

**Testimony of
Raymond K. McCulloch
On Behalf of the American Bankers Association
Before the
Committee on Banking, Housing, and Urban Affairs
United States Senate
March 2, 2004**

Mr. Chairman, I am Raymond McCulloch, Executive Vice President for BB&T Trust, based in Raleigh, North Carolina. I have over 26 years of banking experience, the last twelve of which have been focused on BB&T's institutional trust and employee benefit lines of business. I have previously served as Chairman of the American Bankers Association's National Senior Employee Benefit Services Committee and hold the professional designation of Certified Retirement Services Professional. BB&T Trust administers over 2,200 employee benefit plans, with an average of 250 participants and total assets of \$5.2 billion. BB&T Trust's parent, BB&T Corporation, Winston-Salem, N.C., is the nation's 13th largest bank with over \$90 billion in assets.

I am pleased to testify on behalf of the American Bankers Association (ABA). ABA brings together all elements of the banking community to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional, and money center banks and holding companies, as well as savings institutions, trust companies, and savings banks – makes ABA the largest banking trade association in the country. The views in my testimony today are also endorsed by the ABA Securities Association (“ABASA”). ABASA is a separately chartered trade association and non-profit affiliate of the ABA whose mission is to represent before the Congress, the federal government and the courts the interests of banking organizations engaged in underwriting and dealing in securities, proprietary mutual funds and derivatives.

The ABA is pleased to testify on the issue of late trading for mutual funds. As investors in mutual funds, either for our own portfolio or for that of our fiduciary and brokerage clients, as well as transfer agents and investment advisers to mutual funds, our members are quite concerned about this issue.

Let me be very clear: ***ABA members emphatically believe that late trading has no place in mutual funds.*** This practice is illegal under current law and we applaud the enforcement actions of the Securities and Exchange Commission (SEC) and other regulators to punish those at fault. More can be done to prevent late trading. We would submit, however, that any additional legislative or regulatory solutions to combat late trading should: (1) protect mutual fund investors; (2) restore investor confidence in mutual funds; (3) preserve choice of distribution channels; and (4) not limit investment options for mutual fund investors.

The SEC has put forth a proposal, often referred to as a “4:00 p.m. hard close.” This rule, which amends Rule 22c-1 under the Investment Company Act, provides 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, i.e., the National Securities Clearing Corporation (“NSCC”), receives the order by the time that the fund establishes for calculating its net asset value (“NAV”). While at first blush this seems to be a simple solution to the problem, it would in fact result in different cutoff times in practice for mutual fund companies and intermediaries that sell shares of funds of those companies. This would create unnecessary confusion for investors and disruptions in the mutual fund market. ***The ABA and ABASA strongly oppose the mandatory 4:00 p.m. hard close as it would have detrimental effects on investors.*** Fortunately, technologies exist today that can accomplish the intended goals without risking investor confusion and market disruptions.

Thus, in my statement today, I would like to emphasize two key points:

- **A “hard close” discriminates against investors based solely upon their choice of distribution channel and denies investors choice by limiting their investment options.**
- **Alternatives to a hard close exist that can accomplish the goal of preventing late trading without disadvantaging mutual fund shareholders.**

I will address each of these in turn.

A “Hard Close” Discriminates Against Investors Based Solely Upon Their Distribution Channel and Limits Investment Options

As mentioned above, the proposed amendment would provide that a mutual fund order receive the current day’s price only if received before the deadline for determining the fund’s NAV by the fund, its designated transfer agent, or a registered securities clearing agency. Typically, most funds calculate NAV when the major U.S. stock exchanges close at 4:00 p.m. Eastern Time. ***Importantly, fund intermediaries, including broker-dealers and retirement plan administrators, would not be able to receive orders up to that same time. They would be required to establish earlier trading cut-off times – as much as six or more hours earlier – in order to transmit mutual fund orders to the fund, transfer agent or clearinghouse in time for the 4:00 p.m. hard close.*** Thus, it creates *in practice* different cut-off times for mutual fund companies than for intermediaries that sell shares of funds of those companies.

Thus, while the 4:00 p.m. hard cut-off would eliminate the potential for late trading through intermediaries that sell fund shares, the unintended consequences are severe. We see no reason to fix a problem caused by a few, yet discriminate against the vast majority of mutual fund investors who use intermediaries, including the millions currently saving for retirement through their company’s 401(k) or individual retirement accounts. Over \$2.11 trillion in assets were invested in defined contribution plans as of year-end 2001, the vast majority of which are in 401(k) plans, according to Employee Benefit Research Institute. As discussed below, there are better, less problematic methods to address late trading.

