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**MEMORANDUM**

**TO:** Public Comment File No. S7-27-03

**FROM:** Penelope W. Saltzman *Penelope W. Saltzman*  
Office of Regulatory Policy  
Division of Investment Management

**DATE:** March 4, 2004

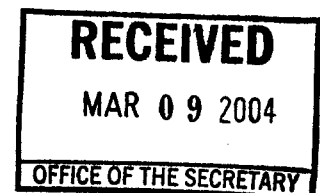
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On February 25, 2004, representatives of Charles Schwab & Co., Inc. (“Schwab”), including Jeffrey Lyons, Fred Potts, Bill Thomas, Koji Felton, Michael Townsend, and Barry Barbash, and representatives of MassMutual Financial Group (“MassMutual”), including Ed Ryan and Patricia Walsh, met with staff members of the U.S. Securities and Exchange Commission to discuss issues relating to the Commission’s proposed rule amendments concerning the pricing of investment company shares in Investment Company Release No. 26288 (Dec. 11, 2003) (“Late Trading Proposal”). The following Commission staff members attended the meeting: Paul Roye, Director, Robert Plaze, Associate Director; C. Hunter Jones, Assistant Director; Penelope Saltzman, Senior Counsel; and Adam Glazer, Attorney, Division of Investment Management.

The Schwab representatives discussed the points and arguments made in the comment letter Schwab submitted in response to the Commission’s Late Trading Proposal. In particular, the Schwab representatives discussed (1) the adverse consequences of a “hard 4” close; (2) the benefits of an alternative approach that would allow intermediaries to obtain same-day pricing for orders they receive by 4 p.m. and submit to the fund, its designated transfer agent, or registered clearing agency after 4 p.m. if the intermediary meets specific requirements, including an enhanced electronic audit trail, annual certification of procedures, independent SAS-70 auditor review, and for those intermediaries not subject to Commission supervision, consent to Commission inspection; and (3) the ways in which the alternative approach might have prevented publicized late trading incidents. The Schwab representatives gave the staff an outline of their talking points, a copy of which is attached.

Both the Schwab and MassMutual representatives commented that there would be significant costs associated with the hard 4. In particular, they emphasized changes to the competitive balance in fund sales that would result because intermediaries would have to establish earlier cut-off times for their customers to place orders. They also noted that their alternative approach would allow intermediaries to choose the most cost-effective alternative for the intermediary: (1) to comply with the hard 4; or (2) to implement additional technological, certification, and audit requirements that would allow later submission of orders.

Attachment

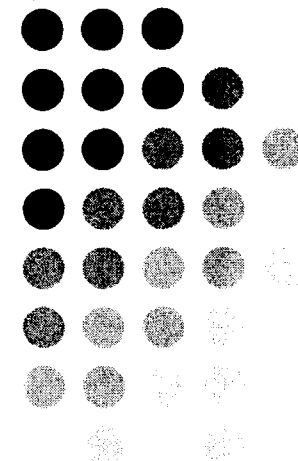


# SMART4

A Stronger & Superior Alternative

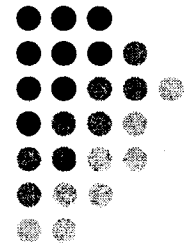
Charles Schwab & Co., Inc.

February 25<sup>th</sup>, 2004



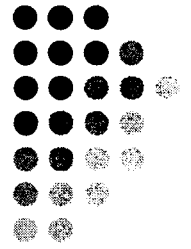
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# While Well Intentioned, Hard 4:00 Has Adverse Consequences



- Penalizes investors who transact mutual funds through intermediaries
- Penalizes investors who invest through 401K plans
- Penalizes small funds and those dependent on intermediary distribution while favoring large direct marketed funds
- Favors operating models (e.g. individual orders vs aggregate orders) that significantly increases ongoing expenses

*We believe that there is a better solution to the problem of late trading that doesn't have the above disadvantages. We call this alternative SMART4...*

