COMMENT LETTER

February 5, 2004

ICI Comments on SEC Fund Pricing Proposal (pdf)

February 5, 2004 Mr. Jonathan G. Katz Secretary U.S. Securities and Exchange Commission 450 Fifth Street, NW Washington, DC 20549-0609 Re: Proposed Amendments to Rule 22c-1 Relating to Pricing of Fund Shares; File No. S7-27-03_____ Dear Mr. Katz: The Investment Company Institute1 appreciates the opportunity to comment on the revisions proposed by the Securities and Exchange Commission to Rule 22c-1 under the Investment Company Act of 1940, which governs the pricing of mutual fund shares.2 Under the proposal, Rule 22c-1 would be revised to provide that, in order to receive that day's price, an order to purchase or redeem fund shares must be received by the fund, its designated transfer agent, or a registered securities clearing agency by the time established by the fund for calculating the net asset value of its shares, which is typically 4:00 p.m. Eastern Time, when the major U.S. stock exchanges close. I. BACKGROUND AND SUMMARY OF COMMENTS As noted in the Proposing Release, recent investigations by Commission staff and state securities authorities have uncovered instances of late trading of fund shares by intermediaries in violation of the Commission's rules. Based upon these findings, the Commission is concerned with the ability of funds to prevent late trading under the Commission's current rules, which permit intermediaries to process fund trades after the close of the major U.S. stock exchanges. To address these concerns and enhance the protection of mutual fund shareholders, the Commission has proposed amendments to Rule 22c-1 that are designed to prevent investors from obtaining the current day's price on fund orders submitted by intermediaries after the time a fund calculates its net asset value. 1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,668 open-end investment companies ("mutual funds"), 611 closed-end investment companies, 111 exchange-traded funds and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $7.456 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 million households. 2 SEC Release No. IC-26288 (Dec. 11, 2003) (the "Proposing Release"). Mr. Jonathan G. Katz February 5, 2004 Page 2 of 10 Consistent with our commitment to ensuring the fair treatment and protection of mutual fund investors, as well as our commitment to working with the Commission and others to address conduct – or the potential for conduct – that is harmful to fund shareholders, the Institute supports the Commission's proposal to tighten existing regulations governing fund pricing. Indeed, last October, the Institute called for sharply limiting the types of entities that would be permitted to accept orders up to the time a fund prices its shares in order to receive that day's price.3 (This approach has come to be referred to as a "hard 4:00 p.m. cutoff" because most funds price their shares as of 4:00 p.m. Eastern time.) The following month,

