PROFIT SHARING / 401k COUNCIL OF AMERICA
UNITED STATES CHAMBER OF COMMERCE

COMMENTS ON SECURITIES AND EXCHANGE COMMISSION PROPOSED RULE ON MANDATORY REDEMPTION FEES FOR REDEEMABLE FUND SECURITIES
File number S7-11-04

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Secretary
Securities and Exchange Commission
Washington, DC 20549-0609
Submitted electronically

The Profit Sharing/401(k) Council of America (PSCA)[1] and the United States Chamber of Commerce[2] appreciate this opportunity to comment on the Commission's proposed rule on mandatory redemption fees for redeemable fund securities. As we explain in detail in this letter, our principal concerns are:

- The proposed rule is premature. The Commission should reinvigorate and enforce an effective fair value pricing requirement that will eliminate stale net asset value prices that permit time zone arbitrage before proposing or implementing other market timing remedies.

- Any measures to address market timing should accommodate alternative measures jointly agreed to by funds, intermediaries, and sponsors of employer-provided retirement plans.

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[1] The Profit Sharing/401(k) Council of America (PSCA) is a non-profit national association of employers who sponsor defined contribution retirement plans for their workers. For over fifty-five years, PSCA has identified and shared best practices with its members, represented their interests in Washington, and provided analysis and reportage on the latest regulatory changes. PSCA members range in size from very small independent businesses to firms with hundreds of thousands of employees. Our members believe that profit sharing, 401(k), and related savings and incentive programs strengthen the free-enterprise system, empower and motivate the workforce, improve domestic and international competitiveness, and provide a vital source of retirement income.

[2] The United States Chamber of Commerce is the world's largest business federation representing more than three million businesses and organizations of every size, sector, and region, with substantial membership in all 50 states. The Chamber of Commerce is committed to strengthening the retirement security of all Americans and believes that the employer-provided retirement system is a vital factor in retirement security. As such, the Chamber and its members strive to improve participation in and accessibility to the employer-provided retirement system.

- The Commission should consider if the cost and complexity resulting from this proposed rule will outweigh the benefit to investors. These costs will be born by investors and will result in reduced savings for retirement.

- Should the Commission decide to proceed with the proposed rule, only those retirement plan transactions that provide participants with market timing opportunities should be subject to the requirements of the proposed rule.

The lack of an effective fair value pricing system makes this proposed rule premature.

There are two elements to market timing, both of which harm long-term shareholders. One element is short-term traders who seek to quickly capture an increase in net asset value. The other element is investors who take advantage of a structural defect in funds that creates inaccurate share prices to engage in time zone arbitrage. To eliminate time zone arbitrage, the Commission requires a fund to adjust its net asset value to reflect events occurring after the market close of the fund's underlying assets in a process known as fair value pricing. In the background section of the proposed rule, the Commission states "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 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.[3]"

Unfortunately, the Commission has not ensured that fair value pricing is properly employed. According to a recent news story reporting statements by Commission officials, one third of 960 mutual funds questioned by the Commission had not engaged in fair value pricing in the previous 20 months.[4] During the same period, more than half of the funds reported using fair value pricing five times or less. All of those funds held half or more of their assets in foreign securities. Finally, according to the news article, the funds that made no use of fair value pricing had high levels of share turnover, a common indicator of market timing.

Any effort to examine market timing and recommend remedies without first ensuring the implementation of the existing fair value pricing requirements is premature. A strictly enforced fair value pricing system is much more effective in eliminating time zone arbitrage than arbitrary fees and time limits. The reasonableness of a two percent redemption fee cannot be determined because the cost of market timing without time zone arbitrage is unknown. Any proposed rule should be delayed and reevaluated after the Commission institutes an effective fair value pricing system.

Retirement plans, intermediaries, and funds should be permitted to develop alternative approaches to address market timing abuse.

