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October 27, 2003

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OFFICE OF THE SECRETARY

Paul F. Roye
Director, Division of Investment Management
Cynthia M. Fornelli
Deputy Director, Division of Investment Management
Douglas J. Scheidt
Chief Counsel, Division of Investment Management
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: White Paper on Mutual Fund Reform

Dear Messrs. Roye and Scheidt and Ms. Fornelli:

Thank you for taking the time last week to meet with representatives of Charles Schwab & Co, Inc., to discuss our ideas to combat illegal late trading of mutual funds and to better enable mutual funds to implement their policies concerning market timing. As we discussed with you last week, we are enclosing a white paper explaining our ideas on both topics, as well as our concerns about the unintended harms that a 4 p.m. "hard close" for mutual fund orders would cause for individual investors. We are also enclosing draft rule language (a proposed Rule 22c-1(e)), to implement our ideas concerning late trading.

As we discussed with you last week, Schwab is one of the nation's largest financial services firms for retail investors, with 7.7 million customer accounts and $876 billion in customer assets. Our affiliate Charles Schwab Investment Management manages the SchwabFunds family of mutual funds, which is one of the nation's ten largest fund families in terms of client assets. Schwab's Mutual Fund Marketplace service first pioneered the mutual fund supermarket concept in the 1980s, and our Mutual Fund OneSource service pioneered the open architecture approach of selling no-load, no-transaction fee mutual funds from thousands of mutual funds at hundreds of different mutual fund families. Through participation in SchwabFunds, Mutual Fund OneSource, and our Mutual Fund Marketplace service (which includes transaction fee funds and some load funds), Schwab clients hold more than 10 million mutual fund positions totaling more than $240 billion in mutual fund assets. In addition, Schwab Corporate Services, through Schwab Plan and third-party administrators, serves over 2 million charles SCHWAB

401(k) plan participants. As noted in the attached white paper, it was Schwab that obtained the 1997 SEC no-action letter allowing intermediaries to aggregate mutual fund orders received before market close and transmit them to fund companies or their transfer agents after market close, and containing procedures designed to prevent illegal late trading.

Schwab strongly shares the Commission's belief that effective reform is necessary to restore investor confidence in the mutual fund industry, and we hope our white paper and our draft regulation will assist the Commission and its staff in achieving this goal. If you have any questions concerning these issues, or would like further information concerning these critical issues, please contact me at 202-638-3750.

Very truly yours,

Geof Gradler
Senior Vice President and Head, Government Affairs
Charles Schwab & Co., Inc.

White Paper on Mutual **Fund** Reform

Recent, highly-publicized scandals affecting the mutual fund industry have underscored the need for the regulatory community to take strong and effective steps to restore the confidence of individual investors in mutual funds. Meaningful reform is needed to prevent illegal late trading of mutual funds, and to enable mutual funds to enforce consistently their policies concerning short-term trading or "market timing" of mutual funds. However, some of the proposed reforms now under public discussion – especially the proposal that all orders be received by fund companies (rather than by intermediaries such as brokerage firms) prior to 4 p.m. eastern time ("Market Close") – are unnecessary and will have a dramatic negative effect on individual investors. This white paper offers a set of proposals on late trading and market timing reform and also explains why an early order cut-off, without an exception for firms following the procedures set forth below, would harm individual investors.

Executive Summary

We propose a five-part reform program to prevent illegal late trading of mutual funds. Specifically, each mutual fund, and any intermediary accepting mutual funds on behalf of the fund, should be required to establish and maintain comprehensive policies and procedures designed to prevent or detect late order trading that must include, at a minimum:

(1) an enhanced electronic audit trail for mutual fund orders documenting the actual time of receipt of the order from the end client, and the time of any subsequent cancellation of the order;
(2) enhanced compliance surveillance of mutual fund orders;
(3) annual certification that the firm has and is enforcing procedures to prevent or detect possible late trades and an annual reporting requirement similar to the TA-2 to report volume of exceptions and explanations;
(4) annual audit review of late-bade prevention and detection procedures; and
(5) enhanced SEC jurisdiction for inspection of late-trade prevention and detection procedures.

Any firm that implements these steps would be allowed to aggregate mutual fund orders that it receives prior to the close of trading, and transmit those orders to the mutual fund (or its transfer agent) after the close of trading. Any firm that did not implement these steps would be required to transmit all its mutual fund orders to the fund or its transfer agent prior to the close of trading rhst day.[1]

We also propose the following steps to ensure that mutual funds are able to deter detrimental market-timing activity consistent with their publicly-stated policies:

[1] **A** draft Rule 22c-1(e), to incorporate these requirements, accompanies this white **paper.**

(1) The SEC should enhance funds' ability to charge a redemption fee (RF) if a fund position is resold shortly after purchase. For funds that are harmed by market timing, RFs are the most effective deterrent to market timing.
(2) The SEC should establish clearer guidance through rule-making on fair value pricing to prevent arbitrage based on the use of stale prices in establishing mutual funds' daily net asset values ("NAVs").
(3) Intermediaries should provide fund companies with sufficient information to help funds monitor, detect and prevent potential market timing activity by clients of the intermediaries. The ultimate responsibility for enforcing a fund's policies on market timing should remain with the fund. Intermediaries are not in a position to interpret and apply a fund's market timing policies.
(4) The SEC should'clarifythat a fund should not be permitted to give some clients access to information about the fund's positions, unless that information is generally available to all clients of the fund.

