May 10, 2004

Submitted Electronically
Jonathon G. Katz
Secretary, Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Re: Mandatory Redemption Fees for Redeemable Fund Securities
(Release No. IC-26375A; File No. S7-11-04)

Dear Mr. Katz:

On behalf of the SPARK Institute, this letter comments on proposed new rule 22c-2 under the Investment Company Act of 1940, as amended (the "Investment Company Act"), which would impose mandatory fees ("redemption fees") upon the redemption of shares of mutual funds and also impose certain related information reporting requirements on financial intermediaries.[1] The SPARK Institute is an educational trade council affiliated with the Society of Professional Administrators and Recordkeepers ("SPARK"). SPARK member companies provide services to approximately 97% of the approximately 45 million participants in 401(k) and similar defined contribution plans ("plans") in this country. SPARK Institute members represent a broad cross section of plan service provider companies, including many of the major players in the defined contribution retirement plan industry. We understand that the mandatory redemption fee and information reporting requirements under the proposed rule would apply to transactions processed for participants in participant-directed plans.

Most ordinary Americans' experience in investing in mutual funds occurs through their retirement plans — approximately one-third of mutual fund shares are held through these plans.[2] Americans investing in mutual funds through their retirement plans are already facing redemption fee policies and other restrictions because of recent attention to the potential harm that abusive frequent or excessive trading, *i.e.,* market timing, may impose on long-term mutual fund investors. These new policies and other restrictions are

[1] "Mandatory Redemption Fees for Redeemable Fund Securities," Release No. IC-26375A (March 5, 2004), 69 Red. Reg. 11762 (March 11, 2004).

[2] 69 Fed. Reg. at 11764 n.17.

expected to increase plan complexity, participant confusion and administrative costs because of the complexity of plan recordkeeping and trade order processing systems, coupled with the fact that most plans invest in different mutual funds (often from different fund complexes) proposing non-uniform redemption fee policies and other restrictions. The mandatory redemption fee and financial intermediary reporting requirements of proposed rule 22c-2, if finalized, will add substantially to the expected complexity, confusion and cost. The SPARK Institute urges the Securities and Exchange Commission ("Commission") to carefully weigh these additional administrative burdens against the expected benefits of proposed rule 22c-2.

We recognize that the Commission must take action to curb abusive excessive or frequent trading in shares of mutual funds, which harms long-term mutual fund investors, including plan participants and beneficiaries. However, the SPARK Institute believes that the problem of abusive excessive or frequent trading can be addressed while taking into account the special circumstances of participant-directed retirement plans. In particular, the SPARK Institute urges the Commission to consider the following.

1. Reconsider the Benefits of a Mandatory Redemption Fee The Commission already recognizes that its proposed mandatory redemption fee will not "cure" the problem of market timing and will be supplemented by additional mutual fund policies and procedures, including longer redemption fee holding periods.[3] In light of the significant anticipated costs to plans of imposing mandatory redemption fees, including the direct costs to participants of the redemption fees as well as indirect higher plan administration costs, the Commission should consider whether the expected benefits of a mandatory redemption fee to plans and other mutual fund shareholders will justify these costs.

2. Adopt Uniform Redemption Fee Rules for Participant-Directed Plans Uniform guidelines or rules (applying to a mandatory redemption fee imposed by the Commission and where redemption fees are imposed under policies and procedures adopted by mutual funds) would significantly reduce the administrative cost and complexity of applying redemption fees in the case of participant-directed plans. The SPARK Institute urges the Commission to consider adopting the following rules.

- Redemption fees should only apply to "participant-directed exchanges" between plan investment options because only these participant-directed transactions could involve potential abusive frequent or excessive trading.

[3] *See* 69 Fed. Reg. at 11763 ("our proposals are not designed to be an exclusive cure for the problem of abusive market timing . . . ."); 69 Fed. Reg. at 11767 ("The proposed mandatory redemption fee is designed to work together with our other initiatives and with tools fund managers already have at their disposal to curb harmful market timing.")

Routine plan transactions that do not create an opportunity for abuse that are already governed by detailed plan rules and other governmental agency regulations should be exempt (*e.g.*, contributions, rollovers, loans, distributions, and withdrawals).

- There should be certain uniform rules that apply with respect to redemption fees imposed on plan participants, including a mandatory *de minimis* rule that limits the application of redemption fees to transactions over a designated threshold and a single redemption fee amount that may be applied, *e.g*., 2%.

- There should be special rules exempting certain types of plan transactions from redemption fees, including changes in plan investment options directed by a plan fiduciary (*e.g.*, replacement of investment options, and transactions relating to the migration from one plan service provider to another), rebalancing transactions performed under standing instructions, and transactions generated by participant instructions with respect to a plan "fund of funds" investment option.

