AMERICAN BENEFITS COUNCIL

VIA EMAIL
rule-comments@sec.gov

May 10, 2004

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

Re: Comment on proposed mandatory redemption fees for redeemable fund securities; File No. S7-11-04.

Dear Mr. Katz:

The American Benefits Council (the Council) appreciates the opportunity to express our concern about the impact on millions of qualified retirement plan participants of the proposed mandatory redemption fees for redeemable securities contained in Release No. IC-26375. Before promulgating a final rule, we urge the Securities and Exchange Commission (the Commission) to consider the impact such a rule would have on these millions of retirement plan investors as well as the substantial additional costs associated with implementing this rule.

The Council is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans. Accordingly, we are keenly interested in this issue, not only from the perspective of the firms that provide retirement plan investment products and services, but, rather, primarily from the perspective of companies that sponsor retirement programs on behalf of their employees and retirees.

The Council commends the Commission for its efforts to protect mutual fund investors and to restore investor confidence in mutual funds. Nevertheless, the Council is concerned that the mandatory redemption fees will disadvantage retirement plan

participants and would not constitute the most effective method of addressing market-timing activity.
We understand the mandatory redemption fees are designed to address market-timing trading abuses by requiring mutual funds (with limited exceptions) to impose a 2 percent redemption fee on the redemption of shares purchased within the previous five days. The Council is concerned the mandatory redemption fee will be imposed on various plan transactions where it is clear that market timing is not the motivation for the activity and is further concerned that fees will be imposed when the participant clearly does not have any control over the timing of a particular transaction. In addition, the Council is concerned that very substantial costs will be incurred to modify processes, procedures and systems to meet these new requirements thus increasing the costs associated with such plans to both plan sponsors and participants. We believe that such costs are unnecessary in the retirement plan marketplace, which in many cases has effectively addressed abusive market timing by placing trading restrictions on the funds and/or participants involved. Finally, the Council is concerned that these new requirements will cause extensive confusion for plan participants.

Better Tools to Battle Market Timing

Council member companies and their participants are concerned about reduced returns from market-timing activity and commend the Commission's efforts to address the problem. However, the Council is concerned that the mandatory redemption fee unfairly penalizes plan participants who have little or no control over some of redemption activity that occurs within their retirement plan account. In addition, the Council believes the mandatory redemption fee is not the most effective tool to battle market-timing abuses.

The proposed rule indicates the Commission is reviewing fair value pricing practices. We understand the Commission wishes to determine – if fair value pricing is implemented effectively – whether it will render a mandatory redemption fee unnecessary in the fight against market timing. The Council emphatically agrees that appropriate implementation of fair value pricing would address market-timing concerns in a more effective manner than a mandatory redemption fee. Regardless of the required holding period and level of fees imposed, market timers will still "game the system" when money can be made above the imposed redemption fees. Setting fees higher only unfairly punishes investors innocent of market-timing activities.

As stated in the Commission's proposal, "[a] significant proportion of abusive market timing has been designed to exploit systematic pricing discrepancies between the value assigned to a fund's portfolio securities for purposes of calculating the fund's net asset value and the 'fair value' of those portfolio securities." Market-timing practitioners attempt to take advantage of price differences for immediate gain at the expense of long-term fund holders. In the most blatant market-timing abuses, investors take

advantage of price differences between the time a foreign market closes (where most or all of the fund's underlying assets are traded) and the fund's net asset value is determined.
The Council believes the Commission's efforts to stem market-timing activity would be better focused on providing guidance necessary so that funds can effectively use fair value pricing, rather than mandating an expensive fee regime designed to discourage such activity. We understand these funds could incur significant costs to implement fair value pricing and these costs could be passed along to plans and plan participants. Therefore, the Council recommends that the Commission's guidance on fair value pricing include simplified, less costly methods of implementation.

If a mandatory redemption fee is imposed, the fund should be permitted to waive redemption fees for certain investors, such as retirement plan participants, who the fund's board of directors has determined do not represent a high potential for abuse.

In order to discourage market timing within the plan, it may be possible to create a safe harbor approach to eliminate the redemption fee that would require retirement plans to impose uniform trading restrictions on funds otherwise subject to the redemption fee, such as no voluntary trades out of a fund within five days. In the fall of 2003, the Council conducted a survey of member companies that indicated that when market-timing activity is detected within a retirement plan, plans typically implement holding requirements or restrictions on trading applicable to particular participants or across a fund. These types of restrictions serve the retirement plan community well in eliminating participant market-timing activity.