We believe that these steps, each of which is discussed in more detail below, will provide an effective deterrent to illegal late trading of mutual funds, and will allow funds to enforce their policies concerning late trading (whatever those policies may be) consistently and fairly. Moreover, the bulk of these reforms can be implemented quickly, and none would necessitate legislative action. These measures will make it unnecessary to take the more drastic step of bamng all mutual funds from accepting any order unless it was received by the fund by the close of the equities markets, generally at **4** p.m. Eastern time. Today, under a no-action letter the SEC staff issued in 1997, a mutual fund is deemed to have acted in accordance with the requirement of Rule 22c-1 under the Investment Company Act of 1940 in accepting an order so long as it was received by an intermediary (such **as** a brokerage firm) prior to Market Close.[2] Indeed, today most mutual funds receive the majority of their orders for the day in the form of aggregated orders from intermediaries after Market Close. To require funds to receive all their orders by Market Close would require intermediaries to establish earlier cut-off times, such as 3 p.m. or 2 p.m. Eastern time. This would adversely impact investors for the following reasons:

- Retirement plans, because of the enhanced complexity of aggregating and pricing orders at the individual, plan and third-party administrator levels, would have even earlier, less convenient cut-offs (12 p.m. Eastern = 9 a.m. Pacific = 6 a.m. Hawaii). In practice almost all retirement plan participants would get next-day pricing, not same-day pricing:
- Investors will be confused and frustrated by different cut-offs for mutual funds than for equities, bonds, and other types of pooled investment products, particularly on days of high market volatility, when they place their orders before the equity markets close but do not receive that day's pricing for their mutual fund order.
- Investors will be further confused by the different cut-off times for retirement accounts and regular accounts.
- Investors will lose confidence in mutual funds if **they** miss the early cut-off time and, for example, are unable to enter **an** order or sell in a declining market.

[2] Charles Schwab & Co,, 1997 SEC No-Act LEXIS 733 (avail. July 7, 1997).

- Investors will be particularly frustrated if, for example, they had entered an order early in the day, but are unable to cancel that order if the market becomes volatile after an early cut-off but prior to Market Close.
- Investors will be prevented from making a same-day exchange from one fund family to another – the ability to sell a position in one fund at that day's NAV, and invest the entire amount of proceeds at another fund at the same day's NAV – a process that depends on funds' ability to accept aggregated orders from brokerage firms after Market Close.
- investors on the West Coast will have a special hardship (2 p.m. Eastern cut-off time = 11 a.m. Pacific = 8 a.m. Hawaii).

Moreover, because investors who buy directly from the fund would continue to have the later cut-off time, an early cut-off time for orders placed through intermediaries creates a strong disincentive to using mutual fund supermarkets, which provide numerous benefits to investors. Among those benefits are:

- Supermarkets enhance clients' ability to comparison shop among different fund families and make better informed decisions, while buying and selling at the same price as if they invested directly with the fund.
- Enabling comparison shopping among different fund families creates downward pressure on Operating Expense Ratios ("OERs") and other costs.
- Supermarkets are able to give customers advice to assist them in choosing among different funds and fund families – advice that will be unavailable for customers who invest directly with particular fund families.
- Supermarkets allow customers to move money much more easily from one fund family to another. Supermarket customers are therefore able to rebalance their portfolios more quickly and easily, and are less likely to stay in poor performing, high cost funds than customers who invest directly with a fund.
- Supermarkets allow clients to see all their assets in all fund families on a single webpage and a single statement.

The SEC staff has repeatedly acknowledged the benefits to investors of fund supermarkets, as recently as its letter to the House Financial Services committee this past summer. Over the past 10 years, individual investors have moved the majority of their mutual fund holdings to mutual fund supermarkets.

Requiring an early cut-off time for mutual fund orders through intermediaries will create other competitive distortions in the markets:

- An early cut-off would discourage the use of intermediaries and stifle the creation of new, small, entrepreneurial funds, which primarily reach potential clients through supermarkets (and do not have the scale to market directly to clients). The result will be to make smaller firms less competitive, discourage the creation of new funds, and create higher barriers to entry which will result in fewer choices and higher costs for investors.
- By discouraging supermarkets, and encouraging direct investment with funds, an early cut-off would require funds to build out more duplicative infrastructure for handling

customers and orders, with the result of increasing costs overall in the mutual fund industry.

- By discouraging mutual fund supermarkets] an early cut-off will particularly harm 401(k) plan participants] because it will encourage more 401(k) plans to offer choices from only a single fund family. Thts will:
  - reduce choice and the ability to diversify retirement assets across multiple fund families]
  - encourage higher OERs and other costs, and, as a result,
  - potentially increase risk and decrease clients' returns.
  - force almost all plan participants to receive next-day pricing, not same day pricing, because of the time involved in aggregating and pricing 401(k) plan orders.
  - possibly cause plan sponsors to decide that the harm caused by next-day pricing requires them to offer other types of investments instead of mutual funds.
- An early cut-off would disadvantage mutual funds compared to investors in competing products that will continue to have later cut-off times: equities, exchange-traded funds (ETFs), closed-end funds, bank collective trust funds, insurance company separate accounts, managed accounts, etc. It would encourage investors to prefer those products (many of which are less regulated and have less robust disclosure) over mutual funds.

Late Trading Reform

Late trading of mutual funds – accepting orders for execution on a given day after the markets have closed on that day – is clearly illegal under current Rule 22c-1 of the Investment Company Act. Late trading is harmful to legitimate investors – it allows some investors an informational advantage concerning market-sensitive news that is announced after the close, and after all other investors have already placed their orders. This informational advantage is denied to other investors in the fund, and allows the late traders to profit at the expense of those other investors. The regulatory community must take aggressive steps to prevent late trading. When the SEC staff agreed in 1997 that mutual fund orders could be aggregated after the close of trading, its no-action letter included stringent procedures to help ensure that all orders were received before the close of trading.'

To ensure compliance with late trading regulations, all funds, and all intermediaries who accept orders on behalf of funds, should be required to establish and maintain policies and procedures that include, at a minimum, the following sets of controls: enhanced audit trails, enhanced compliance surveillance, enhanced audit review, and consent to SEC inspection jurisdiction. Any intermediary that is not able to establish and maintain these sets of controls should be required to transmit all their orders to the fund or its transfer agent before Market Close. Following is more detail on our recommendations in each area.