3. <u>Modify Financial Intermediary Reporting Requirements</u> Where financial intermediaries assess redemption fees, the financial intermediaries' reports to mutual funds should only include information about those transactions that result in redemption fees, and should be submitted to mutual funds at the same time that the redemption fees are remitted (*e.g.*, monthly). Financial intermediaries should not be required to automatically report other information, so long as the financial intermediaries make additional information about plan and participant transaction available upon a mutual fund's request. This change would significantly mitigate the administrative cost of financial intermediary reporting, while still ensuring that mutual funds receive the information necessary to confirm that redemption fees are properly assessed by financial intermediaries and to detect market timers.

We discuss these recommendations in more detail below. In addition, some technical comments on the proposed rule are provided.

I. The Uncertain Benefits of a Mandatory Redemption Fee Will Not Outweigh the Anticipated Costs to Plans

SPARK members represent a broad cross section of the banks, insurance companies, mutual fund managers, third party administrators and benefit consultants that are engaged in providing recordkeeping and other administration services to defined contribution plans. SPARK Institute members represent a cross-section of these service provider groups, including many of the major players in the defined contribution retirement industry. In recent months, as mutual funds have reviewed and updated their

policies and procedures designed to address abusive frequent or excessive trading, SPARK Institute members have had first hand experience with issues raised by the imposition of redemption fees on plan participants' transactions by mutual funds. Already, mutual funds are proposing new redemption fee policies and other restrictions that are expected to result in significant new plan administrative burdens, including reprogramming of participant recordkeeping and trading systems and extensive participant communications requirements. The new restrictions are also expected to cause participant confusion about the rules that apply in their plans because different mutual funds are proposing different redemption fee policies and other restrictions. Ultimately, the costs associated with these new requirements will be borne by plan participants for little, if any, benefit.

In this context, the SPARK Institute questions whether the proposed mandatory redemption fee will provide additional protections to plan participants and other mutual fund shareholders. In this regard, the effectiveness of the proposed mandatory redemption fee is unclear, especially with respect to investors that are making frequent trades using large account balances and sophisticated market timing strategies. In this regard, a two percent redemption fee would not deter market timing where the possible profit from short-term trading will exceed the two percent redemption fee. In addition, because the "first in, first out" ("FIFO") method is proposed for applying the mandatory redemption fee, traders with large account balances could avoid redemption fees altogether simply by using only a portion of their account balance in frequent trading. Given these limitations on the extent to which the proposed mandatory redemption fee will discourage frequent trading, especially by larger traders, even the Commission recognizes that mutual funds are likely to impose their own additional redemption fee policies. And, if mutual funds will impose additional restrictions, the proposed mandatory redemption fee would add administrative complexity for plans and participants, and increase participant confusion, without any apparent benefit.

The Commission explains in proposing rule 22c-2 that, in addition to possibly deterring frequent trading, a mandatory redemption fee also would benefit mutual funds by requiring frequent traders to reimburse mutual funds for redemption-related costs. In this regard, it is suggested that the cumulative effect of frequent trading by "smaller short-term traders" may be greater than the costs imposed by a few large traders.[4] However, this rationale generally does not hold true with respect to the transactions of participants in participant-directed plans. Plan participant transactions usually are aggregated and netted with transactions of other participants in the same plan, and the plan's transactions are further aggregated and netted with transactions of other plans in "omnibus" transactions.[5] Moreover, the order taking, aggregating and netting work is

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[4] 69 Fed. Reg. at 11763.

[5] The recordkeeping and trade processing systems developed by plan recordkeepers and administrators are capable of processing millions of participant-level investment transactions occurring in connection with

done by retirement plan recordkeepers and administrators, not the mutual fund or its transfer agent. Consequently, a mutual fund generally would not process a purchase or redemption as a result of each participant's investment instructions, and in any event, the fund only processes one transaction no matter how many plan participants have submitted instructions. Thus, a mutual fund generally should not incur additional costs as a result of frequent participant trading, except in very unlikely circumstances where participants' trades involving the same abusive conduct result in a large trade order, after aggregation and netting with legitimate trades from the plan and other plans receiving services through the same "omnibus" account, relative to the overall size of the mutual fund.

Because of these issues, the SPARK Institute believes that the proposed mandatory redemption fee will result in additional administrative burdens for plans and plan participants, but will not provide benefits that justify these costs. Instead, the mandatory redemption fee would only be a new revenue stream for mutual funds, at the expense of unsophisticated plan participants and other mutual fund shareholders. Accordingly, we urge the Commission to reconsider whether to impose a mandatory redemption fee, or to consider exempting participant-directed plans from the portion of proposed rule 22c-2 imposing the mandatory redemption fee.