Retirement plan sponsors, intermediaries, and funds work cooperatively to eliminate market timing abuse by retirement plan participants. As a result, market timing abuse by retirement plan participants is rare, as it is in other investment arrangements. The prevalent practice is to identify market timers and to take proactive and progressive measures to stop them from further activity, beginning with speaking to the individuals and then applying more harsh remedies if they do not stop engaging in improper trading

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[3] 69 Fed. Reg. at 11768

[4] "SEC Inspections Staff Refers Fund Cases Involving Fair Value Pricing to Enforcement," *Daily Report for Executives,* BNA, Inc., April 27, 2004.

activity. Some employers have fought, and won, lawsuits filed by participants who objected when their market timing was stopped. Opposition by retirement plan sponsors to efforts to address market timing, while highly publicized, is rare—and it should not be tolerated.

The Commission should consider the low incidence of market timing within retirement plans compared to the complexity and cost, which will be born by plan participants, in the proposed rule. We believe that the increased costs to participants that will result from the proposed rule will greatly exceed the financial harm to retirement plan participants from market timing. While funds must apply their market timing policies uniformly, they should be permitted to develop separate strategies, in cooperation with intermediaries and plan sponsors, to address market timing by retirement plan participants. These strategies should include the flexibility to identify and eliminate market timing by retirement plan participants upon discovery while applying a redemption fee strategy for other investors.

Should the Commission decide to proceed with the proposed rule, it should be amended to be limited to only retirement plan transactions that provide opportunities for market timing.

In order to market time, an individual needs to control the timing of both the purchase and the redemption, and those transactions must be conducted in a same day pricing environment. In retirement plans, this occurs only when a participant directs the transfer of assets from one investment to another. Payroll contributions, withdrawals, rollovers, qualified domestic relation orders, and loan receipts and repayments do not afford market timing opportunities because the participant does not control the exact timing of the transaction. This concern, and many others, is discussed in detail in the remainder of this letter.

DETAILED DISCUSSION OF PROPOSED RULE

I. Executive Summary and Key Points

A. **The final regulations should not require redemption fees with respect to all funds**. Fund families should be able to decide <u>not</u> to charge redemption fees with respect to funds that they have determined are not likely to be subject to abuse.

B. **If a fund family does impose a redemption fee with respect to a fund, it should be permitted to waive redemption fees for certain investors, like retirement plan investors, who the fund's board of directors has determined do not represent a high potential for abuse or where other valid practical concerns would lead the board to determine not to impose redemption fees.**

C. **Redemption fees should not apply to all retirement plan transactions.** The only retirement plan transactions to which redemption fees should apply are participant-initiated exchanges or inter-fund transfers. All other redemptions, such as those triggered by distributions and loans, should not trigger a redemption fee because they do not present the opportunity for abuse that redemption fees are intended to address. These redemptions must meet certain requirements and cannot be reinvested in the plan in a manner that would permit market timing.

D. **The final rules should require that the parameters surrounding the application of redemption fees (for example, the amount, holding fees, de minimis rules and hardship exceptions) should be uniform.** Most recordkeepers have many arrangements with fund families. If the final rule provides simply for minimum requirements rather than setting uniform rules, many recordkeepers may not be able to program their record-keeping software for the varied regimes imposed by fund families. Many recordkeepers are dependent upon third party software vendors to change their software to accommodate redemption fees, and the vendors may or may not program all of the necessary changes. This will lead to recordkeepers making fewer funds available to participants in retirement plans, and eliminating some funds currently available.

E. **Of the three approaches set forth in the proposed regulation, the one that should be mandated is the one under which the recordkeeper calculates and imposes redemption fees.** The other two approaches, under which the recordkeeper sends data to the fund in order to assess redemption fees, are not workable. It will be virtually impossible for recordkeepers to match retirement plan transactions with other transactions engaged in by participants in other accounts the participants' hold in the fund outside of the retirement plan.

