99

THE FINANCIAL SERVICES ROUNDTABLE

1001 PENNSYLVANIA AVE., NW
SUITE 500 South
WASHINGTON, DC 20004
TEL 202-289-4322
FAX 202-289-1903

E-Mail steve@fsround.org
www.fsround.org

STEVE BARTLETT
PRESIDENT

February 5, 2004

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: "Amendments to Rules Governing Pricing of Mutual Funds," SEC Rel. No. IC-26288, File No. S7-27-03

The Financial Services Roundtable[1] is pleased to offer its comments on the above-captioned amendments proposed by the Securities and Exchange Commission (the "Commission" or the "SEC"). The Roundtable supports vigorous additional efforts by the Commission to protect mutual fund shareholders from late trading. From intermediaries to funds, more can and should be done to ensure that all investors are treated fairly in terms of the price they receive when buying and selling fund shares.

Roundtable member firms support requiring participants in the process of transmitting investor orders in mutual funds to adopt forceful safeguards against late trading. The Roundtable advocates requiring funds and fund intermediaries, as a condition to be eligible to receive mutual fund orders up to the 4:00 p.m. closing time, to have electronic time stamping systems and abide by associated compliance, certification and independent audit requirements. The Roundtable believes these requirements, described in detail below, would better serve investors than the amendments to Rule 22c-1 proposed by the Commission. As described below, Roundtable members believe these amendments would be disruptive and confusing to investors, who would face difficulty in trading and would therefore be discouraged from investing in mutual funds.

I. Introduction

Mutual funds have become an indispensable tool for Americans seeking to invest in order to meet future financial goals. Mutual funds are a favored long-term investment vehicle for individuals and households looking to save and build wealth.
American households today account for nearly three-quarters of all mutual fund ownership.

---

[1] The Financial Services Roundtable unifies the leadership of large integrated financial services companies. Its membership includes nearly 100 firms from the banking, securities, investment and insurance sectors. In addition to communicating the benefits of integrated financial services to the American public, the Roundtable is a forum in which financial services industry leaders address critical public policy issues.

Given this involvement by American individuals and families, retaining investor confidence in mutual funds is critical both to the fund industry's continued success and to the financial future of American investors. As mutual fund managers and distributors, Roundtable members recognize that recent instances of late trading have the potential to undermine investor confidence in mutual funds and the U.S. markets as a whole. Roundtable members care deeply about restoring investor trust and offer the comments below in the hope of achieving that goal.

II. Enhanced Protections Against Late Trading

A. Current Prohibitions Against Late Trading

A key tenet of mutual fund investing is that all orders to buy or sell the shares of an open-end investment company received on a particular day are executed at the same price. Rule 22c-1[2] issued under the Investment Company Act requires funds to calculate a "net asset value" ("NAV") at least once a day.[3] Typically, mutual funds calculate their NAVs as of 4:00 p.m. Eastern time, the closing time of the major U.S. stock exchanges. Under Rule 22c-1, orders to buy or redeem mutual fund shares must be executed at a price based on the NAV next calculated after receipt of the order.[4] The Rule therefore requires that orders for most funds received after 4:00 p.m. be executed using the next day's price.

"Late trading" refers to the practice of seeking to submit an order to buy or redeem fund shares after the 4:00 p.m. pricing time yet receive that day's price rather than the price set at 4:00 p.m. the following day, or placing a conditional order prior to 4:00 p.m. that is either confirmed or canceled after 4:00 p.m. A late trader typically seeks to trade profitably on the basis of news occurring after 4:00 p.m., such as earnings announcements or developments in overseas markets. The late trader's profits can be said to come at the expense of all other shareholders in the fund. As noted above, late trading is specifically prohibited by Rule 22c-1.

For over three decades, the Commission has interpreted "receipt" as used in Rule 22c-1 to include receipt of an order to buy or redeem mutual fund shares by retail brokers and other intermediaries.[5] The SEC staff reiterated this position as recently as 1997.[6] Roundtable members believe this interpretation has played a significant part in the acceptance by American investors of mutual funds as an investment option. Investors are able to place orders to buy or redeem fund shares through broker-dealers, through retirement accounts, and through variable insurance carriers, free of any concern that they might be receiving a less advantageous price that they would have received by transmitting their order directly to the fund distributor. Broker-dealers and retirement plan administrators can offer investors the convenience of investing in many different funds through a single portal.

---

[2] 17 CFR 270.22c-1.
[3] 17 CFR 270.22c-1(b).
[4] 17 CFT 270.22c-1(a).
[5] See Staff Interpretive Position Relating to Rule 22c-1, SEC Rel. No. IC-5569 (December 27, 1968).
[6] Charles Schwab & Co., Inc., SEC Staff No-Action Letter (July 7, 1997).