II. Special, Uniform Rules Should Apply to Participant-Directed Plans

As was noted, participant-directed 401(k) and other defined contribution retirement plans play a critical role in the retirement savings of American workers and also constitute a substantial portion of mutual fund assets.[6] The numbers of these plans and plan participants participating in these plans have grown substantially in recent years. In fact, the Department of Labor estimates that there are some 730,000 private sector pension and 401(k) plans.[7]

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defined contribution retirement plans every business day, while also applying complex plan administration requirements. An important feature of these systems is the use of "omnibus" recordkeeping and trade processing systems, so that mutual funds are not required to open individual shareholder accounts for each plan participant. These systems allow cost-effective delivery of plan administration and investment transaction processing, even where participants have small account balances and make small dollar value contributions. Without these systems, plan participants would be required to deal with mutual funds on the same basis as "retail" investors, which would make mutual fund investments more expensive for plans and could also put mutual funds out of the reach of plan participants with small account balances.

[6] Generally, tax-qualified defined contribution retirement plans, including 401(k) and similar plans, do not promise participants a specific amount of benefits at retirement. Instead, while participants are employed by the employer plan sponsor, participants or the employer (or both) contribute to "individual accounts" maintained for each plan participant. The contributions are held and invested on behalf of participants, and each participant ultimately receives a benefit based on the amount of contributions made to his or her individual account, plus or minus investment gains and losses, plan expenses, and other adjustments provided by the plan.

[7] U.S. Department of Labor, Employee Benefits Security Administration, "Labor Department Issues Guidance on Fiduciary Duties In Response to Mutual Fund Abuses," Feb. 17, 2004 (Media Release),

From its comments relating to proposed rule 22c-2, it is clear that the Commission intends to strike a balance between protecting mutual fund shareholders from market timing and imposing unfair new burdens on mutual fund investors, and especially small investors. However, rule 22c-2, as proposed, could result in redemption fees imposed in connection with plan participant transactions even though there may be no possibility of market timing abuse involved in the transactions. For example, a participant might be subject to the proposed mandatory redemption fee on a transaction that the participant has not directed, such as where a plan fiduciary makes a change to plan investment options that results in a redemption of mutual fund shares immediately after the participant made a plan contribution or directed a plan transfer that caused a purchase of that mutual fund. Also, as already noted, administrative costs in imposing a mandatory redemption fee (if imposed) will be significant on an initial and ongoing basis.

The Commission can address these fairness and cost issues by including special, uniform rules tailored to participant-directed plans, specifically including the special rules that are discussed in more detail below. In addition, the SPARK Institute urges the Commission to consider adopting these special rules to apply for all redemption fees imposed in connection with participant-directed plans, whether or not the Commission adopts a proposed mandatory redemption fee rule.

A. Need for Uniformity

Where plans are designed to be participant-directed, participants generally direct the plan trustee or another plan fiduciary how their contributions and account balances should be allocated among a selection of plan investment alternatives.[8] These investment alternatives are selected by a "fiduciary" of the plan ("plan fiduciary"), who must select and monitor the plan's investment alternatives prudently.[9] As participant-directed

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available at www.dol.gov/ebsa. These numbers do not include an additional substantial number of tax-qualified participant-directed plans sponsored by various governmental entities and church organizations.

[8] Some defined contribution plans do not allow participant direction — instead, the trustee or other plan fiduciary, or a plan investment manager, determines how plan assets are invested.

[9] Private sector 401(k) and similar plans are subject to Employee Retirement Income Security Act of 1974 ("ERISA"), which requires (among other things) that plans are operated in accordance with governing plan documents naming one or more "fiduciaries" charged with the management and operation of the plan. *See* ERISA § 402. These fiduciaries include an "administrator," "trustee" and other "named" fiduciaries. Under ERISA section 3(16), the "administrator" is responsible for the overall administration of the plan and the employer plan sponsor is the administrator unless the plan names a different plan administrator. A professional plan recordkeeper or administrator is almost never named as a fiduciary administrator of a plan; in fact, in most cases, professional plan recordkeepers and administrators do not perform any functions that could cause them to be "fiduciaries" of a plan. The plan "trustee" is responsible for management and control of plan assets. *See* ERISA § 403(a). Plans often provide for a separate "named

retirement plans have developed in recent years, it has become common that plan fiduciaries are able to select from a menu of mutual funds distributed by different fund complexes under an "open architecture" model.[10] This approach allows plan fiduciaries to select from a broad range of mutual funds to obtain the best combination of investment performance and cost for plan participants.

However, the open architecture approach may be problematic for plan administrative purposes where different sets of rules and restrictions relating to redemption fees on different mutual funds must be implemented under the plan. As the Commission recognizes, implementation and ongoing administration of the redemption fees and the information reporting requirements under the proposed rule is expected to result in substantial costs. For participant-directed plans with an open-architecture investment structure, these costs will be further magnified if mutual funds are allowed unrestricted flexibility in procedures for imposing redemption fees and other restrictions to curb market timing.

