NDCC

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TO: **Jonathan G. Katz, Secretary, Securities and Exchange Commission by email to: *rule-comments@sec.gov***

FROM: **National Defined Contribution Council (NDCC)**
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RE: **Mandatory Redemption Fee for Redeemable Fund Securities -- File No. S7-11-04**

NDCC is composed of seasoned industry practitioners dedicated to improving pension savings so that every working American can achieve financial security through participating in a retirement plan. It is the only organization formed specifically to address the special needs of plan service providers. Membership comprises over 50 companies, representing all aspects of the defined contribution industry.

The confidence many Americans have in our financial system has been tested with the recent disclosure of illegal activities at certain mutual fund firms and other financial institutions. A vast majority of plan participants who invest in mutual fund and other pooled/group accounts have been unaware of the possibility that more sophisticated investors could unfairly enrich their own accounts through market timing activities to the detriment of the typical investor. Mutual funds were the investment of choice for average investors trying to prepare for their own security and financial future through their retirement account and other savings. It is paramount that investor confidence be restored in and by our financial institutions. Mutual funds should be viewed as one of the ideal investments to secure the retirement future for Americans through the continued promotion and formation of defined contribution plans.

NDCC applauds the Securities and Exchange Commission's (SEC's) efforts to regain the confidence of the average investor by attempting to control excessive trading and market timing in its recent proposed new rule 22c-2 (under 17 CFR Part 270.22c-2 [Release No. IC-26375A; File No. S7-11-04]). NDCC believes it is imperative that investors once again trust the mutual fund investments they own. Members of NDCC are concerned, however, that the SEC's proposed rule imposing a 2% market fee for most redemptions within a five day period would not achieve the objective of limiting market timing and would instead cause substantial new burdens and costs on retirement plans, costs that will ultimately be borne by the participants in those plans.

The imposition of a redemption fee does not address the underlying problem, and will instead penalize investors. To truly address the cause of market timing, pricing flaws that make it profitable should be eliminated. This could be best accomplished by not only requiring funds to utilize fair value pricing, but also by adopting a uniform and standard methodology for calculating closing NAV.

The Current Proposal Will Not Achieve the Desired Objective

The SEC in its proposed rule stated the following objective:

> "reduce or eliminate the opportunity of short-term traders to exploit other investors in the mutual fund by (i) requiring them to reimburse the fund for the approximate redemption-related costs incurred by the fund as a result of their trade, and (ii) discourage short-term trading of mutual fund shares by reducing the profitability of the trades."

NDCC believes that the rule neither reduces short-term trade opportunities nor stems the rising transactional costs that some mutual funds are experiencing.

The reasons the proposed rule does not achieve the SEC's objective are varied, but at the core of the issue is the following tenet: *The implementation of a 2% fee across most funds for most redemptions within five days does not address the true underlying issue and cause of market timing and excessive trading.* The real cause of market timing is inefficient pricing that has provided for arbitrage opportunities. Thus, the 2% redemption fee attempts to address some of the symptoms and to rectify some of the injustices to long-term investors, but does not address the economic incentives for market timing. In some cases, the fee fosters an environment that lends itself to continued market timing trades. Listed below are the reasons NDCC believes that market timing will continue.

SHORT-TERM TRADES IN RETIREMENT PLANS – THE NEED FOR A STANDARD DEFINITION AND STANDARD CONSEQUENCES OF MARKET TIMING.

Retirement plans have generally been exempt by prospectus from enforcement or application of certain market timing requirements, or have been unable to police such activities. The reasons for this include the following facts:

- There is a lack of consistency regarding the definition of a market timing trade.
- Prospectuses have varied and different language. Often the definitions of market timing and excessive trading are not only different across fund families, but also are varied and different within a fund family.
- ERISA record-keeping systems for defined contribution plans are not equipped to systematically deal with the plethora of possible definitions or the many consequences of engaging in such activity. This is especially true in today's open architecture where recordkeepers may have thousands of funds on their record-keeping system.
- Retirement intermediaries were never required to enforce the terms of the prospectus. The fund and fund family were required to police and monitor such activity, yet they did not maintain, have access to, or request participant level records.
- Many smaller recordkeepers do not have the critical mass to upgrade their systems to monitor and police (or assist the fund in monitoring or policing) market timing and other abusive trading practices.
- Some fund companies never enforced the terms of the prospectus in this area because they viewed the enforcement at the omnibus level, not the participant or account level.

