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Fidelity Investments®

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Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 5th Street, N.W.
Washington, DC 20549-0609

*Re: Amendments to Rules Governing Pricing of Mutual Fund Shares
Release No. IC-26288; File No. S7-27-03*

Dear Mr. Katz:

Fidelity Investments[1] appreciates the opportunity to comment on the Securities and Exchange Commission's proposal to modify the manner in which mutual funds and their agents handle orders to prevent unlawful late trading in fund shares.[2] The Commission proposes to amend its forward pricing rule to "provide that an order to purchase or redeem fund shares would receive the current day's price only if the fund, its designated transfer agent, or a registered clearing agency receives the order by the time that the fund establishes for calculating its net asset value."[3]

## INTRODUCTION AND SUMMARY

Fidelity applauds the Commission's proposal to allow a registered securities clearing agency to accept orders on behalf of mutual funds. Through this proposal, the Commission fosters collaboration among mutual funds, fund service providers and record keepers in the

[1] Fidelity Investments is composed of a group of diversified financial services companies, including several registered broker-dealers, several registered transfer agents, a retirement services administrator, and the largest mutual fund complex in the United States.

[2] SEC Release No. IC-26288 (Dec. 11, 2003) ("Proposing Release").

[3] *Id.*; Rule 22c-1 under the Investment Company Act of 1940 ("1940 Act"), often called the "forward pricing" rule, requires that mutual funds, their principal underwriters, and dealers sell and redeem fund shares at a price based on the current net asset value ("NAV") next computed after receipt of an order to buy or redeem. 17 CFR 270.22c-1(a).

development of a central clearinghouse for mutual fund trades. We urge the Commission to lend its continued encouragement, support and guidance to this endeavor.

We describe below a vision of a central clearinghouse and how it would operate to handle fund trades.[4] The central clearinghouse would:

- Provide increased control and oversight of the trading of mutual fund shares and the prevention of late-trading;
- Provide greater consistency in the trading of mutual fund shares, across the industry;
- Result in minimal impact to investors by allowing them the opportunity to trade up to 4:00 p.m.;
- Allow the Commission direct oversight of order taking, including orders originating with non-regulated entities; and
- Preserve after hours processing of fund orders, which is a critical part of the process of clearing and settling of mutual fund trades.

As the central clearinghouse, National Securities Clearing Corporation ("NSCC"), a registered securities clearing agency, would expand its role, capabilities and capacity to handle all orders of mutual fund shares. The clearinghouse would be a central point of control, open to inspection by regulators and the industry. To ensure compliance with the daily 4:00 p.m. pricing cut-off, a uniform time stamp methodology with supporting technology would be deployed. Only orders meeting the defined cut-off would be processed at that day's prices. Orders would be considered "locked" when time-stamped, and any orders received after 4:00 p.m. would be rejected. With such a system in place, it would be very difficult to execute a trade that was ordered after 4:00 p.m.

The Commission also proposes that orders can be accepted by the fund or a designated transfer agent. This stands significantly and unfavorably in contrast to a central clearinghouse.[5] Investors will be disadvantaged by inconsistent and earlier cut-off times for orders.

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[4] Many mutual funds price at 4:00 p.m. Eastern Time ("ET"). However, at Fidelity many funds determine their net asset values ("NAV") at different times. Our Select Portfolios, for example, price hourly from 10:00 a.m. to 4:00 p.m. ET. Some of our money market funds determine their net asset values at 5:00 p.m. ET. For ease in presenting our arguments within this letter, we assume that all funds determine NAV at 4:00 p.m. ET.

[5] The Commission notes in the *Proposing Release*, "[w]e recognize that this proposed rule change, if adopted, would likely require substantial changes in the way fund intermediaries process fund purchase and redemption orders." *Proposing Release,* at p.4.

Intermediaries will lose the flexibility of being able to process orders after hours. For example, if defined contribution plans must provide orders to funds or their transfer agents by 4:00 p.m., without a central clearinghouse solution, there will be delays in the processing of mutual fund transactions on behalf of plan participants, with most transactions being completed the next day. Moreover, in the case of funds sold through intermediaries or through fund supermarkets, a proposal that requires a "hard-close" at the fund or a designated transfer agent would have a costly effect on the distribution of funds. This includes possible earlier cut off times for investors who may wish to purchase funds from different fund complexes. We believe that a central clearinghouse can and will be designed to overcome these complexities and will emerge as the fund industry's solution to the problems associated with late trading and related abuses. In this letter, we explain how the clearinghouse offers the most effective way to handle fund trades by marshalling economies of scale within the industry and promoting standard procedures.

While Fidelity believes that a central clearinghouse is the most effective forum for handling the complexities of clearing fund trades, we believe that the Commission should make sure that its rule proposal allows funds to process trades effectively after they are sent through the clearing agency. On these issues, Fidelity supports the comments on the proposed rule change submitted by the Investment Company Institute ("ICI") on February 6, 2004. Our letter supplements the ICI's views and offers additional comments designed to improve the rule.