B. Enhanced Protections to Prevent Late Trading

The Roundtable advocates requiring funds and fund intermediaries, as a condition to be eligible to receive mutual fund orders up to the 4:00 p.m. pricing time, to have in place enhanced protections to prevent late trading. The Roundtable previously articulated this view in a letter to the Director of the SEC's Division of Investment Management.[7] Roundtable members greatly appreciate that the Commission has cited the Roundtable's letter and specifically sought public comment on it.

1. Electronic time stamping systems

First and foremost, the Roundtable believes the Commission must require the use of electronic, tamper-proof time stamping systems for orders to buy or redeem mutual fund shares ("secure systems"). Mutual funds and their transfer agents currently are not required to time stamp orders – a significant gap that should be closed.[8] Mutual funds, their transfer agents, and clearinghouses should be required to have secure systems in place. Secure systems, aligned with the atomic clock as with equity order time stamping systems, must record the actual time an order is received from an investor and the time of any subsequent modification or cancellation of that order. This is a critical element in creating a verifiable audit trail. They also must record the time of each transmittal of an order, such as from a retirement plan administrator to a broker-dealer and from an intermediary to a fund or its transfer agent.[9] The Order Audit Trail System adopted by the National Association of Securities Dealers could serve as a model.

In addition, mutual funds and their transfer agents should be allowed to accept mutual fund orders after the 4:00 p.m. pricing calculation that have been stamped with a time prior to 4:00 p.m. only from intermediaries that also utilize secure systems. Broker-dealers already are required to time stamp orders pursuant to applicable books and records regulations. The Roundtable supports a heightened requirement for mutual fund orders, namely that they be entered immediately upon receipt from clients' secure systems rather than recorded on written order tickets. Such a requirement would eliminate the opportunity for abuse that arises when orders are memorialized on paper tickets but then altered or canceled before they are recorded in firm-wide systems.

The Roundtable believes a number of factors can ensure that secure systems offer protection against late trading. It is essential that there be no entry point for orders time-stamped after the time of funds' pricing calculations. The SEC could require that secure systems refuse to accept mutual fund orders time-stamped after 4:00 p.m., so that orders

[7] Letter from Steve Bartlett, President, The Financial Services Roundtable, to Paul F. Roye, Director, Division of Investment Management, Securities Exchange Commission (Nov. 10, 2003). Others advocating similar approaches include the Securities Industry Association, the American Bankers Association, and Charles Schwab & Co., Inc. See SEC Rel. No. IC-26288 at footnote 23.
[8] See SEC Rel. No. 34-47910 (May 29, 2003).
[9] For additional detail regarding the various steps involved in processing mutual fund orders see Letter from Edward L. Yingling, Executive Vice President, American Bankers Association, to Paul. F. Roye, Director, Division of Investment Management, Securities Exchange Commission (November 12, 2003).

received before that time may be sent on for processing, while orders received after that time "queue up" for execution at the next day's price.[10]

In order to be confident that such a secure system is immune to tampering, access must be strictly controlled. The SEC could require that neither a firm's brokerage nor trading personnel have the ability after 4:00 p.m. to enter cancellations or "corrections" of mutual fund orders time-stamped prior to 4:00 p.m. In order to ensure that any changes made are to correct genuine errors, the SEC could require that any changes after 4:00 p.m. be made only by systems operation personnel, that the system document such changes, and that such documentation is provided to their firms' compliance departments for review.

In order not to penalize investors who do not purchase shares directly from mutual funds or through broker-dealers, other intermediaries also should be allowed to adopt secure systems in order to transmit orders to funds after 4:00 p.m. Independent plan administrators and insurance companies, for example, should be given the opportunity to meet the same standard demanded of broker-dealers. The Commission's jurisdiction over funds and their transfer agents should provide a sufficient nexus to ensure that these intermediaries utilize secure systems.

2. Compliance and certification

Construction of the systems described above will not prevent late trading unless the systems are utilized without circumvention. The Roundtable believes that introduction of compliance and certification requirements would help ensure that secure systems are used in all cases and that they have the characteristics outlined above. Funds and intermediaries should be required to institute surveillance programs reasonably designed to detect patterns of late trading, such as patterns of late orders by a single client or by clients of a single registered representative. Mutual funds, their transfer agents and clearinghouses should be required to certify annually that they are operating systems in compliance with such regulations as the SEC adopts regarding such systems. They further should be required to certify that they are accepting orders only from intermediaries who also utilize secure systems. This requirement should go a long way toward addressing the concern that intermediaries not subject to regulation by the Commission could continue to serve as a conduit for late trading. Finally, broker-dealers should be required to certify annually that they are operating systems in compliance with SEC regulations as a condition to the authority to receive mutual fund orders up to 4:00 p.m. The Commission should engage the Federal bank regulators in a dialogue to encourage them to adopt a similar requirement for the institutions they oversee. Coordination of enforcement efforts between the SEC and the Federal bank regulators would also do much to deter and prevent late trading.

