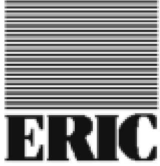

The ERISA Industry Committee

Advocating the Employee Benefits Interests of America's Largest Employers
1400 L Street N.W., Suite 350, Washington, D.C. 20005
phone 202-789-1400 / fax 202-789-1120 / e-mail eric@eric.org

STATEMENT OF
THE ERISA INDUSTRY COMMITTEE

SUBMITTED TO
THE U.S. SENATE COMMITTEE
ON
BANKING, HOUSING, AND URBAN AFFAIRS

HEARING
ON
REVIEW OF CURRENT INVESTIGATIONS AND REGULATORY ACTIONS REGARDING THE MUTUAL FUND INDUSTRY: FUND OPERATIONS AND GOVERNANCE

March 2, 2004

The ERISA Industry Committee ("ERIC")[1] is pleased to submit this statement regarding late trading and the Securities and Exchange Commission's proposed amendments to the rule under the Investment Company Act requiring forward pricing of redeemable securities issued by registered investment companies ("mutual funds"). The Commission's proposed amendments provide that an order to purchase or redeem mutual fund shares will 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 ("NAV") -- generally, 4:00 p.m. Eastern Time. The proposed amendments were published in the Federal Register on December 17, 2003. *See* 68 Fed. Reg. 70,388.

---

[1] ERIC is a nonprofit association committed to the advancement of the employee retirement, health, incentive, and welfare benefit plans of America's largest employers. ERIC's members provide comprehensive retirement, health care coverage, incentive, and other economic security benefits directly to some 25 million active and retired workers and their families. ERIC has a strong interest in proposals affecting its members' ability to deliver those benefits, their costs and effectiveness, and the role of those benefits in the American economy.

All of ERIC's members sponsor individual account retirement plans, including some of the largest individual account plans in the country, covering tens of thousands of employees and beneficiaries. These plans, most of which are § 401(k) plans, commonly give participants the right to direct the investment of all or part of the investments in their accounts.

These plans are extremely important to employers and employees alike. They provide valuable retirement and other benefits to employees and help employers to recruit, retain, and motivate employees. ERIC's members therefore have a vital interest in assuring that the rules achieve their objectives in a fashion that is consistent with sound plan design and administration.

In 1998, according to the U.S. Department of Labor, there were approximately 300,000 § 401(k)-type defined contribution plans, with over 37 million active participants and over $1.5 trillion in assets. The vast majority of these plans allow participants to direct the investment of all or part of the assets allocated to their accounts. Of the 300,000 § 401(k)-type defined contribution plans in 1998, over 238,000 were participant-directed plans, with nearly 31 million active participants and over $1.25 trillion in assets.[2]

Summary

1. ERIC commends Congress and the Commission for promptly addressing the late-trading abuses that have recently come to light in the mutual fund industry. However, because the Commission's proposed solution discriminates against retirement plan participants, it will fail to restore investor confidence in the equity and soundness of mutual funds. We urge the Committee to ensure that final rules do not discriminate against retirement plan participants.

2. The Commission's proposed amendments relegate participants in § 401(k) and other retirement plans to second-class investor status by depriving many of them of the ability to buy or redeem mutual funds at the closing price on the day they submit their purchase and redemption orders. The proposed amendments are likely to reduce retirement savings by discouraging employees from participating in retirement plans.

3. Retirement plans should be allowed to submit orders to designated transfer agents after the deadline for orders if the plan's recordkeeper has adopted adequate precautions to protect against late trading. Such precautions could include the following:

   (a) Secure time-stamping of orders;

   (b) An annual audit of the plan recordkeeper's controls on late trading; and

---

[2] Pension and Welfare Benefits Administration, U.S. Dep't of Labor, Private Pension Plan Bulletin Abstract of 1998 Form 5500 Annual Reports, Table D6 (Winter 2001-2002).

(c) An annual certification that policies and procedures are maintained by the plan's recordkeeper to prevent late trades and that no late trades were effected during the period under audit.

4. We hope that the Commission will permit the alternative approach that we recommend. If the Commission does not do so, however, we urge the Committee to approve legislation that permits our recommended approach. H.R.2420, passed overwhelmingly by the House of Representatives, instructs the SEC to issue rules to address late trading that permit late processing by retirement plan and other intermediaries if procedures exist to prevent late trading and such procedures are subject on an independent audit. Similar provisions are found in S. 1971, cosponsored by Senators Corzine, Dodd and Lieberman; and S.2059, cosponsored by Senators Fitzgerald, Levin, and Collins.

Discussion

1. ERIC commends Congress and the Commission for promptly addressing the late-trading abuses that have recently come to light in the mutual fund industry. However, because the Commission's proposed solution discriminates against retirement plan participants, it will fail to restore investor confidence in the equity and soundness of mutual funds.