Most of the reasons listed above will still exist after the implementation of the SEC's 2%/five-day proposed rule. For example:

- There is no consistency regarding the definition of a market timing trade. The SEC proposal does not directly address this main issue. Recordkeepers will only be able to curb and eliminate short-term trading through automation where systematic programs are used to either assess a standard fee or enforce a standard "waiting" period before a subsequent trade is permitted. The SEC proposal does not preclude funds from adding additional fees, imposing a tiered fee (e.g., 2% during the first five days and 1% in the next 55 days), instituting holding periods longer than five days, canceling the trade at the discretion of the fund if the manager believes or has reason to believe trades are being market timed, or other requirements that can change on a fund-by-fund basis.
- Prospectuses have varied and different language. Unless some standardization can be obtained, retirement recordkeepers will be faced with the same quandary, which is: "I have over 1000 funds on my retirement recordkeeping system. I cannot possibly understand and enforce the varied and myriad differences in each fund's prospectus regarding market timing trades."
- Retirement intermediaries were never viewed as the entity that was required to enforce the terms of the prospectus. ERISA recordkeeping systems may be able to be programmed to enforce parts of the SEC proposed rule, but this will not eliminate each fund's unique definition of market timing that would still exist under the proposed rule.
- Many smaller recordkeepers do not have the critical mass. If enforcement activity in this area increases due to recent scandals, many retirement intermediaries will limit the funds they offer to their clients, as they will be unable to keep up with the policies of the various funds regarding market timing.

For the reasons stated above, standardization is paramount for retirement plan intermediaries.

THE FIFO RULE IS THE ONLY POSSIBLE APPROACH RETIREMENT PLAN RECORDKEEPERS CAN IMPLEMENT, BUT MARKET TIMING WOULD STILL BE POSSIBLE.

Unscrupulous investors will quickly be able to circumvent the imposition of the 2% fee and still "time" large trades within or outside a retirement plan and effectively escape the 2% fee under the FIFO rule. Thus, the FIFO rule would not substantially deter market timing, and it could be argued that FIFO accounting actively fosters market timing trades.

If, despite the issues with the 2%/five-day approach, the SEC chooses to move forward on that basis, NDCC wants to make it absolutely clear that FIFO is the only administratively workable approach for the following reasons:

- Recordkeepers and funds that have instituted this capability or are in the process of implementing this capability have done so on a FIFO basis. Thus, vast resources have already been spent in implementing a FIFO approach.
- Investments that implement a surrender charge or a Contingent Deferred Sales Charge (a CDSC is generally imposed on "B" and "C" shares as well as many annuity products) are required to liquidate shares that no longer have a back end fee, or those shares that have the lowest back end fee. This requires recordkeepers to sell the oldest shares first. It

would be impossible or very difficult to implement an accounting system that uses LIFO for certain purposes and FIFO for other purposes.

- Some recordkeepers have a mixture of funds, some of which pay a commission and others that do not pay a commission to a broker. As a result, retirement recordkeepers generally have "rules" to sell shares based on financial interest of the plan participant by selling shares that will not generate another commission. A redemption fee based on FIFO accounting can be more easily accommodated and is consistent with these types of plans and investments.

THE FIVE-DAY WAITING PERIOD DOES NOT ADDRESS THE REAL ISSUE WITH MARKET TIMING AND WILL NOT DETER MARKET TIMERS IN RETIREMENT PLANS.

