

assets in another fund and therefore must calculate their NAV on the basis of the other fund's NAV.⁴⁰ These funds are registered investment companies, and are subject to regulation and oversight by the Commission. The exception would permit a conduit fund, such as a "master-feeder" fund or an insurance company separate account, to submit its orders based on the NAV established by the other fund on the same day.⁴¹

We request comment on the exceptions included in the amended rule. Are there other exceptions that we should consider?

III. General Request for Comment

The Commission requests comment on the proposed amendments to rule 22c-1, suggestions for additions to the proposed amendments, and comment on other matters that might have an effect on the proposals contained in this Release. We note that the comments that are of greatest assistance are those that are accompanied by supporting data and analysis of the issues addressed in those comments.

IV. Cost-Benefit Analysis

The Commission is sensitive to the costs and benefits imposed by its rules. As discussed above, the proposed amendments to rule 22c-1 would require that an order to purchase or redeem fund shares be received by the fund, its designated transfer agent, or a registered securities clearing agency, by the time that the fund's board of directors establishes for calculating the fund's NAV in order to receive the current day's price.

A. Benefits

We anticipate that funds and shareholders would benefit from the proposed amendments. The amendments to rule 22c-1 are designed

to prevent late trading in fund shares. Preventing late trading would ensure that the value of a fund's outstanding redeemable securities would not be diluted through the sale of a fund's securities at a price below its NAV, or the redemption or repurchase of a fund's securities at a price above its NAV.⁴² This dilution harms the fund's long-term shareholders who lose at least as much as late traders gain in profits. By preventing this dilution, long-term investors would have more confidence in the financial markets as a whole, and funds in particular.

Funds would benefit by the increase in investor confidence, as investors would be less likely to seek alternative financial products in which to invest. Long-term investors also would benefit. Without these protections, many long-term investors, who would prefer to invest in mutual funds, may choose other investment instruments to avoid losses to late traders. Finally, these reforms will reduce the transaction costs that funds incur. When a late trader rapidly moves a large amount of money into and out of a fund, the fund incurs significant costs in buying securities and then selling them. These transaction costs include commissions and the spread between the bid and ask prices.

B. Costs

Currently, orders for a fund's shares received by broker-dealers, 401(k) plan administrators, and other third-party intermediaries from their customers prior to the fund's pricing time are eligible to receive that day's price. The proposed amendments to rule 22c-1 would limit same-day pricing to orders received by the fund, its designated transfer agent, or a registered clearing agency prior to the fund's pricing time. As a result, third-party intermediaries (including broker-dealers and retirement plan administrators) and NSCC would incur certain costs, and funds and investors might incur costs.⁴³ In addition, fund designated transfer agents would incur costs as a result of a recordkeeping requirement contained in the proposed amendments.

Third-party intermediaries would have to combine their fund share orders for processing prior to the pricing time, and therefore their customers may have to place their orders earlier in the day than investors who conduct business directly with the fund's designated

transfer agent in order to receive that day's price.⁴⁴ This would put intermediaries at a competitive disadvantage with designated transfer agents, and may result in a number of an intermediary's customers or potential customers bypassing the intermediary and purchasing or redeeming shares directly with the designated transfer agent. Alternatively, intermediaries, in order to compete with designated transfer agents, may upgrade their computer systems in order to process orders more quickly, thus allowing customers to place their orders as close to the pricing time as possible while qualifying for that day's price.⁴⁵ We would expect that the systems would become increasingly efficient over time and thus reduce the delay between the intermediary's receipt of the order and transmission to Fund/SERV or the designated transfer agent. The Commission, however, has no reasonable basis for determining the number of customers or potential customers that intermediaries might lose or the costs associated with the potential lost customer orders. The computer system upgrade would impose one-time costs. The Commission, however, has no reasonable basis for determining the costs of the technological upgrades intermediaries might incur as a result of the proposed amendments, because each intermediary could upgrade in a way that it deems best for its particular computer system.

NSCC, which operates Fund/SERV, would incur costs as a result of the proposed rule amendments. Under the proposed amendments, orders transmitted to Fund/SERV by broker-dealers and other intermediaries prior to a fund's pricing time would receive that day's price. Orders transmitted to Fund/SERV after a fund's pricing time, including orders received by the intermediary prior to a fund's pricing time, would receive the fund's next-day price. Intermediaries, therefore, would likely transmit a number of orders to Fund/SERV close to the pricing time, resulting in a substantial increase in the volume of transmissions received by Fund/SERV just prior to the pricing time. In response to this increase, NSCC would likely have to increase Fund/SERV's capacity to handle the expected

⁴⁰ Proposed rule 22c-1(b)(2).

⁴¹ Conduit funds rely on section 12(d)(1)(E) of the Act, and include most insurance company separate accounts. See 15 U.S.C. 80a-12(d)(1)(E). Section 12(d)(1)(E) permits a fund's acquisition of securities issued by another fund if, among other requirements, the security is the only investment security the acquiring fund holds (or the securities are the only investment securities the acquiring fund holds if it is a registered unit investment trust that issues two or more classes or series of securities, each of which provides for the accumulation of shares of a different fund). The separate account invests the proceeds from the sale of interests in variable annuity and variable life insurance contracts in shares of the underlying mutual fund according to the directions of the investor in the insurance contract. "Master-feeder funds" typically are arrangements in which two or more funds invest in a single fund. Investors purchase shares in the "feeder" fund, which is an open-end fund and a conduit to the master fund. See H.R. REP NO. 622, 104th Cong. 2d Sess., at 41 (1996).

⁴² It has been estimated that shareholders lose as much as \$400 million per year as a result of late trading. See Eric Zitzewitz, *How Widespread is Late Trading in Mutual Funds?* (Sept. 2003) <http://gobi.standord.edu/ResearchPapers/Library/RP1817.pdf>.

⁴³ See *supra* notes 11-12 and accompanying text.

⁴⁴ Some have estimated that orders would have to be submitted from two to four hours before pricing time. See Tom Lauricella, *Funds, Regulators Seek Balanced Fix in U.S. Industry*, Wall St. J. Eur., Oct. 31, 2003 at M1.

⁴⁵ Some administrators of 401(k) plans have informed us that they likely would not be able to process any purchase or redemption requests the same day they are made due to the myriad of rules governing 401(k) plans. See *supra* note 22 and accompanying text.