Because the vast majority of employer-sponsored defined contribution plans allow participants to direct the investment of their retirement accounts, and because many participant-directed plans offer mutual funds as investment options, ERIC has a strong interest in assuring that mutual funds operate efficiently, equitably, and lawfully.

ERIC is deeply concerned by the recent reports of widespread "late trading" -- the practice of permitting a redemption order received after 4:00 p.m. to receive the share price calculated as of 4:00 p.m. (*i.e.*, before the order is submitted). A late trader can take advantage of events occurring after 4:00 p.m., such as earnings announcements, to buy on the basis of good news or to sell on the basis of bad news -- at the expense of other investors in the mutual fund, many of whom are often retirement plan participants.

ERIC therefore strongly supports the prompt attention that the Commission has given to the late trading practices promptly after they came to light. Late trading unfairly advantages late traders at the expense of retirement plan participants and other investors and erodes the confidence of plan participants and other investors in the efficiency, equity, and soundness of mutual funds.

However, the Commission's proposed remedy for late trading will fail to restore investor confidence in the equity and soundness of mutual funds. As we explain in the following section of this statement, the Commission's proposed amendments will relegate retirement plan participants to second-class investor status by effectively depriving many of them of the ability to buy or redeem mutual funds at the closing price on the day they submit their purchase and redemption orders.

2. The Commission's proposed amendments discriminate against participants in § 401(k) and other retirement plans and are likely to reduce retirement savings by discouraging employees from participating in retirement plans.

Currently, plan recordkeepers and administrators commonly agree with mutual fund managers that plan participants and beneficiaries can have their transactions effected as of the fund's generally applicable 4:00 p.m. deadline as long as the recordkeeper or administrator receives directions from the participants and beneficiaries by the 4:00 p.m. deadline, even though the recordkeeper or administrator subsequently processes and aggregates the transactions and provides the mutual fund manager with aggregate instructions some time after the 4:00 p.m. deadline. This practice allows plan participants and beneficiaries to direct transactions on the basis of terms and conditions that are comparable to those that apply to individuals who deal directly with mutual funds or their designated transfer agents.

The Commission's proposed amendments, however, will relegate retirement plan participants to second-class status and put them at a disadvantage in comparison to individual investors. While individual investors will be able to buy and sell mutual fund shares right up to the 4:00 p.m. deadline, retirement plan participants will be required to give their buy or sell directions to plan recordkeepers and administrators much earlier in the day (or even the previous business day) in order to have their transactions executed at the 4:00 p.m. closing price. This is so because the plan's recordkeeper or administrator will be required to impose an earlier deadline on plan participants and beneficiaries in order to process, combine, and communicate to the mutual fund the thousands of directions it receives daily from plan participants and beneficiaries.

For example, on any given day, a plan recordkeeper or administrator might have to review and process thousands of requests to make investment switches, applications for withdrawals, distributions, and loans, and new investments in the plan (*e.g.*, rollovers and new contributions). If a plan participant wishes to make a hardship withdrawal from a § 401(k) plan, for example, the plan administrator must confirm that the participant has sufficient funds in his or her account to finance the withdrawal, that the participant is eligible to make a withdrawal (*e.g.*, confirm that the participant meets the plan and Internal Revenue Code requirements for making a hardship withdrawal), and that the funds that the participant seeks to withdraw are eligible for withdrawal; all of these steps must be taken for *all* participants *before* the administrator submits the plan's aggregate net purchase or redemption order to the mutual fund or its designated transfer agent. If all of these transactions must be submitted to the mutual fund by 4 p.m. in order for participants and beneficiaries to obtain the benefit of that day's 4 p.m. NAV, the plan's recordkeeper or administrator will be required, as a practical matter, to mandate that participants and beneficiaries submit their transactions by a much earlier time (for example, by noon Eastern Time or 9 a.m. Pacific Time).

Because they will discriminate against retirement plan participants, the Commission's proposed amendments will discourage employees from participating in retirement plans and depress retirement savings. Employees who have a choice between saving under a retirement plan and individual saving will be encouraged by the Commission's proposed amendments to save on their own rather than through the retirement plan.

Although retirement plan participants typically regard their plan investments as long-term investments for retirement, they do not necessarily regard their specific investment choices (for example, the particular mutual funds they have chosen) as long-term commitments. Many plan participants want the capability of moving promptly from one investment to another at appropriate times of their choosing. If a retirement plan does not give them this capability, participants will be encouraged to save on their own outside of the retirement plan rather than under the retirement plan.

The Commission's proposing release gives little weight to these concerns; it characterizes retirement plan participants as long-term investors who are generally insensitive to the time at which purchase or redemption orders are processed. Long-term investors, however, still make investment decisions -- such as the decision to move their account from one mutual fund to another -- at a particular time, and are indeed quite sensitive the prices at which such transactions are consummated.

