PROPOSED RULE: AMENDMENTS TO RULES GOVERNING PRICING OF MUTUAL FUND SHARES

On December 11, 2003, the Securities and Exchange Commission (the "SEC") proposed amendments to Rule 22c-1 (the "Proposed Rules")[1] under the Investment Company Act of 1940, which currently requires forward pricing of redeemable securities issued by registered investment companies ("funds"). The Proposed Rules provide that an order to purchase or redeem fund shares would receive the current day's price only if the fund, its designated transfer agent or a registered securities clearing agency receives the order by the time that the fund establishes for calculating its net asset value. The amendments are designed to prevent unlawful late trading in fund shares.

Proposed Pricing Requirements

Rule 22c-1 or the "forward pricing" rule, in its current form, requires funds, their principal underwriters and dealers to sell and redeem fund shares at a price based on the current net asset value ("NAV") next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security.[2] The current Rule is interpreted to deem a purchase or redemption order to be received, for purposes of determining the appropriate day's price, when the retail dealer or other intermediary designated as an agent of the fund (e.g., banks and retirement plans) receives the order, even if it is actually submitted to the fund's primary transfer agent at a later time. The Proposed Rules would deem an order received only when it is received by:

- the fund itself;
- the fund's designated transfer agent; or
- a clearing agency registered with the SEC (e.g., the National Securities Clearing Corporation's Fund/SERV system, currently the only registered clearing agency that operates as an automated system for processing fund orders).

Additionally, the Proposed Rules would require fund-designated transfer agents to record the date and time they receive order information (these transfer agents will operate, in effect, as time-stamping organizations, ensuring that orders are assigned the correct day's price).

[1] SEC Release No. IC-26288; File No. S7-27-03 (December 11, 2003), http://www.sec.gov/rules/proposed/ic-26288.htm.

[2] 17 CFR 270.22c-1(a). The rule also applies to any other person designated in the fund's prospectus as authorized to receive purchase orders or tenders of securities for redemption.

Purchase and Sale Orders; Exchanges

In order to eliminate late trading through fund intermediaries, the Proposed Rules would require that all purchase and redemption orders be received by (i) the fund, (ii) a single transfer agent designated by the fund and required by written contract to receive order information and maintain a record of the date and time it receives the information ("designated transfer agent"), or (iii) a registered clearing agency (e.g., Fund/SERV) no later than the time at which the fund prices its securities (e.g., 4:00 p.m.), in order to obtain the current day's price. As a consequence, fund intermediaries such as broker-dealers, banks and administrators of retirement plans would have to submit orders before 4:00 p.m. in order for their customers to receive the 4:00 p.m. price. Orders received later would be required to receive the following day's price under the Proposed Rules.

The SEC indicated in the Proposed Rules that if the Rules were adopted as proposed, it would likely require substantial changes in the way fund intermediaries process orders. Intermediaries will likely require investors, at least until new systems can be developed, to submit purchase orders at an earlier time in the day (e.g., 2:00 p.m.) in order to obtain the 4:00 p.m. price (in order to allow the intermediary to process the purchase and redemption orders before submitting them to the fund, its designated transfer agent or the clearing agency).

The Proposed Rules would also propose to define the term "order" to clarify when an order is complete (and therefore received) for purposes of obtaining the appropriate day's price. Under the Proposed Rules, an "order" would mean the direction to purchase or sell either (i) a specific number of shares of a fund (e.g., all the shares held in the account) or (ii) an indeterminate number of shares of a specific value (e.g., 10,000 shares of the fund). In order to prevent the cancellation or modification of orders after the pricing time applicable to the order, the proposed definition would also deem each order to be irrevocable as of the next pricing time after receipt by the fund, its designated transfer agent or registered clearing agency.

The Proposed Rules also contain a special provision for exchange orders in order to maintain the ability of funds to offer "seamless" exchange transactions.[3] The Proposed Rules define "order" to include a direction to purchase redeemable securities of the fund using proceeds of a contemporaneous order to redeem a specific number of shares of another fund.