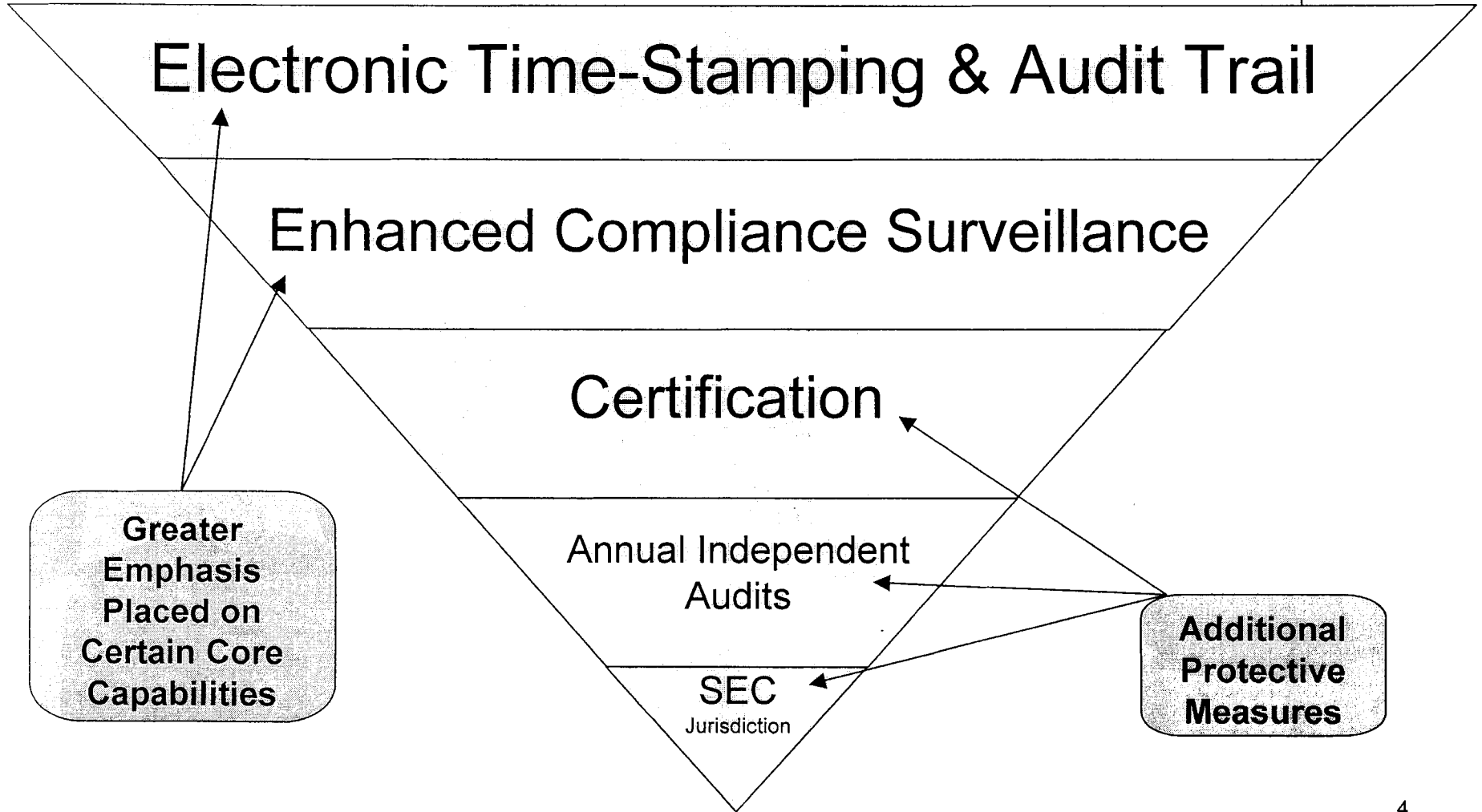
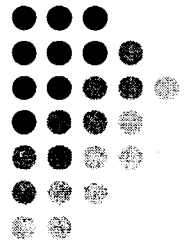


# SMART4

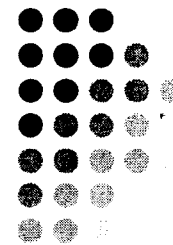
- Sets a new and higher standard for all participants in the mutual fund selling process
- Mitigates the impact to individual investors
- Provides a strong incentive for intermediaries to invest in SMART4 requirements
- Leverages technology that already exists today
- Requires intermediaries who do not meet SMART4 requirements to abide by a Hard 4

*Each of the 5 components has specific benefits that when combined provides a stronger and more comprehensive solution to the problem of late trading*