Specifically, as discussed below, we recommend that the Commission (1) clarify with respect to the central clearinghouse as to the definition of order when transactions are enriched; (2) clarify that a defined contribution plan withdrawal transaction, to be executed in a pre-defined manner dictated by the plan, may be locked in at the clearinghouse with a specified dollar amount, or consider an exemption for these complex transactions; (3) broaden the definition of designated transfer agent to allow mutual fund companies to have multiple transfer agents to handle mutual fund order processing; (4) restate and reemphasize its longstanding position that funds may establish their own error correction; (5) clarify that funds may reject orders after they have been received based on the fund's criteria of what it means for an order to be in "good order"; and (6) provide limited relief for funds of funds and other two-tier fund products.

## I. Registered Securities Clearing Agency/Central Clearinghouse

The proposed rule change would permit fund orders to be received by a registered clearing agency in order to receive that day's price. The Proposing Release notes that presently NSCC is the only SEC registered clearing agency that operates an automated system for processing of mutual fund orders. We strongly support and applaud the Commission for providing for an alternative to the 4:00 p.m. "hard-close" at the fund or its designated transfer agent in the form of a central clearinghouse.[6] We believe that this approach incorporates the best

[6] Referred to in the Commission's proposal as a registered securities clearing agency.

of the current trade environment, results in minimal impact to investors and at the same time effectively addresses the potential for abuse that currently exists. It also leverages the current capabilities of NSCC's Fund/SERV and Defined Contribution Clearing and Settlement ("DCC&S") system service offerings.

The Commission estimates that fund transfer agents receive approximately half of all mutual fund orders directly from funds each year and the other half are received through the Fund/SERV system of NSCC. NSCC currently supports over 652 fund memberships, and 30,246 CUSIPS. Eighty-seven million orders were received by NSCC's Fund/SERV system in 2003.

While the number of fund orders received by transfer agents and NSCC continues to grow each year, the Commission's proposal will place even more pressure on these operations. However, a new regulatory framework is necessary to prevent illegal trading in fund shares after the 4:00 p.m. pricing time. As a way to minimize or even eliminate this activity, Fidelity supports the idea of a central clearinghouse. We believe a central clearinghouse is preferable to a "hard-close" at the fund or its designated transfer agent. We also believe that it is the preferred alternative in the prevention of late trading. The concept of a clearinghouse may be achieved by expanding NSCC's role, capabilities and capacity to handle all orders of mutual fund shares. To that end, Fidelity has been an active participant in an industry consortium led by NSCC.[7] Over twenty companies, representing broker-dealers, banks, insurance companies, mutual funds, service providers and record keepers, have been active in the development of the clearinghouse requirements. The clearinghouse alternative is described in detail below.

NSCC, an independent third party, would be a central point of control, open to inspection by regulators and the industry. To ensure compliance with the daily 4:00 p.m. pricing cut-off, a uniform time stamp methodology with supporting technology would be deployed. Only orders meeting the defined cut-off would be processed at that day's prices. Orders would be considered "locked" when time stamped, and any orders received after 4:00 p.m. would be rejected, except for legitimate error correction subject to appropriately documented policies, procedures and review. A central logging, monitoring and reporting function would keep track of all orders. With such a system in place, it would be very difficult to execute a trade that was ordered after 4:00 p.m. because there always would be verification of the time stamp.

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[7] Fidelity Investments and Edward D. Jones & Co. initiated the clearinghouse effort with NSCC in October, 2003. The detailed explanations provided reflect Fidelity Investments' understanding of the clearinghouse proposal as developed by a broader consortium under the direction of NSCC. Final requirements may differ from those outlined in this document.

A. Proposed Process[8]

*1. Orders*

The initiating party submits an order file to NSCC. The order file will contain a time stamp provided by the initiating party to indicate the time at which the file was prepared for submission to NSCC. All orders would be required to have the following information provided:

- dollar value, share amount or percentages (in cases of portfolio rebalancing);
- buy or sell instructions;
- mutual fund security/CUSIP;
- account number; and
- an order identification number (*e.g.,* NSCC control number).

Orders missing this information would be rejected. Completed orders would be "locked." A locked order indicates that a confirmed transaction has been submitted to NSCC. While the order instructions are locked, there are orders that will require enrichment (see below).

*2. NSCC Receipt*

NSCC would apply a time stamp to each file upon receipt. The NSCC time stamp would be added as part of the information on the order. The NSCC time stamp would be considered the official time of receipt. All orders received by NSCC by 4:00 p.m. (or prior to the fund-stated pricing time) on the current day would be forwarded to the fund with all time information necessary to determine the same day pricing for the orders. All orders received by NSCC after 4:00 p.m. of the current day would be rejected by NSCC and returned to the initiating party.

*3. Order Enrichment*

For selected orders, additional information (*i.e.,* enrichment of order information) would be required to accurately process the "locked" order. This information would be provided after the 4:00 p.m. close as additional information (*i.e.,* fund prices) required to accurately fulfill the order. Additional information (*i.e.,* enrichment of order information) would be required to calculate breakpoints and commissions on omnibus transactions. Also, for exchange transactions additional data would be required in order to update the order. In these transactions, actual dollars/shares would update the estimate in the "locked" order at a later time. For

[8] *See* Notes from NSCC meeting, distributed December 4, 2003.

rebalancing, where percentages were supplied, numbers of shares and dollar amounts would be supplied as enrichment, but specification of dollar amount or share amounts and percentages would be sufficient to constitute an irrevocable commitment to the transactions.

Order enrichment instructions would follow the "to be enriched" order later when the additional information becomes available. The order enrichment would be matched to the original order based on the NSCC control number. The "to be enriched" order would be updated with the enrichment information and would be forwarded to the fund for trade execution.