To understand the problems created by the SEC proposal, it is important to understand the operational complexities of these transactions. For example, processing 401(k) plan participant orders is an operationally complex and time-consuming task, no matter which type of financial intermediary is servicing the plan. There are multiple processes and systems involved for correlating and transferring data between receipt of the participant’s order and delivery of that order to the fund company. Processing trade orders for a typical participant-directed plan involves as many as five steps and four systems between the participant trade request and fund company receipt. Specifically, once the participant communicates a trade request (before the 4:00 p.m. Eastern Time market close), it is moved to the primary participant recordkeeping system, where it is given a value and reconciled with that

participant's account. The participant's transaction is then combined and netted with others from that same plan, each one having been previously reconciled and valued. Next, the plan's trade orders are combined with other transactions from other plan accounts held by that recordkeeper, which are again valued, netted and reconciled. The penultimate step requires the recordkeeper's net trade order to be turned over to the intermediary where it is valued and combined with trades of other recordkeepers for a single transmission on each fund. These processing steps are taken after the 4:00 p.m. close to give plan participants the same consideration for trade orders as a direct investor and to allow both sides (sale and purchase) of an investment option or rebalance of portfolio to occur as of the same trade date.

At BB&T, this process generally takes about three hours. Other banks have estimated that this may take six hours or more, which means that trade orders would have to be placed ***before 10:00 a.m.*** Eastern Time in order to have any chance to get today's NAV. For plan participants located on the West Coast, the chance of receiving that day's NAV is even slimmer.

The discriminatory impact of the proposed 4:00 p.m. hard close is most clearly illustrated when an individual investor invests in the same mutual fund through three different distribution channels: a retail brokerage account, a 401(k) plan trustee by a bank, and an account held directly by the mutual fund. Today, if that investor makes an investment decision at 3:00 p.m. on day one that he or she wants to redeem the mutual fund shares held in all three accounts and communicates that decision simultaneously to all three financial service providers, the investor's trade orders for all three accounts will be effected at today's NAV. ***Under the proposed 4:00 p.m. hard close, the investor's trade order will be effected at two, and possibly three, different NAV prices despite the fact that the decision to redeem was communicated at the exact same time.***

Specifically, the account held at the mutual fund will definitely receive today's NAV. The account held at the brokerage account may or may not receive today's NAV depending on the amount of processing required. The degree of processing required for plan participant orders guarantees that the mutual fund shares held through the 401(k) plan will be priced at the next day's NAV, or possibly the NAV for additional days later. Different NAV prices for simultaneous orders will initially lead to investor confusion and, most likely, create a strong investor bias towards dealing directly with the mutual fund for all types of investment accounts.

The transaction discussed above involves a simple redeem or purchase order. Even more complexity is involved when a participant's order involves a *transfer* from one fund to another, i.e., a simultaneous redemption and purchase. Today, if a participant places an order to sell 1000 shares of Fund X and use the proceeds to purchase shares in Fund Y, a bank trustee can process both legs of the transaction, because, some time after the 4:00 p.m. market close, they have electronically been provided with NAVs for both Funds. With a 4:00 p.m. hard close to the mutual fund, the bank trustee would have to place the order to redeem 1000 shares of Fund X before 4:00 p.m. Without a NAV for Fund X, the bank trustee could not place the purchase order for Fund Y before 4:00 p.m. Instead, the plan participant will purchase Fund Y shares at the next day's NAV. Here, again, a 4:00 p.m. hard close favors the mutual fund distribution channel over that provided by banks, broker-dealers, and others. Under the proposed 4:00 p.m. hard close, the participant's redemption and purchase orders will both be effectuated at today's NAV if both Fund X and Fund Y are members of the same fund family.

The differing cutoff times would encourage investors to deal directly with mutual funds or their agents, rather than through intermediaries. Investors who invest directly with the mutual fund will get the benefit of today's NAV, while investors who invest through intermediaries will get the next-day's NAV, at best. The ABA is strongly opposed to a system that discriminates against investors based solely upon their choice of distribution channel.

Creating incentives to deal directly with mutual funds rather than intermediaries would also mean that investors would gravitate to only one family of funds, regardless of whether those funds were "best in class" among all funds of a similar type and investment strategy. Thus, the ability of investors to choose the best combination of funds across all funds that are offered would be limited, denying investors both diversification and potential returns. For example, many employee benefit plans today offer participants fifteen or more investment options from a *variety of mutual fund providers*. For example, at BB&T, we offer over 200 funds from a wide variety of sponsors, including SEI, Managers, Vanguard, Oppenheimer, American, Dodge & Cox, T. Rowe Price, Fidelity, Goldman Sachs, Ariel, Royce, and AIM in addition to BB&T Funds. We trade over 100 funds each day. If a 4:00 p.m. hard close is in place, investors may be forced to choose only one mutual fund provider to be able to receive daily valuation and trading. If an investor is invested entirely in one fund family, there is far

greater potential for loss if that fund family encounters difficulties. History has shown time and again that lack of diversification hurts investors.