Exceptions

The current Rule includes several exceptions from the forward pricing requirements, all of which would be preserved under the Proposed Rules.[4] The Proposed Rules also provide for an

[3] An investor who exchanges between two funds engages in two transactions - a redemption of the securities he owns in one fund and a purchase (using the redemption proceeds) of securities in another fund. Typically, exchanges between funds in the same fund complex, and sometimes in different complexes, are processed as a single transaction so that they receive the same day's prices. In the case of an exchange involving a fixed number of shares (e.g., in which the investor redeems all of his shares of the first fund), neither the amount nor the number of shares of the second fund will be known until the NAV of the first fund is determined, which will be sometime after 4:00 p.m.

[4] Current exceptions to Rule 22c-1 include the following: (1) an exception for sponsors of unit investment trusts engaged exclusively in the business of investing in eligible trust securities from selling or repurchasing trust units

additional exception allowing for investor orders to receive same-day treatment if, as a result of an emergency, a dealer (or its agent) was unable to transmit the orders or if the fund's designated transfer agent was unable to receive the orders. The so-called "emergency exception" would be available to dealers only if the CEO certified to the fund (i) the nature, existence and duration of the emergency and (ii) that the intermediary received the orders before the applicable pricing time (a fund would also be required to keep a record of each certification it received for a period of six years). This exception is designed to address natural disasters or other occurrences external to the intermediary, and not internal operational difficulties.

A second exception has been proposed addressing "conduit funds", which invest all their assets in another fund and, therefore, must calculate their NAV on the basis of the other fund's NAV. This proposed exception would allow a conduit fund, such as a "master-feeder" fund or an insurance company separate account, to submit its orders after 4:00 p.m. based on the NAV established by the other fund on the same day.

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January 7, 2004

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in a secondary market at a price based on the offering side evaluation of the eligible trust securities in the trust's portfolio; (2) an exception for registered investment companies which does not prevent a fund from adjusting the price of its redeemable fund shares sold pursuant to a merger, consolidation or purchase of substantially all of the assets of a company which meets the conditions specified in Rule 17a-8; and (3) an exception permitting any registered separate account offering variable annuity contracts, and person designated in such account's prospectus as authorized to consummate transactions in such contracts, and any principal underwriter of or dealer in such contracts, to apply the initial purchase payment for any such contract at a price based on the current NAV of such contract which is next computed generally not later than two business days after receipt of the order.

Appendix: Same Day Prices and the "Hard Close"

As noted in our memorandum, the SEC has acknowledged that its 4:00 p.m. "hard close" proposal, if adopted, will affect order processing by intermediaries. The 401(k) industry and others have said that the proposal will disadvantage 401(k) plan participants by requiring them to wait for "next day" prices when they buy, redeem and exchange mutual fund shares. (Others who hold mutual fund shares through intermediaries, such as fund supermarkets and bank programs, will be affected similarly.) The SEC downplays this concern—"we believe that the burden on most fund investors will be small because most are not sensitive to the time at which their purchase or redemption orders are priced." This is because they purchase mutual fund shares through "automatic purchasing programs" and think of the time and date of purchase as a "random event" dependent upon payroll processing or mail delivery. We are not convinced that the SEC has taken this point sufficiently seriously.

Even if 401(k) investors are content to regard the timing of their contributions and investments as a kind of dollar cost averaging, they also trade. Those who do not enjoy the ability to trade on a daily basis—and we are unsure how many remain—may not be pained at "next day" prices, but most mutual fund shareholders want to know the price at which they buy, sell and exchange their shares as closely as possible, whether they monitor and adjust their holdings frequently or not. (When you buy a new car, whether you plan to buy another one in six months or keep this one for years, you care about the price. We care about the price of everything we buy or sell. Price awareness is even greater in a rapidly fluctuating market.) The Wall Street Journal says that investors could miss out on market upswings. The long-held perception in the mutual fund distribution industry is that investors want same day prices. If it is important to know how mutual fund investors feel about same day prices, and perhaps it is, surely the SEC can gather evidence on the question.

Why must "same day" prices be a victim of the SEC's proposal? Despite making little of 401(k) investor concerns, the SEC thinks that the necessary cut-off time change need be no more than a few hours. "Intermediaries will likely require investors to submit purchase [and redemption] orders at an earlier time in the day (*e.g.,* 2:00 p.m.) to obtain the 4:00 p.m. price, in order to allow the intermediary time to process the purchase and redemption orders before submitting them to the fund, its designated transfer agent, or the clearing agency." By contrast, it has been reported that the American Benefits Council says that the proposed rule, if adopted, will require 401(k) participants to place orders between 10:00 a.m. and noon Eastern time. (Eastern time applies for most mutual funds; west coast 401(k) investors will be at a greater disadvantage.)

