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May 10, 2004

The Honorable Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: Comments on proposed rules regarding Mandatory Redemption Fees for Redeemable Fund Securities; File No. S7-11-04.

Dear Mr. Katz:

Hewitt Associates is a global human resources outsourcing and consulting firm that delivers a complete range of human capital management services to companies, including outsourcing of defined contribution plan administration. We are the second largest employee benefits consulting firm in the world.[1] We are the largest independent recordkeeper—i.e., not an affiliate of an investment management organization—for 401(k) retirement plans. In that capacity, Hewitt serves 5.5 million defined contribution participants, representing $200 billion in assets.[2]

Hewitt respectfully submits these comments in response to proposed regulation "Mandatory Redemption Fees for Redeemable Fund Securities," File No. S7-11-04, published on March 3, 2004.

SUMMARY

Hewitt commends the Commission for its efforts to protect the interests of long-term mutual fund investors from the actions of short-term traders. For many years, Hewitt has worked with our clients, as plan sponsors, and their fund managers to deal with this issue. Nevertheless, we are concerned that the proposed mandatory redemption fees do not sufficiently address some of the unique features of the defined contribution marketplace. Without more clarity and specificity on how these fees would be applied in the defined contribution marketplace, there is potential for (a) inconsistency of rules, leading to greater cost and confusion and (b) unfairly hurting the majority of 401(k) investors who are not engaged in market timing.

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[1] *Business Insurance Magazine,* July 28, 2003.
[2] *Plansponsor.com's America's Top 10 Recordkeepers* survey.

In particular, Hewitt would like to draw attention to the following primary concerns:

Consistency in the application of redemption fees is critical. The ability to utilize a best-in-class investment solution whereby plan sponsors can offer funds from multiple mutual fund families is valued. However, to the extent that each fund has different rules stipulating how it wants a plan recordkeeper to apply those rules, the inconsistencies can cause significant confusion to participants and added costs to administer the plans.

Application of the rules on a broad set of transactions, as proposed, will unfairly hurt the majority of plan participants. Market timing is typically conducted by a tiny minority of plan participants. If mandated, the fees should be directed only to transactions in which market timing is possible.

Confidentiality rules regarding participant data must be preserved. We urge caution in requiring the sharing of sensitive participant data when the use of such data is not clear and the protection of such data is not guaranteed.

Hewitt suggests the following alternatives for the Commission to consider:

1. **Within the retirement plan marketplace, apply redemption fees and other trading restrictions only to participant-directed transfers.**

2. **Require that all funds adopt the *de minimis* rule, rather than allowing it to be optional.**

3. **Should redemption fees be applied to a broader set of transactions beyond participant-directed transfers (per our suggestion), provide more clarity around the proposed hardship rules.**

4. **Reconsider the need for fund managers to receive individual participant data from plan recordkeepers or other intermediaries. If such a requirement is retained, there is a real need to better protect confidentiality of participant data.**

The Unique 401(k) Environment

The detrimental effects on long-term shareholders of frequent trading by short-term investors are just as prevalent in the 401(k) environment as in other sectors. In fact, due to daily-valued and often load-free, no transaction-fee platforms, a 401(k) plan without appropriate trading rules can provide an attractive opportunity for a market timing investor. However, the many unique features to 401(k) plans require well thought out and consistent rules to curb market timing. These are described below.

a) **Choice of Investment –** Plan sponsors have the fiduciary obligation under ERISA to select the most appropriate fund option within each asset class. This results in most plan sponsors offering funds from multiple fund families. This also requires a plan recordkeeper, such as Hewitt, to offer access to multiple fund families. Hewitt's *2003 Trends and Experiences in 401(k) Plans Survey* reports that the median 401(k) plan offers 12 investment options and the average plan offers 14 investment options. Due to participant communication complexities, inconsistent trading rules across funds could be a deterrent for plan sponsors to offer to participants the best funds from multiple fund families. Inconsistent trading rules would also raise the cost of administration.

