

designated by the fund and required by written contract to receive order information and maintain a record of the date and time it receives the information ("designated transfer agent"), or a registered clearing agency (e.g., Fund/SERV) no later than the time at which the fund prices its securities (e.g., 4 p.m.), in order to obtain the current day's price.<sup>20</sup> As a consequence, fund intermediaries, such as broker-dealers, banks, and administrators of retirement plans would have to submit orders to the fund before 4 p.m. in order for their customers to receive the 4 p.m. price.<sup>21</sup> Orders received later would have to receive the following day's price.

We recognize that this proposed rule change, if adopted, would likely require substantial changes in the way fund intermediaries process fund purchase and redemption orders. The capacity of computer systems that process those orders will likely have to be expanded to handle more transactions within a shorter period of time. Intermediaries will likely require investors to submit purchase orders at an earlier time in the day (e.g., 2 p.m.) to obtain the 4 p.m. price, in order to allow the intermediary time to process the purchase and redemption orders before submitting them to the fund, its designated transfer agent, or the clearing agency. Administrators of defined contribution employee pension plans, (e.g., 401(k) plans) have informed us that they likely will be unable to process any purchase and redemption requests the same day they are made.<sup>22</sup>

We seek comment on these costs, and whether they are justified by the benefits of the proposed amendments. In proposing these amendments, we assume investors and intermediaries will adapt to the new requirements, just as they adapted when we required

forward pricing in 1968. Investors for whom it is important to be able to place orders shortly before 4 p.m. will seek out fund complexes that permit investors to submit orders directly to the fund's designated transfer agent. Some fund intermediaries also may compete for such investors by developing more efficient order processing systems. Others may eschew such customers because they tend to be short-term traders or market-timers. We believe that the burden on most fund investors will be small because most are not sensitive to the time at which their purchase or redemption orders are priced. They make longer-term investments, often as part of an automatic purchase program, and treat the time and date of the purchase order as a random event controlled by their employer's payroll processing protocols, or the delivery of the mail. In some cases, a purchase order executed at the next day's price will be executed at a lower price than it would the same day; in other cases, it will be executed at a higher price.

We also seek comment on an approach that has been suggested.<sup>23</sup> This approach would require fund intermediaries, in order to be eligible to submit orders to designated transfer agents or Fund/SERV after 4 p.m., to have adopted certain protections designed to prevent late trading.<sup>24</sup> Such protections could include:

- Electronic or physical time-stamping of orders in a manner that cannot be altered or discarded once the order is entered into the trading system;
- Annual certification that the intermediary has policies and procedures in place designed to prevent

late trades, and that no late trades were submitted to the fund or its designated transfer agent during the period; and

- Submission of the intermediary to an annual audit of its controls conducted by an independent public accountant who would submit his report to the fund's chief compliance officer.

We have identified these three protections as important components of this approach. Would each of these protections be appropriate to preventing trading in fund shares? Are there other protections that would be necessary or appropriate to prevent unlawful late trading while permitting intermediaries to continue processing purchase and redemption orders after 4 p.m.? If so, what are they?

Would such an approach be effective at stopping late trading? Some broker-dealers appear to have easily circumvented current system controls, including the time-stamping required by our rules. Our staff reports that at least one broker-dealer that had obtained an annual audit of its internal controls by an independent auditor has submitted late trades. We are therefore concerned that an independent auditor may fail to detect weaknesses in internal controls that allow late trading to occur. How could we prevent any such protections and controls from being circumvented similarly in the future? How would we police compliance with the controls by the fund intermediaries over which we have no regulatory authority? Finally, we recognize that this approach might require different systems changes than those required under the proposed amendments discussed in this Release. What costs would this approach impose on intermediaries? Would these costs be passed on to fund investors? Are there other conditions that would be more effective, or equally effective but less costly?

#### A. Proposed Pricing Requirements

Rule 22c-1 currently deems a purchase or redemption order to be received, for purposes of determining the appropriate day's price, when the retail dealer receives the order, even if it is actually submitted to the fund's transfer agent at a later time. The proposed amendments would deem an order received only when it is received<sup>25</sup> by (i) the fund itself, (ii) the fund's designated transfer agent, or (iii) a clearing agency registered with the

"fund," even if those intermediaries are agents of the fund.

<sup>20</sup> See proposed rule 22c-1(a).

<sup>21</sup> The general requirement of the rule would be subject to a few limited exceptions. See *infra* Section II.C.

<sup>22</sup> See, e.g., Letter from Robert G. Wuelfing, *The Spark Institute, Inc.*, to Paul F. Royce, Director, Division of Investment Management, Securities and Exchange Commission, and Cynthia M. Fornelli, Deputy Director, Division of Investment Management, Securities and Exchange Commission (Oct. 31, 2003) ("Spark Institute Letter") (available in the public comment file). Another administrator has noted that orders would have to be placed several hours earlier than 4 p.m. See Testimony of E. Scott Peterson, Global Practice Leader of Defined Contribution Services, Hewitt Associates, Submitted for the Record, U.S. Senate Subcommittee on Financial Management, the Budget, and International Security, Committee on Governmental Affairs, Hearing on Mutual Funds, Trading Practices and Abuses that Harm Investors, 108th Cong., 1st Sess. 6 (Nov. 3, 2003).

<sup>23</sup> Several groups have urged us to adopt such an approach. See, e.g., Letter from Marc E. Lackritz, President, *Securities Industry Association*, to Paul F. Royce, Director, Division of Investment Management, Securities and Exchange Commission (Oct. 31, 2003); *Spark Institute Letter*, *supra* note 22. See also Letter from Edward L. Yingling, Executive Vice President, *American Bankers Association*, to Paul F. Royce, Director, Division of Investment Management, Securities and Exchange Commission (Nov. 12, 2003); Letter from Steve Bartlett, President, *The Financial Services Roundtable*, to Paul Royce, Director, Division of Investment Management, Securities and Exchange Commission (Nov. 10, 2003); Letter from Geoff Gradler, Senior Vice President and Head, Office of Government Affairs, *Charles Schwab & Co., Inc.*, to Paul F. Royce, Director, Division of Investment Management, Securities and Exchange Commission, Cynthia M. Fornelli, Deputy Director, Division of Investment Management, Securities and Exchange Commission, and Douglas J. Scheidt, Chief Counsel, Division of Investment Management, Securities and Exchange Commission (Oct. 27, 2003) (advocating similar approaches). Each of the letters cited is available in the public comment file.

<sup>24</sup> These protections would be required for intermediaries other than the fund's designated transfer agent or the registered clearing agency.

<sup>25</sup> We use the term "receive" in the proposed rule text for purposes of proposed rule 22c-1 only. Receipt of an order in NSCC's Fund/SERV refers only to its role as an electronic communication hub that transmits fund orders from the broker-dealer to the appropriate mutual fund processor.