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MEMORANDUM

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

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

DATE: April 26, 2004

Attached are two outlines submitted by Charles Schwab & Co., Inc. ("Schwab"), detailing Schwab's recommended "Smart 4" solution to mutual fund late trading. The outlines further detail Schwab's recommendations made in the February 25, 2004 meeting between Schwab and staff members of the U.S. Securities and Exchange Commission.

Attachments

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THE "SMART 4" SOLUTION TO MUTUAL FUND LATE TRADING

Numerous firms in the mutual fund and retirement plan business have come together to offer a tough, sensible solution that will end illegal late trading 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" 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. The SEC or its designee would have to certify that the intermediary has met the requirements before it could be permitted to receive orders up to Market Close. Any entity that chooses not to comply would operate under 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. The core elements of the "Smart 4" proposal:

- **Electronic Audit Trail**: Immediate electronic time-stamping of an order, upon its receipt, in a manner that cannot be altered or discarded once the order is entered into the trading system, would be required. Further, a time stamp would be required indicating when an order, or a batch of orders, is transmitted to the next trading step, be it an intermediary, transfer agent, or fund company. Processes allowing trades to be tracked from the initial customer to the mutual fund company would be required. Where an intermediary or multiple intermediaries are involved, each would be responsible for time stamping the order with the time they received and transmitted the order or batch of orders. Further, where trades are batched or aggregated, the aggregating intermediary must be able to identify each underlying individual trade. Systems should automatically assign a unique "transaction identifying number" to an order at the point of entry into the system. A unique user ID identifying the individual who entered the order or the channel (e.g., Internet or voice-response system) from which the order was received must be created.

- **Executive Certification of Procedures**: Entities that handle mutual fund orders – including fund companies and their transfer agents, as well as intermediaries such as brokerage firms and retirement plan third-party administrators – must have senior executives issue annual certifications that they have procedures to prevent or detect unlawful late trading, and that those procedures are working as designed. The SEC should provide guidance on minimum procedures that every entity must meet. Intermediaries must make these certifications available to any mutual fund on behalf of which it accepts orders for purchase or sale of shares of the fund. The certification procedure would be similar to that required of public corporations.

- **Enhanced Independent Audits**: All entities that handle mutual funds orders should 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 review documentation of internal controls; review management's self assessment program; obtain an understanding of a firm's internal controls with respect to SEC Rule 22c-1; evaluate the effectiveness of the design of controls; test the operating effectiveness of controls; and evaluate the results and form an opinion. The auditor would be required to make available its report to the fund's chief compliance officer and escalate unresolved material weaknesses directly to the SEC. If the auditors discover any material control weaknesses, and management does not promptly correct those weaknesses, the auditor should be required to escalate that information to the SEC, similar to the requirement for independent audit escalation under Section 10A of the Securities Exchange Act of 1934.

- **Expanded SEC Jurisdiction and Enhanced Transparency**: The SEC will be granted inspection authority over any intermediary that forwards mutual orders to a fund company after Market Close. Unregistered intermediaries should consent to SEC inspection on the grounds that they are acting as an agent of an SEC-registered mutual fund when they accept orders for that fund. To the extent intermediaries decline to consent to SEC jurisdiction for inspections, they should be required to submit all trades to a registered intermediary (or directly to the fund or transfer agent) prior to Market Close. Banks would be subject to the same Smart 4 requirements as other intermediaries. However, the 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.

- **Enhanced Compliance Surveillance**: A robust compliance surveillance process would be required, including comprehensive policies and procedures that would 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, orders entered by related clients (such as clients of a single adviser), or orders entered by a single registered representative. Where suspicious patterns exist without adequate contemporaneous explanations, firms should take prompt actions to investigate and respond appropriately. The SEC, based on its experience in recent months, should provide guidance as to the patterns companies should be keeping watch for.

The "Smart 4" solution 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 the fund company after Market Close.

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

Numerous firms in the mutual fund and retirement plan business have come together to offer a tough, sensible solution that will end illegal late trading 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" 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. The SEC or its designee would have to certify that the intermediary has met the requirements before it could be permitted to receive orders up to Market Close. Any entity that chooses not to comply would operate under 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 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, recurring distributions, automated rebalancing).

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

- The system time on all computer platforms involved in the process should be synchronized with the atomic clock no less than once a day to ensure the integrity of the system clock.
- Order databases that retain current and historical order records should 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 should be retained consistent with applicable regulatory requirements but in all cases for no less than 3 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.

- Orders must be immediately electronically time-stamped upon receipt, in a manner that cannot be altered or discarded once the order is entered into the trading system. System users should not be able to set or choose a time-stamp or overwrite an existing time-stamp.
- Time stamps are required each time an order, or a batch of orders, is transmitted to the next trading step, be it an intermediary, a transfer agent, or a fund company. This series of time stamps would allow a trade to be tracked from the initial customer to the mutual fund company.
- In cases where trades are batched or aggregated, the aggregating intermediary must be able to identify each underlying individual trade.

