INVESTMENT COMPANY INSTITUTE

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SEC PROPOSES AMENDMENTS TO RULE 22C-1 TO ADDRESS LATE TRADING ABUSES

[16873] December 12, 2003 TO: ACCOUNTING/TREASURERS COMMITTEE No. 38-03 COMPLIANCE ADVISORY COMMITTEE No. 107-03 OPERATIONS COMMITTEE No. 26-03 PENSION COMMITTEE No. 46-03 SEC RULES COMMITTEE No. 102-03 SMALL FUNDS COMMITTEE No. 33-03 TRANSFER AGENT ADVISORY COMMITTEE No. 112-03 RE: SEC PROPOSES AMENDMENTS TO RULE 22c-1 TO ADDRESS LATE TRADING ABUSES The Securities and Exchange Commission has published for comment proposed amendments to Rule 22c-1 under the Investment Company Act of 1940, which governs the pricing of redeemable securities.1 As discussed in more detail below, Rule 22c-1 would be revised 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 securities clearing agency receives the order by the time that the fund has established for calculating its net asset value. Comments on the proposal must be filed with the Commission by Friday, February 6, 2004. The Institute will hold a conference call on Thursday, Dec. 18th at 4:00 p.m. EST to discuss the proposed amendments. The dial-in number for the call is 888-469-0491, and the pass code is 28543. If you plan to participate in the call, please send an e-mail to Deborah Washington at deborah@ici.org. If you are unable to participate in the call, before the call please provide your comments on the proposed amendments to Tamara Salmon by phone (202-326-5825), fax (202-326-5839) or e-mail (tamara@ici.org). I. RULE 22c-1 Rule 22c-1, the "forward pricing" rule, requires that funds, their principal underwriters, and dealers sell and redeem fund shares at a price based on the net asset value next computed after receipt of an order to buy or redeem the fund's shares. The rule also requires funds to 1 See SEC Release No. IC-26288 (Dec. 11, 2003) (the "Release"). A copy of the Release is available on the SEC's website at: http://www.sec.gov/rules/proposed/ic-26288.htm 2 calculate their NAV at least once a day, which typically occurs at 4:00 p.m. Eastern time, when the major U.S. stock exchanges close. Currently, the rule deems a purchase or redemption order to be received, for purposes of determining the appropriate day's price, when a retail dealer receives the order, even if it is actually submitted to the fund's transfer agent at a later time. The Release notes that recent investigations by the Commission staff and state securities authorities have uncovered late trading of fund shares by intermediaries in violation of the Commission's rules. According to the Release, such late trading is neither isolated nor limited to any one type of intermediary. In light of the Commission's concern that its current rules, which permit intermediaries to process trades after 4:00 p.m., have failed to prevent late trading, the Commission has proposed to eliminate late trading through fund intermediaries by revising Rule 22c-1. II. THE PROPOSED REVISIONS TO RULE 22C-1 A.