# Critical Elements of SMART4

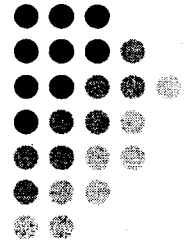


# SMART4 Sets a Higher & Stronger Industry Standard



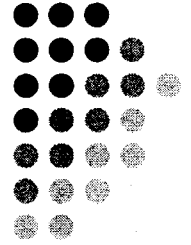
<b>SMART4 Requirements</b>	<b>Industry Practice</b>	<b>SMART 4</b>
<b>Electronic Time-Stamping &amp; Audit Trails</b>	Inconsistent to Non-existent	Required
<b>Compliance Surveillance Reporting</b>	Inconsistent to Non-existent	Required
<b>Annual Certification</b>	Non-existent	Required
<b>Annual Independent Audits</b>	Limited to Non-existent	Required
<b>Consent to SEC Jurisdiction and Inspection</b>	Funds, B/D's and TAs – Yes Others – No	Required

# Electronic Time-Stamping & Audit Trail



- Firms must have the operational and systems capability to accurately capture, record, protect and retain the time-stamp & order data
- Electronic audit trails must be established, maintained, and protected
- Other preventative control measures including segregation of duties

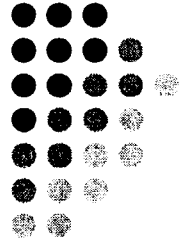
# Enhanced Compliance Surveillance



- Real time or same day reporting designed to detect and prevent abuse
- Annual audits would include a review of the effectiveness, accuracy and completeness of the reports

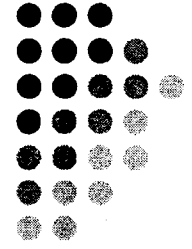


# Certification

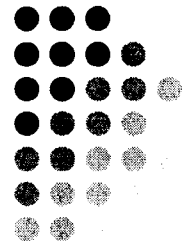


- Ensures executive management awareness, oversight, and accountability
- Satisfies the need for a higher level of self policing and regulatory compliance within the industry
- Follows the model of Sarbanes-Oxley requirements

# Annual Independent Audits



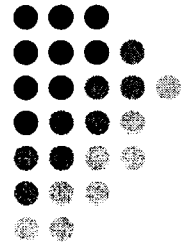
- Provides a level of ongoing, objective, validation, and assurance
- Lessens the burden on the SEC and other regulators to ensure compliance
- Allows for SEC input, guidance, and selective review



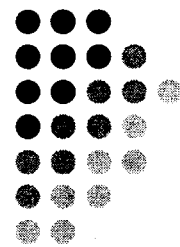
# SEC Jurisdiction

- Required to ensure all firms seeking to receive orders up until 4:00 be subject to SEC inspections and enforcement actions
- SEC enforcement cannot be an effective deterrent if it doesn't apply to all industry participants
- Required to ensure a level playing field among all participants in the mutual fund selling process

# How Would SMART4 Have Prevented Late Trading?

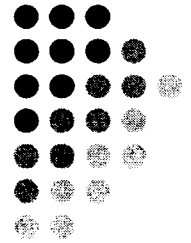


- Time-stamping, audit trails, compliance and surveillance reporting combined would have detected and prevented the vast majority of the incidents of late trading
- In the most egregious cases with criminal activity involving collusion among multiple parties, it would have been detected by certification and independent audits or regulatory inspections
- Requirement to appoint Chief Compliance Officer will also provide protection



# Appendix

# Electronic Time-Stamping & Audit Trail



## *Firms Must Have the Operational and Systems Capability to Accurately Capture, Record, Protect and Retain the Time-Stamp & Order Data*

- Accurate capture and recording of the time a valid order is received
- Immediate recording of orders and time-stamps on the firms books and records (e.g. systems)
- Appropriate design of order processing systems and system security including:
  - Functionality to apply a new updated time-stamp when an order is significantly modified
  - Limiting system access for order entry, order entry after cutoff for that day's price, changes after cutoff, cancels, etc.

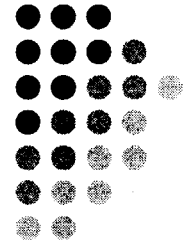
## Electronic Audit Trails Must Be Established, Maintained, and Protected

- Audit trail must be readily accessible
- Data retention required of all data elements comprising the order
- Data should be appropriately backed up
- Information security policies required - protecting against inappropriate and unauthorized modification or deletion of data

## Other Preventative Control Measures

- Segregation of duties - client service, operations, systems (e.g. database mgmt), etc.

