

STATEMENT OF  
WILLIAM A. BRIDY  
PRESIDENT  
FINANCIAL DATA SERVICES, INC.

before the

U.S. SENATE BANKING HOUSING AND URBAN AFFAIRS COMMITTEE

“Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Fund Operations and Governance”

March 2, 2004  
538 Dirksen Senate Office Building

I. Introduction

Chairman Shelby, Ranking Member Sarbanes, and members of the Committee, I am William A. Bridy, President of Financial Data Services, Inc., a wholly owned subsidiary of Merrill Lynch & Co., Inc. My business unit has overall responsibility for the prompt and accurate processing of all mutual fund orders placed through our firm. I am pleased and honored to appear before the Committee on behalf of the Securities Industry Association (SIA)<sup>1</sup> to discuss measures to eliminate late trading, as this Committee has contributed so much to the effort to protect the investing public.

As a preliminary matter, we, and all members of SIA, agree that the practice of late trading is unequivocally illegal, and its very existence threatens to undermine the public’s trust and confidence in mutual funds. For this reason, we applaud the strong enforcement actions the SEC and other regulators have taken to date to punish wrongdoers. We believe that these enforcement actions, and the broad attention they have received, have already had a significant deterrent effect on potential wrongdoers and have propelled broker-dealers, other intermediaries, and mutual funds to focus their compliance efforts more sharply on preventing late trading.

---

<sup>1</sup> The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs more than 800,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated an estimated \$142 billion in domestic revenue and \$283 billion in global revenues. (More information about SIA is available on its home page: [www.sia.com](http://www.sia.com).)

We also applaud the expeditious manner in which legislators and regulators proposed rulemaking after evidence of late trading first surfaced in September 2003. In that regard, a manager's amendment relating to late trading was added to H.R. 2420, and the bill, inclusive of the manager's amendment passed the House of Representatives by a vote of 418 to 2 on November 3, 2003.<sup>2</sup> Additionally, 3 of the 4 bills introduced in the Senate contain provisions that address late trading.<sup>3</sup> Furthermore, the SEC has issued its own late trading proposal.<sup>4</sup>

My testimony today will focus on a "hard close" solution at the intermediary level whereby mutual fund orders will be entitled to receive current day pricing, as long as the order is received by a broker-dealer or other intermediary by the time the subject mutual fund determines its net asset value (usually 4:00 p.m. Eastern), provided certain other conditions are met. The testimony is predicated on two core principles. First, that a critical factor is not where an order is physically located at the time a fund's net asset value (NAV) is determined, but rather whether its receipt by such time can be verified with a high degree of certainty. Second, and most importantly, the available hard close solutions must not be detrimental to, or in any way disadvantage, the tens of millions of honest mutual fund shareholders who are not trying to "game" the system.

## II. Current Proposals

### A. Legislative

Section 205 of the Baker bill contains a provision specifically contemplating a hard close at the broker-dealer, plan administrator or other intermediary level, provided such intermediaries have procedures designed to prevent the acceptance of trades after the time at which NAV is determined, and such trades are also subject to an independent audit to verify adherence to those procedures. Sections 306 and 315 respectively of the Corzine-Dodd and Fitzgerald-Collins-Levin bills contain substantially similar provisions, and neither the Akaka or Kerry-Kennedy bills would preclude an intermediary hard close solution.

### B. Regulatory

---

<sup>2</sup> "Mutual Funds Integrity and fee Transparency act of 2003," introduced by Congressman Richard Baker (R-LA).

<sup>3</sup> S.1971 introduced by Senators Corzine and Dodd, S.1958 introduced by Senators Kerry and Kennedy and S.2059 introduced by Senators Fitzgerald Collins and Levin. Senator Akaka has also introduced mutual fund legislation (S.1822), but it does not contain a late trading provision.

<sup>4</sup> SEC Release No. IC-26288 (December 11, 2003)

In December, 2003 the SEC proposed amendments to Rule 22c-1 of the Investment Company Act which would preclude mutual fund orders from receiving current day pricing unless the order was received directly by a fund, its designated transfer agent, or a registered clearing agency by the time the fund establishes its NAV for the day. The SEC proposal followed a recommendation by the Investment Company Institute (ICI) requiring that all orders be received by the fund company by the hard close in order to receive current day pricing.<sup>5</sup> Although the SEC release accompanying the proposal invited comment on whether the SEC should consider an intermediary approach, contrary to the intent of the legislative proposals, the proposal excludes an intermediary solution. The SEC proposal also appears to be inconsistent with the spirit of the legislative initiatives, since with respect to a hard close solution at the fund level it provides neither for procedures designed to detect and prevent late trades, nor for required audits to verify adherence to such procedures. This is no small shortcoming given that in testimony before a Senate subcommittee, the SEC has indicated that it found approximately a 10% shortfall in late trading compliance *at the fund level*.<sup>6</sup> In a recent press release<sup>7</sup> issued in conjunction with the filing of a comment letter on the SEC proposal, the ICI moderated its position stating that