in Congressional testimony, the Institute reaffirmed its support for such a step: . . . the Institute believes that existing regulations should be tightened to better protect against the possibility of late trading. The most effective solution to this problem would be to require that all purchase and redemption orders be received by a fund (or its transfer agent) before the time of pricing (e.g., 4:00 p.m. Eastern time). While such a requirement could have a significant impact on the many investors who own mutual funds through financial intermediaries, the recent abuses indicate that the strongest possible measures are necessary to ensure investor protection. 4 Our support for a hard 4:00 p.m. cutoff is based, in large part, on our concern that existing technology may not be sufficient both to provide an unalterable date and time stamp for a trade at the time it is actually received by a fund intermediary and to prevent investors from placing trades prior to the time a fund prices it shares, only to cancel such trades once the price is determined by the fund. The lack of this technology has, in part, enabled the late trading abuses recently uncovered by regulators and had led the Institute to support the imposition of a hard 4:00 p.m. cutoff. At the same time, to the extent the Commission is able to assure itself that technology does exist that would, in fact, enable intermediaries to document, through unalterable means, the precise date and time when an order was received by the intermediary and ensure that orders received prior to the time the fund prices its securities are processed and not cancelled once the fund's price is determined, we would encourage the Commission to revisit the list of entities that, for pricing purposes, may receive orders on behalf of the fund by the hard 4:00 p.m. cutoff. However, until the Commission can be assured that such technology exists, we believe that the Commission's proposed approach of limiting the list of qualified order recipients for purposes of determining the appropriate price of fund shares, and requiring those orders to contain certain specified information, are appropriate measures to prevent the types of abuses uncovered during the recent investigations. 3 See "Mutual Fund Leaders Call For Fundamental Reforms to Address Trading Abuses," Investment Company Institute, October 30, 2003. 4 See Statement of Paul G. Haaga, Jr., Chairman, Investment Company Institute, Mutual Funds: Who's Looking Out for Investors, Before the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services, 108th Congress, 1st Sess. (Nov. 4, 2003) at pp. 5-6. Mr. Jonathan G. Katz February 5, 2004 Page 3 of 10 Accordingly, the Institute supports adoption of the proposed revisions to Rule 22c-1. At the same time, it is important to note that there are currently pending in Congress various bills that include provisions that would establish standards for the receipt of orders in mutual fund shares; and that these provisions are not consistent with the SEC's proposal.5 Consequently, we are concerned that, if the Commission adopts the proposed revisions to Rule 22c-1 in the near term, funds and their intermediaries could be forced to expend substantial resources to change their processing systems, only to have these changes rendered moot if legislation subsequently is enacted that takes a different approach. To avoid this result, we recommend that the Commission (1) defer adoption of the proposed rule until such time as the legislative outlook becomes clearer and (2) provide a sufficiently lengthy transition period before funds must comply with the new requirements. We further recommend certain revisions to the Commission's proposal to ensure that the revised rule meets the Commission's objective of preventing late trading while, at the same time, facilitating the ability of mutual funds to comply with the new, more rigorous regulatory requirements. In particular, we recommend that the Commission revise its proposal to: (1) permit mutual funds, in very limited circumstances and subject to conditions set forth in the rule, to designate one sub-transfer agent in addition to one primary transfer agent as an entity that would be able to receive orders up until the time that the fund prices its shares; (2) clarify that, with respect to unit investment trusts, orders received by the trust's depositor are eligible to receive the current day's price; and (3) permit funds of funds within the same family of funds that

operate rely on Section 12(d)(1)(G) of the Investment Company Act to claim the proposed rule's exception for conduit funds. We additionally recommend that the rule or adopting release address various technical issues arising under the proposed definition of "order" (e.g., the use of percentages in orders, the ability of funds to reject orders, and the treatment of in- kind orders). Each of these issues is discussed in detail below. II. COMMENTS ON THE PROPOSED RULE A. "Designated Transfer Agent" Under the proposal, a fund may deem an order to be received by the fund when it is received by the fund's designated transfer agent.6 Each fund could have only one designated transfer agent, which would be identified in the fund's registration statement and required by written contract to (1) receive order information on behalf of the fund and (2) maintain a record of the date and time it receives the trade information.7 The Institute supports including a 5 See fn.20, below. 6 As noted in the Proposing Release, while an order would have to be received by a fund's designated transfer agent by the time the fund prices its securities to ensure same-day pricing, the designated transfer agent would be permitted to complete its processing after the pricing time. Proposing Release at n.28. Such order would, however, have to be date and time stamped before the fund prices its securities to receive that day's price. 7 Transfer agents are required to be registered with the Commission under Section 17A of the Securities Exchange Act of 1934. The Proposing Release seeks comment on whether the Commission's transfer agent rules under this section should include time-stamping and record retention requirements for designated transfer agents. Proposing Release at p. 6. The Institute supports such a requirement for registered transfer agents provided it is tailored to the unique records and systems utilized by mutual fund transfer agents. Mr. Jonathan G. Katz February 5, 2004 Page 4 of 10 designated transfer agent in the proposed rule's limited list of entities that may receive orders on behalf of the fund. We recommend that the proposed rule be revised, however, to permit a fund also to appoint one designated sub-transfer agent subject to conditions being added to the rule to prevent circumvention or exploitation of the rule's intent.8 It is not uncommon for mutual funds to have shared transfer agent arrangements, even though they are required to have a single designated transfer agent that is named in their registration statement. In such arrangements, the fund's shareholder servicing and processing responsibilities are shared by two registered transfer agents – the fund's designated transfer agent (usually an affiliate of the fund sponsor) and a sub-transfer agent, which is an external transfer agent service provider that has contractually agreed to accept fund trades on the fund's behalf.9 These arrangements enable the fund's designated transfer agent to keep pace with the daily volume of trades by dispersing the orders received by the fund. Importantly, fund investors that interact with the sub-transfer agent are generally unaware that they are not dealing with the fund's designated transfer agent because, for purposes of servicing fund shareholders, the sub-transfer agent conducts business in either the name of the fund or the fund's designated transfer agent. Also important to these arrangements is the fact that the sub- transfer agent is exclusively responsible for processing all fund trades that are received via a distinct method of order delivery (e.g., direct mail, internet, telephone), regardless of the source of such orders. 10 Our recommendation is designed to accommodate funds with these types of arrangements by providing them with a limited measure of flexibility with respect to their receipt of fund orders. It would benefit investors by avoiding all fund orders processed by a transfer agent in a shared transfer arrangement having to be rerouted to be consolidated and funneled through a single designated transfer agent. Such consolidation may likely result in order backlogs, such that some trades that are received by the designated transfer agent prior to the time the fund prices its securities cannot be date or time stamped until after such pricing, resulting in those investors getting the next day's price, a result clearly not intended by the proposed rule. To avoid weakening the rule in any manner that might permit late trading, the Commission should condition the