b) **Limited Transaction Choices –** 401(k) plans have specific rules as to how participants can invest and gain access to their money for withdrawal. This differs from a retail brokerage or mutual fund account, where investors can have much broader access to their investments. Specifically, there are three primary ways in which money is invested in a plan. The most common is through periodic payroll contributions, whereby dollars are taken out of each paycheck. Second, for participants repaying 401(k) loans, payments are typically also taken automatically from paychecks. The third primary method is through a lump-sum rollover contribution, which is an infrequent event for a single participant yet typically represents a significant dollar amount.

   There are also specific rules as to how participants can take their money out of plans. Most distribution transactions in a 401(k) plan occur on an infrequent basis. While still employed, the options are typically limited to loans, hardships and other in-service withdrawals. Once terminated or retired, participants would be eligible for distributions in the form of lump sum or periodic payments.

   Participants often do have the ability, on a daily basis, to transfer dollars between investment choices. This is typically accomplished through a transfer (e.g., "move $1,000 from Fund A to Fund B") or a reallocation (e.g., "place 30% of my account balance in Fund A and 70% in Fund B"). A sampling of overall trading activity across Hewitt's clients over a selected period found that while transfers make up less than 2% of all transaction requests, they represent approximately 50% of all transactions in terms of asset movement.

   One feature that is becoming increasingly popular is automatic rebalancing, in which participants set up pre-existing instructions to have their accounts rebalanced on a periodic basis (typically quarterly). This encourages

participants to rebalance their accounts according to their long-term investment goals.

c) **Inability to dictate funding source –** When plan participants request, for example, loans from their accounts, plan rules typically dictate that the dollars be removed from the plan on a pro-rata basis across the investments in which they have money. Most plan rules and recordkeeping systems are not designed to allow participants to instruct the specific funds that loan proceeds would come from. Such an ability would result in additional complexities for participants.

Redemption Fees to Combat Market Timing in the 401(k) Environment

For many years, Hewitt has worked with our clients and their fund managers to combat the issue of market timing in 401(k) plans. We have administered a variety of different approaches to curb the activity. We have also done extensive research to determine which approaches are most effective to curb inappropriate trading. We have used these studies to help our clients, as plan sponsors, determine effective solutions for market timing behavior.

A recent Hewitt study, *Preventing Excessive Trading in International Funds*, has shown two approaches that are found to be very effective. In the Aging of Monies approach, money that is transferred to a restricted fund cannot be transferred out for a set period of days. Our research has found that as little as five business days was very effective in curbing excessive trading. The other approach is redemption fees. This approach was also found to be effective if the redemption fee amount was set at a high enough level to negate the market opportunity and the fee is applied on the first instance of frequent trading. Our study has shown that a client with a redemption fee of 1%, which was applied on the third instance of market timing within a 90-day period, was effective in reducing excessive trading but not effective in eliminating it.

We have had much success with plan sponsors working with their fund managers and plan administrators to find effective solutions that are acceptable for all parties. Many of our clients, as plan sponsors, have expressed a desire to maintain such flexibility as they believe there may be appropriate solutions that are unique to their participant population and mix of investment options. At the same time, we do recognize that there is a need to have more consistent rules across the industry. Therefore, should redemption fees become mandatory, as proposed by the SEC, we strongly urge the SEC to take further steps to promote consistency.

We also believe strongly that fund managers should be held to the requirement to use fair value pricing. Particularly in the international asset class, fair value pricing is a critical tool to help combat market timing opportunities.

Consistency of Rules

In its proposal, the SEC asks: "Should the rule limit the number of ways that redemption fees may be assessed, in order to promote greater uniformity in the enforcement of redemption fees across funds and their intermediaries?" Our answer to that question in an emphatic "yes."