Many current recordkeeping and third party administrator (TPA) agreements have confidentiality provisions that would not permit information on individual participants to be shared with third parties. Requiring fees to be imposed on a participant level, and requiring plans to provide information to funds including Social Security numbers would violate many confidentiality provisions in these agreements. The owner of the fund position is the plan, itself, and participant data belongs to the plan. Recordkeeping agreements provide that recordkeepers agree to keep participant data confidential. Plan sponsors may also be concerned about the manner in which their participant data might be used (cross selling, for example) and may question whether mutual funds can receive such data unless the proposed rule clearly provides that authority and provides detailed limitations on its use. Some trades are placed by plan trustees and the recordkeeper may not know who is in the account or whether participants or a plan fiduciary decided to make the trade.

The Council also believes the proposed mandatory redemption fee coupled with possible changes under the hard 4:00 p.m. close proposal could prompt some plan sponsors to eliminate mutual fund offerings from potential plan investments. When participant-directed investing became popular for 401(k) type plans, many participants pushed for mutual fund offerings so they could look up the price in the newspaper on a daily basis. This advantage may now be mitigated by the new rules and the ability of participants to now look up a daily price on other types of investments on the Internet.

Discretionary Transactions Only

Under current interpretations of securities laws, the plan (not the individual participants) is considered to be the fund's shareholder. Therefore, the Council urges the Commission to carefully review the proposed fee regime and the types of transactions that occur under retirement plans to ensure that the implementation addresses market- timing concerns without punishing plan participants for normal (non-market timing motivated) activity within the plan.

If the fee is imposed on individual participants, the Council urges the Commission to limit imposition of redemption fees, in the retirement plan setting, to voluntary participant-initiated exchanges or inter-fund transfers. All other redemptions, such as for distributions and loans, should not trigger a redemption fee because they do not lend themselves to potential market-timing abuses. In addition, entering or exiting a qualified retirement plan is subject to very detailed rules on timing and substantial penalties if the rules are broken.

The Council believes eliminating potential market timing is the intent behind the proposed regulation. However, if the regulation is intended to reimburse funds for the costs of short-term trading, orders to purchase or redeem funds are placed with the mutual fund companies on an aggregated plan basis and directions by participants could net out to result in no buy or sell orders. However, redemption fees could still be imposed on the individual participants.

Many retirement plan transactions are made for specific reasons that can be easily identified and monitored. The specific requirements for these transactions are spelled out under the Internal Revenue Code, ERISA, or the plan's administrative rules. For most plan transactions, participants do not control the timing and, therefore, have little opportunity to time trades. The Council encourages the Commission to limit the rule's application to retirement plans so that only participant-initiated exchanges and transfers are covered. This would exclude the following retirement plan transactions from the redemption fees:

- Transactions that occur because the participant or his/her former spouse exercises a plan right (investment gain is not the primary purpose of the redemption) or the plan's fiduciary makes a decision that results in the transaction (non participant-directed). These include, among others, in-service withdrawals including hardship withdrawals, loans, payments required by qualified domestic relations orders, conversions between recordkeepers, assessment of plan expenses against the participant's account, and changing fund selections.

- Transactions that fall outside the definition of "discretionary transactions" as defined in Rule 16b-3 of the Securities Exchange Act of 1934. These transactions include employee and employer contributions into the plan (including elective deferrals and rollover contributions); trust-to-trust transfers; legally required or permitted corrective distributions including those made under the Internal Revenue Service EPCRS program; loan repayments and loan payoffs; distributions made on account of death, termination of employment, disability or retirement (even if there is a time delay after the event before the distribution); required minimum distributions and reinvestment of dividends.
- Automatic rebalancing where elected by the participant to occur on a pre-scheduled, recurring basis.

Consistency in Fee Imposition Needed

If a redemption fee is imposed, retirement plans need uniformity in order to reduce the costs of implementation, insure consistency of administration, and communicate the changes to affected participants. First, uniformity is needed with respect to the types of transactions to which the fee is applied. The Council encourages the Commission to limit application to participant-initiated exchanges and inter-fund transfers as discussed above. However, at the very least, the Commission should spell out the types of transactions under a retirement plan subject to the fee so that plans and plan participants do not face costly and confusing differences between fund families on the types of transactions that will be covered.

In addition, uniformity is needed with respect to the *de minimis* rule, the definition of "unanticipated financial emergency" for purposes of the exception, the amount of the redemption fee, and the length of the holding period. The more flexibility that funds have under the final rule, the more difficult it will be to communicate these rules to participants and the more difficult it will be for participants to understand the rules.

De Minimis Rule

The proposed rule allows funds to forego the assessment of a redemption fee if the value of shares redeemed is $2,500 or less. As an alternative approach, the proposed rule would require funds to forego assessing the fee if the value of shares redeemed is $2,500 or less. The Council recommends the Commission take the alternative approach and require the *de minimis* exception to be mandatory. The Council would also recommend the *de minimis* rule be indexed for inflation. Again, this helps alleviate administrative difficulties and costs and eases problems of communicating the new rules to participants.

