ERIC

The ERISA Industry Committee

Representing the Employee Benefits Interests of America's Largest Employers

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PROPOSED AMENDMENTS
TO
THE SEC'S MUTUAL FUND FORWARD-PRICING RULE

Introduction. The SEC has issued proposed amendments to its rule governing the pricing of mutual fund shares. The proposed amendments are designed to curb "late trading" in mutual fund shares. In this paper we summarize the background for the proposed amendments, the current and proposed pricing rules, and the impact of the proposed amendments on § 401(k) and other retirement plans that allow participants to direct the investment of the funds in their accounts.

Background. The mutual fund industry is under attack for a variety of alleged practices and abuses, including:

- Inadequate governance,
- Excessive fees and expenses,
- Inadequate disclosure,
- Selective disclosure of fund investments,
- Other favors given to certain shareholders,
- Market timing by certain shareholders, and
- Late trading by certain shareholders.

Although it has not been alleged that all mutual funds have engaged in all of these practices, it has been alleged that there are widespread problems in the governance and operations of many mutual funds.

The Forward-Pricing Rule. The SEC's forward-pricing rule (Rule 22c-1 under the Investment Company Act) requires mutual funds to sell and redeem fund shares at a price based on the current net asset value ("NAV") next computed after receipt of an order to buy or redeem fund shares. This rule also requires mutual funds to calculate their NAV at least once a day.

Most mutual funds calculate their NAV when the major U.S. exchanges close, at 4 p.m. Eastern Time. Under Rule 22c-1, an investor who submits an order before 4 p.m. must receive that day's price, and an investor who submits an order after 4 p.m. must receive the next day's price.

Late Trading. "Late trading" refers to the practice of permitting a purchase or redemption order received after 4 p.m. to receive the share price calculated as of 4 p.m. as of that day (*i.e.,* before the order is submitted). A late trader can take advantage of events that occur after 4 p.m., such as earnings announcements, to buy on good news or sell on bad news -- at the expense of other investors in the mutual fund.

Purchase and Redemption Transactions. Mutual fund investors do not submit their purchase and redemption orders directly to the fund. They submit their orders to a variety of intermediaries. Order information is ultimately submitted to the transfer agent that acts as the fund's primary recordkeeper. Investors who deal with the fund directly by telephone or computer generally submit their orders to the fund's transfer agent.

Many investors, however, invest in mutual funds through intermediaries, such as broker-dealers, banks, and § 401(k) and other retirement plans. Instead of submitting hundreds or thousands of individual purchase and redemption orders, intermediaries typically combine and net out the orders they receive each day and submit a single file containing omnibus purchase or redemption order information to the fund's transfer agent.

Many of the orders are routed to the transfer agent through the National Securities Clearing Corporation ("NSCC") -- currently the only SEC-registered clearing agency -- which operates an automated system to process fund orders, known as Fund/SERV. Fund/SERV provides a central processing system that collects order information, sorts order information by fund, and transmits the order information to each fund's transfer agent.

Although purchase and redemption orders must be received by an intermediary by 4 p.m. in order to receive that day's price, the current SEC rules allow the intermediary to forward the order information to either Fund/SERV or the fund's transfer agent after 4 p.m. The intermediaries -- which include retirement plans as well as broker-dealers and banks -- typically process orders received before 4 p.m. in the early evening hours before submitting them to Fund/SERV or fund transfer agents.

The SEC's Proposed Amendments. The SEC has proposed amendments to Rule 22c-1 that would deem an order to be received only when it is received by (i) the fund itself, (ii) the fund's transfer agent, or (iii) an SEC-registered clearing agency such as the Fund/SERV system.

The amendments were prompted by investigations by both state authorities (including the New York and Massachusetts attorney generals) and the SEC that have under uncovered late trading of mutual fund shares by intermediaries. The SEC's proposing release states that these are not isolated cases or limited to one type of intermediary.

Impact on Participant-Directed Retirement Plans. If adopted, the SEC's proposed amendments will require substantial changes in the way that intermediaries process orders to purchase or redeem mutual fund shares. If the amendments are adopted, in order for a purchase or redemption order submitted to an intermediary to qualify for that day's 4 p.m. NAV, the processing that the intermediary now performs during the evening hours, after the 4 p.m. deadline, would have to be completed before 4 p.m.

Many individual account retirement plans (including most § 401(k) plans) allow participants to elect how the plan will invest the funds in their accounts. Many of these plans allow participants to choose to have their accounts invested in a variety of mutual funds and also allow participants to direct the plan to transfer the investments in their accounts from one mutual fund to another from time to time. If the amendments are adopted, the administrators of such participant-directed plans will be required (1) to expand the capacity of their systems to handle orders more promptly and/or (2) to impose earlier deadlines for plan participants to submit their purchase and redemption orders in order to have the transactions qualify for that day's 4 p.m. NAV.

Employers and plan administrators have objected to the discriminatory impact of the amendments on participants in participant-directed retirement plans. Under the amendments, investors who deal directly with a mutual fund's primary transfer agent will be able to make purchases and redemptions at the current day's NAV as long as they submit their purchase and redemption orders by 4 p.m. on that day. By contrast, when a § 401(k) plan is administered by a third-party administrator that is not affiliated with the mutual fund, plan participants will have their purchase and redemption orders consummated at the current day's 4 p.m. NAV only if their orders are submitted to the plan well before 4 p.m., perhaps as early as noon Eastern Time (9 a.m. Pacific Time) or by the close of business on the preceding day.

Among the objections voiced by employers and plan administrators are concerns that the proposed amendments will (1) treat retirement plan participants as second-class citizens, (2) impose additional costs on retirement plans (which generally are borne by plan participants), (3) confuse participants, who will not understand the reason for the delay in effectuating the purchases and redemptions they have elected, (4) undermine participants' confidence in the efficient and equitable administration of their plans, and (5) discourage retirement savings.

The SEC's proposing release solicits comments on an alternative approach under which intermediaries would be eligible to submit orders after the 4 p.m. deadline if certain measures are adopted:

- Electronic or physical time-stamping of orders;
- Annual certification that the intermediary has policies and procedures in place to prevent late trades and that no late trades were submitted to the fund or its transfer agent during the period; and
- Submission of the intermediary to an annual audit of its controls by an independent auditing firm.

This approach is based on § 205(b) of the Mutual Funds Integrity and Fee Transparency Act of 2003 (H.R. 2420), which was passed by the House of Representatives by a vote of 418 to 2 on November 19, 2003. A similar provision is also included in S. 1971, which was introduced by Senators Dodd and Corzine on November 25, 2003. Thus far, however, the SEC appears to be unpersuaded either that the proposed protective measures will prevent abuse or that plan participants place great value on their ability to obtain the current day's 4 p.m. NAV.

An informal group of mutual funds and retirement plan administrators has floated an alternative "trial balloon" proposal under which all trades of mutual fund shares would be handled by a central clearinghouse administered by a third party and open to inspection by regulators and the industry. Under the "trial balloon" proposal, orders submitted to the clearinghouse by 4 p.m. would be processed at that day's prices. Orders received after 4 p.m. would be rejected except to the extent necessary to correct legitimate errors (which would be subject to appropriate review). It remains to be seen whether this approach is practical and whether it will substantially alleviate the concerns voiced by employers and plan administrators.

ERIC Comments. ERIC is in the process of preparing comments on the SEC's proposed amendments to its forward-pricing rule. We anticipate that the comments will take the position that the proposed amendments should create an exception for retirement plans that have adequate measures to prevent late trading abuses.