All original "to be enriched" orders that have not been enriched by the initiating party would be forwarded to the fund at the end of the day. At the end of the processing cycle, all "to be enriched" orders remaining in NSCC's database would be prepared and forwarded to the fund as part of the normal process. We recommend that the Commission clarify in the definition of order that the enrichment process performed after 4:00 p.m. nonetheless is consistent with the definition of an order to include "indeterminate number of fund shares of a specific value" even though the exact amount of the shares to be purchased is not quantified until after 4:00 p.m.

*4. Order Cancellation*

During the normal course of business, orders would need to be cancelled and corrected throughout each day. Centralizing orders through NSCC, time stamping each transaction and creating an audit trail would enhance controls with respect to these processes. Corrections and cancellations must be received by 4:00 p.m. for current day orders. The transactions would be accepted, recorded and passed through to the fund company or its transfer agent. Corrections and cancellations received after 4:00 p.m. for current day orders would be considered late and would follow the post 4:00 p.m. exception protocol described for orders (see also Corrective Processing, section III, B, 1, below).

B. <u>Defined Contribution Plan Transactions</u>

For defined contribution plans, many orders are composed of different investment options and are subject to legal guidelines and plan rules. Record keeping systems maintain the plan rules and were not designed as trading systems. There is additional complexity with the manner in which these transactions are processed.

Absent a central clearinghouse, transactions involving multiple mutual funds become more complex for record keepers, as individual feeds would need to be built with each fund complex to allow for transmitting trades independently. This process would require de-linking all investment options in a transaction and providing independent trade information requests to all fund companies prior to 4:00 p.m. Without the clearinghouse, we believe that task would require cutting off transactions several hours before market close, which could disadvantage individual retirement plan participants. By using the clearinghouse, all feeds can be centralized and there is a greater opportunity to "lock" order instructions, up until 4:00 p.m., at the clearinghouse. With the clearinghouse, we believe that most types of defined contribution plan transactions should be able to be accepted until close to 4:00 p.m., resulting in minimal disruption to participants' investment activity.

The clearinghouse is most effective in the handling of direct purchase orders (contributions, loan repayments) and exchanges. These transactions represent approximately 85-95% of all participant transactions. For complex defined contribution transactions that depend on account valuation in order to determine transaction processing methodology and availability (*e.g.,* loans, hardship withdrawals), there are challenges associated with the clearinghouse approach. Whether using a central clearinghouse or not, the impact to the defined contribution industry is significant.

### *1. Clearinghouse Process for Defined Contribution Activity*[9]

The processes described in this section address defined contribution transactions processed through NSCC's Fund/SERV system. The process requires that the orders or "order intent" be submitted to Fund/SERV by 4:00 p.m.

#### *a. Purchase Transactions (e.g., contributions, loan repayments)*

Representing 80-90% of defined contribution activity, these transaction types will not require enhancements to the Fund/SERV system, but may result in systems and business process changes for third party administrators, record keepers, defined contribution aggregators, service providers, and trust companies.

For these transaction types, the record keeper would know the specific details upon receipt; therefore, an NSCC order file for these transactions could be "locked" and transmitted to NSCC before the 4:00 p.m. cutoff. Administrators would need to establish a plan participant trading deadline (prior to 4:00 p.m.) that would allow sufficient time for the administrators to aggregate the plan contributions and loan repayments, and send an appropriate order file to NSCC for receipt prior to 4:00 p.m. While we recognize there would be some disadvantage to participants, we believe it would be less than a "hard-close" at the fund or its designated transfer agent and that participants would be relatively insensitive to an earlier cutoff.[10]

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[9] Refer also to draft DTCC Concept Paper, January 26, 2004.

[10] Currently payroll contribution fund elections may be modified up to 4:00 p.m. on the day that the plan's contribution is being made. We believe that most participants do not utilize this feature and are unlikely to time their changes based on current market information. Therefore, the Consortium felt comfortable with an earlier cut-off.

*b. Exchange and Rebalance Transactions (e.g., transfers and reallocations)*

Representing 10-20% of total defined contribution activity, the values of these transactions are affected by the daily change in NAV. This transaction type would require changes to the Fund/SERV system and its users, and new business processes must be built around the use of the Fund/SERV exchange record.

The proposal suggests a two-step process where (i) the exchange record would be used to communicate a fully determined and locked sell side, along with the intent to use the proceeds to execute the buy side. The securities on the buy side would be identified and the amount would be determinable, i.e., an amount equal to the proceeds of the sell side. This record would be received at NSCC before 4:00 p.m., and (ii) a second set of instructions representing the buy side would be submitted after the NAV has been established (*i.e.*, post 4:00 p.m.) to complete the full intent of the transaction. The submission of the post 4:00 p.m. purchase transactions would be tied to and "legitimized" by the intent communicated on the pre-4:00 p.m. exchange records. This process mirrors the order enrichment process that was previously described.

Once the NAVs are available, the administrator would go through its normal pricing and calculation routines to determine the value of the sell side, which would then be used to fund the buy side. After determining this information, the administrator would then send a second set of instructions (*e.g.*, regular purchase or buy-side exchange record) corresponding to the buy side of the original exchanges. These transactions would also include information from the original exchange, such as control number, sell-side CUSIP, and share amount, along with the price that was used to calculate the proceeds/dollar value. NSCC would use this information to compare to the original exchange order to verify that the instructions and intent have not changed.