A recent Hewitt survey of approximately 130 plan sponsors asked: "How important is it that restrictions/redemption fees be uniform across all mutual funds?" With respect to redemption fee amount and holding period amount, 82% and 84% of respondents, respectively, felt it was either very important or somewhat important. With respect to the type of transaction that should be subject to the restriction, an even higher 91% of respondents felt it was either very important or somewhat important to have consistency.

Encouraging long-term savings for retirement is often a significant task for plan sponsors. Much time and effort is required to educate participants about the benefits of tax deferred savings. Beyond that, plan sponsors must also explain a myriad of Internal Revenue Service, Department of Labor, and investment fund rules to participants. Therefore, plan sponsors are particularly sensitive to the need for more consistent and easily understood rules. Participant confusion can be a significant deterrent not only to optimal participant behavior, but also to participation in plans altogether.

Besides participant confusion, inconsistent and unclear rules can also lead to significant cost issues. In its proposed rules, the SEC asked about the cost of administering redemption fees. In order to minimize these costs, it is important to develop consistent rules regarding redemption fees. If unique programming was required for each fund or fund company, expenses would increase substantially. These are expenses that would ultimately be borne by plan sponsors and/or participants.

Recommendation: We recommend that the SEC, in its final ruling, ensure there is as much consistency as possible in the rules a 401(k) investor will face.

There are several dimensions to the application of redemption fees in which we believe consistency is important. Specifically:

- **Type of transaction**: We believe the fee should apply only to participant-directed transfers in the 401(k) environment as this is where the abusive trading tends to occur.
- **Accounting approach**: We agree with the SEC that FIFO is the most appropriate method. This would be least disruptive for a majority of investors. FIFO has tended to be the industry norm in applying these rules; therefore, most systems are already programmed to track units in this way. In addition, we believe this is the fairest application of the rule. Investors should have access to dollars that they have invested in a fund for the required period of time. We believe that FIFO is the most intuitive, so communication to investors is also less complicated with this approach.
- ***De minimis* and hardship provisions:** Allowing discretion among fund managers to determine whether these provisions are required, and allowing discretion on how a hardship is defined, would lead to many administrative and communication issues within a 401(k) plan.

While we think participant confusion would be decreased if there were consistent rules for the length of the holding period and redemption fee amounts, funds with different characteristics may need additional flexibility to set different parameters in these two areas. For example, an international fund might need higher redemption fee amounts and longer holding periods to discourage market timing. Such variations would not be as disruptive as would inconsistencies across other parameters, namely type of transaction, accounting approach, *de minimis* rules, and hardship provisions. To be sure, additional participant education would be required for differing redemption fee and holding period amounts, yet such differences would be a simpler concept for participant to grasp than differences among the above mentioned parameters, such as type of transaction. In addition, the anticipated administrative costs of allowing differing holding period and redemption fee amounts is significantly smaller than having to administer differences in type of transaction, accounting approach, *de minimis* rules, and hardship provisions.

Hewitt Suggests That Redemption Fees Apply Only to Participant Directed Transfers

The SEC proposal asks whether the *de minimis* provision "sufficiently distinguish(es) harmful rapid trading from occasional transactions that may involve a purchase of fund shares followed by redemption." We think the answer to this is "no," particularly as it relates to some of the unique features of a 401(k) plan.

If the true intent of mandatory redemption fees is to serve as tools to combat market timing, we suggest that in the 401(k) environment, fees should apply only to participant directed transfer activity. This targets the specific transactions in which market timers are able to engage in rapid trading in and out of funds. It is through these events that market timers are able to move large sums of money at discretion. If fees are applied to a broader set of transactions, they will inappropriately impact many participants who are not engaging in market timing behavior.

Participant transfers sometimes result from pre-existing rebalancing instructions, or "Automatic Rebalancing." Because such transactions are executed as a result of prior instructions, and not as a result of participant decisions on the same day, Automatic Rebalancing programs clearly do not support market timing. Thus, it would be inappropriate and unnecessarily costly to impose redemption fees on such transactions.