Today, an investment transfer -- whereby a plan participant transfers all or part of his or her account from one mutual fund to another -- can be effected at the current day's 4 p.m. NAV, as long as the participant submits appropriate investment instructions to the plan's recordkeeper by 4 p.m. on that day. By contrast, under the Commission's proposed amendments, the same transaction could take several days: if the order were submitted to the plan's recordkeeper on Thursday afternoon, for example, it probably would not be possible to effect the redemption portion of the transaction until Friday at 4 p.m. and, since the redemption proceeds would not be known until late on Friday, the purchase portion of the transaction probably could not be effected until the following Monday at 4 p.m. Thus, a transaction that can be accomplished in one day today could require *five days* under the Commission's proposed amendments. Because day-to-day fluctuations in share prices can be very substantial, even a one-day lag -- and, *a fortiori*, a five-day lag -- can make a big difference to plan participants, who will not understand the reason for, or be sympathetic with, delays that cause them to incur investment losses and prevent them from realizing investment gains.

The Commission's proposed amendments will undermine employee confidence in the equitable administration of their retirement plans. Employees will not understand why the purchase and redemption orders that they submit outside of a plan, directly to a mutual fund, receive the benefit of same-day pricing (for orders submitted by 4 p.m.), while the orders they submit to a retirement plan do not. Moreover, where a retirement plan is administered by a member of a mutual fund family, employees will not understand why the orders they submit with respect to funds within the family receive the benefit of same-day pricing (for orders submitted by 4 p.m.), while orders submitted with respect to funds outside of the family do not. The disparate results that will occur under the Commission's proposed amendments will bewilder employees, will undermine their confidence in their retirement plans, and could cause some employees to reduce their plan contributions or to cease contributing altogether.

To the extent that the Commission's proposed amendments cause individual savings to replace retirement plan savings, they will reduce retirement savings. Savings under retirement plans have advantages that cannot be matched by individual savings: matching employer contributions, pre-tax savings under Internal Revenue Code § 401(k), tax-free investment growth, the discipline of saving on a payroll deduction basis, tax penalties on early

withdrawals, tax-free rollover opportunities, and the selection of investment options, including mutual funds offered by different mutual fund families, by experienced and expert fiduciaries. Individual savings arrangements do not have these advantages.

The Commission should not adopt amendments that undermine one of the fundamental objectives of our nation's employee benefit laws: to encourage and support retirement savings. The Commission should not penalize an individual who chooses to save through a retirement plan, rather than through an individual arrangement, merely because the financial intermediary that administers the retirement plan is not affiliated with mutual funds that the plan offers.

Moreover, the Commission's proposed amendments will interfere with prudent and efficient investment of retirement plan assets. The proposed amendments will favor bundled retirement plan services offered by mutual fund families, which will be able to offer same-day pricing for transactions involving their own funds, over independently-administered plans which offer independently-managed investment options, but will not be able to offer same-day pricing under the proposed amendments.

By creating a regulatory regime that favors plans administered by mutual fund families (and in favor of the mutual funds in that family), the Commission's proposed amendments could distort the judgments of plan participants when they make investment decisions and distort the judgments of employers when they select plan administrators. Such distortions are not in the interest of retirement plan participants or in the interest of our economy.

Plan participants and the economy as a whole will benefit from a regulatory regime that does not distort the judgments that plan fiduciaries must make when they select the investment options that are in the best interests of plan participants: plan fiduciaries should not be required to compel plan participants to give up same-day pricing in order for the plan to offer mutual funds that are not affiliated with the plan's administrators. Plan participants and the economy as a whole will benefit from capital markets that operate on a level playing field, rather than a playing field that is tilted in favor of some investment vehicles and against others.

Many plan fiduciaries have responded to revelations of abuse in the mutual fund industry by dropping tainted funds offered by their plans and replacing them with untainted funds. If the Commission's proposed amendments become effective, however, plan fiduciaries will be discouraged from making such changes -- particularly where the plan is administered by an affiliate of a mutual fund family and offers only mutual funds that are members of the same family. In the past, plan fiduciaries have responded to reports of abuse by dropping tainted funds within the mutual fund family and replacing them with outside funds. The Commission's proposed amendments, however, will discourage fiduciaries from shifting to outside funds, since the use of outside funds will likely require participants to give up same-day pricing. Discouraging fiduciaries from shifting to outside funds will interfere with fiduciaries' efforts to select funds that best serve the interests of plan participants. The Commission's proposed amendments will thus harm participants, not help them.

Although the Commission is appropriately concerned about the abusive practices that some financial intermediaries have engaged in under current law, retirement plan

participants should not be penalized for the abusive practices of those intermediaries. The remedies for the abuses of intermediaries should be directed at the intermediaries themselves, not at the millions of retirement plan participants who have not engaged, and have no intention of engaging, in abusive conduct. In the following section of this statement, we recommend an approach that is appropriately targeted at intermediaries rather than at retirement plan participants.