“...The Institute first urged that trade reporting requirements be substantially tightened in early October in the wake of investigations by government officials that revealed late trading abuses involving a number of mutual funds. In renewing its support for tough new requirements today, Institute General Counsel Craig Tyle also encouraged the Commission to consider whether some intermediaries may already be able to “document through unalterable means the precise date and time” when orders were received. In such instances, the letter suggests, the SEC should consider the benefits that could accrue to fund shareholders by allowing the intermediary to receive orders on the fund’s behalf before the hard 4:00 p.m. deadline.”

### III. Feasibility and Implications of Various Hard Close Alternatives

#### A. Hard Close at the Fund Level

Essentially, the SEC proposal allows for hard close solutions only at the fund or registered clearing agency level. In its proposing release, the SEC recognizes that requiring a hard close at the fund level would necessitate that intermediaries establish an earlier (pre-close) cut-off time for investors to submit

---

<sup>5</sup> ICI Press Release “Mutual Fund Leaders Call for Fundamental Reforms to Address Trading Abuses,” (October 30, 2003).

<sup>6</sup> Testimony of Stephen M. Cutler before the Senate Subcommittee on Financial Management, The Budget, and International Security (November 3, 2003).

<sup>7</sup> ICI Press Release “ICI ‘Strongly Supports’ SEC Proposal to Prevent Late Trading of Mutual Funds,” (February 5, 2004).

fund orders and obtain current day pricing, and that with respect to 401(k) plans, investors might not be able to receive same day pricing at all.<sup>8</sup>

This earlier cutoff would be necessary to allow broker-dealers to perform all essential order reviews prior to the 4:00 p.m. close. Among other things, that would include analysis to assure that any sales discounts (breakpoints) are properly applied. Even though many things can be done electronically to check for account linkages, much of this is still a manual process. Because of the numerous and varying rules that each fund group follows, many of these orders need to be held in the firm's system and reviewed manually before they are sent to the Fund/Serv system maintained by the National Securities Clearing Corporation ("NSCC"), and ultimately to the fund. If they are not properly reviewed, investors may not receive the discounts to which they are entitled. Other intermediaries, such as banks, must perform similar tasks prior to sending orders to fund companies.

Orders processed through 401(k) plans<sup>9</sup> involve even more complexities than those faced by broker-dealer recordkeeping systems. For example, 401(k) recordkeepers must place trades collectively, and perform a number of reconciliations at the participant and plan levels when executing transactions. In addition, recordkeepers perform other services that add time to the process, such as determining eligibility for loans, since federal law regulates the amount of a loan based on a participant's account balance, and there are other complexities that I will leave to my co-panelists to address.

The net results of the earlier cut-off time is that the vast majority of fund shareholders who either prefer, or have no alternative but, to deal through intermediaries (as is the case with 401(k) accounts) would be denied the ability to effect fund purchases at current day prices for at least a portion of, and possibly an entire trading day. Correspondingly, with redemptions, shareholders would be exposed to an additional day of market risk. The SEC proposing release suggests that these earlier cutoff times would not impose a significant burden on most mutual fund investors who are making longer term investments, frequently through 401(k) plan payroll deductions, and who treat the time and date of investment as something of a random event.<sup>10</sup> In essence, the SEC is speaking of those investors who are solely investing periodically in a static manner. This fails to consider a whole range of other activities in which 401(k) plan investors engage, which impose risks that cannot be managed through dollar-cost averaging.

For example, various studies have shown that in 2002 between 14 and 23.1% of 401(k) plan participants had outstanding loans, and 21% of participants

---

<sup>8</sup> See SEC proposing release at 4.

<sup>9</sup> Approximately one third of all mutual fund shares are held in 401(k) plans. See SEC proposing release, note 8.

