

January 9, 2004

Proposed SEC Rule Concerning Pricing of Mutual Fund Shares

The Securities and Exchange Commission (the “SEC”) has proposed a rule amending current Rule 22c-1 under the Investment Company Act of 1940, as amended (the “1940 Act”): “Amendments to Rules Governing Pricing of Mutual Fund Shares” (the “Proposed Rule”).¹ Comments on the Proposed Rule must be submitted to the SEC by February 6, 2004. This memorandum outlines the requirements of the Proposed Rule.

A. Introduction

The 1940 Act requires registered investment companies (“funds”), their principal underwriters and dealers to sell and redeem fund shares at prices based on the fund’s net asset value (“NAV”) next computed after receipt of an order to buy or redeem fund shares. This requirement is known as “forward-pricing.”² The 1940 Act also requires funds to calculate their NAV at least once a day, and most funds perform this obligation as of 4:00 P.M. when the main U.S. stock exchanges close.³ As a result of these two rules, an investor who submits an order to buy or redeem fund shares before 4:00 P.M. on Monday will receive a price based on the NAV at 4:00 P.M. on Monday; if the order is placed after 4:00 P.M. on Monday, the investor will receive a price based on the NAV at 4:00 P.M. on Tuesday.

Currently, the SEC considers an order to be received when the retail dealer receives the order from the customer, even if the order is actually submitted to the fund transfer agent at a later time. For example, if an investor submits an order to his or her broker-dealer to buy fund shares at 3:00 P.M. and the broker-dealer submits the order to the fund’s transfer agent at

¹ Proposed Rule: Amendments to Rules Governing Pricing of Mutual Fund Shares, 17 CFR Part 270; Release No. IC-26288, File No. S7-27-03; RIN: 3235-AJ01 (December 17, 2003).

² Forward-pricing is required under Rule 22c-1 of the 1940 Act.

³ All times herein are eastern standard.

4:15 P.M., current SEC regulations consider the order to have been placed at 3:00 P.M. and the sale of fund shares to the investor at a price based on the 4:00 P.M. NAV to be legal.

However, in the past few months, regulators have discovered circumstances whereby certain investors placed or canceled orders to buy or redeem fund shares after 4:00 P.M. but still received a price based on the NAV at 4:00 P.M. of that day. This practice is known as late trading and is illegal under the aforementioned securities rules. In order to accomplish late trades, certain investors had arrangements with financial intermediaries, and occasionally fund managers. Most of the late trading went undiscovered by regulators, despite a requirement to time-stamp orders, because intermediaries typically submit aggregate orders to fund transfer agents after 4:00 P.M., and because certain investors were permitted by intermediaries to cancel or modify orders after 4:00 P.M. but before submission to the fund's transfer agent.

B. Proposed Pricing Requirements

The SEC is proposing to deem a purchase or redemption order *received* only when it is received by (1) the fund itself, (2) the fund's transfer agent or (3) a clearing agency registered with the SEC.⁴ These entities are regulated by the SEC and would be required to record the date and time they receive fund order information.⁵ The SEC believes these fund designated transfer agents, in effect, will serve as a time-stamp for orders and ensure that investors receive the correct day's price.⁶

Under the Proposed Rule, an order would constitute a request to buy or redeem either (1) an indeterminate number of shares of a specific dollar value or (2) a specific number of shares. Moreover, each customer order would be deemed irrevocable after the next NAV

⁴ For example, the National Securities Clearing Corporation's Fund/SERV system.

⁵ Proposed Rule, Release No. IC-26288 at Section II.A.

⁶ *Id.*

pricing time after receipt by the fund, the fund's transfer agent or a registered clearing agency.⁷ The SEC believes this proposal will prevent the cancellation or modification of orders after the pricing time applicable to the order.⁸ In effect however, the Proposed Rule also requires investor orders to be submitted to retail dealers much earlier than before (i.e., far before 4:00 P.M.) so that the retail dealers can submit the orders to fund transfer agents by 4:00 P.M. and receive prices based on that day's NAVs.

Fund exchanges present an issue. An investor who seeks to exchange shares in one fund for shares in another fund technically engages in two transactions: first a redemption and second a purchase. The purchase order can only be satisfied with proceeds from the redemption order. The NAV price for the redemption order, and thus the amount of proceeds, will be determined at the next computed NAV price. Since the specific information for the purchase order (i.e., number of fund shares or dollar amount) would be received after 4:00 P.M. and after the initial satisfaction of the redemption order, it could be difficult for mutual funds to offer investors the ability to exchange shares at the same day's prices. To resolve this issue, the Proposed Rule would consider an exchange a single order and thus permit funds to use the same day's prices for the entire transaction.⁹

Finally, the SEC proposes to adopt two new exceptions to the forward pricing rule. The first, an emergency exception, would permit investors to receive the current day's price if an emergency (e.g., hurricane, power failure) rendered the intermediary unable to transmit the order to the fund, the fund's transfer agent or a registered clearing agency by 4:00 P.M. In order to receive the benefit of this exception, the chief executive officer of the intermediary would be required to provide a written certification of the nature and existence of the

⁷ *Id.*

⁸ *Id.*

⁹ *Id.* at Section II.B.

emergency and state that the order was received before the relevant NAV pricing time.¹⁰ If the intermediary is unable to receive orders, the chief executive officer of the intermediary must notify the fund.

The second exception pertains to “conduit funds,” which invest all assets in other funds and can only calculate its NAV after the funds in which it has invested have calculated its NAV.¹¹ The Proposed Rule would permit conduit funds to submit orders based on the NAV established by the other fund on the same day.¹²

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If you have any questions about the Proposed Rule or would like to consider submitting a comment on any part of the Proposed Rule, please do not hesitate to contact us.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents.

Mark S. Bergman	212-373-3258	Steven R. Howard	212-373-3508
Raphael M. Russo	212-373-3309		

PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP

¹⁰ *Id.* at Section II.C.

¹¹ Conduit funds are registered with the SEC and rely on Section 12(d)(1)(E) of the 1940 Act. Examples of conduit funds include “master-feeder” funds or insurance company separate accounts.

¹² Proposed Rule, Release No. IC-26288 at Section II.C.