II. Two Percent Redemption Fee

A. If the Commission decides to implement the two percent redemption fee, it should be mandatory and uniform. The more flexibility that the rules give to funds to impose differing redemption amounts, the more difficult it will be for retirement plan recordkeepers to communicate the differing rules to participants, and the more difficult it will be for participants to understand these rules. This will discourage saving for retirement. In addition, the introduction of tiered fee structures will be even more difficult to communicate to participants.

B. Uniformity in the amount of the fee would make it easier for retirement plan recordkeepers to program their systems to track and collect the fee.[5] Tiered fees would cause a great deal more difficulty than flat fees. See Section III.A., below (similar concepts apply here).

Unless various "nondiscretionary" and other retirement plan transactions (see below) are exempted, the higher the amount of redemption fee that is charged, the more punitive the effect on unsuspecting plan participants.

III. Five-Day Holding Period

A. The flexibility that the proposed rule gives to funds to determine the length of the holding period would make it more difficult for retirement plan recordkeepers to program their systems to meet each fund family's rules. Each fund family, or even funds within fund families, could impose different rules. It would be difficult to communicate to participants the different holding periods for different funds. Participants will be likely to become confused as to when a redemption fee will or will not apply and therefore be less likely to save for retirement. The cost of programming to apply different holding periods that vary by fund family, or even by fund, could be significantly higher than if uniform holding periods apply, particularly if tiered holding periods were to apply, and recordkeepers would need a longer period of time to implement the various fund's holding periods. The cost of programming would be likely to be passed on to the participants. On a sliding scale, the more flexibility permitted to fund

[5] . We are assuming—as has the Commission—that in the overwhelming majority of cases, fund families will direct responsibility for determining whether redemption fees apply and collecting them to intermediaries.

families to adopt disparate rules, the longer it will take for programming by recordkeepers to occur.

B. The Commission asks in the preamble to the proposed rule whether the rule should contain a special provision addressing account transfers within the previous five days, such as 401(k) plan rollovers to IRAs, to prevent the imposition of the redemption fee in those circumstances.[6] The answer is "yes," but we think the exception for retirement plan-related transactions should be much broader. The only retirement plan transactions to which redemption fees should apply are participant-initiated exchanges or inter-fund transfers because these are the only transactions that permit market timing within a retirement plan. All other redemptions, such as those triggered by distributions and loans, should not trigger a redemption fee because they do not present the opportunity for abuse that redemption fees are intended to address. In addition, various purchases of shares should not be matched with redemptions.

1. Unlike retail accounts, in retirement plans accounts, the reason (or triggering event) for the transaction generally can be easily identified, such that those transactions that can be identified as not providing the opportunity for abuse should be exempted.

2. The following describes the three categories of retirement plan transactions (i.e., all of those other than participant-initiated exchanges and transfers) that we believe should not be subject to redemption fees because they can be easily identified as not being prone to abuse:

   a. The first would be those falling outside the definition of "discretionary transaction" as defined in Rule 16b-3 under the Securities Exchange Act of 1934[7].

   b. The second would be transactions unique to retirement plans, where the transaction is discretionary, the transaction does involve a redemption, but is other than a participant-initiated inter-fund transfer or exchange between a plan's investment alternatives. In each of these situations, investment gain is not the primary purpose of the redemption; rather, the redemption occurs because the participant exercises a plan right[8]. PSCA and the U.S. Chamber believe that the imposition of a fee with respect to redemptions in connection with these transactions would be unfair to participants, would be burdensome and costly for recordkeepers to implement and would not serve the intended purposes of imposing a redemption fee.

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[6] We include in the scope of retirement plans, not just tax-qualified plans under section 401(a) of the Internal Revenue Code, but also section 403(b) plans, governmental section 457 plans, etc.