ability of a fund's designated sub-transfer agent to accept 8 We recognize that some funds currently utilize multiple sub-transfer agents. While funds could continue to use multiple sub-transfer agents, under our recommendation, orders processed by these multiple transfer agents, other than by the fund's designated sub-transfer agent, would not be deemed received under the rule for pricing purposes. 9 Pursuant to these contracts, which are between the fund's transfer agent and the sub-transfer agent, the sub-transfer agent agrees to receive and date and time stamp orders it receives on behalf of the fund. The allocation of responsibilities between the fund's designated transfer agent and the sub-transfer agent may vary among fund complexes that utilize this configuration. For example, a fund's external sub-transfer agent might be responsible for accepting, processing, and servicing all fund orders received via direct mail from investors, while the fund's designated affiliated transfer agent processes all shareholder transaction requests received by telephone and via the internet, all written shareholder correspondence, as well as orders received from intermediaries through Fund/SERV or by telephone. 10 Thus, this type of arrangement is very different from arrangements in which several different financial intermediaries (e.g., broker-dealers) each handle trades for their own customers that are fund shareholders. Mr. Jonathan G. Katz February 5, 2004 Page 5 of 10 trades on behalf of the fund under the rule on the sub-transfer agent: (1) having a contractual agreement with the fund's designated transfer agent under which the sub-transfer agent is required to (i) receive on behalf of the fund's designated transfer agent all fund orders through one or more specified methods of delivery and (ii) maintain a record of the date and time it receives trade information; (2) being registered with the Commission as a transfer agent (and, thereby, subject to the Commission's regulatory jurisdiction); and (3) being identified in the fund's registration statement as the fund's sub-transfer agent. B. Unit Investment Trusts Rule 22c-1 as currently in effect and as proposed to be amended applies to registered investment companies that issue redeemable securities, which includes both mutual funds and unit investment trusts.11 To ensure that the rule treats unit investment trusts in a manner that is analogous to the proposed treatment for mutual funds, the Institute recommends that the Commission clarify that, as applied to unit investment trusts, the revised rule will require that, in order to receive the current day's price, an order to purchase or redeem trust units must be received by the sponsor,12 a designated transfer agent, or a registered clearing agency by the time established by the trustee or other person that, pursuant to the trust indenture, is responsible for calculating the value of trust units. This accommodation is necessary because, in most cases, the sponsor is the entity that receives orders on behalf of the trust and therefore should be qualified under the rule to receive trust orders for purposes of determining the price to be applied to such order.13 C. Conduit Funds As proposed, Rule 22c-1 would provide a limited exception for conduit funds that rely on Section 12(d)(1)(E) of the Investment Company Act (i.e., master-feeder funds, insurance company separate accounts).14 According to the Proposing Release, this exception is intended to address those funds that invest all of their assets in another fund and, therefore, must calculate their NAV on the basis of the other fund's NAV. Because the proposal would require a 11 As noted in the Proposing Release, the rule contains an exception for sales of UITs in the secondary market that meet certain conditions. The proposed amendments would retain this provision. 12 A UIT sponsor, which is also the "depositor" that deposits the securities into the trust, registers the trust with the Commission as an investment company under the 1940 Act. See Memorandum on the Regulation of Unit Investment Trusts from the Division of Investment Management to the Securities and Exchange Commission (Oct. 5, 1988). Any orders received by the sponsor should be required to be date and time stamped by the sponsor. 13 In addition to the depositor receiving orders to purchase or redeem trust units, orders are likely to be received by the trust's trustee or by a registered clearing agency. For example, redemption