As stated above, the most frequent transactions in 401(k) plans are payroll contributions and loan repayments. A recent Hewitt study of plan activity showed that across our client base, payroll contributions make up nearly 73% of all transactions, although they represent only around 13% of all dollar movements. These transactions are typically made on a scheduled and non-discretionary basis, based on payroll cycles. Our experience shows that market timers cannot use contributions or loan repayments to execute their strategy. We do not foresee sufficient benefit for the added expense it will take to track these assets for purposes of being eligible for redemption fees.

Plan participants can also contribute to their 401(k) plans through rollover contributions. Given these are infrequent occurrences, we also suggest that such contributions not be subject to redemption fees. Like payroll contributions, the effort to track these purchases for redemption fee eligibility is not justified by any added benefit.

401(k) plan participants are limited in their ability to withdraw money from their plans. Active employees may be allowed to take loans or in-service distributions. Terminated employees can take lump sum or periodic distributions. Because plan rules dictate that such transactions are infrequent by design and because these transactions typically result in taxable events, they do not provide a means for market timers to engage in excessive trading behavior. The imposition of such unnecessary fees would also add additional costs to the administration of the redemption fee rules.

As part of plan sponsors' on-going due diligence, they may choose to replace funds which are no longer meeting their investment criteria. In such cases, after due notification, participants' assets will automatically be liquidated from one fund and reinvested in another option of the plan sponsors' choosing. The impacted funds also receive sufficient lead time for these transactions. Although these transactions result in

significant movement of assets, individual participants are not using them to engage in market timing. Therefore, it would be inappropriate to require the imposition of redemption fees on such plan sponsor-initiated transactions.

Other occasional transactions in the 401(k) environment should also not be subject to redemption fees. Those include reinvestment of dividends, corrective adjustments, and payment of plan expenses.

Recommendation: Given the many different types of transactions that could occur in a 401(k) plan, we suggest that instead of identifying transactions that would be subject to redemption fees, the SEC should mandate that fees apply only to participant directed transfers.

HARDSHIP RULES

Hewitt appreciates the SEC's sensitivity to the needs of smaller investors and believes that the proposed redemption fee exemption for an "unanticipated financial emergency" would generally be beneficial for individual investors if outright withdrawals would otherwise be subject to redemption fees. (This need becomes moot if redemption fees apply only to transfers between funds.) However, we also believe that this proposed provision would be very burdensome to administer in the retirement plan environment and would be difficult for plan participants to understand and benefit from to the extent that it conflicts with, differs from, and complicates all of the procedures that they must already follow in order to receive money from their employer plans.

If the final rules apply to all retirement plan transactions, we request that the SEC provide more guidance on the circumstances under which this exemption can be achieved and address the following concerns specific to retirement plan sponsors, recordkeepers and participants:

a) **Detailed and uniform guidance as to what constitutes an "unanticipated financial emergency" for purposes of the SEC's proposed exemption should be provided.** If this determination is left to the discretion of the individual funds, the inconsistency in application would create a number of issues in the retirement plan environment, including:

   — Having multiple interpretations of this provision from individual fund providers would be burdensome for plan sponsors to communicate to participants in a clear and concise manner, would confuse participants, and could lead to plan sponsors choosing to offer a more limited variety of fund families to reduce this burden.

- It would be difficult for participants to understand and effectuate the steps necessary to request a redemption fee exemption for purposes of an "unanticipated financial emergency." Today, loans, withdrawals and distributions under a retirement plan are usually paid pro rata from all of the funds participants are invested in. In the future, a participant might need to submit five or six different requests to different funds for a single distribution. (Note: It is very rare today for retirement plans to allow participants to take distributions from specific funds; instead, the majority of plans and their supporting systems are set up to follow the pro rata approach.)

