

February 6, 2004

BY ELECTRONIC MAIL

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: File No. S7-27-03

Dear Mr. Katz:

On behalf of Fund Democracy^[1] and the Consumer Federation of America,^[2] we welcome this opportunity to comment on the Securities and Exchange Commission's proposal^[3] to require that orders for the purchase or sale of mutual fund shares be received by the fund, its designated transfer agent, or a registered clearing agency before the time the fund is priced in order to be executed at that price ("hard 4:00 close").^[4]

Like the Commission, we have been appalled by reports of funds' processing orders for fund shares after the fund has been priced. This practice allows the traders to use information that is released after the pricing time to earn illegal profits that come directly out of the pockets of the fund's other shareholders. We agree that prompt, effective action must be taken to detect and prevent such trading. We are not convinced, however, that the hard 4:00 close necessarily provides the best long-term solution to this problem and recommend that it be adopted only as an interim measure pending further review of more equitable approaches.

We are concerned that the Commission's proposal will relegate some retail investors to the status of what some have described as "second-class shareholders." The Commission concedes that, in some cases, it may not be practicable under a hard 4:00 close for all investors to obtain a same-day price, even if their orders are submitted well in advance of the 4:00 close. Some investors, for example, may be able to obtain a same-day price only if their orders are submitted during early business hours. Retail investors in California and other western states and those who invest through employer-sponsored retirement plans will be especially likely to have such limited trading options. This inequity is exacerbated by the fact that it will be borne by retail investors. Ironically, the professional traders who actually engaged in the late trading that precipitated this proposal will still be able to obtain a same-day price if the hard 4:00 close becomes law.

The Commission has suggested that retail investors should not care about obtaining a same-day price.^[5] We agree that, as a general matter, a financial plan that attaches importance to the ability to buy or sell fund shares at a particular price may be ill-advised. Our reluctance to support a hard 4:00 close should therefore not be read to endorse the view that the right to obtain a same-day price necessarily provides economic value to investors. Rather, we believe that depriving only certain investors of this right is inequitable. Furthermore, we do not believe that Congress, in enacting the federal securities laws, intended to authorize the Commission to codify principles of financial planning, regardless of how sound they may be.

In keeping with this line of reasoning, the Commission has suggested that any inequities resulting from the rule are perceived rather than real, since at least as many investors will benefit from getting the next day price as will be harmed by it. But perceptions matter. The investor who is harmed is likely to take little comfort from the fact that others benefited. If investors who suffer such harm perceive that an SEC rule is the cause, their faith in the ability of government regulators to protect their interests is likely to be undermined. At a time when investor confidence has suffered a series of severe shocks, we can ill afford to adopt policies that will further undermine investor confidence.

We believe that effective alternatives to hard 4:00 close exist that do not create similar inequities. The Commission discusses certain of these alternatives, but finds them wanting because they can be “easily circumvented.” Part II, Proposing Release. But the hard 4:00 close itself also may be circumvented. Ongoing revelations in connection with the current mutual fund scandal make it clear that some employees, even high-level executives, may be willing to alter transfer agent records to facilitate late trading. This would not be prevented by a hard 4:00 close. While we agree that the hard 4:00 close probably provides the most secure system for preventing late trading, it is illusory to think that it is a foolproof panacea.

In recommending against alternatives to the hard 4:00 close, the Commission notes that fund managers are not able to discern late trading when the trades are submitted after hours through intermediaries. In fact, there is nothing preventing fund managers from contractually requiring that intermediaries implement procedures and provide evidence of their effectiveness to fund managers as a condition of their executing trades through the fund. One might argue that this is impracticable because intermediaries will not offer funds that impose this requirement, but this problem can be solved without resorting to a hard 4:00 close. The fund industry could establish standards for such contracts that effectively eliminated any competitive disadvantage, or it could publicize the compliance risks of using an intermediary that refused to agree to such terms. Alternatively, the SEC could require such contractual provisions as a condition of opting out of a hard 4:00 close.

Another reason cited by the Commission for its opposition to alternative approaches is its lack of inspection authority over certain intermediaries. See Part II, Proposing Release. As noted above, however, the SEC could effectively obtain such authority by imposing a hard 4:00 close that fund managers could opt out of if intermediaries agreed contractually to submit to SEC review of fund trading policies and procedures and inspection of fund trading records. Alternatively, the Commission could ask Congress to enact legislation that gives the agency the needed authority.

With these considerations in mind, we urge the Commission to explore alternatives to the hard 4:00 close more fully and to revisit formally in the future the question of how best to prevent late trading. In doing so, the Commission also should consider the effects of steps that it has recently taken to strengthen compliance at fund companies. For example, the Commission recently adopted rules requiring that funds have policies and procedures in place that are designed to prevent late trading, among other things. The Commission further required that these policies and procedures be administered by a chief compliance officer who reports to the board. The Commission’s staff now inspects fund service providers for compliance with trading rules,

whereas previously it did not do so.^[6] Ongoing criminal and civil enforcement actions also will reduce the likelihood of late trading. We believe that these steps, taken together, will both deter late trading and increase the likelihood of its being detected should it occur.

In conclusion, we recommend that the Commission reconsider the hard 4:00 close. If a hard 4:00 close is the only mechanism that can be implemented in the short-term to prevent late trading, then we recommend that the Commission adopt the hard 4:00 close on a trial, six-month basis, and during this trial period develop more equitable alternatives.

Respectfully submitted,

Mercer Bullard
Founder & President
Fund Democracy

Barbara Roper
Director of Investor Protection
Consumer Federation of America

cc (U.S. mail only):
The Honorable William H. Donaldson
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
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^[1] Fund Democracy, a nonprofit membership organization, provides a voice for mutual fund shareholders by publishing information that targets mutual fund practices, policies and rules that are harmful to fund shareholders and by lobbying for mutual fund reform.

^[2] The Consumer Federation of America is a nonprofit association of 300 consumer groups, representing more than 50 million Americans, that was established in 1968 to advance the consumer interest through research, education, and advocacy.

^[3] Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Rel. No. 26288 (Dec. 11, 2003) (“Proposing Release”).

^[4] We refer to this proposal as the “hard 4:00 close” proposal because most funds price their shares at 4:00 eastern time.

^[5] “[M]ost [fund investors] are not sensitive to the time at which their purchase or redemption orders are priced.” Proposing Release at Part II.

^[6] Testimony of William H. Donaldson, Chairman, Securities and Exchange Commission, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate (Nov. 18, 2003) (stating that SEC staff had not inspected for late trading or market timing).