orders are often received and effected by the trustee, which typically is a registered transfer agent and which would be required to comply with the proposed rule's requirements for designated transfer agents in order to accept orders at the current day's price. In addition, some unit investment trust units are redeemed through a system offered by NSCC, which, as a registered clearing agency, would be qualified to receive orders under the proposed rule. 14 The exception in proposed Rule 22c-1(b)(2) provides that a fund may deem receipt of an order to have occurred immediately before the applicable pricing time if the fund, its designated transfer agent, or registered clearing agency receives the order from a registered investment company that invests in the fund in reliance on Section 12(d)(1)(E) of the Investment Company Act. Mr. Jonathan G. Katz February 5, 2004 Page 6 of 10 customer's order to be received by the conduit fund, its transfer agent, or a clearing agency prior to the time the fund prices its securities in order to receive the current day's price, the limited relief provided to these conduit funds would not enable customers to engage in late trading. The Institute recommends that the Commission extend its proposed exception to funds of funds that are within the same family of funds and that rely on Section 12(d)(1)(G) of the Investment Company Act. Expanding the proposed rule's exception for conduit funds to include these fund of funds arrangements would enable the acquiring fund (1) to invest the proceeds of all orders it receives from investors prior to the time of pricing its securities in the acquired fund(s), and (2) receive that day's price from the acquired fund, even if the acquired fund receives the acquiring fund's order after the acquired fund has priced its securities for that day. Because all such processing and transactions between the acquiring fund and the acquired fund(s) would be based on irrevocable orders that have been received and date and time stamped by the acquiring fund before such fund prices its shares, the limited relief we recommend would not enable investors in these funds to engage in late trading. In the absence of such relief, investor orders received by the acquiring fund before it prices it securities might not be fully processed and invested in the acquired fund until the day following receipt of such orders. D. Proposed Definition of "Order" To clarify when an order is complete and has been received for purposes of obtaining the appropriate day's price, the Commission has proposed to add a definition of "order" to Rule 22c-1. As proposed, "order" would mean "a direction to purchase or redeem a specific number of fund shares or an indeterminate number of fund shares of a specific value." This definition would also expressly provide that each such order would be "deemed to be irrevocable as of the next pricing." The Institute recommends that the Commission address in the rule or adopting release each of the following issues relating to this definition. 1. Elements Required for an Order to be Deemed Complete a. Specific Number or Value of Fund Shares To reduce the likelihood that late traders can alter orders after a fund prices its shares, the Commission has proposed to require that, for an order to be complete, it must indicate either a "specific number" of shares or shares of a "specific value." The Institute concurs that the amount or value of shares on an order should be unalterable after the fund prices its shares. It is fairly common, however, for an order to describe the number or value of shares to be purchased or redeemed in terms of a percentage of fund shares held in an account rather than as a specific dollar or share amount. This is particularly common in asset allocation programs, in which an investor allocates his or her investments among various funds or accounts and rebalances such holdings periodically as necessary to maintain these allocations. To accommodate these arrangements, the Institute recommends that the Commission make explicit that, as used in the definition of "order," the terms "specific number of fund shares" and Mr. Jonathan G. Katz February 5, 2004 Page 7 of 10 "shares of a specific value" include a specific percentage of fund shares in an account or a specific percentage of an account's value.15 b. Exchanges The definition of "order" has been designed, in part, to preserve the ability of funds to offer "seamless" exchange transactions by including, as part of the