For example, different mutual funds could impose different procedures for applying the *de minimis* threshold at which redemption fees will apply, "tiered" redemption fees (*e.g.*, 2% for a short holding period and then 1% for redemptions within a longer holding period), and shorter or longer holding periods. Implementing these different restrictions in plan recordkeeping systems would be extremely costly. Further, on an ongoing basis, substantial effort would be required to ensure the applicability and amount of fee are correctly determined in each case. Moreover, all of these different restrictions must be communicated to plan participants, who are likely to find these restrictions more confusing where each mutual fund is subject to different rules.

These problems can be addressed if the Commission adopts uniform rules for redemption fees applied to participant-directed plans. In particular, the SPARK Institute recommends the following two uniform rules for any participant-directed plans.

- Redemption fees should be uniformly set at 2% (or other appropriate level as determined by the Commission). For example, mutual funds should not be permitted to impose a higher or lower redemption fee, or to impose "tiered"

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fiduciary" that is responsible for plan investment matters, such as the selection and monitoring of plan investment alternatives. Other persons may become plan fiduciaries, if they perform one or more "fiduciary" functions, as defined by ERISA section 3(21).

[10] An important reason for this development is that plan recordkeepers and administrators often are not affiliated with mutual fund investment managers and therefore developed the capability of providing plans access to a broad, diversified selection of mutual funds and other investment options. Today, even plan recordkeepers and administrators that are affiliated with large mutual fund complexes typically make their competitors' mutual funds available to plan clients.

fees, *i.e.,* a 2% fee charged on redemptions within 5 days and a 1% fee charged on redemptions after 5 days but within 90 days.

- The *de minimis* standard proposed in rule 22c-2 should be mandatory and uniform, at least with respect to transactions in participant-directed plans. Specifically, the Commission should require mutual funds to waive the assessment of redemption fees if the amount of shares redeemed is under a specified threshold. The SPARK Institute recommends that the *de minimis* threshold should be $10,000, so that no redemption fees would apply unless the amount redeemed by a participant is greater than $10,000.

B. Apply Redemption Fees Only to Participant-Directed Exchanges

In addition to the uniform rules recommended above, the SPARK Institute strongly urges the Commission to limit the application of redemption fees imposed on participants of participant-directed plans to "participant-directed exchanges." This approach would be consistent with other rules issued by the Commission with respect to participant-directed plans where there may be concerns about potentially abusive trading. Specifically, Rule 16b-3(c) under the Securities Exchange Act of 1934 ("Exchange Act") exempts from the short-swing profit recovery provisions under section 16 of the Exchange Act transactions by participants under "tax-conditioned plans" (including tax-qualified 401(k) and similar plans) other than "Discretionary Transactions" such as "fund-switching" or intra-fund transfers.[11] The exemption was premised on the view that adequate safeguards exist against "speculative abuse" when a plan satisfies conditions imposed under the Internal Revenue Code and the Employee Retirement Income Security

[11] 17 C.F.R. § 240.16b-3. Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Release No. 34-37260 (May 31, 1996), 61 Fed. Reg. 30376 (June 14, 1996). Similarly, Rule 16a-3(g)(1) provides relief from insider reporting requirements under section 16(a) of the Exchange Act for transactions in issuer equity securities that are exempted by Rule 16b-3(c). Plan transactions exempted by Rule 16b-3(c) are also exempted under the Commission's regulations under Section 306(a) of the Sarbanes-Oxley Act of 2002 (prohibiting executive officers and directors of an issuer from purchasing or selling issuer equity securities during a pension plan black-out). 17 C.F.R § 245.101(c)(2). Rule 16b-3 defines "Discretionary Transaction" as "a transaction pursuant to an employee benefit plan that: (i) Is at the volition of a plan participant; (ii) Is not made in connection with the participant's death, disability, retirement or termination of employment; (iii) Is not required to be made available to a plan participant pursuant to a provision of the Internal Revenue Code; and (iv) Results in either an intra-plan transfer involving an issuer equity securities fund, or a cash distribution funded by a volitional disposition of an issuer security." The definition of "Discretionary Transaction" would include participant-directed "intra-plan" exchanges and transfers involving equity securities offered under a plan, and also loans and in-service distributions funded by a sale of equity securities. The definition specifically excludes transactions in connection with a participant's death, disability, retirement or termination of employment on the basis that "[a]lthough such transactions have an element of volition, the insider's opportunity to speculate in the context of death, disability, retirement or termination of employment would seem well circumscribed." 61 Fed. Reg. at 30380. Generally, rules and regulations applicable to tax-qualified plans would similarly limit participants' opportunity to engage in abusive market timing through loan transactions, withdrawals at termination of employment or retirement, or in-service distributions.

