

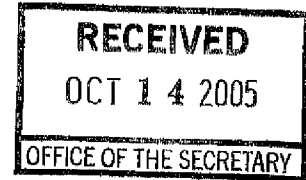
MEMORANDUM

S7-27-03-280

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

FROM: Adam Glazer
Office of Regulatory Policy
Division of Investment Management ("IM")

DATE: October 11, 2005



On October 7, 2005, representatives of The SPARK Institute, Inc. ("SPARK") 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 Act Release No. 26288 (Dec. 11, 2003) ("Late Trading Proposal"). The following Commission staff members attended the meeting: Robert Plaze, Associate Director, IM; Penelope Saltzman, Branch Chief, IM; Adam Glazer, Attorney, IM; and John G. Niarhos, Senior Risk Advisor, Office of Risk Assessment.

The representatives discussed aspects of (i) the alternative approach to the Late Trading Proposal described in SPARK's comment letter dated February 6, 2004, and (ii) the process by which order instruction errors will be processed, described in the document attached to this memorandum.¹ The alternative approach would allow fund intermediaries (such as broker-dealers and retirement plan administrators) to obtain same-day pricing for orders they receive by 4 p.m. and transmit to fund companies after 4 p.m. as long as the intermediary meets specific requirements, as described in the documents attached to the memorandum to this file dated August 19, 2004.

Attachment

¹ Representatives of SPARK first discussed their alternative approach with staff members at a meeting on April 14, 2004, and first discussed the application of a sequence number at a meeting on October 20, 2004.



September 26, 2005

The SPARK Solution
Red Flag Mitigation and
Post-Market Close Error Correction
Requirements and Industry Standards

The SPARK Institute recently modified certain requirements of The SPARK Solution in response to feedback it received from key industry stakeholders, including the NSCC/DTCC, mutual fund companies, and retirement plan service providers, such as banks, investment managers, brokerage companies, third party administrators, and insurance companies. Generally, the key stakeholders support The SPARK Solution but requested certain changes relating to (1) the red flags reported to the mutual fund companies, and (2) post market close error corrections made by “Intermediaries.” The modifications address certain initial concerns expressed by some stakeholders regarding the potential number of “false positive” red flag reports that the mutual fund companies might receive. The SPARK Institute, whose members are responsible for providing recordkeeping and transaction processing services for the substantial majority of retirement plans, believes that these modifications will significantly reduce the number of false positive red flags without increasing the potential risk of trading abuse. This document summarizes the modifications.

- I. **Stakeholder Feedback** – As noted above, certain mutual fund companies expressed concern about the potential number of false positive red flag reports they might receive and requested that The SPARK Institute modify the SPARK Solution to minimize such possibility. More specifically, the fund companies expressed concern about whether they would be able to process trade orders that are red flagged with a potential irregularity even though the red flag might not relate to their funds and even though the red flag might be a false positive that could be reasonably explained in near-real time. The fund companies indicated that they would be willing to process trades under the SPARK Solution if they generally only received red flag reports when warranted due to true potential trading irregularities.

Under the original version of the SPARK Solution, the potential for false positive red flags existed because the SPARK Solution did not permit an Intermediary to make any changes or correct any problems if the Intermediary discovered a system or transaction processing error while performing their normal after market closing time order processing. The nature of the retirement plan record keeping and trade processing business is that it involves complicated retirement plan rules, high volumes of data and transactions, and a significant number of information and trade processing systems. Consequently, record keeping, processing, and system errors that may require human intervention can occur on a regular basis. In order to minimize

the potential for false positive red flag reports being sent to the fund companies when no irregular trading activity has taken place, Intermediaries must have the ability to correct certain system and transaction processing errors that occur or are identified by the Intermediary when they are performing their normal after market closing time order processing.

The changes to the SPARK Solution set forth below provide Intermediaries with the ability to make limited corrections identified during normal after market closing time order processing in order to facilitate trading and minimize the number of potential red flag reports received by the fund companies. The changes also include additional controls in order to minimize the risk of trading abuse associated with the error correction process.

