

order information to the fund's primary transfer agent.¹⁰ Many of the purchase and redemption orders are routed to fund primary transfer agents through the National Securities Clearing Corporation ("NSCC"), currently the only registered clearing agency¹¹ that operates an automated system for processing those orders for funds¹² ("Fund/SERV").¹³ Fund/SERV provides a central processing system that collects order information from clearing brokers and others, sorts all the incoming order information according to fund, and transmits the order information to each fund's primary transfer agent.¹⁴

Although purchase and redemption orders must be submitted to retail dealers and other intermediaries by 4 p.m. in order to receive that day's price, our rules permit those intermediaries to forward the order information to Fund/SERV or fund primary transfer agents at a later time.¹⁵ These intermediaries,

which include broker-dealers, banks, and administrators of retirement plans, typically process orders received before 4 p.m. in the early evening hours before submitting them to Fund/SERV or fund primary transfer agents. The process is typically completed in the middle of the night.

II. Discussion

Investigations by Commission staff and state securities authorities have uncovered late trading of fund shares by intermediaries in violation of our rules, in some cases with the assistance of fund managers.¹⁶ Our investigations and examinations are ongoing, but to date suggest that late trading of fund shares is not isolated, nor is it limited to any one type of fund or intermediary.¹⁷

Fund managers themselves have permitted late trades by favored investors. Late trading not only violates rule 22c-1, but managers who permit late trading also breach their fiduciary duties to the funds and fund shareholders. We have approved a new rule requiring that all funds have policies and procedures in place designed, among other things, to prevent late trading facilitated by fund personnel. We believe these new policies and procedures, administered by a chief compliance officer reporting directly to the fund's board of directors, will make such schemes more difficult. Vigorous civil enforcement, as well as criminal enforcement actions, when appropriate, will further deter such behavior.

Fund intermediaries have blended late trades with legitimate trades in the file containing net order information submitted to Fund/SERV or a fund's primary transfer agent after 4 p.m., effectively concealing the late trades from fund managers and from our compliance examiners. When we adopted rule 22c-1, we also amended our broker-dealer recordkeeping rules to require time-stamping of fund orders, which would permit us to detect late

trades.¹⁸ The rule has been circumvented by, for example, routinely permitting favored investors to place orders before 4 p.m., but cancel them after late news is received. Purchase orders would survive only when good news released after 4 p.m. increased the value of the fund's portfolio, while redemption orders would survive only when bad news depressed the value of the portfolio. Similarly, orders have been placed before 4 p.m. to be modified or changed after 4 p.m. Also clients that had placed an order for one fund's shares before 4 p.m. that was rejected by the fund, have been permitted to substitute an order for another fund's shares after 4 p.m. In each of these circumstances, the broker's records would appear to support a series of bona fide trades all of which were time-stamped before 4 p.m.

We are very concerned that our current rules, which permit intermediaries to process trades after 4 p.m., have failed to prevent late trading, and that available tools to control late trading facilitated by fund intermediaries have proven inadequate. Fund managers have informed us that, although they contractually require intermediaries to segregate orders submitted before 4 p.m. from those submitted later, they have no practical way to enforce that contractual obligation because they cannot discern late trades. Some broker-dealers engaging in late trading appear to have successfully concealed their activities from our examination staff and the self-regulatory organizations. Other fund intermediaries are not subject to our regular examination, and we cannot take steps we believe are adequate to prevent late trading through those intermediaries.

To eliminate late trading through fund intermediaries, we are proposing to amend rule 22c-1, as discussed in more detail below, to require that all purchase and redemption orders be received by the fund,¹⁹ a single transfer agent

¹⁰ Some intermediaries submit one aggregated purchase order and one aggregated redemption order in a single "batch." Others submit orders in multiple batches in the course of the day. The intermediary will batch customer orders it receives during the day at various times, with a 4 p.m. cut-off time for orders that are included in the last batch transmitted to the fund's primary transfer agent for same-day pricing. Orders received by the intermediary after the last cut-off time are included in a batch of orders transmitted to the fund's primary transfer agent for next-day pricing.

¹¹ A "clearing agency" is a person that acts as an intermediary in making payments or deliveries (or both) in connection with transactions in securities, or that provides facilities for comparing data with respect to the terms of securities transactions to reduce the number of settlements or the allocation of securities settlement responsibilities. See 15 U.S.C. 78c(a)(23)(A). A clearing agency is a self-regulatory organization, and its rules of operation are subject to approval by the appropriate federal regulatory agency. See 15 U.S.C. 78c(a)(26), 78s(b).

¹² Shares of exchange-traded funds ("ETFs"), however, are cleared through NSCC and the Depository Trust Company. An ETF typically is a registered open-end investment company with shares that trade intra-day at market-determined prices. See *Actively Managed Exchange-Traded Funds*, Investment Company Act Release No. 25258, nn. 6-8 and accompanying text (Nov. 8, 2001) [66 FR 57614 (Nov. 15, 2001)].

¹³ "Fund/SERV" is an acronym for the Mutual Fund Settlement, Entry and Registration Verification Service. Only NSCC members who are Fund/SERV participants may use the system. Funds or their distributors are NSCC members, who designate the primary transfer agent to receive information on share transactions on the fund or distributor's behalf.

¹⁴ The primary transfer agent provides Fund/SERV with its electronic confirmation of the order, and Fund/SERV forwards those confirmations back to the clearing brokers. In 2002, Fund/SERV processed 83 million fund transactions at a value of \$1.3 trillion. See *DTCC Business Volumes Set Records in 2002*, The Depository Trust & Clearing Corporation, Press Release (May 5, 2003) (available at <http://www.dtcc.com/PressRoom/2003/2002review.html>).

¹⁵ See Staff Interpretive Position Relating to Rule 22c-1, Investment Company Act Release No. 5569 (Dec. 27, 1968) (rule 22c-1 "contemplates that the time of receipt of the order by the retail dealer is

controlling" for purposes of determining the price obtained by the dealer). See also Charles Schwab & Co., Inc., SEC Staff No-Action Letter (July 7, 1997) (the time an order was received by a person designated in the fund's prospectus will be deemed the time the order was received for purposes of rule 22c-1).

¹⁶ See, e.g., In the Matter of Steven B. Markovitz, Investment Company Act Release No. 26201 (Oct. 2, 2003).

¹⁷ See Testimony of Stephen M. Cutler Concerning Recent Commission Activity to Combat Misconduct Relating to Mutual Funds Before the Senate Subcommittee on Financial Management, the Budget, and International Security, Committee on Governmental Affairs, 108th Cong., 1st Sess., 11-15 (Nov. 3, 2003).

¹⁸ See Adoption of Rule 22c-1 Under the Investment Company Act of 1940 Prescribing the Time of Pricing Redeemable Securities for Distribution, Redemption, and Repurchase, and Amendment of Rule 17a-3(a)(7) Under the Securities Exchange Act of 1934 Requiring Dealers to Time-Stamp Orders, Investment Company Act Release No. 5519 (Oct. 16, 1968) [33 FR 16331 (Nov. 7, 1968)]. See also 17 CFR 240.17a-3(a)(6)(i) (requiring broker-dealers to record each brokerage order and information pertaining to the order, including the time the order was received and the time of entry).

¹⁹ Under the rule, orders submitted to various intermediaries, such as third-party administrators, would not be considered orders received by the