Simply put, a 4:00 p.m. hard close favors the mutual fund distribution channel over that provided by banks, broker-dealers and other intermediaries because it allows the mutual fund complex to perform the processing tasks after 4:00 p.m. while all other providers must perform the requisite processing before 4:00 p.m. ***ABA strongly believes that the SEC should avoid adopting a solution to prevent illegal late trading that discriminates against investors based solely upon their choice of one distribution channel over another.*** The consumers should not be sacrificing choice to be able to receive daily valuation.

An Alternative to Hard Close Exists That Will Not Disadvantage Investors

Fortunately, alternatives to the 4:00 p.m. hard close do exist that would eliminate the potential of illegal late trading without disadvantaging mutual fund shareholders. The key to this solution is to require a tamper-proof order capture system where the entry time of an order can be verified with a high degree of certainty. An independent company would do the time stamping. ***This would allow fund intermediaries to receive orders up to the time of the NAV calculation.***

We believe that the technology exists today to permit the creation of a tamper-proof system for ensuring that trades are, in fact, received at the time the trade is stamped and cannot be altered after the time stamped without detection. The large volume of daily mutual fund trades requires an electronic network solution. Applications using cryptography, particularly one referred to as public key infrastructure (PKI), are increasingly being used in banks, corporations, and the federal government. Digital signatures are one example of how PKI technology identifies the signer and ensures the integrity of the signed data. Digital signatures on every transmission would authenticate the parties involved and also encrypt the content of every message, thereby permitting any alteration to a message content to be detected. Companies are already working to make the “signing” of documents electronically using digital certificates as simple as signing a piece of paper with a pen. Similarly, algorithms are already being used to create a unique identifier or a fingerprint of any file that would work for time stamping.

If the file's contents change at all – even if only an extra space is put in one line – then a different fingerprint is created, making it clear that an alteration has taken place.

Most companies that use digital time stamping use encryption hardware that is certified by the National Institute of Science and Technology. We believe that the time-stamping of the file should be done by an independent company storing the certified encryption hardware. The company that time-stamps the order would digitally sign the data using digital certificates, thus creating a verifiable and auditable method for assuring the time of the transaction and integrity of the original data. This solution can accommodate trade orders placed by intermediaries either individually or in batch form.

There would, of course, be other associated requirements consistent with this approach that would have to be employed by the intermediary. For example, operating business standards and technical interoperability requirements that ensure consistency and legal reliability will likely be needed. Audit programs and compliance review programs could then examine and validate that the institution's policies and procedures contain the necessary controls to ensure integrity in the trading process.

Thus, the elements of such a system could include:

- Electronic time-stamping of orders in a manner that orders cannot be altered or discarded once entered into the trading system;
- Annual certification that the intermediary has policies and procedures in place designed to prevent late trades, and that no late trades were submitted to the fund or its designated transfer agent during the period; and
- Submission of the intermediary to an annual audit of its controls conducted by an independent public accountant who would submit his report to the fund's chief compliance officer.

ABA recognizes that not all mutual fund companies, transfer agents, or intermediaries have the capability or desire to input a technology solution such as we have suggested. For example, we understand that some mutual fund companies only accept trade orders with original signatures and accompanying medallion stamps through the mail. Moreover, PKI technology can be expensive to

implement, although programs that are just now coming to market will make PKI technology more accessible to smaller financial institutions and intermediaries. Thus, it is important that the approach be flexible, be sensitive to the attendant costs, and provide a considerable implementation period of at least one year.

The point is this: technology exists today – and is rapidly improving – that can be used to create a solution that meets the goal of assuring no late trading is occurring and does not create adverse consequences for investors.

Conclusion

As investors in mutual funds, either for our own portfolio or for that of our fiduciary and brokerage clients, as well as transfer agents and investment advisers to mutual funds, ABA member banks applaud the SEC's goal of protecting mutual fund investors and restoring investor confidence in mutual funds by taking steps to eliminate the potential for illegal late trading. We are encouraged that the SEC is attacking the current market scandals by bringing swift enforcement actions when wrongdoing is uncovered and believe that those who violate the current prohibition on late trading should be brought to justice. We also believe that further regulation designed to prevent or minimize the possibility of these abuses occurring in the future is warranted.

The ABA appreciates efforts by Senators and Congressmen to assure that solutions to late trading do not disadvantage investors. We are hopeful that with your strong encouragement the final SEC regulation will recognize this as well; should it not, addressing this through legislation will become necessary.

Thank you for the opportunity to present the views of the American Bankers Association.