Act of 1974, as amended ("ERISA"), and therefore, "routine" plan transactions (such as periodic contributions and distributions in connection with death, disability, retirement or termination of employment) should be exempt.[12]

Participant-directed plans may engage in investment transactions for a variety of reasons and purposes, as follows.

- Contributions Plans purchase mutual fund shares upon receipt of new plan contributions from participants or the employer, in accordance with participants' standing instructions. Typically, participants contribute periodically by payroll deduction at a set rate (*e.g.*, 5 percent of earnings annually). Employers may "match" participant contributions, or contribute specific amounts on an annual basis, or make discretionary contributions, in accordance with the plan's terms. Some plans allow participants to make "rollover" contributions from another tax-qualified plan, or a "rollover individual retirement account," under certain limited conditions.

- Distributions and Withdrawals If a participant takes a withdrawal or distribution of benefits, the plan may redeem mutual fund shares. Usually, participants may withdraw or receive a distribution from their plan accounts only upon termination of employment or retirement. Some plans also permit participants to take "in-service" distributions because of hardship or for other reasons, under certain conditions. Under certain circumstances, a plan may be required to distribute some or all of the participant's account (*e.g.*, under mandatory "cash-out" rules for account balances of $5000 or less and under mandatory distribution rules for participants reaching age 70 and 1/2). Participants taking a withdrawal or distribution cannot "reinvest" amounts received in the plan. All of these transactions are governed by detailed plan rules as well as regulations under the Internal Revenue Code, which strictly limit the circumstances under which participants can receive withdrawals and distributions from a plan.

- Loans Plans may allow participants to take loans based on their participant account balances, and redeem mutual fund shares if a participant requests a loan. Rules under the Internal Revenue Code limit loans to the maximum of $50,000 or no more than one-half of the participant's account balance.[13] As the participant repays the loan, the plan purchases shares with the loan repayments, in accordance with participants' standing instructions for the investment of new plan contributions. Typically, loan repayments are made

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[12] 61 Fed. Reg. at 30379.

[13] Internal Revenue Code, § 72(p).

by payroll deduction, but participants may repay outstanding loan balances with a single lump sum payment.

- Exchanges Plans purchase and redeem shares of mutual funds to effect participants' instructions to change the allocation of the participants' accounts among plan investment alternatives. These "exchanges" also include changes resulting from "rebalancing" transactions, where the participant directs that his or her account is reallocated by percentage among a selection of different plan investment options. Some rebalancing transactions may be performed in accordance with standing instructions submitted by the participant (*i.e.,* on a monthly or quarterly basis, the participant's account is adjusted to conform to a standing asset allocation instruction).

- Fiduciary-Directed Transactions Under ERISA, a plan fiduciary must remain responsible for directing transactions for a participant account if the participant does not provide instructions. Also, to carry out their responsibility to ensure plan investment options are "prudent" and in connection with the general operation of a plan, plan fiduciaries generally have authority to direct plan investment transactions when changing the plan investment alternatives. Therefore, plans may redeem or purchase shares as a result of plan fiduciary directions, such as the termination or substitution of one or more plan investment alternatives after a periodic plan investment review, or a conversion to a new plan service provider.

Generally, all of these plan transactions are governed by specific rules described in governing plan documents and must comply with requirements under the Internal Revenue Code and rules imposed under ERISA.[14]

If redemption fees were to apply to every transaction performed for a participant's account, redemption fees would be imposed in connection with plan transactions that do not provide participants an opportunity for market timing. For example, if a participant's payroll contributions are invested in one or more mutual funds on Day 1, and the participant requests a loan transaction on Day 3, shares redeemed to fund the loan payment could be subject to redemption fees. Similarly, if a participant's rollover contributions are received under a plan on Day 1, and the plan fiduciary makes changes to plan investment alternatives that result in the redemption of all shares owned by the plan (including the participant's shares purchased on Day 1) on Day 4, redemption fees could be imposed. In both cases, imposition of a redemption fee would be plainly unfair.

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[14] Certain tax-qualified retirement plans, such as plans sponsored by a governmental entity or a church organization are not subject to ERISA.

The Commission can avoid this unfair result, and also significantly reduce the costs of administering and imposing redemption fees by limiting the application of redemption fees to participant-directed exchanges. In this regard, of all of the types of plan investment transactions described above, only participant-directed exchanges provide any opportunity for abusive frequent or excessive trading by plan participants. For example, participants do not have the capability to "time" mutual fund share purchases in connection with payroll contributions or periodic loan repayments because the timing of these purchases depends upon when the employer deposits the funds into the plan, and the contributions are invested according to standing participant instructions. Any rollover contributions or lump sum loan repayments by a participant typically require at least one or more days processing time upon receipt by the plan trustee and recordkeeper; therefore, a participant may not "time" purchases of mutual fund shares in connection with these transactions. Also, where plan transactions are directed by a plan fiduciary (*e.g.*, to effect changes in the plan's investment alternatives), the participant would not provide a direction and could not "time" share purchases or redemptions.