Enhanced Audit Trails. The mutual fund industry should work with the NASD to establish an enhanced electronic audit trail for mutual fund orders. This audit trail should document the time of receipt of the order from the client, the time of transmittal within a firm (for example, from a branch or call center to a mutual funds operations group), the time of transmission among intermediaries (for example, from a retirement plan Third-Party Administrator ("TPA") to a broker-dealer), and the time of transmission from the intermediary to the fund or its transfer agent. **A** similar Order Audit Trail System ("OATS") documentation requirement (adopted as part of the reform of Nasdaq) is already in place for equities orders – so it should not be difficult for firms to build a similar capability for mutual fund orders.[4] Further, the SEC should reverse its recent position that mutual fund and variable annuity order tickets do not need to be time-stamped.[5]

Enhanced Compliance Surveillance. Even with an electronic order audit trail, there may be situations where the electronic version of the order is entered shortly after Market Close

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[3] Under Section *22* of the Investment Company Act of 1940 and Rule 22c-1. a mutual fund board must set the time or times at which the fund establishes its net asset value. The vast majority of funds set this time at 4 p.m. Eastern time, the time at which the US equity markets close their main trading sessions.

[4] The SEC and the NASD should work with the industry, as they did with Order Audit Trail System ("OATS"), to establish the precise technical specifications of such a mutual fund order audit trail and a reasonable timeline for cost-effective implementation.

[5] The SEC took the position that mutual fund and variable annuity orders need not be time-stamped in late 2001 when it adopted Rule 17a-3(a)(6)(ii); see also Exchange Act Release No. 47910, Question and Answer 1 (May 29,2003) (interpretative release on books and records).

(for example, when a client calls just before Market Close but the registered representative does not finish inputting the order until shortly after Market Close, or when a computer systems problem delays electronic input of the order). The potential for abuse of this process can be addressed by a robust compliance surveillance process. Firms should require surveillance for suspicious patterns of potential late orders by a single client, orders entered by related clients (such as clients of a single adviser), or orders entered by a single registered representative. Where suspicious patterns exist without adequate contemporaneous explanations, firms should take prompt actions to investigate and respond appropriately. Where there are multiple levels of intermediaries – e.g., a retirement plan TPA that sends orders to a brokerage firm – the last intermediary that transmits the order to the fund should obtain satisfactory assurances about the policies and compliance efforts of the earlier intermediaries.

Moreover, each intermediary's handling of late orders should be transparent to the regulators. Funds and intermediaries who accept customer orders up until Market Close should file annually with the SEC a report of trade activities including reporting of any "late trades" with explanations. This reporting would allow visibility and oversight by the SEC without overwhelming the agency with the need to inspect or examine each firm: the SEC could target firms where the late trading filings indicate unusual activity. This process already exists for transfer agents in the current TA-2 filing. Finally, funds and intermediaries should be required to review late trading policies and procedures with their employees in their annual compliance continuing education meetings.

Certification of **Procedures.** Entities that handle mutual fund orders – including fund companies and their transfer agents, as well as intermediaries such as brokerage firms and retirement plan TPAs – should issue annual certifications that they have procedures reasonably designed to prevent or detect late trading, and that those procedures have been implemented and are working as designed. Intermediaries would make these certifications available to any mutual fund on behalf of which it accepts orders for purchase or sale of shares of the fund. As is typically the case for certifications under the Sarbanes-Oxley Act of 2002, each entity would be responsible for designing a process to give the individuals signing the certification a reasonable basis for believing it to be correct. As with the SEC's recent proposal for investment company and investment adviser compliance programs, the annual certification process would address whether changes are needed to assure the continued effectiveness of the late-trading procedures.

Enhanced Auditor Review. Intermediaries who handle mutual fund orders should be required to conduct an annual auditor review of their late-trade prevention and detection procedures For registered intermediaries such as broker-dealers or banks we suggest a standardized SAS 70 or similar review by independent auditors An independent audit requirement might be burdensome for unregulated institutions such as retirement plan TPAs, but at a minimum TPAs should be required to perform an internal audit review by an independent internal audit function. An audit review would be based in part on the annual written compliance certification by the intermediary's management discussed above, which would in this context serve as the equivalent of **a** management representation letter for an auditor review. Both the management certification and the results of the auditor review should be provided to the funds on behalf of which the intermediary accepts orders. Further, if the auditors discover any material control weaknesses, **and** management does not promptly correct those weaknesses, the auditor should be required to escalate that information to the SEC, similar to the requirement for independent audit escalation in Section 10A of the Securities Exchange Act of 1934.

Consent to SEC Inspection Jurisdiction. The SEC should be able to inspect any intermediary to review whether its late-trade prevention and detection procedures are adequate and are working as designed. The SEC of course already has jurisdiction to inspect broker-dealers who aggregate mutual fund orders. The SEC should require banks and trust companies (such as Security Trust Co.) to "push out" mutual fund order processing activities to an affiliated broker-dealer registered with the SEC. The Gramm-Leach-Bliley Act contemplated that these types of securities processing activities (a core part of the definition of broker-dealer activity in the Exchange Act) would be handled by broker-dealer affiliates; however, the SEC has yet to issue regulations implementing this portion of Gramm-Leach-Bliley. Alternatively, the SEC could require that banks register as transfer agents to engage in this type of mutual fund order aggregation and processing.

Unregistered intermediaries (such as retirement plan TPAs) should consent to SEC inspection on the ground that they are acting as agent of an SEC registered mutual fund when they accept orders for that fund.[6] Indeed, some TPAs are already subject to SEC jurisdiction as registered sub-transfer agents for fund companies. To the extent intermediaries such as TPAs declined to consent to SEC jurisdiction for inspections, they would be required to submit all trades to a registered intermediary (or directly to the fund or transfer agent) before Market Close. Since this would be a substantial competitive disadvantage for TPAs, we believe most if not all would consent.

Why Investors Would Be Harmed by an Early Cut-Off of Mutual Fund Orders

In our view, if funds and intermediaries implement the steps outlined above, it will be unnecessary to take the more drastic step of barring all mutual funds from accepting orders unless received by the fund by Market Close. We believe that ordinary retail investors would be substantially harmed by this requirement primarily because intermediaries such as broker-dealers, who handle the vast majority of mutual fund orders, would need to impose early cut-off deadlines to ensure that its orders were received by the funds prior to Market Close. This early cut-off would disadvantage mutual fund investors who place orders through intermediaries.