definition, an investor's "direction" to purchase shares of one fund using the proceeds of a contemporaneous order to redeem a specific number or value of shares of another fund. The Institute supports this accommodation for exchange transactions. We are pleased that the Commission is proposing to treat transactions in which the funds in question are from two different fund families as exchanges for this purpose, as this will accommodate a fairly routine type of transaction. For example, an investor who holds fund shares in a brokerage account may redeem shares from a fund within one family and use the proceeds to purchase shares in a different family.16 Such transactions are quite common, especially in wrap accounts and retirement plans. It may be the case that systems changes will be needed at NSCC in order to "link" these types of transactions involving different fund families. The Institute recommends that the Commission encourage NSCC to build the systems necessary to accommodate in a single day exchanges involving different fund complexes.17 2. Enriching Orders with Non-Value Information The Institute recommends that the Commission clarify that orders received prior to the time a fund prices its shares may be "enriched" after such pricing so long as such enriching does not affect the elements of the trade that make it a complete order (i.e., the value or number of fund shares bought or sold). This clarification is necessary to ensure that an order that is received prior to the time the fund prices it shares will receive that day's price, even though certain elements of the trade may not be determined until after the fund prices its shares. For example, an order may be enriched after the fund prices its shares with respect to the amount of a contingent deferred sales load imposed on the trade or the applicable sales load breakpoint discounts for which the investor is eligible. Such enriching would seem to be consistent with the types of processing that the Proposing Release acknowledges may occur after a fund prices its shares without affecting the price applicable to an order.18 15 Similarly, the Commission should clarify that an order to redeem all shares in an account would be a valid order for purposes of the rule. 16 Proposing Release at p. 7. 17 In addition, the Institute recommends that the Commission affirm, consistent with previously expressed views of the staff, the continued ability of funds under Section 11(a) to make an exchange offer on a specified delayed basis so long as the offer is fully and clearly disclosed in the fund's prospectus. See Investment Company Institute (Pub. Avail. Nov. 13, 2002). 18 See fn.7, above. Mr. Jonathan G. Katz February 5, 2004 Page 8 of 10 3. Ability of Funds to Reject Orders As noted above, the proposed definition of "order" would expressly provide that each order "is deemed to be irrevocable as of the next pricing time after the fund, its designated transfer agent, or a registered clearing agency receives it." This provision is intended to prevent the cancellation or modification of orders by investors after the pricing time applicable to the order. While we support this provision, we recommend that the Commission confirm our understanding that it only applies to the ability of an investor or a financial intermediary to revoke a trade, and not to the ability of a fund to reject a trade. For example, if a fund that prohibits market timing discovers that some of the trades it received that day were from a person known by the fund to engage in market timing, the fund may lawfully reject those trades even after the fund has struck that day's net asset value. Similarly, if a fund determines that an account holder is attempting to effect more frequent trades than the fund's disclosed policies and procedures permit, the fund should be able to reject those trades after it prices its securities. This clarification is necessary to enable funds to protect their investors by ensuring compliance with their regulatory responsibilities and their disclosed policies and procedures. 4. In-Kind Transactions As proposed, the term "order" does not address "in-kind" purchases of mutual funds. With an in-kind transaction, in lieu of purchasing fund shares for cash, shares are purchased with other securities that the investor transfers to the fund. The value of the transferred securities, however, likely will not be known until the close of the trading day. As such, it would be difficult, if not impossible, for an investor to obtain a fund's current day NAV for