3. Independent audit

Finally, the SEC could require independent audits of these systems at least annually to ensure that they are in fact protecting against late trading. Mutual funds, their transfer agents and clearinghouses would be required to receive independent audits of

[10] There must be provision in the rules adopted by the Commission for entry of order during emergencies that may render electronic systems unavailable.

their systems. In addition, they would be required to accept orders only from intermediaries whose systems also receive independent audits. Broker-dealers would be required to receive independent audits of their systems.

The Commission could specify the requirements of these audits. The Roundtable suggests that the considerable body of literature and practice regarding independent audits of internal controls, such as Statement of Auditing Standards 70, be used for guidance. The Commission could identify the eligibility of independent auditors to review these systems and the types of abuses that such audits must be designed reasonably to detect. The Commission further could require that the results of such audits be provided as appropriate to the SEC, to mutual fund directors, and to fund and broker-dealer chief compliance officers.

4. Conclusion

The Roundtable believes that mandating that mutual funds, their transfer agents, clearinghouses, and intermediaries implement the electronic systems and compliance, certification and audit requirements described above would be an appropriate and effective means of preventing future occurrences of late trading. While not without cost, these requirements are necessary to ensure that mutual funds continue to operate, and be perceived by investors as operating, in the interest of all their shareholders. Roundtable members believe that the costs and benefits of such an approach are decidedly more attractive than those of the amendments to Rule 22c-1 proposed by the Commission and discussed below.

III. Amendments to Rule 22c-1 Proposed by Commission

A. Amendments to Rule 22c-1 Proposed by the Commission

The Commission proposes to amend Rule 22c-1 to require that all orders to purchase or redeem mutual fund shares be received by the mutual fund, a single transfer agent designated by the fund, or a registered securities clearing agency by the time that the fund establishes for calculating its net asset value in order to receive that day's price.[11] Fund intermediaries such as broker-dealers, issuers of variable insurance products, and retirement plan administrators would be required to submit orders to the fund before 4:00 p.m. in order for their customers to receive that day's price. This proposal is sometimes referred to as a "hard close," as orders received by the fund after 4:00 p.m. would be executed at the next day's price regardless of when those orders had been delivered by investors to intermediaries. An exception would allow investors to receive the same day price in cases of emergency such as power failure.

B. Drawbacks to Amendments Proposed

The Roundtable believes that the "hard close" at the mutual fund proposed by the Commission is not the best way to protect against late trading. As described below, it would actually disadvantage many fund shareholders. It would require significant changes to investors' current practices and create confusion among investors. The

[11] SEC Rel. No. IC-26288 at 4.

differing cut-off times for mutual fund orders would result in differing prices and difficulty for investors executing particular types of trades, such as exchanges. Over time, this would create distortions in the marketplace and discourage investment in mutual funds.

1. Earlier cut-off time would require significant changes in investor behavior

Mutual funds today receive over half of their orders in the form of aggregated orders provided by intermediaries after 4:00 p.m.[12] Under the proposed rule, intermediaries such as broker-dealers and retirement plan administrators would have to establish earlier cut-off times for their customers in order to process mutual fund orders and transmit them to the fund, transfer agent or clearinghouse by 4:00 p.m. A similar adverse impact would befall purchasers of variable insurance contracts which use mutual funds as the underlying investment vehicles; these contractholders would also be subject to cut-off times much earlier than 4:00 p.m. This earlier cut-off time might be 2:00 p.m. Moreover, today many mutual fund investors place their orders toward the end of the trading day, as they have no reason to place their orders earlier in the day. These factors suggest that the proposed rule would entail a significant change in investor behavior: investors purchasing shares through intermediaries such as broker-dealers or pension administrators would either have to change the timing of their placement of mutual fund orders or change the manner in which they buy and sell mutual fund shares to deal directly with funds. Purchasers of variable insurance contracts would be even more severely disadvantaged; they would have to place orders well before the 4:00 p.m. cut-off, as the product design and regulatory requirements would prohibit allowing direct placement of orders with the underlying fund.