Using the clearinghouse, we believe that exchanges, transfers and reallocations should be able to be accepted by record keepers until quite late in the trading day. Specifically, we estimate that the trade cutoff need be no earlier than 3:50 p.m. for these types of trades, barring unusual plan restrictions or trade guidelines, and could be as late as 3:59 p.m. We disagree with commentators who suggest that transactions at 12:00 noon or an even earlier cutoff would be required for these types of transactions.

*c. Liquidations and Plan Level Activities (e.g., loans, hardship withdrawals, distributions, plan deconversions)*

For less than 5% of total defined contribution activity, these transactions are incomplete until all fund positions in accounts are valued and the amount of the transaction can be fully determined. This creates complexity for these transactions under the Commission's proposal, which would require submitting final trades to the fund before the actual trade amounts could be determined.

For example, suppose a participant in a 401k plan requests an in-service withdrawal for \$10,000 to use as a down payment to buy a house. That withdrawal is liquidated from the participant's fund holdings in a predefined manner as dictated by the plan. Typically, any after-tax sources of money are liquidated first, then pre-tax amounts, and so forth. Within each money source (after-tax, pre-tax), the participant holds a position in one or several mutual funds. If the plan has a liquidation method that requires 100% of after-tax monies to be taken first before pre-tax amounts, and the participant has a balance of \$9,950 in his/her after-tax money source split between several funds, it is unclear whether market movements between yesterday and the current trade date may require part of the distribution to be taken from only the after-tax money source or a combination of pre-tax and after-tax money sources. It should be noted that, to the extent that the participant ultimately liquidates pre-tax account balances, 100% of those dollars are subject to taxes and early withdrawal penalties. Therefore, determining the actual liquidation amount based upon the participant's current account value becomes critical.

Additionally, if \$10,000 were the maximum permitted based upon the prior day's account value when the participant called in, a significant change in the account balance could make a \$10,000 in-service withdrawal no longer permissible under plan rules. If \$10,000 were liquidated from the account, after such a change in the account balance, the participant would violate plan rules governing in-service withdrawals. A current valuation of the account would reveal that the order should be canceled or modified. If trade instructions sent prior to 4:00 p.m. could not be enriched, the information necessary to prevent violations of plan rules would not be available thereby putting the plan participant in jeopardy.

The example above is indicative of the complexity of many other defined contribution transactions such as loans, hardship withdrawals, retiree withdrawals, plan conversions, etc. The Commission's proposed rules do not permit account balance determination prior to processing the transaction. As a result, it is impossible to process these transactions if final trade instructions must to be provided to the fund by 4:00 p.m.

It should also be noted that simply basing the transaction on the previous day's account balance does not solve these problems. If we use the situation outlined above as an example, the participant's transaction, once processed on a current day's basis, may exceed certain plan maximums because it was based upon the previous day's account balance. If transaction "buffers" were instituted then the amount available to the participant would be artificially reduced and there is no guarantee that the buffer instituted would not run the risk of being exceeded if there were a significant shift in the market values of the participant's investment holdings. If, however, the Commission agreed that the in-service withdrawal transaction would be "locked," for purposes of same-day pricing, provided that the communication delivered prior to 4:00 p.m. contained the total dollar amount of the withdrawal, specified the transaction type, and that the withdrawal must be executed in a pre-defined manner as dictated by the plan, the central clearinghouse could provide the needed control to ensure the decision to withdraw was irrevocably communicated prior to 4:00 p.m.[11]

We would suggest that the Commission clarify that the central clearinghouse may "lock" withdrawal transactions on the terms outlined above, or otherwise consider an exemption for the following complex defined contribution transactions: loans, hardship withdrawals, distributions and plan conversions. These transactions are governed by ERISA, Department of Labor guidelines and plan rules, which dictate the amount available for participants to liquidate and the frequency with which participants can transact. Many of these transactions also come with significant tax and plan consequences such as a tax penalty for early withdrawal, suspension from making further contributions to the plan or limiting future ability to take transactions as in the case of a loan.

C. Assessment of the Clearinghouse Alternative

A central clearinghouse will have a number of important benefits, in addition to preventing late trading. The central clearinghouse would create a consistent method to sending trade intent orders to a single entity for time stamping and order processing. The clearinghouse would provide tight controls that are reliable and systems that are resistant to tampering/evasion. Contrasted with order receipt at the fund or its designated transfer agent, for the majority of transactions, orders may be taken up to or close to 4:00 p.m.[12] The clearinghouse alternative is more efficient and less costly than setting up individual transaction feeds to multiple fund complexes. Centralization also ensures consistency in control and oversight versus reliance on the controls of each fund company. Fund companies also may recognize operational efficiencies through the centralization of order flow.

NSCC is well positioned to assume the role (*i.e.,* proven technology, ability to scale, existing functionality present with Fund/SERV and DCC&S). While NSCC will be expanding their capacity to support increased order flow and enhancing their capabilities to time/date stamp orders and assist in the enforcement of the regulations, there will be no impact to the clearing and settlement process.