In the background section of the proposed rule, the SEC recognizes that short-term and frequent traders seek to exploit anticipated changes in a fund's value through inefficiencies within the valuation of a mutual fund. Indeed, many short-term market timers have successfully enriched their own accounts to the detriment of long-term investors through time zone arbitrage. The SEC also notes that:

> "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. We believe that the use of fair value pricing, as required by the Act, can reduce or eliminate the arbitrage opportunities that these market timers seek, and that the primary response of funds and fund managers must, therefore, be to more accurately calculate the daily net asset value of the fund by using fair value pricing methods when closing prices are unreliable."

The implementation of a 2% fee on redemptions within a five-day holding period will not eliminate the abusive practice of time zone arbitrage, nor will it change the environment that fosters such possibilities. The primary advantages that a market timer utilizes in reaping short-term profits are stale prices and time zone arbitrage. Although it is true that market timers often "lock in" those profits by selling those same securities within a short period of time, the only material difference the proposed rule would cause for market timers is that the profits they reap would be "unrealized" for a few days longer. For the five-day period to truly be effective, it would have to be shown that arbitrage opportunities and stale pricing are a fleeting and self correcting phenomena in which the price of the stale fund reverts back to the pre-arbitrage pricing within a few days. Although we have not proved this through empirical data, most industry experts believe that stale pricing and arbitrage opportunities change a fund's value for the long term, and only other and different market forces may increase or decrease a fund's value in the period right after an arbitrage opportunity presents itself.

Thus, the 2%/five-day rule will not be an effective tool in curbing abusive trading practices such as market timing and excessive trading. Standardization through fair value practices and defining of market timing (discussed later) will be more effective tools to achieve a fair and equitable financial system that protects small, long-term investors.

SOME INVESTMENTS WILL BE UNAFFECTED WHEN THE SAME ABUSES OCCUR.

The SEC proposed rule, if implemented, would only affect mutual funds, certain annuities and other securities. It would likely not affect some non-registered annuities, Collective Trust, or certain pooled accounts not under the SEC jurisdiction. However, abusive trading practices such as market timing and excessive trading that may occur in retirement plans are indifferent to the type of the underlying investment in the trust. Thus, investors with securities that still have stale pricing and opportunities of time zone arbitrage will continue with these unfair trading practices if the security is not subject to the same type of rules that apply to mutual funds.

TYPICAL TRANSACTIONS IN RETIREMENT PLANS CANNOT BE DEALT WITH EFFICIENTLY UNDER THE PROPOSED RULE.

The vast majority of transactions in retirement plans do not create an opportunity for market timing because the participant does not control the timing of such transactions. These transactions include:

- Salary deferral contributions
- Company contributions
- Rollover contributions
- After-tax contributions
- Loan repayments
- Hardship withdrawals
- Age 59 ½ withdrawals
- Other in-service withdrawals
- Installment payments
- Lump sum distributions
- Loans
- “Funds of Funds” or “lifestyle funds” (Many plans will incorporate a lifestyle fund as one of the plans investments. A lifestyle fund often is an investment that invests in other mutual funds, i.e., a fund of funds. A fund manager may sell shares in one of the funds within this investment for liquidity needs or for investment reasons.)
- A fiduciary decision to replace a fund (i.e., liquidating an entire fund in favor of a new fund)
- Elimination of a fund by a fiduciary or a conversion to another recordkeeper
- “Automatic” rebalances (some participants have their recordkeeper “automatically” rebalance their retirement portfolio based on their risk tolerances and fund choices)
- Participant directed transfers, re-balances or exchanges.

Many of the above transactions will cause a liquidation in a fund; yet it is only the last item (participant directed transfers, re-balances, exchanges) that can realistically have an abusive trading practice associated with it. Thus, the SEC proposal would clearly have the effect of imposing a 2% fee on normal plan transactions that would not be part of a market timed trade or an excessive trade.

For example, if a participant requested a loan from a fund and the loan was liquidated within five days of the year-end profit sharing or matching allocation/funding, the participant would incur a 2% redemption fee. Yet it is clear that this participant did not engage in any type of market

timing or other abusive trading practice and usually has no control over when such transactions occur.

Likewise, if a fiduciary decides to replace a fund with a more prudent alternative, participants who had made a transfer or investment within five days of the decision would be subject to a redemption fee, yet they clearly are not engaging in any type of abusive trading practice. Nor should fiduciaries require a blackout of five days within a plan in order to make or implement the decision to change investment alternatives within a plan.

