

Special Notice to Members

SEPTEMBER 2003

SUGGESTED ROUTING

Legal and Compliance
Mutual Fund Sales
Operations
Senior Management

KEY TOPICS

Mutual Fund Transactions

ACTION REQUIRED

Mutual Fund Transactions

NASD Reminds Member Firms of their Obligations
Regarding Mutual Fund Transactions and Directs
Review of Policies and Procedures

Executive Summary

Investment Company Act Rule 22c-1(a) generally requires that redeemable securities of investment companies be sold and redeemed at a price based on the net asset value (NAV) of the fund computed **after** the receipt of orders to purchase. It is a violation of NASD Rule 2110, and may be a violation of the federal securities laws and NASD Rule 2120, for member firms and their associated persons to knowingly or recklessly effect mutual fund transactions that are priced based on NAV that is computed prior to the time the order to purchase or redeem was given by the customer. Furthermore, it may be a violation of NASD Rule 2110 and the federal securities laws to knowingly or recklessly facilitate certain mutual fund transactions, such as market timing transactions, in conjunction with, or with the acquiescence of, a mutual fund sponsor, fund administrator, investment adviser, underwriter, or any other affiliated person¹ where those other parties acted contrary to a representation made in the prospectus or statement of additional information pursuant to which the mutual fund shares are offered.

NASD is issuing this *Notice to Members* to (1) remind members of their responsibility to ensure that they have policies and procedures reasonably designed to detect and prevent the occurrence of mutual fund transactions that would violate NASD Rule 2110 and the federal securities laws; and (2) direct each member firm executing mutual fund sales and redemptions to review its policies and procedures to assure that they are adequate with respect to the matters that are discussed in this *Notice to Members*.

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Questions/Further Information

Questions concerning this *Notice* may be directed to Marc Menchel, Executive Vice President and General Counsel, Regulatory Policy and Oversight, NASD (202) 728-8071; Daniel M. Sibears, Senior Vice President & Deputy, Department of Member Regulation, Regulatory Policy and Oversight, NASD (202) 728-8221; or Tom Selman, Senior Vice President, Investment Companies/Corporate Finance, NASD (240) 386-4500.

Discussion

Investment Company Act Rule 22c-1(a) essentially requires the forward pricing of mutual fund shares. In practice, mutual fund companies usually calculate their NAVs at the close of trading (4:00 p.m. EST). The purpose of the rule is to place all purchasers of mutual fund shares on equal footing as to price and information on any one day. Investors who seek to purchase or redeem mutual fund transactions after the close of trading at the NAV calculated for the same trading day gain the possibility of an information advantage based on after-close news that could affect the mutual fund's holdings but is not reflected in the NAV pricing for that day.

Member firms and their associated persons that knowingly or recklessly effect or facilitate an after-close mutual fund purchase or redemption at the same day's NAV (late trading) violate NASD Rule 2110, which requires the observance of just and equitable principles of trade. Such conduct may also be violative of the federal securities laws and NASD Rule 2120. Late trading is not excused or mitigated as a result of the consent or acquiescence of a mutual fund company, mutual fund sponsor, fund administrator, investment adviser, underwriter, or any other affiliated person.

Member firms executing mutual fund purchases and redemptions must have and implement policies and procedures reasonably designed to detect and prevent the occurrence of late trading. Member firms should pay particular attention to policies and practices regarding the entry of trades time stamped before or at the close but entered or executed after the close.² Similarly, members should take steps reasonably designed to ensure that their systems to correct errors after the close cannot be subverted for the purposes of effecting late trading.

In addition, member firms and their associated persons who knowingly or recklessly undertake, effect, or otherwise facilitate transactions in conjunction with, or with the acquiescence of, a mutual fund sponsor, fund administrator, investment adviser, underwriter, or any other affiliated person where these other parties would have acted contrary to a representation made in the prospectus or statement of additional information (SAI) pursuant to which the mutual fund shares are offered violate NASD Rule 2110 and may be found to have violated the federal securities laws and NASD Rule 2120.

For example, certain mutual fund companies represent in their prospectuses or SAs that they engage in practices that are intended to prevent or control market timing transactions. Market timing transactions include mutual fund trades that occur when the purchaser or seller believes that the mutual fund's NAV does not fully reflect the value of the fund's holdings – for example, when the fund has in its portfolio particular holdings, such as foreign or thinly traded securities, which are priced on a basis that does not include the most updated information possible. In order to retard the efforts of investors who seek to profit on these pricing inefficiencies by executing mutual fund trades on a day when the NAV likely will not fully reflect the value of a fund's holdings and realizing the profit by trading the next day, some mutual fund companies have implemented measures to counteract the efforts of timers and have represented in their prospectuses or SAs that they are conducting these measures. Consequently, where the mutual fund company and/or its affiliated persons have represented that they have taken steps to protect investors from market timers, a member firm and its associated persons may not knowingly or recklessly act in conjunction with, or with the acquiescence of, the fund and/or its affiliated persons to undertake, effect, or facilitate a market timing transaction. Again, members must have in place policies and procedures reasonably designed to detect and prevent this collusion with mutual funds and their affiliated persons to circumvent the mutual funds stated procedures.

Members must review the adequacy of their policies and practices with regard to the matters discussed in this *Notice to Members*. NASD intends to examine for reasonable policies and practices with regard to these matters.

Endnote

- 1 As used in the this *Notice to Members*, the term "affiliated person" is as defined under Section 2(a)(3) of the Investment Company Act of 1940.
- 2 There may be situations where member firms legitimately receive orders prior to or at the close of trading but enter such orders after market's close. However, members bear the burden of demonstrating that they have implemented policies and procedures that are reasonably designed to prevent the occurrence of late trading.

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