Plan rules may allow a participant to determine the timing of share redemptions under a plan to fund loans, withdrawals or distributions. Nevertheless, these transactions also do not provide opportunity for market timing abuse. In this regard, participants must be eligible for withdrawals and distributions under plan rules and cannot reinvest the withdrawal or distribution proceeds through the plan. In the case of a loan, participants cannot "time" the reinvestment of loan repayments because the repayment is typically made by periodic repayments; and if the participant makes a lump sum repayment, at least one or more days processing time for reinvestment removes the participant's opportunity to "time" the reinvestment of the loan repayment. Also, the reinvestment typically would be implemented based on a participant's standing instructions for the reinvestment of new plan contributions, further adding to the difficulty of using these types of transactions to engage in market timing activities.

Therefore, to address market timing by plan participants, redemption fees need only apply to participant-directed exchanges, and participant-directed exchanges should be the only plan transactions that are monitored to determine whether any redemption fees should be assessed. Importantly, this approach would provide substantial relief to plans (and also to mutual funds) from the administrative costs and other burdens of redemption fees because it would substantially reduce the number of transactions that need to be monitored for purposes of imposing redemption fees.

C. Other Special Rules on Redemption Fees

In addition to our recommendation that only participant-directed exchanges should be subject to redemption fees, the SPARK Institute requests the Commission issue rules or other guidance addressing how redemption fees may be applied in connection

with certain types of transactions that may occur in connection with participant-directed plans.

1. Fiduciary-Directed Transactions As noted, plan fiduciaries may direct certain transactions for participant accounts under a participant-directed plan. Where a plan fiduciary directs transactions for a participant's account and directs both a purchase and redemption transaction that would result in a redemption fee, the SPARK Institute agrees that the redemption fee should apply. However, it is important that transactions directed by a plan fiduciary are not "matched" with transactions directed by participants for purposes of assessing a redemption fee. Thus, for example,

- where a plan fiduciary (*e.g.*, in connection with a change in plan investment options) directs amounts in a participant's account to be invested in a mutual fund, and the participant then directs the reallocation of such amounts to another plan investment option, no redemption fee should apply to the redemption of shares resulting from the participant instruction; and

- if a participant directs that a portion of his or her account balance should be allocated to a mutual fund and, subsequently, the plan fiduciary directs that such amounts should be invested in another mutual fund, no redemption fee should apply upon the redemption of shares caused by the plan fiduciary's direction.

Additionally, transactions associated with the migration of a plan from one service provider to another should not result in the imposition of a redemption fee. Thus, for example,

- where a plan fiduciary redeems shares of a fund in order to transition the plan to another service provider, the resulting sales should not trigger a redemption fee;

- where a plan transitions a mutual fund position held in an omnibus account by an outgoing service provider to a new service provider by directing the fund company to re-register plan shares to the new service provider, a redemption fee should not be imposed on subsequent participant-directed sales of the transitioned shares. In this situation, it is administratively impractical for the new service provider to impose a redemption fee because it will not have the participant level transaction history. The risk of abuse under these circumstances is minimal because service provider changes are infrequent occurrences, participants have no control over the timing of the transition, and such transitions usually involve a "black-out" period (*e.g.*, typically 5 business days or more) during which participants cannot direct any purchases or sales; and

- regardless of how a plan effects a change in service providers, plan participants are generally given advance notice of and an opportunity to re-allocate their accounts before a "black-out" period as noted above in order to position their account in anticipation of the temporary limit on participant directed activity. Participant directed sales in anticipation of a "black-out" period should not result in the imposition of a redemption fee.

2. Rebalancing Transactions As noted, "rebalancing" transactions occur where a participant's account is allocated by percentages among several plan investment options. These rebalancing transactions may generate exchanges between plan investment options. Some plan recordkeeping systems permit participants to perform a rebalancing transaction on any business day, and in that event, any exchanges that result from the rebalancing would be subject to redemption fees (if applicable taking into account the *de minimis* exception). However, where a rebalancing transaction is performed according to a standing instruction provided by the participant in advance, redemption fees should not apply since this would not be the type of instruction that could involve market timing abuse.

3. "Fund of Funds" Transactions Plan fiduciaries may sometimes establish plan investment options that are investment portfolios comprised of more than one mutual fund. For example, plan fiduciaries may use this approach to create a "balanced fund" or one or more so-called "life-style" funds under a plan. If such a "fund of funds" is established by a plan fiduciary, a participant investment election to invest in the fund of funds would generate plan purchases of shares of each of the mutual funds comprising the fund, and when the participant elects to allocate his or her account balance to another plan investment option, those mutual fund shares would be redeemed by the plan.