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[11] The definition of an order, as previously described, would require a modification for these transactions. The "locked" transaction would be a loan of X dollars. The clearinghouse would time stamp the "locked" transaction ensuring receipt prior to 4:00 p.m. Final trades would be included in the files delivered to NSCC for after hours processing. The records of these transactions (*i.e.,* "locked" transactions and final trades) would be available for audit.

[12] The clearinghouse provides for the opportunity to transact up until 4:00 p.m. Through systems modifications and changes in business processes, intermediaries should provide investors the same flexibility that they have today. That being said, it should be recognized that if such modifications are not made, earlier cut-offs may be required.

The central clearinghouse also links Commission authority to the investment order taking process. As a result, the Commission could better oversee compliance in respect to order taking that originates at entities it does not regulate directly (such as Third Party Administrators ("TPA") or insurance companies). Lastly, the independence of the clearinghouse could serve to reassure the investing public that the proper controls are in place.

To comply with the revised regulatory requirements changes will be required for the industry. While the clearinghouse is the preferred alternative it will require NSCC to enhance its technological capabilities and expand its operating capacity. Mutual fund companies and all intermediaries will be required to modify their systems, enhance or expand their communications connectivity and modify their business processes. Communication and education of investors as to changes that may affect them will be required. Sufficient time will be needed to affect these changes. Industry-wide, we believe these changes will take twelve to eighteen months to implement fully.

With change and increased control there are also increased costs. NSCC will be required to invest in expanding its existing services, technologies and systems infrastructure. These costs will be passed back to the intermediaries and fund companies through a per transaction fee. Over time it is expected that the cost per transaction would decline as order flow increases. We would encourage NSCC to take a close look at their business/cost model to ensure that it does not unduly burden small firms. Ultimately, we believe that centralization of order flow will provide greater operational efficiency and economies of scale, helping to offset the initial increased cost of this alternative.

## II. OTHER ALTERNATIVES

Fidelity's advocacy for the clearinghouse alternative has been driven by the following:

- To ensure the fair treatment and protection of mutual fund investors;
- To increase control and oversight of the trading of mutual fund shares and the prevention of late-trading;
- A belief that greater consistency in the trading of mutual fund shares, across the industry, is required;
- To minimize the potential negative impact to investors that a "hard-close" at the fund or its designated transfer agent would present;
- To maintain a level playing field across the industry such that intermediaries were not unduly disadvantaged; and

- A need for greater clarity with respect to the assignment of fiduciary responsibility to anyone and everyone touching a trade at any point in its execution.

While we strongly support the central clearinghouse alternative, Fidelity recognizes that another alternative has been proposed in the form of time stamp technology that is distributed locally, at intermediary and fund companies and overseen centrally, possibly by a clearing agency. This technology may provide efficiencies to processes that would be otherwise impacted by the Commission's proposal. If the Commission could be assured that the technology is tamper-proof, and that orders received are stamped with the precise date and time in which they were received and not cancelled after the determination of that day's price, we believe that this technology, coupled with SAS70s and an independent audit may be a viable alternative. However, if the Commission decides that entities other than the fund, transfer agents or a registered securities clearing agency can receive orders, we believe that it should consider proposing rules that would subject those entities to a heightened standard of liability when submitting mutual fund orders.[13]

## III. ORDER PROCESSING

### A. Designated Transfer Agent

The Commission's proposed rule change "would deem an order received when it is received by (i) the fund itself, (ii) the fund's designated transfer agent, or (iii) a clearing agency registered with the Commission."[14] A "designated transfer agent" is defined as an entity that is designated in the fund's registration statement and required by written contract to receive order information and maintain a record of the date and time it receives the order information.[15] Under the proposal, each fund may have only one designated transfer agent.

Fidelity believes that the proposed rule change should be broadened to allow for more than one designated transfer agent for a fund where those transfer agents are under common control. In many situations, registered investment companies have more than one transfer agent that provides services to the funds, as either a sub-transfer agent or a transfer agent that is part of

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[13] The Commission could separately propose rules that would make it a violation of Section 10(b) of the Securities Exchange Act of 1934 for any person to transmit an order to purchase or redeem a security from a registered investment company under false pretenses with the purpose of late trading or aiding or abetting late trading.

[14] *Id.* at p. 6 (footnotes omitted). While the proposal provides a definition of transfer agent and a description of a clearing agency, it does not explain what it means for the "fund itself" to receive an order. Since mutual funds are organized and incorporated under state law, and typically do not have employees, operations or offices for the acceptance of orders, it is unclear as to how an order could be received by the fund itself. Further clarification from the Commission on this point would be helpful.

[15] *Id.*, at footnote 27.

the mutual fund complex that services and administers the fund. These transfer agents are contractually obligated to carry out services on behalf of the designated transfer agent or fund sponsor and may or may not be named in the fund's registration statement. Fidelity has several registered transfer agents under common control that provide servicing and processing for the Fidelity family of mutual funds.[16] These services include, among other things, processing cash and share transactions at the aggregate level, ensuring correct processing of exchanges between funds, administering loads and other terms of sale of fund shares, relaying back order information to different agents who process fund transactions, and maintaining responsibility for correction of errors at the fund level.[17] Transfer agents within a fund complex may share responsibility for certain functions in order to realize economies of scale and efficiencies in order processing, administration and master record keeping.[18]

A transfer agent that services funds distributed through retirement plans, for example, may have developed specialized systems to handle order receipt and record keeping for retirement plan participants. It may be necessary for a transfer agent servicing funds sold to retail investors to leverage some of the record keeping functions of the transfer agents in the retirement channel. Under the Commission's proposal, the retail transfer agent would either have to merge with the retirement transfer agent to become the sole designated transfer agent, license the system from the retirement transfer agent or build the services itself. We believe that a simpler way to achieve the Commission's goals would be to allow both transfer agents to be designated transfer agents. Implementing the proposal that one designated transfer agent be the entity that must receive orders for all transfer agents under common control of a particular mutual fund complex would result in a cumbersome process of either revamping the legal structure of transfer agents (*e.g.,* creating one single transfer agent that controls all of the necessary services for each fund) or establishing license or other systems' sharing agreements to allow for the appropriate systems being used among transfer agents to fall legally under the control of the designated transfer agent.