Deadlines in retirement accounts might be even earlier. This would certainly be the case for participants in plans administered by independent administrators that are not affiliated with funds. In addition, many plans invest in funds through insurance company separate accounts that are not registered as investment companies. With earlier deadlines, retirement plan participants might experience an inability to purchase mutual funds in a rising market or to sell mutual funds in a declining market. This could reduce plan participants' enthusiasm for investing in mutual funds altogether.

2. Differing cut-off times would create investor confusion

The proposed rule would create confusion for investors, as they would encounter different rules and different results when trading mutual funds. First, an investor would likely face different time cut-offs for placing mutual fund orders for his accounts at different broker-dealers and for any retirement accounts. Second, within each account, an investor would likely face different rules for placing mutual fund orders than for placing orders for other securities, such as equities. Finally, an investor could even face different cut-off times for placing orders in different mutual funds with the same broker.

3. Differing cut-off times would result in differing prices and difficulty in trading

[12] Letter from Geof Gradler, Senior Vice President and Head, Office of Government Affairs, Charles Schwab & Co., Inc., to Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission (October 27, 2003), at 7.

Not only would investors face confusion arising out of differing rules, they would receive different results, namely same-day versus next-day pricing, depending on the manner in which they trade mutual fund shares. Investors could lose the ability to execute same-day exchanges of funds. Broker-dealers today can effectuate sales of stocks or bonds to purchase fund shares, or vice versa. Similarly, broker-dealers and other intermediaries can exchange shares of funds from different fund families. Under the SEC proposal, investors selling mutual funds after 2:00 p.m. could not use the proceeds to buy other securities on the same trading day. The price for the sell side of the transaction would not be known until after 4:00 p.m. and therefore the buy side could not be entered until the next day.[13] This likely would make exchanges across different fund families impossible to carry out in a single day. Given the earlier deadlines and the time differences, retirement plan participants and investors on the West Coast in practice would likely receive next-day rather than same-day pricing for their mutual fund transactions. Investors would thus find it difficult if not impossible to engage in the kinds of transactions they now take for granted.

4. Creation of distortions in the marketplace

Earlier cut-off times for intermediaries could create an incentive for investors to trade directly with mutual funds. This would create undesirable distortions in the marketplace. It would discourage investors from using intermediaries that allow them easily to compare funds from different families and to see the performance of the various funds in which they invest in a single place. This could also lead to less competition among mutual funds on the basis of cost, a result at odds with the policy behind the Commission's efforts to increase the transparency of mutual fund costs. It would favor larger funds, which are more likely to market directly to investors, and disadvantage smaller funds that may rely more heavily on intermediaries for distribution.

An earlier cut-off time for intermediaries accepting retail orders would also create an undesirable arbitrage opportunity. If fund shareholders such as institutional traders are able to trade directly with fund companies at a time when the majority of retail investors are cut off, they will have a potential advantage over retail investors. Any substantial news item that occurs after the retail cut-off but while the markets are still open will be reflected in stock prices and ultimately in funds' NAVs for the day. Institutional traders would be able to capitalize on this opportunity. To the extent that retail investors lose confidence in the fairness of such a "two-tiered" market, they will tend to favor other investment opportunities over mutual funds.

C. Conclusion

The Roundtable does not believe that the costs associated with the proposed amendment to Rule 22c-1 are justified by the benefits. To the contrary, not only would the proposed rule impose direct costs in the form of changes to computer systems and the like, it would have negative implications for investor confidence and the marketplace. It would force investors to confront different rules for mutual funds and other securities; different rules for different methods of investing in mutual funds; different prices for

---

[13] Today these types of transactions can be sent to intermediaries without exact share or dollar amounts, as they are matched and completed by intermediaries after 4:00 p.m.

different mutual fund transactions; and an inability to engage in certain types of trades on a same-day basis. While the amendment may prevent late trading, it would do so only by making all trading in mutual funds more confusing and less attractive.

IV. Final Conclusion

Careful and considered action by the Commission to protect mutual fund shareholders from late trading will do much to restore and maintain investor confidence in mutual funds as an investment tool. The Roundtable supports the imposition of tough additional requirements on all participants in the mutual fund order transmittal process. These would require market participants to implement, adhere to and monitor electronic tamper-proof systems to ensure that only orders placed by investors before 4:00 p.m. are executed at that day's price. Such a requirement would achieve the Commission's objective of investor protection without simultaneously and unnecessarily disadvantaging many mutual fund investors across the country. The Roundtable appreciates that the Commission has sought public comment on its initial proposal and looks forward to working with the SEC to devise enhanced protections for investors. We hope that the comments we have offered here will lead to the SEC to consider this alternative further.

Best regards,

Steve

Steve Bartlett