In a letter to the Commission dated December 1, 2003, the Council advocated a *de minimis* rule for redemptions of $10,000 or less, partially to address the concern that the employee's contribution from his/her paycheck would be matched up with the sale and the redemption fee imposed. Applying the first-in, first out (FIFO) method of calculating the fee alleviates this concern somewhat. However, market timers are unlikely to trade in small dollar amounts and having a mandatory dollar floor will relieve some administrative difficulties for retirement plans. The Council also urges the Commission to maintain the FIFO calculation method. FIFO will have the least effect on small investors and a last-in, first-out (LIFO) calculation method would penalize retirement plan investors with small account balances.

Unanticipated Financial Emergency

The proposed rule indicates funds will be required to waive the redemption fee in the case of an "unanticipated financial emergency" if the shareholder requests the waiver in writing and the redemption is $10,000 or less. The fund could also waive the fee on redemptions greater than $10,000 in these emergency situations. Thus, waiver is mandatory for redemptions of $10,000 or less but at the fund's discretion for redemptions in excess of $10,000.

This exception will be exceedingly difficult for recordkeepers and TPAs to process and communicate to participants unless an "unanticipated financial emergency" is defined for retirement plan purposes and is exactly the same (with the same documentation requirements) as a "hardship distribution" under ERISA. The Council encourages the Commission to use the ERISA hardship distribution definitions and requirements for "unanticipated financial emergency" distributions from qualified retirement plans.

Even with use of the ERISA hardship distribution definitions two problems remain. First, the rule again needs to be uniform as discussed above – the required waiver for redemptions greater than $10,000. Second, many plans permit distributions for any reason after the participant attains age 59 1/2 (as permitted under the Internal Revenue Code) and many of those plans do not permit hardship withdrawals after that age because participants have relatively liberal access to their account. Applying the hardship standard to these post-59 1/2 withdrawals would be a significant added burden.

The cost of this exception for recordkeepers and TPAs will be considerable, as discussed in more detail below.

Redemption Fee/Holding Period

The proposed rules provide a mandatory 2 percent redemption fee for funds held less than five days but provide flexibility to allow longer holding periods and decreased fees for those longer holding periods. This flexibility would make it more difficult for recordkeepers and TPAs to program their systems to meet each fund family's rules. Each fund family, or even funds within a fund family, could impose different rules. Some lifestyle-type funds, including a fund made up of multiple funds, could have varying fees and holding periods that would be extremely difficult to program and/or communicate to participants. Participants may become confused as to when a redemption fee will or will not apply under the retirement plan and decline to save for retirement using the employer-sponsored retirement system.

The Council recognizes that if the Commission chooses to impose a mandatory redemption fee to discourage market-timing activity, one uniform fee and holding period may be inappropriate for all types of funds. In the event the Commission determines more than one fee structure is warranted, the Council would advocate a limited number of holding period/fee structures for fund companies to reduce administrative complexity. In addition, the restricted choice structure is easier to explain to plan participants. For example, the Commission could set the possible holding period/fee structures:

- 5-day holding period, 2.0 percent redemption fee
- 30-day holding period, 1.5 percent redemption fee
- 90-day holding period, 1.0 percent redemption fee
- 180-day holding period, 0.5 percent redemption fee

The Council asks the Commission not to allow funds to use a two- or more-tiered approach to the redemption fee with, for example, a 2 percent redemption fee for funds held fewer than five days and a 1 percent redemption fee for funds held five days or more but fewer than 90 days. The cost and amount of work involved in implementing a tiered redemption fee structure increases exponentially and becomes even more difficult to communicate to participants.

<u>Who Imposes the Fee</u>?

The Commission's proposed rule would allow mutual funds and third party intermediaries to impose the fee on the underlying investor by one of three methods. First, the intermediary could transmit to the fund (or its transfer agent), at the time of the transaction, the account number used by the intermediary to identify the transaction. The fund could then match the current transaction with previous transactions and impose the redemption fee when applicable. Second, the intermediary could identify redemptions that would trigger the fee and transmit information to the fund (or its transfer agent) sufficient to allow the fund to assess the redemption fee. Third, the intermediary could impose the redemption fee and remit the proceeds to the fund.

In order to avoid the confusion and increased costs caused by different applications of this rule, the Council recommends the Commission either mandate the third option (the fee is imposed by the intermediary) or allow intermediaries to make the selection. If recordkeepers and TPAs must provide different information to different funds, significant additional programming and costs will be involved.

The fist two options are cumbersome and unworkable in the current administrative environment (and complexities would be compounded by a hard 4:00 p.m. close). The recordkeeper or TPA would communicate the transaction request to the fund; the fund would calculate the fee and send an "adjustment to the transaction request" back to the recordkeeper or TPA. This would significantly disrupt the recordkeeper's and TPA's nightly system processing cycle. If the fund family requires transaction requests to be forwarded at the participant level, transaction costs would increase exponentially and would ultimately be passed on to plans and plan participants.