II. SPARK Solution Modifications

A. Post-Market Close Error Correction Requirements and Industry Standards

1. **Deletions** - An Intermediary may only delete erroneous instructions that it would otherwise have been required to process for same day pricing. Every deletion must be captured electronically in accordance with the critical trade information template for "Delete/Cancel" instructions as defined under the SPARK Solution. The critical trade information template for such instructions includes the transaction type identification (i.e., manual trade instruction), plan identification, participant identification, system transaction identification or TSN of the deleted transaction, system operator identification, and industry standardized reason code.

All post-market close deletion information will be included in the time stamp packet and transmitted to the trading agent (e.g., the DTCC), but properly coded post-market close deletions will not by themselves cause red flags to be reported to the fund companies. The post-market close deletion information must be available upon request.

2. **Additions** - Intermediaries are not permitted to unilaterally add an instruction or order after the market closes in order to correct an error and receive the same day pricing that would have otherwise applied to the original erroneous instruction. Generally, new or replacement instructions that are created or received by an Intermediary after the market close in order to correct an error must receive forward pricing in accordance with the general SPARK Solution requirements that apply to new instructions. However, under certain limited circumstances, in order to accommodate an error correction with the same day pricing that would have applied to an original erroneous instruction, an Intermediary may request permission directly from the mutual fund company to submit a manual trade to the fund company prior to the fund company's order acceptance cut-off time. It is anticipated that such requests will only be made and accommodated when (1) the Intermediary has identified the cause

of the error and the affected funds before the affected fund companies' order acceptance cut-off, and (2) the Intermediary can reasonably demonstrate that, but for the error, the instruction or order would otherwise be eligible for same day pricing. More specifically, it is anticipated that Intermediaries will limit their requests to situations involving the conversion of an entire plan onto their service platform and other situations involving the movement of large blocks of funds that could have significant adverse consequences if not corrected using same day pricing. Any such requests that are approved must be documented by the Intermediary and maintained for inspection.

- B. Additional Electronic Independent Third Party Controls - "Manual Trade Instruction" Review** - The third party time stamp technology must run an electronic compare of all post-market close manual trade deletions and identify any that are nearly identical and offsetting to a manual trade instruction that was entered into the Intermediary's systems prior to market close. Any such manual trade instructions identified by the third party time stamp technology must be identified as a potential irregularity and returned to the Intermediary for immediate follow-up. Upon receipt of such information the Intermediary must delete the post-market close manual trade instruction in accordance with Section II, A, 1 above and resubmit the instruction file through the third party time stamp technology for validation. Upon validation the third party time stamp technology creates a "clean" time stamp packet in order to allow the Intermediary's other Orders for the day to be submitted to the fund company for processing. If the Intermediary believes that the deleted post-market close manual trade instruction should be eligible for same day pricing, the Intermediary may request an accommodation from the fund company in accordance with Section II, A, 2 above. The time stamp packet submitted to the trading agent will include the manual trade instruction irregularity information reported to the Intermediary, even if such irregularity is cleared in accordance with the requirements hereunder. Properly cleared irregularity information will also be transmitted by the trading agent to the affected fund companies. However the properly cleared irregularity will not by itself cause a red flag to be reported to the fund company. Additional information about any such manual trade instruction irregularity must be available upon request.
- C. Red Flags Reported to Mutual Fund Companies** – Generally, under the foregoing requirements, industry standards and additional controls, mutual fund companies will receive red flags with respect to Intermediary orders when (1) an instruction is deleted after market close and does not have an acceptable reason code, (2) an electronic instruction is added after market close for same day pricing, and (3) an irregular manual trade instruction identified in accordance with II, B herein is not properly deleted.

If you are interested in additional information about these changes to the SPARK Solution, and other aspects of the SPARK Solution, please contact Larry Goldbrum of The SPARK Institute at 704-987-0533.