



Securities Industry Association

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February 6, 2004

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: SEC Late Trading Proposal – Amendments to Rules
Governing Pricing of Mutual Fund Shares (Release No. IC-
26288; File No. S7-27-03)

Dear Mr. Katz:

The Investment Company, Operations, and Retirement & Savings Committees (the “committees”) of the Securities Industry Association¹ (“SIA”) welcome the opportunity to comment on the above-referenced release (“proposing release”) which proposes certain amendments to rule 22c-1 under the Investment Company Act of 1940 to eliminate late trading² of mutual funds. Specifically, these amendments would provide that a mutual fund order receive the current day’s price only if the fund, its designated transfer agent or a registered securities clearing agency receives the order by the time the fund has established for calculating its net asset value for the day. The proposed requirement that all orders be received by one of these designated entities prior to this point in time is generally referred to as the “hard close”.

As a preliminary matter, we agree that the practice of late trading is unequivocally illegal. Its very existence threatens to undermine the public’s trust and confidence in

¹ The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs more than 800,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2002, the industry generated \$222 billion in domestic revenue and \$304 billion in global revenues. (More information about SIA is available on its home page: www.sia.com)

² Late trading may be defined as the improper entry of a mutual fund purchase or sale order after the fund’s net asset value has been determined, for the purpose of obtaining current day pricing.

mutual funds. For this reason, we applaud the strong enforcement actions the Commission and other regulators have taken to date to punish wrongdoers. We believe that these enforcement actions, and the broad attention they have received, have already had a significant deterrent effect on potential wrongdoers and have propelled broker-dealers, other intermediaries and mutual funds to focus their compliance efforts more sharply on preventing late trading.

We also understand the need for, and we support, additional measures to prevent late trading going forward. We believe that with certain modifications the measures contained in the proposing release will contribute to achieving that objective, but should not be the *exclusive* means for enabling investors to receive current day pricing. In that regard, we appreciate that the proposing release has specifically described and invited comment³ on a recommendation made by SIA, and others, that would allow for a hard close at the broker-dealer or other intermediary level, provided they utilized an electronic order capture and routing system which assigns a verifiable order entry time, together with additional safeguards.⁴ The critical factor with regard to any alternative should not be where the order is submitted, but rather whether its timely entry can be verified with a high degree of certainty, since there is little which would indicate that funds have performed inherently better than broker-dealers in preventing late trading.⁵ More fundamentally, alternatives need to be available that effectively deter late trading without disadvantaging the tens of millions of innocent fund shareholders who effect their transactions through a broker-dealer or other intermediary, as well as through administrators of 401(k) and similar retirement plans.

OVERVIEW

Broker-dealers and other intermediaries play a critical role in the distribution of mutual funds. Third-party financial professionals such as full service broker-dealers, mutual fund supermarkets (discount brokers), financial planners, banks, retirement plans, and insurance companies distribute the vast majority of mutual fund assets. Indeed, individual investors make only 12 percent of purchases of mutual fund assets directly from funds,⁶ and it appears that most of those are made by institutions. Full-service and discount brokers provide significant benefits to investors. They promote competition among funds by offering investors a convenient and accessible way to compare and select from a range of different mutual fund families. By providing consolidated statements to their customers, full-service and discount brokers reduce costs to investors by making

³ See proposing release, at 5.

⁴ SEC Letter from Marc E. Lackritz, President, Securities Industry Association to Paul F. Roye, Director, Division of Investment Management, SEC (October 31, 2003)

⁵ At SIA's Annual Meeting in Boca Raton Florida, SEC Chairman Donaldson noted that 10 per cent of funds, as well as 25 per cent of broker-dealers, have been involved in enabling late trading by customers. Remarks of Chairman William H. Donaldson to the Securities Industry Association, November 7, 2003, <http://www.sec.gov/news/speech/spch110703whd.htm> at 2-3. Therefore, a verifiable order entry time stamp should be an essential element of any response to late trading that relies on when orders are received, whether by a fund or an intermediary.

