

however, that regulatory reforms are necessary to help prevent such abuses from recurring in the future. The Commission is proposing a package of rule amendments intended to address abuses that have surfaced in the areas of late trading, market timing, and selective disclosure. In this release, we are proposing disclosure reforms intended to shed more light on market timing and selective disclosure of portfolio holdings. In a second release, we are proposing amendments that would require that an order to purchase or redeem redeemable securities of a registered investment company be received by the company, its designated transfer agent, or a registered securities clearing agency by the time that the fund establishes for calculating its NAV in order to receive that day's price. In addition, we are publishing a release adopting rules requiring registered investment companies and investment advisers to adopt and implement written compliance policies and procedures, review those policies and procedures annually, and designate a chief compliance officer responsible for their administration.

A. Forward Pricing and Market Timing

Section 22 of the Investment Company Act of 1940 (the "Investment Company Act") regulates the pricing, distribution, and redemption of redeemable securities, including mutual fund shares.⁵ Paragraph (c) of section 22 gives the Commission broad power to regulate the pricing of redeemable securities, including the power to prescribe by rule methods for computing the price that a shareholder will receive upon redemption. Rule 22c-1(a) under the Investment Company Act requires mutual funds to sell and redeem their shares at a price based on the NAV next computed after receipt of an order. This requirement is referred to as "forward pricing." The purpose of

trading of mutual fund shares by several of its employees, and by failing to take adequate steps to detect and deter such trading activity through its own internal controls and its supervision of investment management professionals); *In the Matter of James Patrick Connelly, Jr.*, Release No. IC-26209 (Oct. 16, 2003) (vice chairman of investment advisory firm violated antifraud provisions of the federal securities laws by allowing select investors to time mutual funds managed by the firm); *In the Matter of Steven B. Markovitz*, Release No. IC-26201 (Oct. 2, 2003) (hedge fund trader who engaged in late trading of mutual fund shares violated antifraud provisions of the federal securities laws and rule 22c-1(a) under the Investment Company Act).

⁵ Both mutual funds and unit investment trusts issue redeemable securities. See section 4(2) and 5(a)(1) of the Investment Company Act [15 U.S.C. 80a-4(2) and 80a-5(a)(1)]. For purposes of simplicity, this section of the release only refers to mutual funds.

this requirement is to prevent dilution and assure that prices bear an appropriate relation to the current NAV of a mutual fund's shares.⁶ Rule 22c-1 generally requires mutual funds to compute their NAVs at least once daily, Monday through Friday, at a specific time or times as determined by their boards.⁷ Typically, mutual funds calculate their NAVs once each day at or near the close of the major U.S. securities exchanges and markets (usually 4 p.m., Eastern time).

Mutual funds generally calculate their NAVs by using the closing prices of portfolio securities on the exchange or market on which the securities principally trade. In some cases, however, the closing price of a security held in a mutual fund's portfolio may not reflect its current market value at the time of the fund's NAV calculation, for example, if an event that will affect the value of those securities has occurred since the closing price was established, but before the fund's NAV calculation.⁸

When market quotations for a portfolio security are not readily available (including when market quotations are unreliable), a mutual fund is required to calculate its NAV by using the fair value of that security, as determined in good faith by the fund's board.⁹ In a separate release adopting rule 38a-1 under the Investment Company Act, we are reemphasizing the obligation of mutual funds to fair value their securities under certain circumstances. If a mutual fund misprices its shares by failing to use fair value pricing when market quotations for its portfolio securities are unreliable,

an investor may take advantage of the disparity between the portfolio securities' last quoted prices and their fair value. When mutual fund shares are mispriced, short-term traders have an arbitrage opportunity that they can use to exploit the fund and disadvantage the fund's long-term investors by extracting value from the fund without assuming any significant investment risk, through market timing.¹⁰ Mutual funds that fair value their portfolio securities consistent with their obligations can effectively reduce or eliminate the profit that market timers seek to exploit.¹¹

Mutual funds that invest in overseas securities markets are particularly vulnerable to market timers who may take advantage of time zone differences between the foreign markets on which international funds' portfolio securities trade and the U.S. markets which generally determine the time as of which NAV is calculated ("time-zone arbitrage"). For example, a market timer may purchase shares of a mutual fund that invests in overseas markets based on events occurring after foreign market closing prices are established, but before the fund's NAV calculation, that are likely to result in higher prices in foreign markets the following day. The market timer would redeem the fund's shares the next day when the fund's share price would reflect the increased prices in foreign markets, for a quick profit at the expense of long-term fund shareholders. Market timing opportunities are not limited to international funds. Mutual funds that invest in small-cap securities and other types of investments which are not frequently traded, including high-yield bonds, also can be the targets of market timers.¹²

⁶ Investment Company Act Release No. 5519 (Oct. 16, 1968) [33 FR 16331 (October 8, 1968)] (adopting rule 22c-1) ("Rule 22c-1 Adopting Release").

⁷ Rule 22c-1(b) under the Investment Company Act [17 CFR 270.22c-1(b)].

⁸ Investment Company Act Release No. 14244 (Nov. 21, 1984) [49 FR 46558, 46559-46660 n.7 (Nov. 27, 1984)].

⁹ See Accounting Series Release No. 118 (Dec. 23, 1970) [35 FR 19986 (Dec. 31, 1970)]; Investment Company Act Release No. 14244 (Nov. 21, 1984) [49 FR 46558, 46559-46660 n.7 (Nov. 27, 1984)].

Subsequent to the issuance of these releases, our staff has reminded funds of their fair valuation obligations. In 1999 and 2001, the Division of Investment Management issued interpretive letters elaborating on funds' obligations under sections 2(a)(41) of the Investment Company Act and rule 22c-1 [17 CFR 270.22c-1] thereunder. Letter from Douglas Scheidt, Associate Director and Chief Counsel, SEC Division of Investment Management, to Craig S. Tyle, General Counsel, Investment Company Institute (Dec. 8, 1999) (<http://www.sec.gov/divisions/investment/guidance/tyle120899.htm>); Letter from Douglas Scheidt, Associate Director and Chief Counsel, SEC Division of Investment Management, to Craig S. Tyle, General Counsel, Investment Company Institute (Apr. 30, 2001) (<http://www.sec.gov/divisions/investment/guidance/tyle043001.htm>).

¹⁰ See Rule 22c-1 Adopting Release, *supra* note 6 (describing market timing). Market timing may take many forms. In this release, we use the term to refer to arbitrage activity involving the frequent buying and selling of mutual fund shares in order to take advantage of the fact that there may be a lag between a change in the value of a mutual fund's portfolio securities and the reflection of that change in the fund's share price.

¹¹ "Fair valuation" refers to the process of determining the current market value of a security when market quotations are not readily available (such as when there are no market quotations for the security or if the market quotations for the security are unreliable). When market quotations for a security are not readily available, a fund is required to calculate its NAV by using the fair value of that security, as determined in good faith by the fund's board.

¹² See Eric Zitzewitz, *Who Cares About Shareholders? Arbitrage-Proofing Mutual Funds*, Research Paper No. 1749, Stanford Graduate School of Business Research Paper Series (Oct. 2002), available at <http://faculty-gsb.stanford.edu/zitzewitz/Research/arbitrage1002.pdf> ("Zitzewitz"), at 2 (estimating arbitrage returns available in domestic small-cap equity funds at 20-25 percent