However, in the case of a fund of funds, special rules are required to avoid inappropriate redemption fees. In this regard, purchases and redemptions caused by the instructions of different participants should not be matched. In addition, purchases and redemptions directed by a plan fiduciary with respect to the fund of funds should not be matched with any participant instruction for purposes of determining redemption fees.

4. Non-Qualified Plan Transactions Many employer plan sponsors maintain "non-qualified" deferred compensation plans that provide certain officers and other highly-compensated employees the opportunity to defer a portion of their compensation until termination of employment or retirement. Benefits payable under these plans may be determined based on the investment return of investment options selected by the participants. It is common that these investment options "mirror" the investment options available under tax-qualified 401(k) or other participant-directed plans offered by the employer plan sponsor.

Some employer plan sponsors maintain investment assets to pay benefits under these plans under so-called "rabbi trusts" or similar arrangements. In the event of insolvency of the employer plan sponsor, these assets would be available to pay claims of the employer plan sponsor's general unsecured creditors. However, the assets still may be invested consistent with the investment elections of the plan participants and, in practice, these plans may be administered very similarly to tax-qualified 401(k) and similar participant-directed plans.

Accordingly, the SPARK Institute requests that the Commission clarify that redemption fees would be determined in the case of these types of plans following the same rules that would apply in the case of a participant-directed tax-qualified plan.

III. Information Reporting Requirements

The proposed rule would require "financial intermediaries" to automatically provide mutual funds with certain transaction information, even if financial intermediaries are entirely responsible for monitoring transactions and assessing the redemption fees.[15] The SPARK Institute believes that this requirement will impose significant costs on financial intermediaries as well as on mutual funds receiving the information. Moreover, at this point, it is unclear whether mutual funds will review (or even have the ability to review) information provided under the proposed rule. Indeed, the proposed rule does not specify what analysis, if any, mutual funds must perform.

Therefore, the SPARK Institute urges the Commission to revise the proposed rule. Specifically, where financial intermediaries agree to monitor transactions and assess the redemption fees, financial intermediaries should only be required to provide automatically information about the participant-directed exchanges that result in the imposition of redemption fees. The information should be reported at the same time that redemption fees are remitted to mutual funds, *e.g.*, monthly. (In this regard, the proposed weekly reports would be burdensome. Monthly reporting would be equally effective.) These changes would significantly reduce the numbers of transactions to be reported to mutual funds and, therefore, significantly reduce the cost of this reporting.

The Commission explains that the proposed information reporting is necessary so that mutual funds can confirm that financial intermediaries are properly assessing redemption fees, and can detect market timers who the fund has prohibited from purchasing fund shares and who attempt to enter the fund through a different account. It may also be helpful in assessing whether appropriate breakpoint discounts are applied. All of these objectives can also be accomplished, without imposing burdensome and unnecessary reporting, by providing that mutual funds must contract with financial

[15] 69 Fed. Reg. at 11766, 11773.

intermediaries to provide investor identification information and transaction information on request rather than automatically. This would ensure that mutual funds obtain the investor and transaction information needed for compliance purposes, without requiring burdensome automatic reports that may be of little use.

IV. Other Comments

A. "Financial Intermediary" Definition

While the SPARK Institute understands that the mandatory redemption fees and information reporting requirements under the proposed rule would apply to transactions directed by participants under participant-directed plans, there are technical issues in how the rule has been drafted. If the Commission finalizes the rule, these issues should be clarified.

First, section (a) of the proposed rule provides that a redemption fee is charged when shares are redeemed within five days of purchase, but does not distinguish that, in the case of a participant-directed plan, the purchase and redemption transactions that are monitored for this purpose must be directed by the same participant. In this regard, a plan trustee acting on behalf of a participant-directed plan is typically viewed as the "shareholder" of mutual fund shares held by a plan. Thus, one reasonable reading of proposed rule 22c-2 would be that shares redeemed by the plan within five days of purchase are subject to a redemption fee, even if the purchase and redemption transactions result from directions of different plan participants. Therefore, this section of the proposed rule should be revised by adding that, in the case of a participant-directed plan, the redemption fee applies only to redemptions resulting from instructions by the same plan participant who directed a purchase of shares by the plan within the previous five days (or other holding period as determined by the Commission).

Second, the definition of "financial intermediary" is not clear, so it is unclear who has the "financial intermediary" obligations under the proposed rule. The proposed rule defines the term "financial intermediary" to mean a "record holder" as defined in rule 14a-1(i) under the Exchange Act.[16] Rule 14a-1(i) defines a "record holder" to mean "any broker, dealer, voting trustee, bank, association or other entity that exercises fiduciary powers which holds securities of record in nominee name or otherwise or as a participant in a clearing agency registered pursuant to section 17A of the Act."[17] Rule 14a-1(c) defines "entity that exercises fiduciary powers" as "any entity that holds securities in nominee name or otherwise on behalf of a beneficial owner . . ."[18]

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16 *See* Proposed Rule 22c-2(f)(1).