As noted above, under a no-action letter the SEC staff issued in 1997, a mutual fund may accept an order after Market Close so long as it was received by an intermediary (such as a broker-dealer) prior to Market Close.[7] Today, most mutual funds receive the large majority of their orders for the day in the form of aggregated orders from intermediaries after Market Close.

[6] For many years, the SEC has taken the position that a registered broker-dealer is responsible for supervising the activities of its registered representatives even if those registered representatives were independent contractors, not employees of the brokerdealer. See, e.g., William V. Giordano, Securities Exchange Act Release No. 36742 (January 19, 1996). This position has been based on the theory that the SEC has jurisdiction over anyone acting as agent for a registered entity, even though not technically employed by that entity.

[7] Charles Schwab & Co., 1997 SEC No-Act LEXIS 733 (avail. July 7, 1997).

It would be a tremendous change for the entire industry to move back to pre-Market Close orders. To require funds to receive all their orders by Market Close would require intermediaries to establish earlier order cut-offs, such as 3 p.m. or (more likely) 2 p.m. Eastern time.

Retiremeni Plan Investors. Retirement plans, because of the enhanced complexity of aggregating and pricing orders at the individual, plan and TPA levels, would have even earlier, less convenient cut-offs. A discussion of the order entry process for retirement plans is attached as Appendix **A.** The latest order cut-off a retirement plan TPA could administer is likely to be 12 p.m. Eastern time (9 a.m. Pacific time and 6 a.m. in Hawaii). In practice, almost all retirement plan participants would receive next-day pricing, not same-day pricing. As discussed below, forcing retirement plan participants to get next-day pricing would raise serious fiduciary issues for retirement plan sponsors about whether they should offer mutual funds as an investment option, when other investments with same-day pricing are available as alternatives.

Investor Confusion and Loss of Confidence. An early cut-off time for mutual fund orders will be confusing to investors by virtue of:

- different cut-off times for mutual funds than for equities, bonds, and other types of pooled investment products;
- different (and earlier) cut-off times for transactions through intermediaries than for transactions directly with the fund; and
- different cut-off times for retirement accounts than for their regular brokerage accounts.

Investor confusion will be particularly acute on days of high market volatility, when investors place their orders before the equity markets close but do not receive that day's pricing for their mutual fund order. An investor also will be challenged to understand why a mutual fund trade placed in the investor's brokerage account received the current day's price when the same trade placed at the same time in the investor's retirement account did not. Ultimately, as a result of this confusion, there is a danger that investors will lose confidence in mutual funds, particularly when an investor misses the early order cut-off and, for example, is unable to sell in a declining market.

Loss of Same-Gay Exchange. An eariy order cut-off will prevent one of the most significant benefits of the current order aggregation process. the ability to make a same-day exchange from one fund family to another. Same-day exchange allows an investor to sell a position in one fund at that day's NAV. and invest the entire amount of proceeds at another fund at the same day's NAV. In this process, an investor is never required to be out of the market. Same-day exchange works as follows: the exact amount of investor's proceeds from the sale of the first position is not known until *the* first fund establishes that day's NAV (necessarily after the close of the market). The intermediary then takes that amount, and places a purchase order for exactly that amount with the second fund family (also at that day's NAV). This process depends on funds' ability to accept aggregated orders from brokerage firms after Market Close. Establishing a requirement that all orders be received by the fund before Market Close will destroy the ability to same-day exchange between fund families.

West Coast Investors An early order cut-off will impose a special hardship on broker-dealer clients on the West Coast. If, in order to meet the 4 p.m. cut-off time for getting orders to a fund company, an intermediary must impose a 2 p.m. Eastern time order cut-off, that translates to an 11 a.m. Pacific time order cut-off, and an 8 a.m. order cut-off in Hawaii. This hardship will be even greater on days when the Market Closes early, such as the day before (or after) July 4th, the day after Thanksgiving, and Christmas Eve, when the order cut-off would be pushed even earlier (perhaps to 11 a.m. Eastern time, which translates to 8 a.m. Pacific time and 5 a.m. Hawaiian time).

Effect on Mutual Fund Supermarkets. An early order cut-off would only apply to mutual fund orders placed with intermediaries such as brokerage firms. Lnvestors who buy directly from the fund would continue to be able to place orders until Market Close. As a result, the early order cut-off would create a strong disincentive to using mutual fund supermarkets, which benefit investors in many ways.

The primary benefit of mutual fund supermarkets is that they enhance clients' ability to comparison shop among different fund families and make better informed decisions, while buying and selling at the same price as if the clients had invested directly with a fund. A customer who invests directly with a fund family is only able to use that fund family's facilities to comparison shop among that fund family's offerings. Enabling comparison shopping among different fund families allows more robust competition, and increases the likelihood that investors will find funds that best match their particular needs. Competition among fund families also creates downward pressure on operating expense ratios and other costs. The mutual fund industry has been criticized for not doing a better job ofbringing down costs: harming mutual fund supermarkets will decrease cost-based competition even further. As noted above in the discussion of the same-day exchange process, mutual fund supermarkets allow investors to move money much more easily from one fund family to another. In a mutual fund supermarket, it is not necessary to request a check from one fund family. receive the check, open an account at another fund family, and mail a check to that fund family. The same-day exchange process allows supermarket customers to rebalance their portfolios more quickly and easily. As a result, investors are less likely to stay in poor performing, high cost funds than customers who invest directly with a fund. In short, forcing investors out of mutual fund supermarkets is likely to lower investors' investment returns.