⁶ Investment Company Institute, www.ici.org/stats/res/per09-03.pdf, at 5.

recordkeeping more efficient and enable investors to receive comprehensive investment planning and other valuable investment services. Therefore, any hard close solution that diminishes the benefits to investors of effecting fund transactions through intermediaries would disadvantage the vast majority of mutual fund shareholders. The chief disadvantage is that, as discussed on page 4, many retail investors frequently face situations where they need to liquidate, roll over, or rebalance a mutual fund account, and are exposed to market volatility risk while they do so. The SEC's proposal would require intermediaries to establish earlier trading cut-off times in order to complete processing of fund orders and transmit them to the fund by the hard close. This would effectively force many investors—especially 401(k) holders and the millions of fund investors in non-Eastern time zones—into next-day pricing, thus increasing their exposure to market risk.

DISCUSSION

A. Implications of a Hard Close at the Fund Level

In the proposing release, the Commission recognizes that requiring a hard close at the fund level would likely necessitate that intermediaries establish an earlier (pre-close) cut-off time for investors to submit fund orders and obtain current day pricing, and that with respect to 401(k) plans, investors might not be able to receive same day pricing at all:

“...Intermediaries will likely require investors to submit purchase orders at an earlier time in the day (*e.g.*, 2:00 p.m.) to obtain the 4:00 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...”⁷

This earlier cutoff would be necessary to allow broker-dealers to perform all necessary order reviews prior to the hard close. Among other things, that would include analysis to assure that any sales discounts (breakpoints) are properly applied. Even though many things can be done electronically to check for account linkage for Rights of Accumulation, Net Asset Value (NAV) Transfers, and NAV Reinstatements, much of this is still a manual process. Because of the numerous and varying rules that each fund group follows, many of these orders need to be held in the firm's computer system and reviewed manually before they are sent to the Fund/Serv system maintained by the National Securities Clearing Corporation (“NSCC”), and ultimately to the fund. If they are not properly reviewed, investors may not receive the discounts to which they are entitled. Other intermediaries, such as banks, must perform similar tasks prior to sending orders to fund companies.

⁷ See proposing release at 4.

Orders processed through 401(k) plans⁸ involve even more complexities than those faced by broker-dealer recordkeeping systems. For example, 401(k) recordkeepers must place trades collectively, and perform a number of reconciliations at the participant and plan levels in executing transactions. In addition, recordkeepers perform other services that add time to the process, such as determining eligibility for loans since federal law regulates the amount of a loan based on a participant's account balance.

The net result of the earlier cut-off time is that the vast majority of fund shareholders who either prefer, or have no alternative but, to deal through intermediaries (as is the case with 401(k) accounts) would be denied the ability to effect fund purchases at current day prices for at least a portion of, and possibly an entire trading day. Correspondingly, with redemptions, shareholders would be exposed to an additional day of market risk. The proposing release suggests that these earlier cutoff times would not impose a significant burden on most mutual fund investors who are making longer term investments, frequently through 401(k) plan payroll deduction, and who treat the time and date of investment as something of a random event.⁹ In essence, the Commission is speaking of those investors who are engaged in some form of dollar-cost averaging. This fails to consider a whole range of other activities in which 401(k) plan investors engage, which impose risks that cannot be managed through dollar-cost averaging.

For example, various studies have shown that in 2002 between 14 and 23.1% of 401(k) plan participants had outstanding loans, and 21% of participants with account balances took a plan distribution.¹⁰ Additionally, a major plan administrator reported that in 1998, 24% of their plan participants made exchanges. Furthermore, exchanges increase with age, with a concentration in investors in their 50s and 60s, who have the largest amount of retirement funds such participants made an average of 3 exchanges annually.¹¹

Furthermore, a growing number of 401(k) participants are employing mutual fund portfolio rebalancing services that enables such participants to establish and maintain a targeted asset allocation in accordance with their investment objectives and risk tolerance. Rebalancing usually occurs several times a year. One SIA member reports that it has 800,000 participants enrolled in such a program.

Therefore, the Commission's analysis fails to address what we believe to be the most substantial risks to 401(k) participants – the inability to promptly liquidate or exchange a large mutual fund portfolio in a rapidly declining market. In that regard,

⁸ Approximately one-third of all mutual funds shares are held in 401(k) plans. See proposing release, note 8.

⁹ See proposing release, at 5.

