MEMORANDUM

TO: Public Comment File No. S7-27-03

FROM: Adam B. Glazer
Office of Regulatory Policy
Division of Investment Management

DATE: August 25, 2004

On August 23, 2004, representatives of the American Benefits Council, Charles Schwab & Co., Inc. ("Schwab"), Mass Mutual Financial Group ("MassMutual"), Hewitt Associates, Automatic Data Processing, the Profit Sharing 401(k) Council of America, and Nationwide Financial Services, Inc. met with staff members of the U.S. Securities and Exchange Commission to discuss issues relating to the Commission's proposed rule amendments concerning the pricing of investment company shares in Investment Company Act Release No. 26288 (Dec. 11, 2003) ("Late Trading Proposal"). The following Commission staff members attended the meeting: Paul Roye, Director; Robert Plaze, Associate Director; Penelope Saltzman, Branch Chief, and Adam Glazer, Attorney, Division of Investment Management.

The representatives discussed in greater detail their alternative approach to the Late Trading Proposal as described in Schwab's comment letter. Representatives of Schwab and MassMutual had first discussed their alternative approach with staff members at a meeting on February 25, 2004. The alternative approach would allow intermediaries to obtain same-day pricing for orders they receive by 4 p.m. and transmit to fund companies after 4 p.m. as long as the intermediary meets specific requirements, including (i) a comprehensive system of operational controls, policies and procedures to protect against late trading, and (ii) independent auditor review of the effectiveness of intermediary controls and policies, as described in the attached documents.

Attachments

The "SMART 4" Solution to Mutual Fund Late Trading: Ensuring Transactional Integrity

Over the last several months, numerous firms in the mutual fund and retirement plan businesses have worked together to offer a tough yet sensible solution that will ensure that illegal late trading of mutual funds does not occur while preserving a level playing field for all investors. Building upon the SEC's "Hard 4 Close" proposal, which calls for all mutual fund orders to be received by fund companies by Market Close (generally 4 p.m. eastern time), the "Smart 4" proposal would require any intermediaries that wish to receive mutual fund orders up until Market Close and then process them and deliver them to fund companies after Market Close to implement certain technological and procedural processes. Before being permitted to process trades after Market Close, the entity must file a certification with the SEC indicating that its processes to prevent late trading equal or exceed the SEC's published guidelines, and that those systems are working properly. Any entity that does not to comply with these requirements would be subject to the "Hard 4" proposal as outlined by the SEC.

The goal of the Smart 4 is to use a combination of technological controls, executive certification, and independent verification to ensure transaction integrity – that no mutual fund order can be entered or altered after Market Close and still receive that day's price. Generally, orders are defined as one of the following:

a. Customer-directed trade orders.
b. Customer-directed transactions that will result in a trade order being generated by the system (e.g., a participant loan, investment change, or distribution in a 401(k) plan)
c. Recurring system transactions that will result in trade orders being generated by the system (e.g., fee collection, automatic periodic purchases, recurring distributions, automated rebalancing).

In retirement plans, participant directions (i.e., customer-directed transactions and recurring systems-directed transactions) regarding mutual fund assets held in a plan generally cannot be translated into specific fund trading orders until net asset values are published following the fund's close. The intention of the instruction is established prior to Market Close and the instructions are executed later. Thus, such transactions are effectively locked in before Market Close.

I. *General Systems Controls* serve as a foundation to transactional integrity.

A. The system time on all computer platforms involved in the process must be synchronized with the atomic clock no less than once a day to ensure the integrity of the system clock.
B. Order databases that retain current and historical order records must be secured and protected from unauthorized modification, corruption, or deletion. Appropriate physical and electronic access controls (user identifiers, passwords, sufficient length and complexity, sufficient and periodic forced changes) are required. Data must be

retained consistent with applicable regulatory requirements but in all cases for no less than three years.

II. *Specific Processing Controls* for receiving orders must be in place. These controls must result in an unalterable electronic audit trail for every mutual fund transaction.

A. Orders (or a customer instruction that will result in an order) must be immediately electronically time-stamped upon receipt, in a manner that cannot be altered or discarded once entered into the order entry system. System users must not be able to set or choose a time-stamp or overwrite an existing time-stamp.

B. Time stamps are required each time an order, or a batch of orders, is transmitted to another entity in the trade process, such as an intermediary, a transfer agent, or a fund company.

C. In cases where trades are batched or aggregated, the aggregating intermediary must be able to identify each underlying individual trade.

D. Systems should have security to ensure only authorized individuals have the ability to enter new orders or cancel existing orders before Market Close.