- Many 401(k) plans already contain hardship distribution standards that allow participants to take early withdrawals of their retirement plan contributions in the event of financial hardship. While this is an optional retirement plan provision and only applies to certain in-service withdrawals, it would be confusing for participants to have multiple sets of "hardship" rules under their plans that have different standards and would apply for different types of transactions.

- The "unanticipated financial emergency" exception would not just apply to the same types of transactions for which retirement plans might already have hardship provisions in place, so an entire set of new distribution guidelines for these plans would need to be established and administered. Without a common standard, this would need to be done on a fund by fund basis. This would result in higher administration costs for plan sponsors.

Recommendation: If redemptions fees are applied to payments from retirement plans, Hewitt recommends that the definition of an "unanticipated financial emergency" in this environment be the same as the safe harbor standards that apply for hardship withdrawals from a 401(k) plan (as defined in Internal Revenue Code Section 401(k) and Treasury Regulations Section 1.401(k)(d)(2)). While this standard may be slightly broader than the exemption originally contemplated by the SEC, it is also a bit narrower to the extent that it sets out only four specific circumstances in which a hardship is deemed to occur, including the pre-payment or payment of medical expenses, the purchase of a primary residence, the payment of tuition or related educational expenses, and the prevention of eviction from or foreclosure of the participant's residence.

b) **Guidance should be provided as to whom the request for the "unanticipated financial emergency" exemption needs to be submitted and how it should be processed.** If requests must be submitted to and approved independently by each impacted fund, the result would be an onerous process for plan sponsors and recordkeepers that would create complications and delays in retirement plan administration, including:

- Significant delays in participants' ability to retrieve funds from their retirement plan if the request must be passed to the recordkeeper, and then on to the impacted fund(s), and then back to the recordkeeper by the fund(s) prior to the distribution being able to be made. Not only would this be a difficult and complicated process to administer, but it would result in delays in distribution to participants that seem contrary to the urgency of a financial emergency situation.

- A requirement that recordkeepers hold participant transactions pending a determination from the fund. As noted above, because most participant distributions impact a number of funds, distributions would need to be held pending until all impacted funds reported back to the recordkeeper.

- Significant changes to existing recordkeeping systems. Support for the processes described above does not currently exist in the retirement plan environment and would be costly to implement.

Recommendation: Hewitt recommends that the SEC consider allowing the redemption fee exemption to apply to "unanticipated financial emergency" distributions upon the written (or electronic) certification of the participant, made at the time the distribution request is made at the plan level, that the distribution is for the purposes of one of the four pre-defined hardship circumstances defined in Treasury Regulations Section 1.401(k)(d)(2).

De minimis rule

The proposed regulations would provide discretion to the fund managers in allowing them to set a *de minimis* redemption fee amount on transactions less than $2,500. We agree with the intent of such a rule and believe it will protect the smaller investor. However, in the 401(k) environment, we are concerned that this rule will be applied inconsistently across funds. For much of the same reasons we believe it is critical to have consistency on other aspects of the redemption fee rule, we urge the SEC mandate consistency on the *de minimis* rule.

Recommendation: We ask that the *de minimis* rule, if adopted, be required for all affected funds. That being said, if redemption fees are only applied to participant directed transfers in the 401(k) environment, we see less need for this rule to protect the average plan participant.

Omnibus Accounts Participant File Transfer

In its proposal, the SEC suggested three ways in which redemption fees could be applied when mutual funds are provided through an intermediary, such as Hewitt. From our perspective, the only efficient method would be the third method, whereby the intermediary would impose and remit the redemption fee. This would significantly lower costs and reduce manual work as application of the redemption fee rules could otherwise not be automated. That being said, much of the efficiencies become lost if the intermediary has to impose inconsistent rules for different funds.

The proposed rule would also require a weekly transmission of shareholder transactions from the intermediary to fund companies. We question the necessity of such a rule, particularly in the 401(k) environment. The costs to transmit such data do not seem to be justified by the presumed benefits.