We can expect a scramble during the year of transition to develop sophisticated real-time systems for processing orders and, at least in one scenario, aggregating them over a shareholder population continually during the day. The pressure will be to permit 401(k) investors to place orders as late in the day as possible. The development and operation of these systems will be expensive and will have consequences. Mom-and-pop recordkeepers will have to position themselves differently or exit the industry. If funds are to pay recordkeepers more for enhanced computing and recordkeeping services, fund shareholders will see expenses increase (unless distribution expenses decrease). If aggregating fund orders for a plan or group of plans remains desirable, funds must prepare to receive large numbers of orders in the hour or two before the

4:00 p.m. close—and, again, the pressure to narrow that "order window," or to get to the end of the line, will be heavy. Recordkeepers and intermediaries may encounter a bulge as their cut-off time approaches also. Finally, transfer agents will enjoy a great advantage in the 401(k) recordkeeping business (and may crowd out other players); when a mutual fund's transfer agent, even in its capacity as a plan recordkeeper, receives a plan participant's order for the fund's shares prior to 4:00 p.m., the order will be complete. (There will be a timing benefit for plans, also, that have a mutual fund's transfer agent as recordkeeper and keep all their mutual fund choices in that fund family).

Some observers believe that all orders require the NAV for processing. Currently, 401(k) plan recordkeepers do their batch processing at night, after receiving the NAV from each fund. This permits them to convert dollar orders into share orders (and vice versa). But it is unnecessary to convert dollar orders into share orders; the definition of an "order" in the Proposed Rules specifically contemplates dollar orders. If some 401(k) recordkeepers or fund transfer agents must change their systems to accommodate dollar orders, this will be an acceptable consequence of the SEC's proposal.

The SEC recognizes that some orders do require the NAV, however, and so might not be susceptible to "same day" prices if the "hard close" proposal is adopted. An exchange order—the most common order in the 401(k) environment—involves two transactions, the SEC notes, a redemption followed by a purchase using the redemption proceeds, processed simultaneously. If the exchange is specified for a dollar amount of the shares to be redeemed, it can be processed in the same way as simple purchases and redemptions. But if the exchange is specified for a number of shares (100% of the investor's shares in the first fund is the SEC's example), the dollar amount of the proceeds, and so the dollar amount of the related purchase, cannot be known without the NAV. The SEC says, "To preserve the ability of funds to offer 'seamless' exchange transactions, we propose to define 'order' to include a direction to purchase redeemable securities of the fund using proceeds of a contemporaneous order to redeem a specific number of shares of another." (An order to exchange 50% of my XYZ Growth Fund, a common 401(k) plan order, is specific inasmuch as the number of shares I now own is known.)

Some pension plan industry representatives have argued that the NAV still is necessary for the computations required of a recordkeeper before submitting an aggregated order. A representative of Hewitt Associates has stated that a recordkeeper must make computations "to ensure compliance with retirement plan rules (e.g., vesting calculations, rules determining withdrawal amounts or other benefit payments) as well as regulatory requirements (e.g., regulatory caps on amounts that can be borrowed from particular accounts)." These computations, he asserts, require the determination of account values, presumably as of the date the order is executed, and so the NAV is needed. It is unclear how much of a problem this raises. Some of the required computations may not have to be contemporaneous with the order computations and some may be possible using yesterday's prices. Minor regulatory relief may be necessary. If there are indeed computations that resist all efforts at squeezing them in, then some transactions may have to be delayed. But hardly most of them.

What is needed is evidence, analysis and an understanding of industry practices and potentials. If the SEC's "hard close" proposal will result in next day prices for 401(k) plans and other omnibus accounts, this should be demonstrated. The importance of this disadvantage should be studied more thoroughly. If the SEC concludes that the main consequence of its proposal to 401(k) investors will be a 2:00 p.m. Eastern time cut-off instead of a 4:00 p.m. cut-off, however, it is likely to go forward.