Mutual fund supermarkets also are more convenient for investors. Supermarkets allow clients to see all their assets at all fund families on a single webpage and a single statement. Seeing all their investments in one place allows customers to better determine whether their overall asset allocation and their individual investment choices continue to make sense. Moreover, supermarkets are able to give customers advice to assist them in choosing among different funds and fund families – advice that may be unavailable for customers who invest directly with particular fund families. The SEC staff has repeatedly noted the benefits to investors of fund supermarkets, as recently as-its letter to the House Financial Services committee this summer.[8] Since the introduction of the first no-load, no-transaction fee mutual

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[8] See Memorandum from Paul F. Roye Re: Correspondence from Chairman Richard H. Baker, House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, June 9, 2003, at

fund supermarket in the early 1990s, investors have moved the majority of mutual fund holdings in the industry from direct holdings with funds, to holdings through supermarkets. Investors prefer mutual fund supermarkets. The SEC should not adopt regulatory changes that force clients out of supermarkets and back to direct holdings with fund companies.

Disadvantaging Mutual Funds. Requiring an early cut-off for mutual fund orders through intermediaries will create other competitive distortions. Mutual funds are just one choice among many other types of investments. An early order cut-off that applies only to mutual funds would disadvantage these funds compared to investors in competing products that will continue to have later cut-off times. Equities, exchange-traded funds (ETFs), closed-end funds, bank collective trust funds, insurance company separate accounts, and managed accounts will continue to accept orders through Market Close. If the SEC imposes an early order cut-off only on mutual funds, it would encourage investors to prefer those products over mutual funds. Many of these other products are less regulated and have less robust disclosure.

Disadvantaging Smaller Mutual Funds and Increasing Cost. An early cut-off would also harm newer, smaller, more entrepreneurial mutual funds. These types of funds primarily reach potential clients through supermarkets, and they typically do not have the scale to market directly to clients. The growth of mutual fund supermarkets has been accompanied by an explosion of mutual fund choices for investors. The two phenomena are closely linked: there would not have been the same growth in the number of funds if they were not able to reach potential investors through mutual fund supermarkets. If the SEC adopts regulations that discourage mutual fund supermarkets, the result will be higher barriers to entry for new funds and fewer choices for investors. As a result, the mutual fund industry will move towards an oligopoly of large fund complexes with the size and scale to be able to market directly to investors. The inevitable result of lessened competition will be higher costs for investors.

Moreover, by discouraging Supermarkets and encouraging direct investment with funds, an early order cut-off would result in all funds having to build out more infrastructure for handling customers and orders. Today, most fund companies receive a relatively small number of orders – the work of aggregating thousands of customer orders (and doing all of the attendant sub-accounting) occurs at the brokerdealer, not at the fund company. It is more efficient for broker-dealers to build this infrastructure at the supermarket level, where they can leverage the infrastructure they already have for handling orders for other types of securities. We estimate that, for ourselves alone, the cost, shared by ourselves and the funds, of pushing our order-aggregation function out to the fund companies would be some $4 million/year.[9] If the SEC pushes more clients to invest directly with fund companies, the result will be to increase costs overall in the mutual fund industry.

Reducing Choice for 401(k) Participants. By discouraging mutual fund supermarkets, an early cut-off will particularly harm 401(k) plan participants. As discussed in Appendix A, the process of aggregating mutual fund orders is must complicated for 401(k) and other retirement

73; Investment Company Institute, 1998 SEC No-Act LEXIS 976 at *6 (publicly available Oct. 30, 1998) ("SEC supermarket no-action letter).

[9] See Appendix B: Cost Implications of an Early Order Cut-Off.

plans. If the early order cut-off is established, retirement plans will face strong pressure to offer choices only from a single fund family: in this way, retirement plans will be able to take participant orders later than if the orders must first be routed through an intermediary such as a broker-dealer. Retirement plan sponsors, who have a fiduciary duty to plan participants, will face significant pressure to obtain the latest possible order cut-off to protect plan participants from negative market developments after their order cut-off time. However, limiting plan participants to a single fund family will be a negative development for 401(k) plan participants. It will reduce choice and the ability to diversify retirement assets across multiple fund families. Reducing participant choice will encourage higher OERs and other costs. As a result of reduced choice and increased costs, plan participants will likely face increased risk and decreased returns.

Some commentators have questioned whether it matters if 401(k) investors (who almost by definition are long-term investors) have to wait an extra day to have their orders placed. While the effect of delay on a single investor may be small, the aggregate effect on all investors is large. SEC statements over time on best execution (in the equities context) make clear the SEC's view that it is a serious breach of fiduciary duty to short-change investors by a few pennies per share – in the aggregate, especially over long periods of time, pennies matter.[10] Long-term investors should be fully invested; systematically having money uninvested for a day will increase long-term tracking error and disadvantage investors (especially since significant market events will occur on some of the uninvested days). It will dampen 401(k) plan participants' confidence in mutual funds if they are forced to wait an extra day to sell in a falling market, or to buy in a rising market. Moreover, plan sponsors' fiduciary duties may cause them to abandon mutual funds altogether. Other pooled investment vehicles (such as bank collective trust funds and insurance company separate accounts) will not face the same early order cut-off. Plan sponsors may feel compelled to offer ETFs and closed-end funds, which trade like equities and would not be subject to an early order cut-off, instead of mutual funds. As noted above, mutual funds have the highest level of regulation and disclosure of any investment vehicle; it would be unfortunate if the SEC created an incentive for 401(k) plan participants, who are typically among the least sophisticated investors, to receive investment choices with a lower level of investor protection.

Emergency Situations. We believe that even with an early order cut-off for mutual funds, the regulators will need to establish some sort of exception process. Any securities trading process needs to account for some emergency situations, such as power failures, connectivity failures with the National Securities Clearing Corporation ("NSCC"), other telecommunications or computer failures, and disasters such as hurricanes or earthquakes. Today, broker-dealers or other intermediaries who receive orders from customers before Market Close are able to transmit them to fund companies after Market Close if such an emergency has prevented the transmission from occumng earlier. If there is not such an emergency exception process, investors will be further disadvantaged by an early cut-off time, potentially on the days they may most need liquidity, and will have additional incentive to avoid mutual funds in favor of alternative investment products.