E. Order entry systems should automatically assign the following information to an order:

1. A unique "transaction identifying number" will be assigned by the system without human intervention. System users must not be able to set, alter, or over-write an existing transaction number.
2. A unique identifier that identifies who entered the order or the channel (e.g., Internet or voice-response system) from which the order was received.
3. The date and time stamp when the order was entered.
4. The type of action requested (buy/sell/exchange, or retirement plan instructions such as withdrawal, loan request, fee request, automatic rebalancing, etc.).
5. Fund identifiers (CUSIP or ticker)
6. Quantity of units or dollar amount.
7. Critical data elements of instructions or transactions that will result in orders are action (e.g. withdrawal, loan request, fee request, automatic rebalancing), quantity or dollar amount (if available), or estimated quantity or dollar amount (if available).

F. All orders, and transactions that result in orders, must be entered and recorded into the order entry system by Market Close without exception. In cases where a systems outage occurs, firms are required to recover their system or utilize back-up systems to enter and record all orders received prior to Market Close. Firms would assume the financial risk for any orders that could not be entered into the order entry system before market close.

G. In the event that a bad record must be deleted to resolve a system issue the firm must have procedures and controls to retain a record of what was deleted and to ensure that the deletion was properly authorized by the appropriate control individual who is not directly involved in the trading process.

H. End user systems should have intelligent editing capabilities that prevent the acceptance/entry of orders that are "not in good order" – including, but not limited to, orders that do not have all the required information, do not have the required authorization, or in which the information does not "match up" correctly with the available funds in the customer's account.

III. *Cut-Off Controls* for receiving and processing orders must be in place to ensure that no orders received after Market Close can receive that day's price.

A. The firm must maintain systems that ensure:
1. that orders that are time-stamped after Market Close (and thus receiving the next day's price) are distinguished from orders received prior to Market Close (and thus eligible for that day's price);
2. that customer orders are never time-stamped until entered and accepted by the system and the system time stamp is the only stamp of record;
3. that existing orders requiring modification before Market Close (which have already been time-stamped) be cancelled and a new order re-entered with a new time-stamp;
4. that cancellations of orders before Market Close are captured and retained with their own time-stamp and user ID unique from the original order's time-stamp and user ID; and
5. that existing orders, or transactions that will result in orders, entered before Market Close cannot be modified or cancelled after Market Close.

B. Systems must be able to handle, in a manner that will prevent abuse, legitimate cancellations of purchase orders after Market Close that are the result of Fund Company's decision to reject a purchase order. Access to handle such cancellations must be systematically controlled, limited to the minimum number of authorized employees, and supported with appropriate documentation from the fund company or its transfer agent. These cancellations must generate automated communication to the appropriate management/control/compliance personnel.

C. Systems should have the capability to handle planned (e.g., early market closures on Christmas Eve, etc.) and unplanned events where the order cutoff time may be earlier (or later) than 4:00 p.m. EST.

D. In the case of recurring system transactions, the initial transaction must be input before Market Close in order for orders to be created and executed at the current day's price.
   1. Recurring plan-level transactions (e.g., fees) would require a plan-level entry into the system and time-stamping before Market Close.
   2. Recurring participant-level transactions (e.g., an automatic quarterly portfolio re-balance) would require a participant-level entry into the system and time-stamping before Market Close.

IV. Systems must be capable of warning of violations and ineffective controls must be detectable.

A. Order entry systems must have reporting or other detective controls to identify any attempts to modify orders, enter new orders, or cancel existing orders that occur after Market Close.

B. A duly authorized control officer must be assigned to monitor controls and processing no less frequently than daily. Exceptions identified must be researched and documented, with appropriate actions taken. Appropriate auditable documentation must be produced.

C. Detective controls must generate automated communications (e.g., reports or e-mails) to appropriate management and compliance personnel alerting them to trading exceptions, such as orders entered after Market Close for the current day's price or the cancellation of orders after Market Close that were entered before Market Close.

V. Annual executive certification provides a standard of authenticity of all information.

A. The senior executive and a designated compliance officer of all entities that handle mutual fund orders are required to sign a letter certifying to the SEC the authenticity of the records they have processed.

B. The authenticity must indicate that in fact orders contained within the system have not been tampered with or altered by means outside normal system processing through which the controls above are enacted and that time-stamps have not been altered in a manner that is not apparent to the system.

C. This certification must also represent that full disclosure has been provided, that any suspected or detected breaches have been reported to both the fund company and the SEC along with the nature and supporting information, or that no breaches to the integrity of the systems controls have been detected.

D. This certification must be represented to the SEC on an annual basis coinciding with the annual audit described below.

VI. Enhanced transparency for uncertified intermediaries, independent audits and enhanced compliance surveillance requirements provide additional transparency and independent verification of the effectiveness of controls.