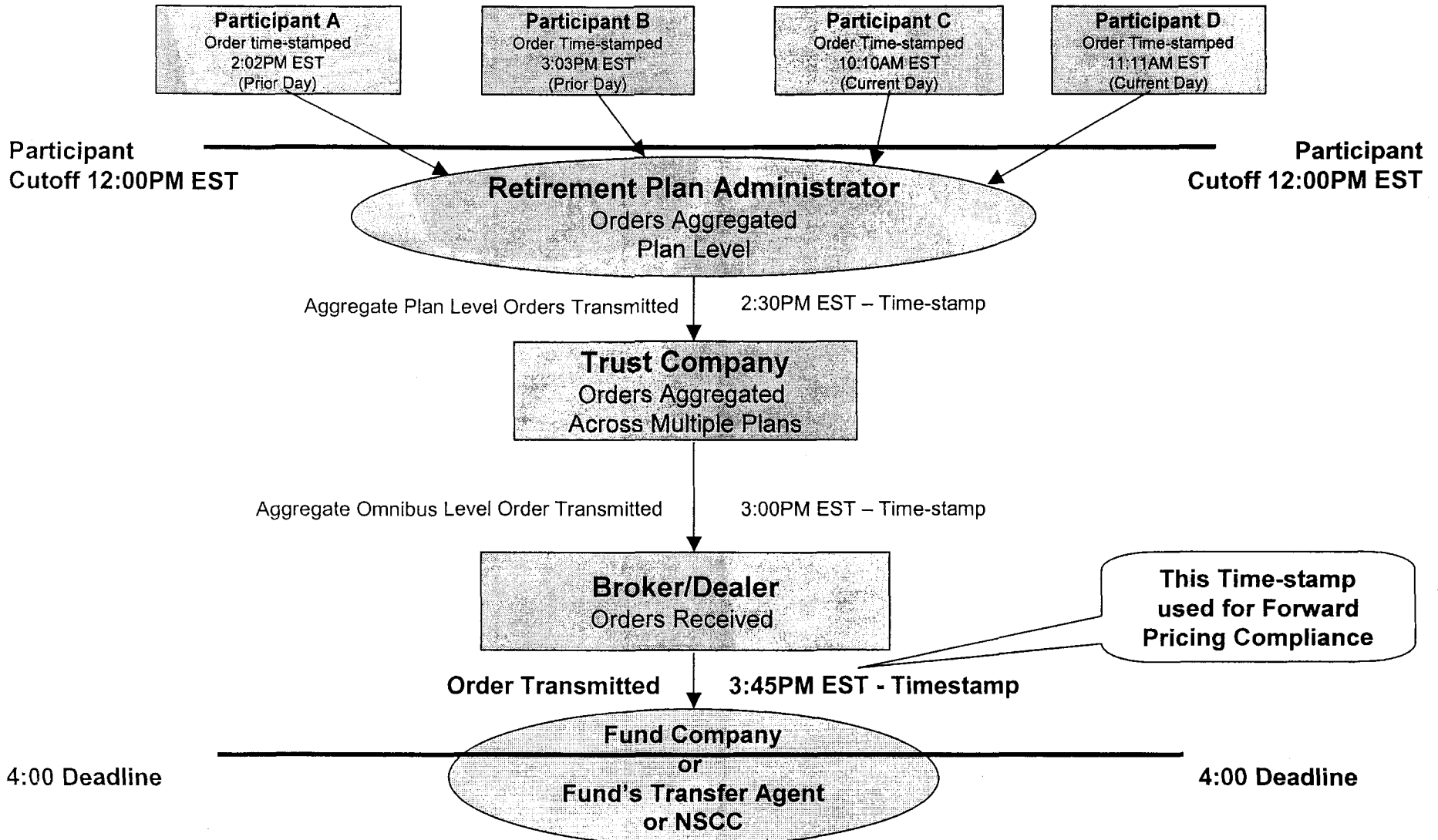
# Enhanced Compliance Surveillance



*Once An Accurate Electronic Time-stamp and Audit Trail Has Been Established, Enhanced Compliance & Surveillance Reporting Methods Can Be Leveraged*