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[10] See Remarks of Chairman Arthur Levitt, Best Execution: Promise of Integrity, Guardian of Competition (Nov. 4, 1999); Order Execution Obligations, Securities Exchange Act Release No. 37619A (Sept. 6, 1996).

Cost and Delay of Early Order Cut-Off. To establish a "hard close" for mutual fund orders at the end of market trading would require reprogramming all computer systems that accept orders, and a fundamental reordering of the order handling and settlement process." These changes would have to be made simultaneously by fund companies, transfer agents, settlement utilities, brokerage firms, investment advisers, retirement plan administrators and other intermediaries. The cost of implementing and testing these changes (as orders are handed off from participant to participant) would be substantial, and those costs would almost certainly be passed on to investors. Such a complex series of systems modifications could not be accomplished quickly. An early order cut-off requirement is neither a quick nor an inexpensive fix to the late trading problem. In contrast, the proposed reforms contained in this white paper would be substantially less costly to implement and could be in place considerably more quickly.

Market Timing Reform

Market timing – the practice of short term buying and selling of mutual fund shares in order to exploit inefficiencies in mutual fund pricing – in some circumstances can harm long-term investors in a mutual fund. In some types of funds – particularly smaller funds that invest in relatively illiquid securities with high trading costs – it can hurt performance to have to establish and then unwind positions to account for rapid flows in and out of the fund. Small-cap technology and international funds historically have had the greatest concerns with market timing activity. In other circumstances, as long as it is disclosed to investors, fund companies may decide legitimately that some kinds of short-term trading activity do not harm other investors or the fund as a whole. Larger funds, funds with more passive management styles (such as index funds) and funds that specialize in more liquid asset classes typically are less concerned about market timing. Market timing is more of a concern in some market environments (such as on days of high volatility) than in others, and funds may legitimately choose to accept market-timing orders in some market conditions and not in others. Moreover, where a purchase by a market-timer offsets sales by other investors (or vice-versa), even funds that typically do not want market timing activity may choose to accept a particular order from a known market-timer. Different fund families, and different funds within the same family, may have very different policies regarding market timing (if they have such a policy at all).[12]

We believe that fund companies should have the information and tools to police potential market timing activity as stated in their announced policies, and should enforce these policies consistently for all investors. We propose reforms in the following areas to ensure that mutual fund investors are not disadvantaged by market timing: redemption fees, fair value pricing, information from intermediaries, and equal access of information to investors. Following is more detail on our recommendations in each area.

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[11] For a discussion of the operational implications of an early mutual fund order cut-off, see Appendix C: Tasks Performed Between Order Cutoff and Order Placement.

[12] The SEC should clarify that a fund must enforce its market timing policies consistently; it may not permit market timing activity by some investors when it forbids the same activity at the same time by other similarly-situated investors.

Reform of Redemption Fees. In our experience, redemption fees (RFs) are the single most effective deterrent to market timing.[13] We have noted that funds which establish RFs typically show a very rapid and significant reduction in market-timing activity. However, the SEC staff has in the recent past limited the effectiveness of RFs by capping them at a maximum of 2%. We urge the SEC to allow funds (especially those most subject to market-timing abuse) to establish multi-level RFs. For example, a fund might establish a 3% RF for redemptions within 10 business days, and a 1% RF for redemptions within 60 business days. While we agree that the level of a RF should bear some reasonable resemblance to the actual costs market-timing cause for a fund, a "hard cap" of 2% in all circumstances is not appropriate. Moreover, the SEC should clarify that a fund board has a fiduciary duty to consider whether a fund should have a RF. A fund board should consider factors such as whether that fund, or other similar funds, have had a history of market-timing activity, and whether that activity has had a detrimental effect on the fund and its long-term investors. In our view, such a determination should be made at least annually by the fund board.

Further, the SEC should provide guidance about the circumstances in which a fund can waive a RF. It is important for RFs to be applied consistently to all clients – otherwise a fund may face a fiduciary question of whether it is preferring some shareholders to others. Many retirement plan recordkeepers and third-party administrators currently do not have systems adequate to charge RFs. If funds are not charging RFs to some classes of investors, it is important that funds disclose this fact. The SEC may want to consider requiring the retirement plan industry to upgrade its systems uniformly to permit assessment of RFs.

Fair Value Pricing. As the SEC staff has been stating for several years, fair value pricing is an important step to ensure that market-timers are not able to arbitrage stale prices for mutual funds. Fair value pricing is especially important for international funds (funds focusing on investments in securities of non-U.S. issuers), which are priced at the close of the US equities markets, often long after foreign markets have closed. Where events occur after the close of overseas markets that affect the value of securities held in US mutual funds, fund advisers should reflect those events in the NAV they set for those funds.

We urge the SEC to establish, through rule-making, clear requirements with respect to fair value pricing. For example, the SEC could establish that where there are statistically significant correlations between markets in different countries, there should be a presumption that fair value pricing adjustments are necessary. For example, if a movement of more than 2% in the US equities market reliably predicts a similar move the following day in the Japanese market, then a fund with a significant concentration of Japanese equities should be required to fair-value-pnce its Japanese holdings. Similarly, if a fund has a history of market timing activity that is detrimental to long-term investors in that fund, then the SEC should clarify that the fund board has a fiduciary duty to review whether the fund's fair value pricing procedures are working adequately.[14]

[13] Because these redemption fees only apply if investors sell their fund holdings within a certain period of time, they are sometimes referred to as conditional or contmgent redemption fees.