¹⁰ See "Beyond the Numbers, The 2003 Annual 401(k) Report," Principal Financial Group, p.50. Also, "Profit-Sharing/401(k) Council's 46th Annual Survey of Profit Sharing and 401(k) Plans", p. 43 (2003).

¹¹ See "Building Futures: How American Companies Are Helping Their Employees Retire. A Report on Corporate Defined Contribution Plans", Fidelity Investments p. 32-33.(1998).

it should be noted that during the five-year period ending December 2003, the Standard & Poor's 500 Index declined by 1% or more on 257 days.¹² Thus, a 401(k) participant approaching retirement seeking to liquidate a \$500,000 equity mutual fund portfolio,¹³ to purchase an annuity in a declining market, could easily lose thousands of dollars by being "locked-in" to his or her investment for an additional trading day. This type of result would potentially cause significantly greater harm to the participant than the dilution effect of late trading.¹⁴

In addition to the disproportionate impact on market risk exposure the fund hard close remedy would have on fund investors, it also fails to provide for an effective, tamper-proof, electronic order capture time-stamping system. The proposed remedy merely carries over the same time-stamping requirement already included in rule 22c-1, which recent history has shown to be prone to abuse both at the fund and broker-dealer levels. While the committees believe this shortcoming can be cured by adopting the SIA electronic order capture time-stamping approach for funds, brokers (discussed below), and 401(k) intermediaries, the problems associated with early order cut-offs cannot be readily resolved. Therefore, the fund hard close proposal should not be adopted as an exclusive remedy.

B. Hard Close at a Registered Clearing Agency

SIA representatives have attended exploratory meetings at NSCC regarding the possibility of broker-dealers or others developing a system modification whereby intermediaries could submit mutual fund orders to the NSCC Fund/Serv system at or prior to 4:00 p.m. NSCC Fund/Serv, through its various linkages, would then transmit the orders to the applicable funds. Under the proposed rule, it would be necessary for intermediaries to transmit "unenriched" orders to NSCC by 4:00 p.m. in order to obtain current day pricing, and then forward enrichment data (such as information relating to sales breakpoints,) after the close. This would essentially turn a one-step process into two steps, and to our understanding it has not yet been determined with certainty what impact that will have on operating efficiencies. Also, the NSCC solution is likely to cause intermediaries to batch more fund orders near the close in an effort to reduce the number that will require subsequent transmission of enrichment data. The impact of such batching will need to be addressed. It is, of course, of utmost importance to assure that any systems or procedural changes implemented by NSCC to address late trading do not inadvertently compromise the efficiencies achieved by its mutual fund clearance and settlement process, which has served its participants and investors so well. It is also uncertain whether this would provide any relief to 401(k) plan participants with respect to early cutoff times.

¹² Source: Standard & Poor's Index 1999-2003. Data provided by Reuters.

¹³ Assumes \$3,000 annual contributions over a 30-year period with an average annual rate of return of 10%. The actual annual average return of the S&P 500 for the 30-year period ending December 2003 was 12.2%.

¹⁴ The proposing release, note 42, cites a study by Professor Eric Zitzewitz which estimates that fund shareholders collectively lose as much as \$400 million annually as the result of late trading. This figure would translate to approximately ½ of a basis point (.00005) of fund assets, based on total fund assets of \$7.2 trillion, or about \$25 per annum for each \$500,000 of fund assets owned.

Therefore, while the committees support further efforts to determine the feasibility of an NSCC hard close solution, given its current uncertain status and the extensive amount of time it will take to develop, it should not serve as an exclusive solution.

C. Hard Close at the Intermediary Level

As noted in the proposing release, and as described in a prior SIA submission to the Commission,¹⁵ SIA has recommended a solution whereby the place of acceptance to which the hard close would apply, would include:

1. The broker-dealer's electronic order capture and routing system which assigns a verifiable order entry time aligned with the atomic clock currently used for equity order time-stamping, provided certain other conditions are also met.
2. The mutual fund's processing agent for orders not sent through a broker-dealer intermediary. The agent would also be subject to maintaining an electronic order capture system, with verifiable order entry time aligned with the atomic clock to document receipt.
3. The electronic order capture system of regulated entities not currently under the SEC's jurisdiction, but regulated by the OCC or other bank regulator, which would impose a companion rule to require a hard close on order acceptance by 4:00 p.m.
4. For entities which are unregulated, or unable to comply with the hard close time-stamping requirement, orders would need to be placed with the fund directly, or some other designated regulated entity that has electronic time-stamping capability to ensure receipt by the hard close cutoff time.

