Coalition of Mutual Fund Investors

February 6, 2004

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549

VIA ELECTRONIC MAIL

Subject: Proposed Rule: Amendments to Rules Governing Pricing of Mutual Fund Shares/File No. S7-27-03

Dear Mr. Katz:

The Coalition of Mutual Fund Investors ("CMFI" or "Coalition") is pleased to submit the following comments regarding a regulatory proposal issued by the Securities and Exchange Commission ("SEC" or "Commission") on December 11, 2003, to prevent unlawful late trading in mutual fund shares.

CMFI is an Internet-based shareholder advocacy organization representing the interests of individual mutual fund investors. The Coalition is based in Washington, D.C., with a Web site that can be accessed at www.investorscoalition.com.

The Coalition is concerned that the current mutual fund pricing rules are inadequate to prevent late trading activities, even though such activities are a violation of current SEC rules and regulations. Late trading violations also appear to be fairly widespread, and in direct conflict with the interests of long-term mutual fund shareholders.

Under Rule 22c-1, financial intermediaries are permitted to process order information after the time established by the mutual fund for calculating its net asset value ("NAV"). Most funds calculate NAV when the major U.S. stock exchanges close at 4:00 P.M., Eastern Standard Time.

In a recent Commission survey of 88 mutual fund complexes, more than 80% of the respondents reported that they allow late processing of share orders received by a fund intermediary before the daily order cutoff, allowing these intermediaries to send in

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orders after 4:00 P.M. And a similar SEC survey of 34 broker-dealers resulted in as many as 25% of respondents admitting that certain customers have placed or confirmed mutual fund orders after 4:00 P.M. and received the 4:00 P.M. share price.

Rules that permit a small group of investors to receive a pricing advantage over other investors need to be changed if the SEC is to create a level playing field for all mutual fund shareholders. The only sensible solution to this problem is to require that all orders be received by the fund or its designated recordkeeping agent—typically which can include a transfer agent, sub-transfer agent, or combination of both--by the 4:00 P.M. deadline. This approach is preferable to a rule that allows fund intermediaries to accept orders by 4:00 P.M. and then take several more hours to "process" and forward the orders on to the funds.

Investigations by the SEC and state securities regulators have found: (1) late trades blended with legitimate trades in omnibus accounts managed by fund intermediaries; (2) widespread circumvention of the Commission's requirements for order time-stamping by broker-dealers; and (3) several instances in which late trading has been successfully concealed from both SEC examinations and industry regulatory audits. The most creative abuse of the current system is the example cited by the Commission in which favored investors are allowed to simply withdraw their purchase or sale order after 4:00 P.M., based on whatever late news is received, but before the intermediary is finished "processing" its order flow for the day. This practice is difficult to detect and permits these favored investors to gain a substantial advantage over other shareholders in the daily pricing of mutual fund shares. In effect, the favored investor is allowed to "beat the house," by withdrawing a losing casino wager after the roulette wheel has come to a stop or the cards at poker have been dealt and uncovered.

If mutual funds are going to be priced under the forward pricing rule, then it is vitally important to have a final and firm cutoff time for all investors seeking to purchase at the 4:00 P.M. daily price. It is that simple. Any other "creative" solution will result in an unfair advantage for some group of favored investors, instead of creating a level playing field for all investors.

The Coalition agrees with the Commission's assertion that the current rules "have failed to prevent late trading, and that available tools to control late trading facilitated by fund intermediaries have proven inadequate." 68 Fed. Reg. 70389 (2003). Late trading violations are not isolated to a few special circumstances or a particular type of intermediary; the problem is much more widespread and requires a strong regulatory solution.

For these reasons, the Coalition supports the Commission's proposal that all orders must be submitted to the fund, its transfer agent, or a registered securities clearing agency before 4:00 P.M., in order to receive that day's 4:00 P.M. price. Orders received after the 4:00 P.M. cutoff time would receive the following day's price.