<sup>10</sup> See proposing release, at 5.

with account balances took a plan distribution.<sup>11</sup> Additionally, a major plan administrator reported that in 1998, 24% of their plan participants made exchanges. Furthermore, exchanges increase with age, with a concentration in investors in their 50s and 60s, who have the largest amount of retirement funds. Such participants made an average of 3 exchanges annually.<sup>12</sup> Furthermore, a growing number of 401(k) participants are employing mutual fund portfolio rebalancing services that enable such participants to establish and maintain a targeted asset allocation in accordance with their investment objectives and risk tolerance. Rebalancing usually occurs several times a year. Our firm alone has 800,000 participants enrolled in such a program.

Therefore, the SEC's analysis fails to address what we believe to be the most substantial risks to 401(k) participants – the inability to promptly liquidate or exchange a large mutual fund portfolio in a rapidly declining market. In that regard, it should be noted that during the five-year period ending December 2003, the Standard & Poor's 500 Index declined by 1% or more on 257 days.<sup>13</sup> Thus, a 401(k) participant approaching retirement seeking to liquidate a \$500,000 equity mutual fund portfolio,<sup>14</sup> to purchase an annuity in a declining market, could easily lose thousands of dollars by being “locked-in” to his or her investment for an additional trading day. This type of result would potentially cause significantly greater harm to the participant.<sup>15</sup>

In addition to the disproportionate impact on market risk exposure the fund hard close remedy would have on fund investors, it also fails to provide for an effective, tamper-proof, electronic order capture time-stamping system. The proposed remedy merely carries over the same time-stamping requirement already included in rule 22c-1, which recent history has shown to be prone to abuse both at the fund and broker-dealer levels. We believe adopting the SIA's electronic order capture time-stamping approach for funds, brokers, and 401(k) intermediaries can cure this shortcoming. The problems associated with early order cut-offs cannot be readily resolved, and mutual fund investors should not be faced with the choice of having to either be denied market access during all or a portion of the trading day, or foregoing effecting their transactions through intermediaries – the preferred choice of more than 88% of fund investors. Nor should any solution be adopted which creates a competitive disadvantage between

---

<sup>11</sup> See “Beyond the Numbers, The 2003 Annual 401(k) Report,” Principal Financial Group, p.50. Also, “Profit-Sharing/401(k) Council's 46<sup>th</sup> Annual Survey of Profit Sharing and 401(k) Plans”, p. 43 (2003).

<sup>12</sup> See “Building Futures: How American Companies Are Helping Their Employees Retire. A Report on Corporate defined Contribution Plans”, Fidelity Investments p. 32-33. (1998).

<sup>13</sup> Source: Standard & Poor's Index 1999-2003. Data provided by Reuters.

<sup>14</sup> Assumes \$3,000 annual contributions over a 30-year period with an average annual rate of return of 10%. The actual annual average return of the S&P 500 for the 30-year period ending December 2003 was 12.2%.

<sup>15</sup> The proposing release, note 42, cites a study by Professor Eric Zitzewitz which estimates that fund shareholders collectively lose as much as \$400 million annually as the result of late trading. This figure would translate to approximately ½ of a basis point (.00005) of fund assets, based on total fund assets of \$7.4 trillion, or about \$25 per annum for each \$500,000 of fund assets owned.

financial institutions. Therefore, the fund hard close proposal should not be adopted as an exclusive remedy.

B. Hard Close at a Registered Clearing Agency

SIA members and representatives have attended exploratory meetings at NSCC, the only current registered clearing agency, regarding the possibility of developing a systems modification whereby intermediaries could submit mutual fund orders to the NSCC Fund/Serv system at or prior to 4:00 p.m. NSCC Fund/Serv, through its various linkages, would then transmit the orders to the applicable funds. Therefore, while SIA supports further efforts to determine the feasibility of an NSCC hard close solution, and looks forwarding to continuing to work cooperatively with the NSCC as the process moves forward, given its current status and the considerable amount of time it will take to develop, it should not serve as an exclusive solution. Under the proposal it would be necessary for intermediaries to transmit “unenriched” orders, which do not include all the data to execute, to NSCC by 4:00 p.m. in order to obtain current day pricing, and then forward enrichment data (such as information relating to sales breakpoints,) after the close. This would essentially turn a one-step process into two steps, and to our understanding it has not yet been determined with certainty what impact that will have on operating efficiencies. Also, the NSCC solution is likely to cause intermediaries to batch more fund orders near the close in an effort to reduce the number that will require subsequent transmission of enrichment data. The impact of such batching will need to be addressed. It is, of course, of utmost importance to assure that any systems or procedural changes implemented by NSCC to address late trading do not inadvertently compromise the efficiencies achieved by its mutual fund clearance and settlement process, which has served its participants and investors so well. It is also uncertain whether this would provide sufficient relief to 401(k) plan participants with respect to early cutoff times.