Regardless of which method is used, the rule requires that the intermediary provide the taxpayer identification number and the amount and dates of all purchases, redemptions or exchanges for each shareholder on at least a weekly basis. Use of the participant's Social Security number raises the confidentiality/privacy concerns discussed above. In addition, this requirement may be the most costly portion of the proposal. Sending reports on a monthly basis should be sufficient for monitoring purposes.

If the SEC's final rule requires funds to match shareholder transactions that occur through multiple accounts or intermediaries, funds could not delegate to recordkeepers and TPAs the entire assessment of redemption fee. The recordkeeper or TPA would be responsible for matching inter-fund purchases and redemptions within the plan and the fund would do a second check. This second check could result in imposition of a fee under the retirement plan based on activity that the participant engaged in outside the plan. Arguably, this may violate the anti-alienation rule under Internal Revenue Code Section 401(a)(13). This section generally provides that benefits under a qualified retirement plan cannot be redirected to pay for something outside the retirement plan. The Council recommends the Commission exempt retirement plan transactions from any such cross-checking requirement.

Cost Issues

Until the regulation is finalized, a meaningful estimate cannot be made of implementation costs. As previously indicated, the more flexibility the final rules provide to funds in determining the amount of fees, holding periods, *de minimis* rules, etc., the more the costs will increase for programming and implementation. If the final rules allow maximum flexibility, programming and implementation fees for recordkeepers and TPAs will amount to millions of dollars. Although these costs are initially born by the recordkeepers and TPAs, ultimately they are borne by plans and plan participants. The Council does not believe the benefits of the proposed rule justify these expenses, especially when applied to the types of retirement plan transactions not prone to market-timing abuses. Programming for redemption fees will likely occur at the same time as programming required for the final hard 4:00 p.m. close (and hopefully alternatives) regulations. Significant lead time of preferably two years, and no less than one year, will be needed.

Consider also that under current daily valuation systems (which could change under the hard 4:00 p.m. close proposal), transactions entered into the recordkeeping system before 4:00 p.m. Eastern Time are automatically processed that night. If recordkeepers and TPAs must determine if the "unanticipated financial emergency" exception applies, systems must be completely overhauled, at enormous expense, to hold each transaction until it is determined whether the exception to the redemption fee applies. In addition, absent exceptions for retirement plan transactions, recordkeepers and TPAs will need to build a system that examines every single transaction – imposing significant expenses in order to go far beyond what is necessary to address market-timing issues.

Many areas of the recordkeeper's and TPA's business, operations and systems will need review and modification in order to handle the imposition of redemption fees as outlined in the proposed rule. Listed below are some of the areas of substantial cost:

- Contracts with both fund families and plan sponsors must be renegotiated to allow (1) for the imposition of redemption fees on individual participants and (2) recordkeepers and TPAs to provide confidential information on participants to the mutual funds.
- Reprogramming of recordkeeping systems will be necessary to allow, among other things, measurement of holding periods, imposition of fees and production of reports of necessary information for the mutual fund companies.
- Participants typically direct their investments under the plan through web sites, telephonic voice response systems or call center personnel. The websites and voice response systems will need to be reprogrammed to notify participants of redemption fees and calculate and communicate redemption fee estimates. Call center personnel will need to be retrained to answer questions from participants regarding redemption fees and will need reprogrammed systems to access the necessary information.
- All retirement plan documents, including, but not limited to, plan documents, summary plan descriptions and plan administration materials will need to be reviewed, rewritten and reprinted to include the needed changes.
- Significant time, money and energy will be expended to explain these changes to participants through written communication and/or in-person meetings.

Finally, as the Council indicated to the Commission in our December 1, 2003, letter, implementation of mandatory redemption fees or required holding periods implicates fiduciary duties on the part of the plan sponsors. The Council suggests that the Commission coordinate closely with the Department of Labor on fiduciary issues. The Council hopes that the Department of Labor will work hand-in-hand with the Commission, providing legal guidance in this area, including clarification that any limitations placed under Commission rules do not jeopardize the plan's ERISA Section 404(c) protection for participant-directed investments.

We appreciate the opportunity to provide further input to the development of potential rules in this area, and to comment on such rules. We believe that the American Benefits Council brings an important and unique perspective from the employer sponsors of retirement plans and we would be pleased to make this and perspective available to the Commission through the submission of additional information or in meetings with the Commission. If additional information from us would be helpful, please contact me or Jan Jacobson, the Council's director, retirement policy, at 202-289-6700.

Sincerely,

James A. Klein

James A. Klein
President