A stated reason supporting this transmittal of data is for auditing purposes. The SEC states that this file would “enable the fund to confirm that fund intermediaries are properly assessing the redemption fee.” We agree that transparency for these purposes is important. However, we do not believe weekly transmittals are required to provide such transparency. Rather, fund companies could fulfill their obligation to monitor and audit intermediaries through periodic and random requests for participant-level data.

Another reason presented by the SEC for this file transmittal is to “permit funds to detect market timers who a fund has prohibited from purchasing fund shares and who attempt to enter the fund through a different account.” However, this is less of an issue in the 401(k) environment given a 401(k) plan has limited access. Only employees of

the plan sponsor are eligible to participate in a given plan. Therefore, we fail to see the need to send TIN data to fund managers on a weekly basis.

As the SEC alludes to in one of its questions, another reason to send transaction information is to "match shareholder purchases and redemptions that occur through multiple accounts or intermediaries." We recognize that the spirit of market timing rules is violated when an individual conducts a round trip trade through multiple platforms. However, without significant evidence pointing to the extent such activity is occurring and the cost it inflicts on long-term shareholders, we find it difficult to justify the cost and the disruption that the proposed remedies would require. We believe that consistent fund rules applied on all trading platforms individually will be sufficient in significantly eliminating all incentives to engage in market timing activity. The goal of a redemption fee is to encourage long-term investing, because the prospect of a redemption fee decreases the liquidity of one's investment. We therefore believe that there would be limited incentive to execute round trip trades across platforms, because such a strategy would still require the investment of assets in a fund that is subject to a holding period requirement. Further, given that the SEC has already determined that FIFO is an acceptable accounting methodology for imposing redemption fees, a frequent trader could execute a similar strategy in a single account if sufficient dollars have aged in the investor's account for a period longer than the holding period.

We are concerned that sending TIN information for participants within an ERISA qualified plan would result in confidentiality issues. An investor's personal information and trading history is sensitive data. First, such data could be used for marketing purposes. In addition, if not secured properly, this information could be accessed by those without the proper clearance. Plan sponsors and intermediaries would have insufficient tools to ensure that funds were properly securing such data and not using the information in inappropriate ways.

Within the 401(k) marketplace, a contractual construct has been developed to allow for the wholesale purchase of retail mutual funds to institutional investors. By using intermediaries who provide services directly to individual plan participants, fund companies are able to provide their services to a broad set of investors. The idea of alliances and an open architecture environment has been a significant advancement in the 401(k) industry over the last decade. Plan sponsors have had the ability to select from a broader set of investment choices to satisfy their fiduciary responsibility of providing best-in-class fund options for their participants, without sales charges or loads.

We are concerned that the suggestions that intermediaries must provide individual participant records on a systematic basis to fund providers does significant damage to

this construct and could significantly raise the cost of alliance-type programs. This could lead to disincentives for fund managers to continue to participate in alliance programs. The suggested approach would require fund managers, as a whole, to track individual trading activity for millions of new investors. Given this is the role intermediaries have traditionally played, this disruption of the current environment can be significant. We would urge that the SEC seriously consider the unintended downstream consequences and potential disturbances that their proposals could result in.

Recommendation: Unless a clearer statement is made as to how individual trading data will both be used and secured, we ask that such file transmissions not be mandated, particularly in the 401(k) environment. We accept the requirement for intermediaries to be subject to periodic audits. If file transmission is required, consistent with our prior comments, we request that only participant directed transfer activity be included on such files.

Conclusion

In closing, we submit these comments in the best interest of our clients' retirement savings plan participants. We strongly endorse measures to protect long-term shareholders from the abusive trading practices of short-term traders. At the same time, we urge the Commission to consider the unique features of the 401(k) environment in considering the design of preventive measures to stop such abusive trading.

Sincerely,

Hewitt Associates LLC

E. Scott Peterson

Sent via e-mail at http://www.sec.gov/rules/proposed/s71104/s71104typea.htm