C. Hard Close at the Intermediary Level

With regard to intermediaries, SIA recommends a three-pronged solution whereby the place of order acceptance to which the hard close would apply, would include:

1. For Broker-Dealers

The broker-dealer’s electronic order capture and routing system which assigns a verifiable order entry time aligned with the atomic clock currently used for equity order time-stamping, provided the other conditions set forth in the Baker, Corzine-Dodd and Fitzgerald bills are met.

2. For Other Regulated Entities  
The electronic order capture system of regulated entities not currently under the SEC's jurisdiction, but regulated by the OCC or other regulator, which would impose a companion rule to require a hard close on order acceptance by 4:00 p.m.
3. For Non-Regulated Entities  
Such entities would have to employ an electronic order capture time-stamping system which is functionally equivalent to that utilized by broker-dealers and other regulated entities. Such "functional equivalency" would need to be certified to by an independent third-party and such certification provided to the fund complexes for whom the fund transactions are processed, and the system would be subject to the same independent audit requirements set forth in the pending legislation.

The SIA recommendation contemplates that orders not accepted into the intermediary's system by the hard close, even where the lack of timely receipt was due to legitimate errors, would, without exception, receive next day pricing. Thus, corrections would have to be effected through their error account, and they, not fund shareholders, would bear the economic risk of loss with respect to any orders processed after the hard close. It is most important to note that, unlike the current time-stamping procedure contained in rule 22c-1, and which would merely be perpetuated in the SEC's proposal, the SIA proposal would impose stringent additional requirements on the use of time-stamping methodology that would make it extremely difficult to "game" the system. The SIA recommendation as it relates to broker-dealers, reflects an approach similar to the NASD's Order Audit Trail System ("OATS"), which is an integrated audit trail of order, quote, and trade information for NASDAQ securities. The applicable NASD rules<sup>16</sup> required member firms to develop a means for electronically capturing and reporting specific data elements relating to the handling or execution of orders, including recording all times of these events in hours, minutes and seconds, and to synchronize their business clocks.

Broker-dealers already subject to OATS requirements should be able to readily transfer the OATS technology to mutual fund order processing without incurring significant additional costs. We understand that there are a number of service providers who may be able to offer similar capabilities to other intermediaries, and that certain other intermediaries may be able to develop this capability internally.

---

<sup>16</sup> NASD Rules 6950-6957, approved by the Commission on March 6, 1998, and as amended on July 31, 1998.

It is our understanding that OATS has significantly enhanced the NASD's ability to track and audits NASDAQ equity orders and detects violations of NASD rules. Utilizing that same technology for tracking mutual fund orders should bring similar benefits to the SEC's examination staff. Additionally, internal compliance reviews and outside audits of broker-dealers and/or other intermediaries could include some or all of the following:

- Written policies and procedures and other controls designed to detect late trading.
- Periodic review of such policies, procedures and controls.
- Periodic audits including random testing of orders (conducted both internally and by outside auditors) to validate the integrity of the system.
- Reviews of error accounts to detect patterns that might be indicative of late trading.

In summary we believe the SIA recommendation would eliminate the inadequacies of the current time-stamping system and create a readily auditable order trail, while avoiding the significant adverse consequences of an earlier order cutoff time. Furthermore, the SIA recommendation could be implemented expeditiously, whereas the NSCC solution would require a lengthy developmental process, and the funds themselves may not be equipped to handle the large increase in direct transactions that could occur if the SEC's proposal is adopted, without modification.

#### IV. Conclusion

In summary, SIA believes that electronic and auditable electronic time-stamping systems, which intermediaries and funds would be required to utilize, is a critical component of any effective hard close rulemaking solution. While imposing a hard close at the fund or registered securities clearing agency should be among the available alternatives, these measures should not be the exclusive solutions, given that they either have negative consequences for innocent investors, or remain untested. On the other hand, significant positive experience with electronic stamping system through OATS strongly supports a technological solution. Importantly, this type of approach would place the vast majority of investors holding their fund investments through intermediaries on a more level playing field with other investors.

We commend the Committee for its efforts to swiftly and effectively address abusive practices such as late trading, and believe that such measures are essential to maintaining the integrity of our capital markets, and retaining the public trust of the 95 million Americans for whom mutual funds are a core investment vehicle.

Thank you.