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[16] Fund complexes such as Fidelity also use the services of outside transfer agents. Further, it is typical for fund complexes to designate other non-transfer agent entities and systems to accept orders for fund purchases and sales and transmit those orders to fund transfer agents, including phone representatives, who are usually broker-dealer employees, and web-based systems that perform transfer agent functions. While we do not propose that these entities be designated under the rule proposal for designated transfer agents, we note that, if adopted, the rule proposal may result in significant changes in the way in which a financial services company such as Fidelity receives and processes mutual fund orders through internal systems and entities.

[17] In addition, the Commission notes that these services can include: "(a) countersigning the issuer's securities when issued; (b) monitoring issuance of the securities to prevent unauthorized issuance; (c) registering the transfer of the securities; (d) exchanging or converting the securities; (e) transferring record ownership of the securities by book entry (*i.e.,* record entry of ownership without issuing a physical certificate). *See* 15 U.S.C. 78c(a)(25)." *Proposing Release,* at footnote 6.

[18] In addition, given the need to locate transfer agent functions over geographically diverse locations to assure best practices (including disaster recovery and contingency planning) even within a single transfer agency business unit, multiple subsidiaries may be used for each location.

If more than one transfer agent is designated by a fund, the Commission will still be able to examine the appropriate entities to determine when orders were received. Permitting transfer agents under common control to serve together as the designated transfer agents will give fund companies the flexibility to divide the order-taking function in a manner that suits their business, while not posing the problems of allowing third parties, whose activities the fund cannot effectively monitor, to accept orders. Additionally, we recommend that the definition of transfer agent include sub-transfer agents that are contractually obligated to carry out services of a designated transfer agent, since these agents will be bound to carry out services that would be typically provided by the designated transfer agents and subject to Commission oversight and inspection.

Accordingly, Fidelity recommends that the Commission broaden the definition of designated transfer agent to include all registered transfer agents that are under common control of the sponsor of the mutual fund and all registered sub-transfer agents that are contractually bound to carry out services on behalf of a designated transfer agent.[19] We further recommend that these transfer agents be subject to the Commission's proposal that designated transfer agents be subject to the time-stamping and record retention requirements, assuming that these requirements are tailored to the unique systems and records used by fund transfer agents.[20] We do not believe that allowing for the receipt of orders by registered transfer agents that are under common control of an advisor or fund sponsor and that are subject to inspection and oversight by the Commission will result in the type of abuses identified by the Commission in the Proposing Release. In its release the Commission notes generally that transfer agents are "organizations, which are regulated by the Commission and operate large automated processing systems [that] will serve to ensure the integrity of fund pricing."[21]

B. Transfer Agent Processing of Mutual Fund Orders

Under the Commission's proposed rule change, once a fund, its designated transfer agent or a registered clearing agency has received an order, it is deemed irrevocable as of the next pricing time for the fund. The Commission states that the proposal is designed to eliminate "the

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[19] We recommend that the Commission use the definition of control found in Section 2(a)(9) of the Investment Company Act of 1940 (stating that "control" means the power to exercise a controlling influence over the management or policies of a company, and that any person who owns beneficially, either directly or indirectly or through one or more controlled companies, more than 25% of the voting securities of a company shall be presumed to control such company).

[20] *Proposing Release*, at p. 6.

[21] *Id.*, at p. 6 (footnotes omitted).

illegal practice of permitting a purchase or redemption order received after the 4:00 p.m. pricing time to receive the share price calculated as of 4:00 p.m. that day."[22]

Fidelity supports the Commission's goal of preventing fraud in the receipt of orders; however, we recommend that the Commission re-examine several important areas regarding how mutual fund orders are processed after the close of pricing for a fund. First, we believe that funds should be permitted, under longstanding Commission interpretations and policies, to develop their own corrective processing for certain types of fund orders.[23] Second, we recommend that the Commission permit funds to reject orders after they have been received based on the fund's criteria of what it means for an order to be "in good order." Each of these comments is discussed below in detail.

*1. Corrective Processing*

The Commission's proposed rule changes do not discuss how mutual funds should handle errors that are uncovered in an order submitted before 4:00 p.m. Common examples of errors in the trade process include:

- An inadvertent failure to process a fund order on the day received that is discovered at a later point;
- The share or dollar amount for a fund purchase is transposed at the time of order entry, and it is not discovered until after 4:00 p.m.; or
- Transactions are submitted on time, but then processed incorrectly, such as a redemption in the wrong fund, or a purchase at an incorrect NAV due to a pricing error.