This recommendation contemplates that orders not accepted into the order entry system by the hard close, even where the lack of timely receipt was due to legitimate errors, would, without exception, receive next day pricing. Thus, in the case of intermediaries, corrections would have to be effected through their error account, and they, not fund shareholders, would bear the economic risk of loss with respect to any orders processed after the hard close. It is most important to note that, unlike the current time-stamping procedure contained in rule 22c-1, and which would merely be perpetuated in the Commission's proposal, the SIA proposal would impose stringent additional requirements on the use of time-stamping methodology that would make it extremely difficult to "game" the system. The SIA recommendation reflects an approach similar to the NASD's Order Audit Trail System ("OATS"), which is an integrated audit trail of order, quote, and trade information for Nasdaq securities. The

¹⁵ See *supra* note 4.

applicable NASD rules¹⁶ required member firms to develop a means for electronically capturing and reporting specific data elements relating to the handling or execution of orders, *including recording all times of these events in hours, minutes and seconds, and to synchronize their business clocks.*

Broker-dealers already subject to OATS requirements, should be able to readily transfer the OATS technology to mutual fund order processing without incurring significant additional costs. We understand that there are a number of service providers who may be able to offer similar capabilities to other intermediaries, and that certain other intermediaries may be able to develop this capability internally.

It is our understanding that OATS has significantly enhanced the NASD's ability to track and audit Nasdaq equity orders and detect violations of NASD rules. Utilizing that same technology for tracking mutual fund orders should bring similar benefits to the Commission's examination staff. Additionally, internal compliance reviews and outside audits of broker-dealers and/or other intermediaries could include some or all of the following:

- Written policies and procedures and other controls designed to detect late trading.
- Periodic review of such policies, procedures and controls.
- Periodic audits including random testing of orders (conducted both internally and by outside auditors) to validate the integrity of the system.
- Reviews of error accounts to detect patterns that might be indicative of late trading.

In summary we believe the SIA recommendation would eliminate the inadequacies of the current time-stamping system and create a readily auditable order trail, while avoiding the significant adverse consequences of an earlier order cutoff time. Furthermore, the SIA recommendation could be implemented expeditiously, whereas the NSCC solution would require a lengthy developmental process, and the funds themselves may not be equipped to handle the large increase in direct transactions that could occur if the Commission's proposal is adopted.

CONCLUSION

For all of the foregoing reasons, the committees believe that electronic and auditable electronic time-stamping systems, which intermediaries and funds would be required to utilize, is a critical component of any effective hard close rulemaking

¹⁶ NASD Rules 6950-6957, approved by the Commission on March 6, 1998, and as amended on July 31, 1998.

solution.¹⁷ While imposing a hard close at the fund or registered securities clearing agency should be among the available alternatives, these measures should not be the exclusive solutions, given that they either have negative consequences for innocent investors, or remain untested. On the other hand, significant positive experience with electronic stamping system through OATS militates in favor of a technological solution. Importantly, this type of approach would place the vast majority of investors holding their fund investments through intermediaries on a more level playing field with other investors.

The committees appreciate the opportunity to comment, and again want to express our appreciation to the Commission and other regulators for strong enforcement efforts to punish late trading. We believe that such efforts coupled with effective rulemaking, will eliminate this insidious activity.

If you have any questions regarding this letter or our earlier communication, please contact Michael D. Udoff, SIA, Vice-President, Associate General Counsel and Secretary at 212-618-0509.

Sincerely,

Stuart R. Strachan
Chair
SIA Investment Company Committee

Ernest A. Pittarelli
Chair
SIA Operations Committee

Laura Gough
Chair
SIA Retirement and Savings Committee

cc: The Honorable William H. Donaldson
The Honorable Paul S. Atkins
The Honorable Cynthia A. Glassman
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¹⁷ *Id.*, Section 205(b) would provide for such an intermediary solution.