A. Any "Smart 4 certified" intermediary or fund company that accepts trades (or transactions that result in trades) from an intermediary that has not certified with the SEC that it is in compliance with "Smart 4" is responsible for ensuring that the orders were received at the uncertified intermediary prior to Market Close. Intermediaries that have not filed certification with the SEC must consent to the verification procedures implemented by the certified intermediary to which it sends transactions. The certified intermediary must require verification procedures that demonstrate in a regulatory examination or outside audit that the uncertified intermediary submitted unaltered orders received prior to Market Close. In any event, a violation at the uncertified entity would be deemed to be a violation at the relevant certified intermediary. Essentially, the certified intermediary that accepts orders from an uncertified intermediary would be vouching for the veracity and authenticity of those orders as valid, pre-Close trades.

B. Banks would be subject to the same Smart 4 requirements as other intermediaries. Inspection and enforcement authority would be vested in the Federal banking agencies with back-up authority held by the SEC. This framework is modeled after the current regulatory scheme under which banks act as transfer agents.

C. Certified entities that process legitimately-received mutual fund orders after Market Close would be required to conduct an annual audit of its illegal late-trading prevention and detection procedures. The SEC should provide guidance as to what procedures, policies, processes and detection capabilities independent auditors should be seeking to verify, including providing specific examples of abuse. At a minimum, the independent auditor must:
   1. Review documentation of internal controls
   2. Review management's self assessment program
   3. Obtain an understanding of a firm's internal controls with respect to SEC Rule 22c-1 compliance
   4. Evaluate the effectiveness of the design of controls
   5. Test the operating effectiveness of controls
   6. Evaluate the results and form an opinion

D. The auditor would be required to make available its report to the fund's chief compliance officer.

E. If the auditors discover any material control weaknesses, and management does not promptly correct those weaknesses, the auditor would be required to notify the SEC, similar to the requirement for independent audit escalation under Section 10A of the Securities Exchange Act of 1934. The SEC would notify the Department of Labor as appropriate.

F. A robust compliance surveillance process would be required to ensure that orders were in fact received prior to Market Close. Surveillance would be required for suspicious patterns of potential prohibited late orders by a single client, a single client using multiple account numbers, orders entered by related clients (such as clients of a single adviser), and orders entered by a single registered representative. The SEC should provide guidance, based on its recent investigations, as to the most common types of patterns and behaviors for which firms should be screening. Where suspicious patterns exist without adequate contemporaneous explanations, firms must take prompt action to investigate and respond appropriately.

The "Smart 4" proposal will ensure that only those entities that have the best systems for preventing illegal late trading are able to accept orders up until Market Close and process them for delivery to Fund Companies after Market Close.

August 19, 2004

Mr. Paul Roye
Director, Division of Investment Management
U.S. Securities and Exchange Commission
450 5th Street N.W.
Washington, D.C. 20549

Dear Mr. Roye:

With this letter, we are pleased to submit to the SEC the most recent draft of the "Smart 4" alternative to the proposed "Hard 4 Close" rule to combat illegal late trading of mutual funds. We appreciate the willingness of you and your staff to engage in an ongoing dialogue with our coalition over the last several months, and to candidly express your concerns about various provisions of the "Smart 4" during that process. We believe that this version of the proposal addresses the concerns expressed by you and your staff about earlier iterations of the "Smart 4."

One area we have focused on in particular is attempting to address your concern about how the SEC can be confident that third-party administrators that fall outside the agency's jurisdiction are abiding by the rules. Our recommendation, spelled out in the attached, is to require all entities that wish to accept trades up to Market Close and engage in processing after Market Close to certify to the SEC that their systems are equal to or better than the "Smart 4" requirements, and that those systems are working properly. SEC-certified intermediaries that take orders or instructions from non-certified intermediaries are then required to take responsibility for ensuring that the orders or instructions were received at the uncertified entity prior to Market Close. By placing the liability on the SEC-certified intermediary, the SEC can allow those intermediaries the flexibility to design whatever contractual or technological solution they like to ensure compliance. We expect that extremely strict provisions will be put in place by the certified intermediary to ensure that all orders it receives from an uncertified intermediary are authentic orders, properly received prior to Market Close.

Again, we thank you for your patience and cooperation over the last several months. The companies and organizations in the "Smart 4" coalition are completely committed to ending illegal late trading, and we believe our solution accomplishes that goal without requiring an earlier trading cut-off time that will leave some types of investors at a disadvantage. We look forward to the opportunity to discuss this latest version of "Smart 4" in more detail and answer your questions at our scheduled meeting on August 23rd.

Sincerely,

American Benefits Council
American Society of Pension Actuaries
Automatic Data Processing, Inc.
Charles Schwab & Co., Inc.
Hewitt Associates
MassMutual Financial Group
Manulife/John Hancock
Nationwide Financial
Profit Sharing/401k Council of America