Keep in mind, retirement plan intermediaries "roll-up" the trades of a plan and generally execute only one or a few transactions in a fund each day. Thus, a plan with 1,000+ participants and many transactions will only process one purchase or one sale at the fund level. Although market timing in the context of participant directed transfers, re-balances and exchanges using stale pricing can be detrimental to other shareholders, we are uncertain and unsure of the amount of harm caused by participants who trade often, as these trades are "wrapped up" into just one transaction.

Retirement plan intermediaries will pass along the cost they incur to comply with the new rules to plans and plan participants. Since it is NDCC's considered view that the proposed rule will not significantly deter market timing, we do not believe that the associated benefits to plans and plan participants outweigh the cost that they will bear. This is particularly true with respect to the myriad transactions within retirement plans that have no potential for market timing. NDCC believes that the cure (as proposed) is worse than the disease.

THE SEC PROPOSAL DOES NOT ADDRESS OR PREVENT MARKET TIMING OF "REDEMPTION FIRST" TRANSACTIONS.

Participants who initiate a market timed transaction by selling first and then quickly repurchasing in the same fund are unimpeded by the SEC proposal. For example, assume a participant is currently and has been heavily invested in an international fund. Further assume he sells all of his shares on a Monday (by going to a money market fund) and then repurchases shares back to that same international fund on Tuesday or Wednesday. Clearly this shareholder is timing his trades, especially if an international event occurs that will cause the fund to depreciate in value. This shareholder is "escaping" the fund before his shares have depreciated, thereby causing the other shareholders to incur the loss on his portion of the fund. The SEC proposal does not deter this type of market timing in any way. Timing trades for the purpose of "loss avoidance" are just as harmful to long-term investors as timing that attempts to capture ill-gotten gains.

ALL SHAREHOLDERS WHO TRADE, TRANSFER, AND LIQUIDATE FUNDS, NOT JUST THE SHAREHOLDERS WHO LIQUIDATE SHORTLY AFTER A PURCHASE, INCREASE TRANSACTIONAL COSTS.

A shareholder who buys a large-cap domestic equity or U.S. government bond fund and then sells the fund shortly afterward, and engages in such activity repeatedly, clearly increases the transaction cost shared by all shareholders in that fund. Since it is difficult if not impossible for shareholders to "time" such funds with stale pricing or time zone arbitrage, it is only the related

transaction cost that could be viewed as unfair to the long-term investor. However, a shareholder who sells his shares in four days versus six days (or any length of time) causes the fund to incur the same cost. The SEC proposal would only require some shareholders (those who sell within five days) to reimburse the fund, while other shareholders would not be required to reimburse the fund for the same approximate transaction cost.

THE REPORTING REQUIREMENTS ARE OVERWHELMING AND WILL NOT BE ABLE TO BE WELL UTILIZED BY FUND COMPANIES.

In the proposed rule, the SEC states:

> "Regardless of which of the three methods described above are used to collect the redemption fee, the proposed rule also would require that, on at least a weekly basis, the financial intermediary provide to the fund the Taxpayer Identification Number (TIN), and the amount and dates of all purchases, redemptions, or exchanges for each shareholder within an omnibus account during the previous week. This information is designed to enable the fund to confirm that fund intermediaries are properly assessing the redemption fees.
>
> It also would 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. In addition, this may in some cases be helpful to funds that would be able to use the information to determine whether shareholders received appropriate breakpoint discounts on purchases of fund shares sold with a front-end sales load."

NDCC is seeking clarification of the intent of the requirement that information be exchanged between the fund companies and the retirement intermediary. If the intent is solely to ensure application of the redemption fee, NDCC believes that only information regarding participant directed transfers, re-balances, and exchanges is necessary (assuming the SEC shares the view that only these types of transactions lend themselves to potentially abusive trading practices, as discussed in greater detail above). NDCC also believes that imposing a weekly exchange of information is too burdensome and is not necessary. The information should be available "upon request" by the fund company, with the retirement intermediary required to comply with the information request in a timely matter.