an in-kind transaction, because the investor's order would not be complete until the value of the securities comprising the in-kind purchase is known. To ensure that an investor in an in-kind transaction can receive the current day's price for fund shares, the Institute recommends that the definition of "order" expressly deem an in-kind order complete upon the irrevocable transfer by the investor to the fund, its designated transfer agent, or a registered clearing agency of specified securities to be used for the purchase of shares of a specified fund. III. TRANSITION PERIOD According to the Proposing Release, if the Commission adopts revisions to Rule 22c-1 in a form similar to that proposed, it would expect to provide a one-year transition period "to accommodate system changes." The Commission has sought comment on whether this would be an adequate transition period. In order to comment on the adequacy of this transition period, funds and fund intermediaries would need to know, with certainty, what changes will be required to their processing systems. Such certainty, however, cannot be provided so long as various legislative proposals to address late trading remain pending in Congress.19 If Congress 19 For example, H.R. 2420, the "Mutual Fund Integrity and Fee Transparency Act of 2003," which was passed by the U.S. House of Representatives on November 19, 2003, would require the Commission to adopt rules permitting execution of after hour trades that are provided to a mutual fund by an intermediary after the time as of which the fund's NAV was determined if the intermediary: (1) has procedures that are designed to permit the acceptance of trades by the intermediary after the time as of which the NAV was determined; and (2) is subject to an independent annual audit to verify that the procedures do not permit the acceptance of trades after the time as of which such NAV was determined. Similarly, S.1971, the "Mutual Fund Investor Confidence Restoration Act," which was introduced Mr. Jonathan G. Katz February 5, 2004 Page 9 of 10 enacts any of these proposals, funds and their intermediaries may be required to comply with regulatory provisions that differ from those currently proposed by the Commission. As such, funds and their intermediaries that, upon the Commission's adoption of the revisions to Rule 22c-1, begin making the necessary changes to their processing systems to comply with the revised rule may find such changes rendered either unnecessary or inappropriate due to intervening federal legislation, resulting in a significant waste of resources. To avoid this result, we strongly urge the Commission to defer adoption of the proposed rule until such time as the legislative outlook becomes clearer. With respect to compliance with whatever solutions are ultimately devised by Congress and the Commission to address late trading abuses, from our perspective, a transition period of one year from the Commission's adoption of rules would appear to be adequate. However, we are cognizant of the fact that the preponderance of the burden for making whatever changes are necessary to implement such rules will largely fall on NSCC. As such, our members' ability to comply with the revised regulatory requirements will likely be directly related to the ability of NSCC to revise existing processing capabilities, or design new capabilities of its Fund/SERV system, as necessary to implement any requirements under the Investment Company Act.20 Accordingly, prior to adopting any revisions to Rule 22c-1 or any rules under Section 22 of the Investment Company Act, we urge the Commission to discuss with NSCC the amount of time it will need to adapt its current processes and systems to the proposed regulatory requirements.21 * * * * The Institute appreciates the opportunity to provide these comments in response to the Commission's Proposing Release. If you have any questions concerning them or would like last November, would, in part, require the Commission to adopt rules to permit the execution of after-hours mutual fund trades "by a broker-dealer, retirement plan administrator, insurance company, or other intermediary . . . if the late trading and detection procedures of such intermediary are subject to inspection by the Commission." S. 1958, introduced by Senator Kerry on November 25, 2003, also includes a provision to address late trading abuses. 20 As noted in the Proposing Release, broker-

dealers and other intermediaries “would likely transmit a number of orders to Fund/SERV close to the pricing time, resulting in a substantial increase in the volume of transmissions received by Fund/SERV just prior to the pricing time. In response to this increase, NSCC would likely have to increase Fund/SERV’s capacity to handle the expected concentration of orders just prior to the pricing time.” Proposing Release at p. 9. 21 As discussed above in connection with exchange transactions, we also recommend that the Commission encourage NSCC to build the systems necessary to accommodate in a single day exchanges involving different fund complexes. The time needed for NSCC to do this should be taken into account in determining what would be an appropriate transition period. Mr. Jonathan G. Katz February 5, 2004 Page 10 of 10 additional information, please contact me at (202) 326-5815, Amy Lancellotta at (202) 326-5824, or Tamara Salmon at (202) 326-5825. Sincerely, Craig S. Tyle General Counsel cc: The Honorable William H. Donaldson The Honorable Paul S. Atkins The Honorable Roel C. Campos The Honorable Cynthia A. Glassman The Honorable Harvey J. Goldschmid Paul F. Roye, Director Robert E. Plaze, Associate Director Division of Investment Management

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