[7] Nondiscretionary actions would include elective deferrals, employee contributions, rollover contributions, and employer contributions into a plan; trust-to-trust transfers into a plan on a participant's behalf; employer-initiated trust-to-trust transfers out of a plan; regular loan repayments, loan prepayments; distributions on death, termination of employment, disability, or retirement, which should be clearly defined to mean any distribution occurring on account of any of these events, regardless of the time lag; cashouts; required minimum distributions; reinvestment of dividends on any plan investment; legally required corrective distributions (ADP, ACP, 415 excess, 402(g) excess); any distribution made under the Internal Revenue Service's EPCRS program.

[8] These transactions would include hardship withdrawals; in-service withdrawals; loans; conversions between recordkeepers; and, payments pertaining to qualified domestic relations orders, among others.

c. The third would be inter-fund transfers as a result of automatic account rebalancing, where elected by the participant to occur on a pre-scheduled, recurring basis.

2. We note that many of the foregoing transactions are made at the direction of the plan administrator, plan sponsor, or other plan fiduciary, not the participant, and others are mandated by law. Examples of the former are the assessment of plan expenses against participants' accounts, conversion of the plan to a new recordkeeper and the de-selection of funds because of poor investment performance. An example of the latter is minimum required distributions. It would be unfair to assess redemption fees upon participants' accounts with respect to these transactions.

IV. Smaller Investors

A. The proposed rule recommends a "first in, first out," or "FIFO" approach. This is the best approach because it would have the least effect on small investors. A "last in, first out," or "LIFO," rule, especially without an exception in place with respect to certain "non-discretionary" retirement plan transactions as described above, will penalize retirement plan investors, who often have small account balances, and who will have their retirement savings diminished, even when there has not been any intent on the part of the participant to trade excessively or time the market.

1. But note that even under a FIFO approach, absent an appropriate exception for retirement plan transactions other than participant-initiated exchanges and transfers, retirement plan intermediaries will still have to build a system that examines every single transaction—which will be significantly more costly to build and go far beyond what is necessary to address the policy goals articulated by the Commission as the justification for the proposed regulation.

B. There should be a uniform de minimis rule. The more flexibility that the rules give to funds to impose differing de minimis rules, the more difficult it will be for retirement plan recordkeepers to communicate the differing rules to participants, and the more difficult it will be for participants to understand these rules. This will discourage saving for retirement. On a sliding scale, the more flexibility permitted to fund families to adopt disparate rules, the longer it will take for programming by recordkeepers to occur. The de minimis rules should also apply for purposes of determining whether a transaction needs to be reported to a mutual fund family. Clearly, dividend reinvestments should not be treated as purchases to be matched with redemptions for purposes of these proposed regulations.

1. Under the proposed Commission rule, the de minimis rule would be permissive rather than required. It should be mandatory—at a minimum, it should be mandatory for redemptions made in the context of a retirement plan.

C. The proposed regulation's "unanticipated financial emergency" exception will be exceedingly difficult for recordkeepers and funds to handle. If the only retirement plan transactions that are subject to redemption fees are exchanges between funds within the plan and inter-fund transfers, this exception becomes irrelevant, because exchanges and transfers within a plan (i.e., not resulting in the proceeds being distributed to the participant) should never be engaged in because of an unanticipated financial emergency. If all other retirement plan transactions are not exempted, the following concerns and issues will arise in connection with implementing the unanticipated financial emergencies exception with respect to retirement plans:

1. The proposed regulation's unanticipated financial emergency exception is somewhat similar to, but significantly different from, the "hardship withdrawal" provision permitted under section 401(k) of the Internal Revenue Code. This is problematic from a retirement plan administration and recordkeeping perspective.

2. The financial emergency exception in the proposed regulation is not the same as the standards for a hardship withdrawal as set by Internal Revenue Service regulations for 401(k) retirement plans. The IRS provision is arguably much narrower in one sense, in that the safe harbor definition covers very specific sorts of hardships. On the other hand, the IRS withdrawal provision is arguably broader, in that a financial obligation might be a hardship but not necessarily an "unanticipated financial emergency."

