall be made applicable to all unitholders with an exemption for redemptions upto Rs. 2 lacs for all unitholders and upto Rs. 5 lacs for senior citizens at mutual fund level in order to keep retail investor and senior citizen insulated from the applicability of swing pricing to certain extent.

Challenges and applicable mitigants

6.12. Following are the measures to mitigate the challenges posed while implementing the Swing Pricing mechanism:

SN	Challenges	Mitigants
1	Small investors get dragged into swing pricing by large investors	Exemption is proposed for redemptions upto Rs 2 lacs/ Rs 5 lacs for senior citizens
2	Uncertainty of whether swing pricing will be applicable or not	In the event of declaration of market dislocation for a given period, no uncertainty shall be there as mandatory swing pricing shall be there for the applicable high-risk schemes.
3	Where AMCs have an option, it would tantamount to "discretionary exit load"	AMCs shall disclose the floor for the swing threshold beyond which swing pricing shall be applicable and the cap of the swing factor in its SID.
4	Performance of schemes being disclosed without swing factor	The scheme performance (as reported under various regulations) shall be reported: a. without taking into account the mandatory swing factor during market dislocation but b. after adjusting NAV for the swing factor during normal times and adjusting NAV for the swing factor if additional discretionary swing factor is levied by the AMC during stress (if any)
5	Small schemes are at a relative disadvantage	During market dislocation times, the mandatory swing pricing shall apply to all the schemes which have High or Very High risk on the risk-o-meter and classify themselves in certain high risk cells of Potential Risk Class (PRC) Matrix



Approval for policies and procedures pertaining to discretionary swing pricing mechanism

6.13. Keeping in view the global practices, it is proposed that the AMCs shall have laid down policies and procedures pertaining to swing pricing mechanism which are approved by majority of the independent directors on the board of AMC and Trustees for discretionary swing pricing (during normal times and additional swing factor during market dislocation).

Disclosure of swing pricing mechanism in SID

6.14. All AMCs shall provide clear disclosures in the SIDs including information on how the swing pricing measure works, under what circumstances it is triggered and the effect on the NAV upon subscription or redemption as a result of swing pricing.

Subsequent phases

6.15. To begin with, mandatory swing pricing mechanism is proposed for those open ended debt schemes which have High or Very High risk on the risk-o-meter and fall in certain cells of PRC matrix as specified above. Further, it is proposed that in subsequent phases, SEBI will examine the applicability of Swing Pricing mechanism to Equity Schemes, Hybrid Schemes, Solution oriented schemes and Other schemes (viz. Index Funds/ETFs)

7. Public Comments

In order to take into consideration the views of various stakeholders, public comments are invited on the proposed framework of swing pricing mechanism and following aspects of this consultation paper:

7.1. Whether there is a need for introducing swing pricing mechanism?

7.2. Whether full swing/partial swing or hybrid model as proposed above be made applicable?

7.3. Whether swing pricing be facilitated in normal times/market dislocation /both?

7.4. Whether swing pricing be made mandatory across all open ended debt schemes or only for those schemes which have High or Very High risk on the risk-o-meter and fall in certain cells of PRC matrix as mentioned above?



- 7.5. Should risk be evaluated as per Risk-o-meter scale or as depicted by the Potential risk class matrix or combination of both?
- 7.6. What should be the swing threshold, if partial swing is suggested by the respondent (during normal times and during market dislocation)?
- 7.7. Is the swing factor specified above for each PRC cell adequate?
- 7.8. Whether Swing Pricing be applicable to all unitholders or with an exemption for redemptions upto Rs. 2 lacs for all unitholders and upto Rs. 5 lacs for senior citizens at scheme level / mutual fund level/PAN level in order to keep retail investor and senior citizen insulated from the applicability of swing pricing to certain extent?
- 7.9. Whether the evaluation of scheme performance with respect to benchmark be done without adjusting NAV for swing factor during market dislocation (when swing pricing is mandatory to the extent of mandatory swing factor) and adjusting NAV for swing factor during normal times (when swing pricing is optional or optional higher swing factor during stress times)?
- 7.10. What should be the leading indicators for assessing market dislocation?
- 7.11. Whether there are any other risks w.r.t. swing pricing mechanism which need to be addressed?
- 7.12. Whether there are any other relevant issues pertaining to swing pricing?

The public comments may be sent to SEBI in the following format:

Name of the person/entity proposing comments:			
Name of the organization (if applicable):			
Contact details:			
Sr. No.	Para of consultation paper	Suggestions/ Comments	Rationale



भारतीय प्रतिभूति और विनियम बोर्ड
Securities and Exchange Board of India

Name of the person/entity proposing comments:			
Name of the organization (if applicable):			
Contact details:			
Sr. No.	Other issues	Suggestions/ Comments	Rationale

Kindly mention the subject of the communication as "**Comments on Consultation Paper for introduction of Swing Pricing**"

[Note: The respondent may specify whether they are market intermediary/ participant (mention type/ category) or public (investor, academicians etc.)]

Comments in aforesaid format may be sent to the following, latest by August 20, 2021:

- a. By email: to swingpricing@sebi.gov.in and/ or Shri Harshad Patil, Assistant General Manager (harshadp@sebi.gov.in)
- b. By post: to the following address-
Shri Bithin Mahanta,
General Manager,
Investment Management Department – II (Division of Funds – III)
Securities and Exchange Board of India,
SEBI Bhavan, C4-A, G-Block,
Bandra Kurla Complex,
Bandra (East), Mumbai 400051