Receipt of Orders 1. The Commission's Proposal As proposed to be amended, Rule 22c-1 would require that all purchase and redemption orders, in order to obtain the current day's price, be received by one of the following entities no later than the time at which the fund prices its securities (e.g., 4:00 p.m.): • the fund; • a designated transfer agent, which would be a single transfer agent identified 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 information;2 or • a registered clearing agency (e.g., Fund/SERV).3 Orders received after the fund prices its securities would receive the next day's price. The Release acknowledges that a consequence of this requirement would be that fund intermediaries would have to submit orders to the fund before 4:00 p.m. in order for their customers to receive the 4:00 p.m. price. 4 (Clearing agencies and designated transfer agents may, however, complete their processing after the pricing time.) The Release also notes that administrators of defined contribution employee pension plans have informed the Commission that they likely will be unable to process any purchase and redemption requests the same day they are made. As discussed below, the proposed revised version of Rule 22c-1 would include 2 Transfer agents are not currently required under the Commission's rules to time-stamp information they record. The Commission seeks comment on whether its transfer agent rules should include a time-stamping and record retention requirement for designated transfer agents. 3 Orders submitted to various intermediaries, such as third-party administrators, would not be considered orders received by the "fund," even if those intermediaries are agents of the fund. 4 The proposed amendment would use the phrase "based on the current [NAV] established as of the next pricing time," instead of the current phrase, "based on the current [NAV] which is next computed." This is to clarify the current requirement that orders received after the pricing time, but before calculation of the NAV is complete, do not receive same-day pricing. See Release at n.26. 3 some exceptions from this new forward pricing requirement, including all of those in the current rule. The Release notes the Commission's belief that its proposal to have fund designated transfer agents and NSCC's Fund/SERV system, which are regulated by the Commission and which operate large automated processing systems, act as time-stamping organization will serve to ensure the integrity of fund pricing. It further notes that this approach has been endorsed by the Institute.5 2. Alternative Approach While the Release generally seeks comment on whether there are other intermediaries (in addition the fund's designated transfer agent or a registered clearing agency) that could serve in the role of receiving fund orders and ensure the integrity of fund pricing, in particular it seeks comment on an alternative approach to the Commission's proposal. This alternative approach, which has been suggested to the Commission, would permit orders received by designated transfer agents or Fund/SERV received after 4:00 to receive the current day's NAV provided that fund intermediaries have adopted certain protections designed to prevent late trading. Such protections could include: • Electronic or physical time-stamping of orders in a manner that cannot be altered or discarded once the order is entered into the trading system; • Annual certification that the intermediary has policies and procedures in place designed to prevent late trades, and that no late trades were submitted to the fund or its designated transfer agent during the period; and • Submission of the intermediary to an annual audit of its controls conducted by an independent certified public accountant who would submit the report to the fund's chief compliance officer.6 The Commission seeks comment on whether each of these protections would be appropriate to preventing late trading in fund shares and whether other protections would be necessary to prevent unlawful trading. Additionally, the Commission seeks comment on how it could police compliance with the controls by fund intermediaries over which the Commission has no regulatory authority. B. Definition of "Order"; Exchanges To clarify when an order is complete (and therefore has been received) for purposes of obtaining the appropriate day's price, the Commission has proposed to add a definition of “order” to the rule. As proposed, “order” would mean the direction to purchase or sell either: (1) a specific number of shares of a fund; or (2) an indeterminate number of shares of a specific value. The definition would also provide that each order “would be deemed to be irrevocable as of the next pricing time after the fund, its designated transfer agent, or registered clearing 5 See Release at n.30. 6 The Release notes, however, that the Commission is concerned with the ability of an auditor to detect weaknesses in internal controls that allow late trading to occur inasmuch as it found that at least one broker-dealer that had obtained an annual audit of its internal controls by an independent auditor had submitted late trades. 4 agency receives it.”7 With respect to exchanges (i.e., a sale of one fund to use the proceeds to purchase another fund), the definition of order would include a direction to purchase redeemable securities of the fund using proceeds of a contemporaneous order to redeem a specific number of shares of another fund. 8 C. Exceptions 1. Emergencies As mentioned above, the revisions to Rule 22c-1 would include several exceptions from the rule’s forward pricing requirement, including each of those in the current rule. A proposed new exception would permit investor orders to receive same-day treatment if, as a result of an emergency, a dealer (or its agent) was unable to transmit the orders, or NSCC or the fund’s designated transfer agent was unable to receive the orders. This relief would only be available for emergencies such as a natural disaster or other external occurrence (e.g., a power failure or hurricane), but not for circumstances such as internal operational difficulties.9 A dealer relying on this exception would be required to have its chief executive officer certify to the fund the nature, existence, and duration of the emergency and that the intermediary received the orders before the applicable pricing time. A fund would be required to maintain a record of each certification it receives from the dealer for six years. If an emergency prevents the designated transfer agent or the clearing firm from receiving order information, the chief executive officer of the designated transfer agent or the clearing agency would have to notify the fund as to the nature, existence, and duration of the emergency.10 2. “Conduit” Funds Another exception proposed to be added to the rule would apply to conduit funds (e.g., master-feeder funds, insurance company separate accounts), which invest all of their assets in another fund and therefore must calculate their NAV on the basis of the other fund’s NAV. This exception would permit a conduit fund to submit its orders based on the NAV established by the other fund on the same day. 7 See Subsection (c)(3) of the proposed rule. This provision has been added to the definition to prevent the cancellation or modification of an order after the pricing time applicable to the order. 8 This provision was added to preserve the ability of funds to offer “seamless” exchange transactions. 9 See Release at n.36. 10 The rule would not require the fund to maintain a record of notifications it receives of an emergency from the transfer agent or registered clearing agency. Also, such notification by the designated transfer agent or NSCC “could be by telephone or in writing and would not need to be certified.” See Release at n.52. 5 III. TRANSITION PERIOD According to the Release, if the Commission adopts revisions to Rule 22c-1 that are similar to those proposed, it would expect to provide a one-year transition period to accommodate systems changes. The Commission seeks comment on whether this would be an adequate transition period. Tamara K. Salmon Senior Associate Counsel

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