[14] Boards also can consider settıng an earlier order cut-off for funds, particularly those holding securities in a single foreign market or related foreign markets which close at or about the same time. This *step,* which a few funds have taken, has the effect of limiting the ability of events after local Market Close to

Information-Sharing Between Intermediaries and Funds. Lntermediaries who accept mutual fund orders on behalf of funds, such as broker-dealers, should provide fund companies with enough information to detect potential market timing activity by the clients of those intermediaries. For example, intermediaries (such as broker-dealers) should provide funds with enough identifying information about mutual fund trades over certain size thresholds to allow the funds to decide whether to accept those orders.[15] The identifying information should allow funds to identify patterns of activity by a single investor over time, and to identify patterns of activity in related accounts (for example, sub-accounts of a single investment adviser). Intermediaries have been reluctant to share this information with fund companies for fear that it may be deemed to violate the privacy rights of clients. However, we believe fund companies have a legitimate need for this information to enforce their own market-timing policies. The SEC should clarify that it does not violate the privacy rights of a client for an intermediary to provide information about that client to a fund for the purpose of monitoring potential market timing activity.[16]

If a fund chooses to ban a particular client, the SEC should clarify that an intermediary should make reasonable efforts to enforce that ban (including against new accounts opened by that client). And if a fund determines that a particular client has engaged in impermissible market timing (either as a direct shareholder or through a particular intermediary), the fund should be permitted to provide the name of the banned client to other intermediaries. Those other intermediaries should make reasonable efforts to determine if that client has accounts at that firm, and should make reasonable efforts to enforce the fund's ban as to that client.[17]

The SEC should also clarify that the intermediary's duty is to provide information to fund companies, but not to enforce the funds' policies. Different fund families (and different funds within a fund family) may have different market timing policies. As discussed above, a single fund legitimately may vary the application of its market timing policy depending on market

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affect the value of a fund. However, this step has the disadvantage of being potentially confusing to investors in the fund, and it creates operational complexity for intermediaries who have to support multiple order cut-offs for different funds.

[15] We have already established a large-order approval process to allow mutual funds to see individual large orders from our clients, each with a special identifying number, so that the fund may decide whether to accept purchase orders, or to extend settlement of sell orders.

[16] Funds should be required either to accept or reject large orders presented through intermediaries within one hour of the time they are received by the fund. This is necessary to prevent the funds from "gaming" market events after Market Close to the detnment of mvestors. Just as it is unfair for mvestors to use post-Market-Close information to place late trades, funds should not be able to use post-Market-Close information to reject customer orders they would otherwise have accepted or accept trades they would have otherwise rejected. Indeed, under current rules, funds *can* even accept a trade and then several hours later decide to rejectthat trade based on new information.

[17] *An* intermediary's efforts to enforce a fund's ban on a customer should be reasonable, but should not be interpreted as a guarantee. Some hedge funds and other investors have undertaken elaborate efforts to change names, addresses, and authorized traders to avoid market-timing bans, and no intermediary can have a foolproof means of detecting all of these efforts.

conditions or on its fund flows from other investors. Thus, intermediaries are not in a position to interpret and apply a fund's market timing policies. It is not efficient or cost-effective for funds to shift this burden to intermediaries.

Equal Access to Information. The SEC should clarify that a fund should not be permitted to give some clients access to information about the fund's positions unless that information is generally available to all clients of the fund. Internal information sharing about a fund's positions within an adviser's holding company is permissible for legitimate reasons (such as compliance surveillance and risk management), subject to access person controls and oversight under the Investment Company Act. However, providing different access to information to different investors about a fund's positions could violate the fiduciary duty of the fund's adviser and the fund to treat all shareholders equally.

Why delaying mutual fund orders is not necessary to address market-timing

Delaying mutual fund orders, either for a few hours by an early order cut-off or by executing at next-day prices for 401(k) plans, has been suggested as a solution to market timing issues. However, we believe this is an overly broad solution when equally effective but less intrusive alternatives are available. Delaying all orders will adversely impact a majority of investors, while only a few investors engage in detrimental market timing. Better transparency from intermediaries to funds will allow fund companies to address market timing in the way fund companies see fit, for only those investors who are actually engaging in market timing. Moreover, as discussed above, our experience is that redemption fees are the best deterrent to market timing, and RFs have no detrimental impact on long-term investors. More active use of fair value pricing will also help deter market timing by reducing opportunities for arbitrage across markets. We believe these steps will be adequate to address market-timing without taking the more drastic step of delaying the execution of all investors' orders for several hours or even an additional day. Moreover, market timing is only an issue for certain types of funds and fund companies; others are not subject to, or are not harmed by, short-term trading. **A** regulatory response that delays execution of orders for all mutual funds (even those not subject to timing abuses) is much too broad. Such an overbroad regulatory response simply would serve to push clients toward investment alternatives other than mutual funds.

Appendix A: The 401(k) Trading Process

Today the 401(k) industry delivers trades to mutual funds after the 4 p.m. ET deadline. The trades that are delivered are aggregated trades of participant activity received by the 401(k) TPA/Recordkeeper before 4 p.m. ET. The aggregation and processing of the 401(k) trades is more complex than retail account trades. This is for three main reasons:

1. Additional compliance restrictions on 401(k) plans results in complex systems, participant account/sub account relationships. and aggregated plan reporting. **A** participant account is presented as, and deemzd one account. Although considered one account, the participant account reflects up to 10 sub accounts (i.e., contribution types). Compliance restrictions require 401(k)'s to track an account according to contribution type or source (i.e., pre tax, after tax, employer match, profit sharing).
2. Same day asset exchange requirements for particiuants. Participants are allowed to move from one fund to another fund at that day's NAV.
3. Multiple levels of aggregation, posting, and trading.performed by multiple uarties. In a 401**(k),** the TPA/Record Keeper receives participant trades at the participant account level. Systematically, trades must then be pro-rated (usually done based on the today's market value) and posted to each contribution type. The TPA/Record Keeper then aggregates all participant trades for a particular plan and sends them to the Trustee/Custodian. The Trustee then posts the aggregated plan trades on a trust/custody system (i.e., for mandatory plan reporting purposes). Most trust companies then aggregate all of their client trades at the asset level to minimize trading or NSCC costs.