3. Retirement plans should be allowed to submit orders to designated transfer agents after the deadline for orders if the plan's recordkeeper has adopted adequate precautions to protect against late trading. Such precautions could include the following:

    (a) Secure time-stamping of orders;

    (b) An annual audit of the plan recordkeeper's controls on late trading; and

    (c) Annual certification that policies and procedures are maintained by the plan's recordkeeper to prevent late trades and that no late trades were effected during the period under audit.

The approach that we recommend will prevent the vast majority of the late-trading abuses with which the Commission is properly concerned. In its proposing release, the Commission raised the possibility that an independent auditor might fail to detect weaknesses in a fund's internal controls that would allow late trading to occur. 68 Fed. Reg. 70,390. However, no rule can offer complete protection against abuse. Even the Commission's proposed amendments could be abused by unscrupulous mutual funds. The approach that we recommend will prevent the vast majority of late-trading abuses, and the Commission can issue guidance and bring enforcement actions to encourage independent auditors to be vigilant in reviewing intermediaries' internal controls against late trading.

In its proposing release, the Commission also raised questions about the cost of adopting the approach that we recommend. The advantage of this approach, however, is that it does not **require** a plan to bear any additional costs. The plan sponsor or the plan's fiduciaries would decide, in their discretion, whether to take use the approach we recommend; they would to not be required to use it.

Any implementation costs would be borne by either the employer or the plan and its participants and beneficiaries.[3] We anticipate that the implementation costs would be relatively small for the administrators of large plans, where the implementation costs would represent a small percentage of the employer's total contribution to the plan (if the costs are borne by the employer) or a small percentage of the plan's total assets (if the costs are borne by

---

[3] The Employee Retirement Income Security Act of 1974 ("ERISA") allows reasonable plan administration expenses to be paid by the plan. *See* ERISA § 404(a)(1)(A). If an individual account plan pays administration expenses, the expenses borne by the plan reduce the value of each participant's and beneficiary's account under the plan. *See* ERISA § 3(34).

the plan). In any event, if the implementation costs exceed the benefits to participants and beneficiaries, the plan sponsor (or the plan's fiduciaries) can decide not to take advantage of the approach we recommend.

4. We hope that the Commission will permit the alternative approach that we recommend. If the Commission does not do so, however, we urge the Committee to approve legislation that permits our recommended approach.

In comments that we filed with the Commission, we urged the Commission to permit our recommended approach. If the Commission does not permit our recommended approach, however, Congress should resolve the issue legislatively, and we urge the Committee to approve legislation that permits our recommended approach.

Section 306(b) of S. 1971, cosponsored by Senators Corzine, Dodd, and Lieberman, directs the Commission to issue rules that permit execution of after-hours trades that are provided to a mutual fund by a broker-dealer, retirement plan administrator, insurance company, or other intermediary after the time as of which the NAV was determined if the late trading and detection procedures and policies of the intermediary are subject to inspection by the Commission. Section 306(b) also directs the Commission, by rule, to require each such intermediary (1) to certify that it has policies and procedures to prevent and detect late trades and that the intermediary has adhered to those policies and (2) to submit to an independent annual audit to verify that the procedures do not permit the acceptance of late trades.[4]

Section 315(b) of S. 2059, cosponsored by Senators Fitzgerald, Levin, and Collins, directs the Commission to determine the circumstances under which to permit (subject to Commission rules and an annual independent audit) the execution of after-hours trades that are provided to a mutual funds by a broker, dealer, retirement plan administrator, or other intermediary after the time as of which the NAV was determined.

We support the general objectives of these provisions, and we will be pleased to work with the Committee and its staff to enact such provisions should the Commission fail to provide rules that preserve the opportunity for same day pricing for all retirement plan participants.

---

[4] A similar provision appears in § 205(b) of H.R. 2420, which was passed by the House of Representatives by a vote of 418 to 2 on November 19, 2003. *See* 149 Cong. Rec. (daily ed.) H11572. Section 205(b) directs the Commission's rules to permit the execution of trades that are provided by a broker-dealer, retirement plan administrator, or other intermediary after the time as of which the NAV was determined if the trades are collected by the intermediary pursuant to procedures that are (1) designed to prevent the acceptance of trades by the intermediary after the time as of which the NAV was determined and (2) subject to an independent audit to verify that the procedures do not permit the acceptance of late trades.

We very much appreciate the opportunity to submit this statement. We look forward to working with the Committee and its staff to address this very important matter.

THE ERISA INDUSTRY COMMITTEE

For additional information, contact:
Janice M. Gregory, Senior Vice President
The ERISA Industry Committee
jgregory@eric.org
(202)789-1400