17 17 C.F.R. § 14a-1(i).

18 17 C.F.R. § 14a-1(c).

The term "beneficial owner" is not defined by the proposed rule, or under rule 14a-1. Rule 14b-2 under the Exchange Act defines "beneficial owner" to mean the person who has or shares, pursuant to an instrument, agreement or otherwise, the power to vote, or to direct the voting of a security.[19] However, it is common under participant-directed plans that the plan trustee, not participants, has voting responsibility for mutual fund shares. Therefore this definition would not achieve the result that participant-directed transactions are subject to redemption fees. Some no-action letters issued by the staff of the Division of Investment Management take the position that plan participants are "beneficial owners" where they direct the investment of their individual accounts under certain conditions.[20] However, given that there are various definitions of the term "beneficial owner," this interpretative position, if applicable, should be incorporated in the proposed rule.

Third, assuming that participants of participant-directed plans are "beneficial owners," the definition of "financial intermediary" provided in the proposed rule would appear to mean the plan trustee is responsible for holding mutual fund shares in trust on the plan's behalf. However, typically, this plan trustee is not responsible for maintaining any participant account records, or for receiving and processing participants' instructions for the allocation of their individual plan accounts among plan investment alternatives. Instead, this information is typically maintained by a plan recordkeeper engaged by the "administrator" of the plan.[21] Therefore, the rule will place the information reporting burdens under the rule on an entity (or in the case of some plans, an individual) who may not maintain the information required to be provided to mutual funds.

The Commission may wish to consider whether the "financial intermediary" obligations, in the case of participant-directed plans, might better be placed with the plan recordkeeper entity that has responsibility to process and transmit orders to mutual funds on behalf of the plan. Typically, this recordkeeper entity (unless the recordkeeper is an affiliate of a financial institution acting as plan trustee) does not hold the plan's shares as

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[19] 17 C.F.R. § 14b-2(a)(2).

[20] *See* PanAgora Group Trust (pub. avail. Apr. 29, 1994) (staff took position that, for purposes of determining compliance with Investment Company Act section 3(c)(1), each participant in a participant-directed plan who invests through the plan in a generic option consisting of a "section 3(c)(1) fund," and decides whether or how much to invest in the section 3(c)(1) fund, should be treated as a single "beneficial owner" of the section 3(c)(1) fund, for purposes of determining whether the fund meets the requirement to have 100 or fewer beneficial owners).

[21] See note 9, *supra*, describing the roles and responsibilities of the "trustee," "administrator" and "named fiduciaries" of ERISA-covered plans. The plan trustee may be a financial institution, or (particularly in the case of small plans) instead may be an individual employed by the employer plan sponsor. If a financial institution is trustee, it may be a "directed trustee" that generally acts only upon directions from a "named fiduciary" of the plan or an investment manager.

a "record owner" and therefore would not be a "financial intermediary" under proposed rule 22c-2(f)(1). However, plan recordkeepers and administrators have access to the information that is required to be provided to funds under the proposed rule and also often have direct or indirect contractual relationships with the mutual funds under which they receive and process orders for the fund's shares.[22]

B. Proposal to Delay Determination of Net Asset Value for Transactions

The Commission requested comment on whether it should require funds to determine the value of purchase and redemption orders for mutual funds at the net asset value calculated the next day after it receives orders, rather than the next time that the fund next calculates net asset value.[23] This approach raises all of the same issues that the SPARK Institute has addressed in comments to the Commission relating to proposed rules that would impose a "hard" 4 p.m. close for the submission of orders for purchases and sales of mutual funds.

Specifically, this approach would substantially diminish the ability of plan participants to promptly effect their plan investment decisions, and given the volatility of today's markets, would deny plan participants the ability to make their investment decisions based on current market information. This would be particularly problematic since large investors, investing directly in stocks, bonds or other securities, or even through exchange-traded funds, would be able to trade on current market information ahead of mutual fund investors.

Therefore, the SPARK Institute respectfully suggests that the Commission reject this approach on the basis that it would harm rather than protect small investors, such as retirement plan participants.

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[22] The Commission's estimates of costs in connection with the proposed rule in fact take the approach that "financial intermediaries" who would be required to transmit information to funds under the proposed rule are banks, insurance companies, and retirement plan administrators. 69 Fed. Reg. at 11770.

[23] 69 Fed. Reg. at 11768.

We hope that these comments are helpful. We will be glad to answer your additional questions and provide any additional information that may be helpful to you. Please feel free to call me (860-658-5058) or Steve Saxon or Roberta Ufford at the Groom Law Group (202-857-0620) if you have questions or comments.

Very truly yours,

Robert G. Wuelfing

cc: Paul F. Roye
Cynthia M. Fornelli