In certain situations, mutual funds and their transfer agents will process transactions in a hierarchy, first processing orders from individual direct purchasers, next processing orders submitted through intermediaries, and finally processing changes in accounts, transfers of assets, and new account registrations. If, for example, a mutual fund customer submits a transfer of assets request to move a direct account to be held by a broker-dealer and also submits a purchase order for a fund, it is possible that the fund may process first the purchase order and then the account transfer instructions. If the processing is not sequenced correctly, the fund may reject the customer's order during its nightly processing cycle. If the fund contacts the intermediary the next morning, presently, the intermediary may request that the fund rerun the transfer and fund order in sequence in order to provide the customer with the transaction.

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[22] *Id.*, at p. 2.

[23] *See Dilution of Net Asset Value and Inappropriate Extensions of Credit in Connection with Sales, Redemptions and Repurchases of Mutual Fund Shares,* Investment Company Act Release No. 6366 (Mar. 5, 1971).

The Commission has historically taken the stance that funds should not be responsible for situations in which fund purchase or redemption orders do not settle. In those situations, the Commission has looked to the fund's principal underwriter to assure that the particular order will settle and if it does not, the underwriter should indemnify the fund. If the fund does not have an underwriter, the Commission has suggested that the fund should consider refusing to take an order unless it is accompanied by payment or unless another party, such as a transfer agent or intermediary, has indemnified the fund against losses resulting from the failure of an investor to make payment. The Commission has also in the past recognized that given the enormous amount of orders processed by funds there are situations in which delays and errors in the processing of transactions occurs. In these situations concerning backlogs and processing errors, the Commission has informally permitted funds to develop corrective policies in handling orders. Under these policies, fund transfer agents typically may put through offsetting corrections to orders.[24]

We strongly recommend that the Commission clarify that funds are permitted to take corrective action for delays and errors discovered during order processing as long as the corrective action follows the fund's documented policies. This could be in the form of an exception to Rule 22c-1 as the Commission proposes for emergency situations, or alternatively by means of clarification that the new rule does not repeal prior guidance on delays and error correction policies.

Without a permitted correction process for funds, an environment may be created in which the various agents or intermediaries delay transmitting orders to the fund in order to make absolutely sure that there are no errors in the orders so as to avoid submitting incorrect *irrevocable* orders that cannot be corrected later by the fund before the next investment cycle.[25] Thus, the process used by intermediaries to ensure that an order is in good shape for transmission to a designated transfer agent may become as cumbersome as to delay orders being transmitted from intermediaries to funds. This will in turn adversely affect mutual fund shareholders who will no longer be able to enjoy the benefits of efficient and speedy processing.[26]

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[24] In many cases, a fund or its transfer agent may take corrective action that would not result in dilution to the fund, if the error were discovered before the fund manager has had the opportunity to invest the proceeds from the day before. *See generally Letter from Stephen K. West, on behalf of the Investment Company Institute, to Kathryn B. McGrath, Director, Division of Investment Management, Securities and Exchange Commission,* (Feb. 5, 1985 and Oct. 11, 1985), reprinted in *Mutual Funds and Their Agents' Liabilities and the Role of Directors,* 1987 Mutual Funds and Investment Management Conference Panel on Operations, by Steven K. West (1987).

[25] Moreover, the Commission risks upsetting the longstanding balance of liability that has existed between funds and underwriters. For example, an underwriter could face strict liability when submitting irrevocable orders to a fund, when in fact this liability could be avoided in situations involving an order that could be corrected by the fund before corresponding investments were made by the fund's portfolio manager. *See id.*

[26] *See Capital Sponsors, Inc.* (SEC No Action Letter, dated Mar. 24, 1971) (allowing underwriters to net gains and losses resulting from order cancellations). *See also Regulation of Investment Companies, Vol.1* (Lemke, Lins, Smiths), pp. 9-42 – 9-43 (2003).

### 2. *Processing in Good Order*

The Commission's proposal would treat orders as irrevocable as of the next pricing time after receipt. The irrevocability requirement appears to be designed to prevent investors, or their agents, from canceling or modifying an order after the pricing time applicable to the order. As an extension of our comments regarding corrective action, we strongly urge the Commission to clarify in the definition of an order that the revocability requirement only applies to the ability of an investor (or its agent) to revoke an order, and not to the ability of a mutual fund to reject an order.

This clarification would continue to permit funds and their transfer agents to establish order acceptance and handling procedures. In addition to the elements of an order articulated in the Commission's release (*i.e.,* "a direction to purchase or redeem a specific number of fund shares or an interdeterminate number of fund shares of a specific value"[27]), the Commission should continue to permit funds to establish criteria for appropriate acceptance of an order. These criteria might include among other things, whether the order is appropriately funded, has sufficient information concerning the identity of a customer or account information.

Our recommendation would also preserve the ability of a fund to reject, for example, an order from a person who has been engaging in market timing or excessive trading, thereby enforcing its own restrictions and complying with applicable rules. A fund also should be able to continue to set its own rules for determining when it must receive the funding for a transaction and be able to reject a trade for lack of funding. Moreover, the clarification is necessary to continue to permit funds to comply with their regulatory responsibilities.