The SEC alludes to other possible uses of the information including application of "breakpoints" and ability to implement other pertinent aspects of the funds prospectus.

Should the SEC require such information on a weekly basis, the SEC should detail the requirements and uses of such information. For example, would fund companies be required to match up this information from all sources to determine if the fund's excessive trading requirements were violated? Or, would a fund that imposed a 60-day "wait" period be required to implement some type of action if a shareholder purchased these shares inside his retirement plan but then sold shares shortly after the purchase in the same fund through an account that was not related to the retirement account? Lastly, if a fund currently enforces certain provisions of its prospectus (like a 60-day wait period) at the omnibus level, would the transmission of this information now require that a fund company enforce this provision at the individual level? This example is further complicated by trades within a retirement plan that "offset" one another, where the excessive trading policy is not violated at the omnibus level but would be violated at the individual level. Since the policy was not violated at the omnibus level, one could argue and prove that other shareholders have not been harmed. And, one could successfully argue that

enforcement at the participant level (if some trades were cancelled by the fund company) actually hurts other investors by increasing the transaction cost.

If such an exchange of information was as exhaustive and as frequent as the proposed rule suggests, fund companies would be uncertain of what to do with all this new information without significant and detailed guidance. Since the focus of the proposed rule is to curb market timing, NDCC is suggesting a more limited exchange and only "as needed" by the fund companies. In order to meet the intention of the proposed rule and to keep the cost and volume of the information at a more reasonable level, NDCC believes a more limited transfer of information is more appropriate.

THE EMERGENCY EXCEPTION IS NOT NECESSARY AND WILL ONLY ADD TO THE COST TO IMPLEMENT THE PROPOSED RULE.

The SEC noted that certain emergencies might require or afford funds the opportunity to waive the redemption fee. The SEC noted such events as emergency surgery, death, disability and other personal hardships. Keep in mind, it is rare for a person or executrix to need funds within five days of an emergency. NDCC believes that an emergency exception is not required, as payment in virtually all emergencies is never required within five days of the event. In addition, most prudent investors set aside a portion of their overall savings in a checking, bank or money market account. Since these types of investments are already exempt, the emergency exception (even though not needed for the reasons stated above) would be redundant.

Fair Value Pricing Will Address The Root Cause Of The Problems

As discussed above, and noted by the SEC in its request for comments, the majority of market timing transactions are an attempt by a small minority of shareholders to exploit pricing inefficiencies resulting in stale prices on certain funds. This practice is most prevalent in international funds where shareholders attempt to "cash in" on a potential pricing discrepancy occurring as a result of the time differential between the close of foreign markets and the striking of a closing NAV by mutual fund companies.

The imposition of a redemption fee does not address this underlying problem, but merely attempts to penalize shareholders from exploiting inefficiency in the market. To truly address the cause of market timing, the SEC should eliminate the pricing flaw that makes it profitable. This could be best accomplished by not only requiring funds to utilize fair value pricing, but by adopting a uniform and standard methodology for calculating closing NAV. While the development of the calculation is beyond the expertise of NDCC, we would urge the SEC to pursue this solution that addresses the root cause of market timing rather than attempting to "treat a symptom."

Conclusion

NDCC believes that taking steps to ensure elimination of stale pricing in certain funds through Fair Value Pricing will strike at the economic cause of market timing and thus is the only viable tool to deter and curtail market timing. If imposed, a 2% redemption fee will ultimately prove

ineffective for the reasons cited, and will impose significant additional costs that will be borne by the same investors it is intended to protect.

However, if the SEC continues to pursue a mandatory redemption fee, NDCC would appreciate the opportunity to work with the SEC so that retirement intermediaries can effectively administer the final rule. The rule will only be effectively implemented, monitored and policed by retirement intermediaries if standardization in the definition and consequences of market timing is adopted.

DISCLAIMER

The opinions expressed in this statement are those of the NDCC organization and its committees, but are not necessarily the opinions of each of its members.