The account/sub account relationship coupled with the same day asset exchange requirements, result in most 401(k) systems *requiring that day's price file* before starting to pro-rate and aggregate that days trades. All prices for a plan, including collective funds and managed portfolios, must be received before starting to aggregate and post the trades. This results in a *later system start time* to pro-rate and aggregate trades (after close when all prices have been received). The multiple layers of aggregation/posting and the multiple parties involved requires a *longer systems andprocessing time frame* than on the retail side. The later start time and the longer time period needed for systems and processing results in trades being delivered to the fund companies anywhere from 10 p.m. ET to the next morning (usually by 9 a.m. ET).. ,

Could the current environment be changed to allow for a hard 4 p.m. cutoff? Major system changes would be needed by all 401(k) providers. Generally, the large providers, who serve as both reccrd keeper and trustee, *may* be able to change their systems to eventually get closer to the 4 p.m. cutoff although at great expense. The mid-size and smaller providers probably would not be able to do so and would probably be forced to trade all assets next day. This would be a competitive disadvantage, Further, the large providers would lack the incentive to make major changes. Most of the large providers also sponsor a mutual fund family. Under the current proposal, their funds would be able to trade same day while their competitors' funds would not. The large providers will use this as a marketing opportunity for their funds. It is doubtful that they would upgrade their systems in order to allow competitor funds to trade same day.

Appendix B: Cost Implications of an Early Order Cut-Off

System Development Costs

- Firms doing business in the omnibus model may find that they must develop real time aggregation of orders in order to have trading cutoff times that are reasonably competitive.
- Speed requires greater investments in technology with little perceived benefit. These investments may be particularly difficult for small firms and could result in firms exiting the mutual fund business which negatively hurts competition and pricing in the long run.

Increased Transaction Costs

- For firms that have made the investments in omnibus processing and the ability to aggregate orders, moving backwards to transmitting orders at a sub-account level to the funds results in an unnecessary duplication of expenses for brokers and funds. This duplication of expenses will cause OERs to rise or alternatively funds and brokers will raise minimums and/or reduce services such as Automatic Investment Plans ("AIPs") that will directly impact small investors.

To illustrate the impact of such a change, we have attempted to detail the incremental costs that would be incurred by one brokerage firm and its affiliated fund family.

- Number of sub-account trades per year = 13,000,000*$0.35=$4,550,000 per year
- Number of omnibus trades per year = 1,300,000*$0.35=$455,000

Cost per trade = $0.35 split between fund and broker

Incremental cost to brokerage firm and its affiliated fund family = $4,095,000 annually

- 3 year cost combined= **$12.3** million
- 5 year cost combined=**$20.**5 million

These expenses would likely be passed on to investors in the form of higher OERs.

Appendix C: Tasks **Performed Between Order Cutoff and Order** Placement

The time between order cutoff and order placement is used to ensure the accuracy and integrity of the omnibus order. This includes:

- Ensuring that all customer orders have been properly entered into our trading system
- Communicating large orders (generally orders over $500k) to fund companies giving them the opportunity to accept the order or reject any orders that they do not want.
- Canceling any orders that were rejected by the fund prior to transmitting to the fund. This is critical when the order being rejected reflects an aggregate order from an investment manager representing potentially several hundred or thousands of individual sub-account orders.
- Reviewing load fund orders to ensure that orders are processed according to Letter of Intent, Rights of Accumulation, reinstatement, and breakpoint provisions and clients receive available benefits. Given the complexities of ROA, LOI, breakpoints, and reinstatements it is unrealistic to expect that all information can be obtained by the front office without requiring research and review from the back office. This involves significant work for the back office and either the cutoff times for load funds will be even earlier or orders will be placed for the following days' price (a significant customer service issue).
- Ensuring that orders are properly aggregated by like order types (buy$, buy shares, sell$, sell shares, etc.) into omnibus level orders

Problems and issues with having to transmit orders to funds by 4 p.m. EST.

- Emphasis would be placed on speed in getting orders to the fund by the deadline resulting in additional exception processing "adjustments" to the omnibus trade and/or acceptance of additional trades. This is a direct cost to the fund and to intermediaries.
- Funds would likely be pressured by brokers to make decisions faster on large orders given a very small window between cutoff time and transmission – this time constraint will make it more difficult **for** funds to make thoughtful informed decisions and increases the **risk** of accepting an order that should be rejected or rejecting an order for a valued client that should have been accepted.
- Orders rejected by funds after omnibus trades have been transmitted can be very problematic and prone to **risk** since the aggregate trade has to be manually adjusted. While the NSCC has functionality to accommodate this (firm exit capability) not all firms have it and it still requires manual processing and errors can be very costly given the dollar amount of aggregate omnibus orders.

Proposed New Rule 22c-1(e)

"Notwithstanding any provisions above, if an order to sell, redeem, or repurchase any redeemable security issued by a registered investment company is transmitted to and received by any person of a type designated in the registered investment company's prospectus as authorized to consummate transactions in any such security (a "designated person"), prior to the specific time or times established by the board of directors of the investment company set in accordance with paragraph (d) of this rule (the "pricing time"), then such security may be sold, redeemed or repurchased at a price based on the net asset value of such security computed as of the pricing time after receipt by the designated person; *provided*, that both the registered investment company or the designated person, and the entity transmitting the order to the registered investment company or designated person have established and maintained policies and procedures sufficient to establish that the order was originally placed with the entity transmitting that order prior to the pricing time. These policies must include:

(1) adherence to an electronic audit trail system for registered investment company orders approved by a national securities association documenting all material steps in the handling of the order;
(2) compliance surveillance of registered investment company orders reasonably designed and maintained to prevent or detect orders submitted after the calculation of the net asset value by the registered investment company;
(3) annual certification of the existence of procedures reasonably designed and maintained to prevent or detect orders submitted after the calculation of the net asset value by the registered investment company;
(4) annual audit review of procedures reasonably designed and maintained to prevent or detect orders submitted after the calculation of the net asset value by the registered investment company; and
(5) consent to Commission jurisdiction, in a form acceptable to the Commission, for inspection and examination of the procedures reasonably designed and maintained to prevent or detect orders submitted after the calculation of the net asset value by the registered investment company.

Note: **The** SEC needs ***to*** amend 22c-1(b) which contains an inadvertent reference to a non-existent paragraph ***(e)*** under **the** rule; the reference is in fact **to** paragraph **(d).**