- Real Time or Same Day Reporting Designed to Detect and Prevent Abuse
  - Orders entered after 4:00 for the current trade date
  - Orders altered after 4:00, including the data elements that were changed
  - Orders cancelled after 4:00
  - Frequency reporting to detect patterns and possible abuse – by rep, fund, fund family, dollar amount, account, investment manager, etc.
  - Knowledge of exact compliance algorithms and other late trading detection methods should be safeguarded from individuals involved in client service and processing of mutual fund orders
  - Other reporting and tools could be developed based on regulatory guidance
- Annual audits would include a review of the effectiveness, accuracy and completeness of the reports

# Hard 4:00 Proposal

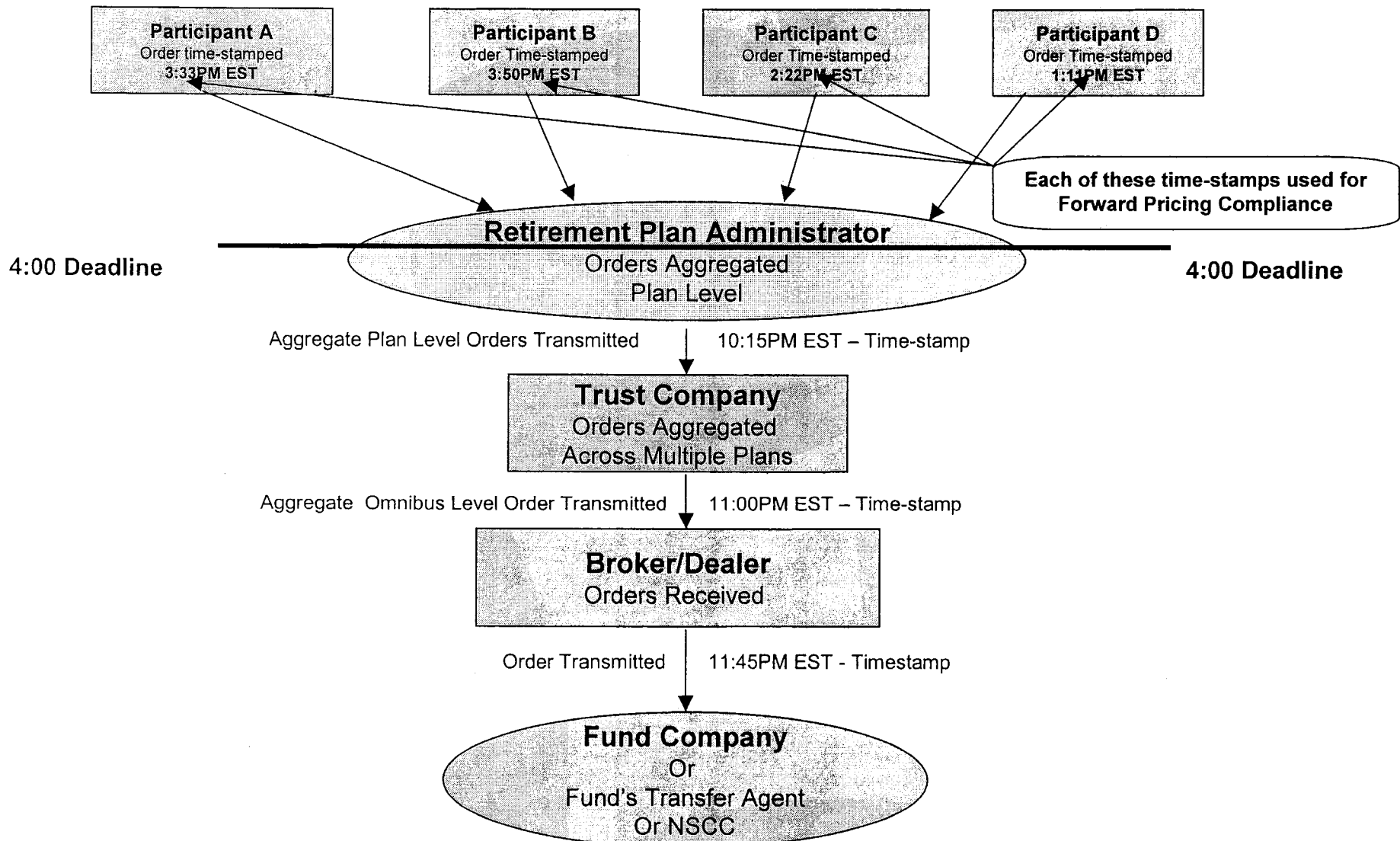




# SMART4 – Electronic Audit Trail

## Example A

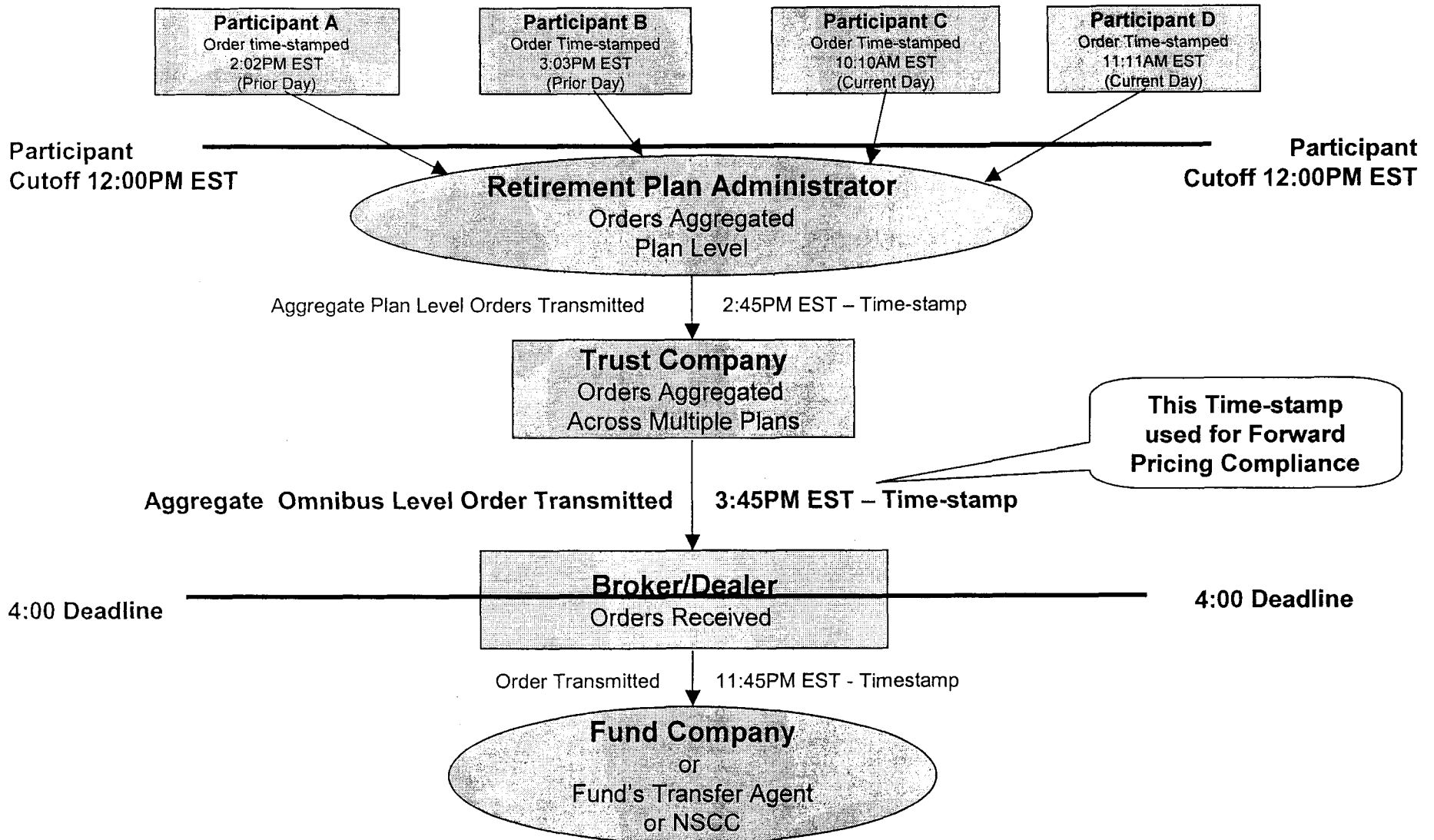
All Intermediaries Meet Requirements of SMART4



# SMART4 – Electronic Audit Trail

## Example B

Only B/D Meets Requirements of SMART4



# SMART4 – Electronic Audit Trail

## Example C

Only Trust Co and B/D Meet Requirements of SMART4