- Systems should automatically assign a unique "transaction identifying number" to an order, or a transaction that results in orders, at the point of entry into the system with no human intervention. System users should not be able to set, alter, or over-write an existing transaction number.
- Systems should have security to ensure only authorized individuals have the ability to enter new orders or cancel existing orders before Market Close.
- Each order, and transaction that results in an order, should capture a unique user ID identifying who entered the order or the channel (e.g., Internet or voice-response system) from which the order was received. In addition. all critical data elements of a trade order and the date/time-stamp should be captured. Critical data elements of a trade order are the action (buy/sell/exchange), fund (cusip or ticker), and quantity or dollar amount. Critical data elements of 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).
- All orders, and transactions that result in orders, must be entered and recorded into the firm's system by Market Close without exception. In cases where a systems outage occurred, firms would be 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 system before market close.
- In the event that a bad record must be deleted to resolve a system issue there should be procedures and controls to retain a record of what was deleted and to ensure that the deletion is properly authorized by the appropriate control individual who is not directly involved in the trading process. No other orders should be deleted from the system.
- 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.
- Systems should have functionality to systematically block purchase orders from clients who have been restricted by fund companies.
- With Customer Directed or Recurring System Transactions, the system will create the corresponding orders and carry forward the transaction time stamp, unique identifier, and transaction number of the original transaction. The system must be designed such that an audit trail connects the original transaction and the corresponding orders.

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.

- Systems must be designed to ensure that orders 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).
- System should be designed such that no orders can be entered in the system after Market Close for current day's price.
- Customer orders should never be time-stamped until entered and accepted by the system and the system time stamp is the only stamp of record.

- 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.
- Systems should require 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.
- Cancellations of orders before Market Close should be captured and retained with their own time-stamp and user ID unique from the original order's time-stamp and user ID.
- Systems should have security and controls designed to prevent existing orders, or transactions that will result in orders, entered before Market Close from being modified or cancelled after Market Close.
- Systems should be designed to handle legitimate cancellations of purchase orders after Market Close that are the result of fund company decisions to reject a purchase order. Notice of any such reject from the fund company must be via electronic delivery to the organization that delivered the original order to the fund. Access to handle such cancellations should 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 should generate automated communication to the appropriate management/control/compliance personnel.
- In the case of Recurring System Transaction, the initial transaction must be input before Market Close for orders to be created and executed at the current day's price.

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

- Systems should have reporting or other detective controls to identify any attempts to change orders, enter new orders, or cancel existing orders that occur after Market Close.
- A duly authorized control officer should be assigned to monitor controls and processing no less frequently than daily. Exceptions identified through these tools should be researched, documented, and appropriate action taken, and appropriate auditable documentation produced.
- Detective controls should generate automated communications to appropriate management and compliance personnel alerting them to trading exceptions, such as orders entered after Market Close or the cancellation of orders after Market Close that were entered before Market Close.

V. Executive certification provides a standard of authenticity of all information.

- The Chief Compliance Officer and the top executive of all entities that handle mutual funds orders should be required to sign a letter certifying to the SEC the authenticity of the records they have processed.
- 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.
- This certification must also represent that full disclosure has been provided, that any suspected or detected breeches have been reported to both the fund company and the

SEC along with the nature and supporting information, or that no breeches to the integrity of the systems controls have been detected.

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

VI. Enhanced SEC jurisdiction, independent audits and enhanced compliance surveillance requirements provide additional transparency and independent verification of effectiveness of controls.

- The SEC should have inspection authority over any intermediary that seeks to accept orders up until Market Close and process those orders after Market Close.
- Unregistered intermediaries should consent to SEC inspection on the grounds that they are acting as an agent of an SEC-registered mutual fund when they accept orders for that fund. To the extent intermediaries decline to consent to SEC jurisdiction for inspections, they should be required to submit all trades to a registered intermediary (or directly to the fund or transfer agent) prior to Market Close.
- Banks would be subject to the same Smart 4 requirements as other intermediaries. However, the 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.
- All entities that handle mutual funds orders should 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:
  - Review documentation of internal controls
  - Review management's self assessment program
  - Obtain an understanding of a firm's internal controls with respect to SEC Rule 22c-1 compliance
  - Evaluate the effectiveness of the design of controls
  - Test the operating effectiveness of controls
  - Evaluate the results and form an opinion
- The auditor would be required to make available its report to the fund's chief compliance officer.
- If the auditors discover any material control weaknesses, and management does not promptly correct those weaknesses, the auditor should be required to notify the SEC, similar to the requirement for independent audit escalation under Section 10A of the Securities Exchange Act of 1934.
- 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), 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 should take prompt action to investigate and respond appropriately.