## IV. FUND OF FUNDS

The proposed rule change provides an exception from the forward pricing requirements for "conduit funds," which invest all of their assets in another fund and must calculate their NAV on the basis of the other fund's NAV. The Commission would permit a conduit fund to submit its orders based on the NAV established by the other fund on the same day.[28] Unfortunately, the proposed rule would prevent same-day purchases of lower-tier funds, both because of operational issues and because the NAV of the lower-tier funds will not be available prior to 4:00 p.m., in two other multi-tier fund structures that do not fall within the definition of "conduit fund" but that are subject to the same regulatory oversight.

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[27] Proposing Release at p. 21. As noted above, we support the proposed additions to the definition of order in the comment letter by the Investment Company Institute.

[28] *Proposing Release*, at pp. 7-8. The Commission's relief is limited to registered investment companies that invest in the fund in reliance on section 12(d)(1)(E) of the Investment Company Act of 1940.

The two such multi-tier fund structures at issue are fund of fund structures that rely on section 12(d)(1)(F) or section 12(d)(1)(G) of the 1940 Act. In each of these structures, the upper-tier fund and lower-tier funds are subject to regulation and oversight by the Commission (as is true for conduit funds). Such structures typically use an automated "splitter" mechanism, which consists of standing instructions from the top-tier fund's portfolio manager specifying the percentages in which the top-tier fund will invest daily net inflows in, or redeem daily net outflows from, the lower-tier funds.[29] The portfolio manager may change the splitter percentages from time to time, but always before 4:00 p.m. of the day the changes are to take effect. Under the proposed definition of "order," transactions in top-tier funds are not permitted after 4:00 p.m.

Each business day, a purchase or redemption order for shares of the top-tier fund is created by aggregating all of the orders received by the fund, its transfer agents and clearing agents prior to 4:00 p.m. The order will then be fed through the splitter but will not reach the lower-tier funds, their transfer agents or clearing agencies until early the following day. Currently, although these orders are processed on the day following the trade date (i.e., the trade date at the top-tier level) by the lower-tier funds, their transfer agents or clearing agencies, they are committed to, and treated as occurring on, the trade date. Under the proposed rule, however, these trades would be treated as occurring on the day following the trade date at the top-tier fund level. As a result, top-tier funds may cut off the public from placing orders before 4:00 p.m. in order to ensure that the transfer agents of the lower-tier funds receive orders by 4:00 p.m. and thereby purchase lower-tier funds on a same-day basis.[30]

Fidelity believes that the procedure allowing same-day trading in lower-tier funds should be permitted to continue not only for registered two-tier fund structures relying on section 12(d)(1)(E) but also for those relying on section 12(d)(1)(F) and section (d)(1)(G). We therefore recommend that the definition of "conduit fund" be expanded accordingly with the added requirement that any changes in splitter percentages must be time stamped prior to 4:00 p.m. of the day they will take effect. We also believe that the definition of "conduit fund" should include registered multi-tier fund structures that have obtained exemptive relief from section 12(d)(1); since such structures technically are not relying on section 12(d)(1)(E), (F) or (G), they would not be "conduit funds" without this additional modification.[31]

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[29] For example, for a top-tier fund owning lower-tier Fund A and lower-tier Fund B, the splitter may specify that daily net inflows into or out of the top-tier fund are to be invested or redeemed 50% in Fund A and 50% in Fund B.

[30] If top-tier funds must change their investment times for receiving orders, these types of products may become unworkable and be supplanted by less well-regulated mutual fund wrap programs offered only to wealthier investors with larger investment minimums.

[31] We support the proposal in the Investment Company Institute's submission to extend the definition of "conduit fund" to structures that rely on section 12(d)(1)(G) but would extend that proposal to the additional categories we have listed. We also urge the Commission to consider whether the definition of "conduit fund" also should include

## V. TRANSITION PERIOD

The Commission seeks comment on whether a one-year transition period for implementation of the proposed rule changes would be an adequate time period. Fidelity believes that a one year to eighteen month time period for fund companies would be adequate as long as the rule proposal is revised to permit multiple transfer agents under common control of the fund complex to be designated to receive orders, and exemptions are granted for certain complex defined contribution transactions. If the proposed rule change is not revised accordingly, we believe that there may be significant redevelopment work necessary to allow for funds to designate a single transfer agent for receipt of orders. This will involve reprogramming computer systems, redesigning the legal relationships among our transfer agents and broker-dealers, and reconfiguring our systems to allow for one transfer agent to have control over them. Additionally, we believe that if exemptions are not granted for certain complex defined contribution transactions, there will be significant changes required in plan documents, communication material, processing systems and participant education.

We strongly recommend that the Commission not adopt an interim solution or two-staged approach to implementing the proposed rule changes. This will result in fund companies and their transfer agents in having to meet two separate time frames and will drive up costs and create complex implementation and coordination issues.

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We appreciate the opportunity to comment on this important initiative. If we may be of further assistance to the Commission, please contact either the undersigned at 617-563-1742, Janice Morris-Hatch, at 617-563-8511, or Alex Gavis, at 617-563-6308.

Very truly yours,

Eric D. Roiter

Senior Vice President and General Counsel

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529 plans, which involve an unregistered upper-tier pool that is, however, the instrumentality of a state, although it would be necessary to develop procedures to ensure that the upper-tier pool cannot accept orders after 4 p.m.

Cc: The Honorable William H. Donaldson
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
Giovanni Prezioso, General Counsel, Office of the General Counsel
Paul F. Roye, Director, Division of Investment Management
U.S. Securities and Exchange Commission