Since a number of mutual funds have arrangements whereby the transfer agent named in the registration statement is not the only entity designated to process mutual fund transactions, the Coalition supports a clarification to the proposed rule which would permit a fund to designate a second recordkeeping entity as an agent of the fund, including, but not limited to, a sub-transfer agent. To avoid any circumvention of the 4:00 P.M. "hard close" rule, any second entity designated by a mutual fund to process transactions on its behalf must be regulated by the SEC as a registered transfer agent.

While the SEC's proposed fund pricing rule certainly does place additional constraints and burdens upon mutual fund intermediaries, these inconveniences are more than offset by the benefits of such a rule to the interests of long-term shareholders. The substantial majority of individuals investing in mutual funds, especially equity funds, have a long-term investment horizon. These individuals are investing for retirement or for some future goal that is several years away. With a long-term investment horizon, these investors are indifferent as to whether their mutual fund shares are priced in the same day as their order or on the following day. Whether the investor is on the West Coast, with a 3-hour time difference, or the investor is purchasing shares through a retirement account, it just does not matter to a long-term investor if he or she receives pricing within the same day.

Unless an investor is engaged in market timing or otherwise trying to "game" the fund pricing system, the Commission is right to conclude that the "burden [of this proposal] on most mutual fund investors will be small because most are not sensitive to the time at which their purchase or redemption orders are priced." 68 Fed. Reg. 70390 (2003).

The Coalition does not support the alternative suggested by the Commission in which orders could be placed by intermediaries after 4:00 P.M., with the implementation of certain regulatory protections to deter late trading. In its description of this alternative proposal, the Commission lists three protective steps that could be taken in lieu of a 4:00 P.M. firm deadline for the receipt of orders by mutual funds: (1) time stamping processes for orders that can't be altered after the fact; (2) an annual certification by intermediaries that policies and procedures are in place to police against late trades; and (3) an annual audit of the internal control processes of fund intermediaries.

The Coalition urges the Commission to reject any reliance on these protective steps as an alternative approach to a 4:00 P.M. firm deadline, as outlined in the proposed rule.

Time-stamping at the intermediary level has been proven so far to be an open invitation to circumvent the forward pricing rules. It is also difficult, if not impossible, for mutual funds to monitor late trading activities with so many intermediaries using omnibus accounts. Further, it is not in an intermediary's economic interest to enforce a mutual fund's rules, and history suggests that forcing an entity to act against its own economic interest is likely to fail. In the view of CMFI, this problem is best solved through the SEC proposal of a firm cutoff time each day at the fund level, instead of relying on intermediaries to police this activity.

An annual certification by fund intermediaries is also not going to adequately address the problem. Again, late trading is not just a violation of existing policies and procedures, it is also a violation of current SEC rules. Yet the practice is still fairly widespread, according to published reports of federal and state investigations and the results of the SEC's own information requests to mutual funds and broker-dealers.

Finally, an annual audit of fund intermediaries has its shortcomings as a tool to prevent late trading. The success of an audit is dependent on the skill of the auditor and it raises the issue that the entity employing the auditor will be required to act in a manner which is contrary to its economic interest if it challenges the procedures and practices of an intermediary that is a major source of sales.

Given these issues, CMFI believes that the problem of late trading needs to be addressed structurally and not through additional procedural steps at the intermediary level, with an after-the-fact audit process.

In summary, the Coalition of Mutual Investors strongly supports the Commission's proposal to implement a 4:00 P.M. firm deadline for mutual fund orders to be received. The Commission is correct in applying this deadline at the mutual fund level, instead of permitting transactions after 4:00 PM by fund intermediaries. What the Commission has proposed is the most effective solution to the problem of late trading and it is the solution that is in the best interests of all mutual fund shareholders.

Thank you for providing CMFI with the opportunity to present its views on this issue. If you or any member of the Commission staff have any questions or need additional information from CMFI, please contact me at 202-783-5300.

Sincerely,

Niels Holch
Executive Director
Coalition of Mutual Fund Investors