3. Many plans already have provisions for hardship withdrawals, and these provisions—as required by law—permit hardships based on the standards in the IRS regulations. If an "unanticipated financial emergency" exception is implemented, it is almost certain that funds will require retirement plan recordkeepers to communicate the exception to plan participants and evaluate whether such an emergency exists. First, so that a completely new set of hardship rules is not imposed on plans and participants, which could vary fund family to fund family, the Commission's rule should state that the reasons for hardship in retirement plan transactions should be co-extensive with those provided for in the plan's existing hardship withdrawal rules, regardless of the type of plan transaction and regardless of whether the hardship is "unanticipated." This will allow each plan to apply a uniform set of hardship rules. The recordkeeper should be permitted to rely on an affidavit from the participant, without having to receive supporting written documentation of a hardship; requiring written documentation will require a subjective determination by the recordkeeper, and will inordinately delay various ordinary retirement plan transactions, such as loans and in-service withdrawals. Whatever rule is imposed, the rule should be uniform so that it can be programmed and implemented efficiently.

4. Note that the "unanticipated financial emergency" exception, as written, would apply to any redemption, regardless of whether it is made in connection with giving a participant an in-service hardship withdrawal under the plan. Even if the Commission were to permit retirement plan intermediaries to utilize the IRS definition of hardship to satisfy the "unanticipated financial emergency" standard, it could still require significant programming or, more likely, administrative burden for plan administrators. For example, under daily valuation recordkeeping systems as currently constructed, transactions entered into the recordkeeping system before 4 p.m. ET generally are automatically processed that night. If recordkeepers were required to make the determination whether the exception to the application of redemption fees applies, systems would have to be completely overhauled, at enormous expense, to hold (i.e. "pend") the transaction until the determination of whether the exception applies is made. In many current systems environments, unless the participant comes in strictly speaking for a hardship withdrawal, no recordkeeper is going to know whether the hardship

exception applies. Post age 59-1/2, many plans don't even permit hardship withdrawals because participants generally are permitted relatively liberal access to their account balances under the Internal Revenue Code without having to demonstrate a hardship. Applying the hardship standard to these post-59-1/2 withdrawals would be a significant added burden.

V. Shareholder Accounts and Intermediaries

A. Under the first method proposed for the imposition of redemption fees in the Commission's proposed regulation, the recordkeeper would be required to transmit to the fund at the time of the transaction the account number used by the intermediary to identify the transaction and the fund would assess the fee. Under the second approach, the recordkeeper would enter into an agreement with the fund requiring the recordkeeper to identify redemptions by participants that would trigger a redemption fee and send holdings and transaction information to the fund sufficient to allow the fund to assess the redemption fee. Under the third approach, the recordkeeper assesses the fee. Regardless of the approach, the proposed regulation provides that on at least a weekly basis, the recordkeeper would provide to the fund each participant's taxpayer identification number (i.e. their social security number), and the amount and dates of all transactions for each "shareholder" within an omnibus account during the previous week.

B. The first approach seems unworkable and cumbersome.

1. To prepare plan-level purchase or redemption requests, the recordkeeper would have to communicate the transaction request to the fund, the fund would calculate the fee, and then send an adjustment to the transaction request back to the recordkeeper. This would significantly disrupt the recordkeeper's nightly system processing cycle. Instead, the fund family might require purchase and redemption requests to be forwarded at the participant level. This would exponentially increase transaction costs, which would ultimately be passed on to the plans and participants.

2. It is not clear what account number would be used—certain participant identifiers, like social security numbers may raise confidentiality/privacy concerns (see below).

C. As discussed in Section V.A., above, under the first and second approaches, the fund will need to communicate back to the recordkeeper what redemption fee has been assessed. The recordkeeper's system would then have to process the redemption fee as a separate transaction, thereby significantly holding up processing of the nightly cycle.

D. Of the three approaches, therefore, the third approach is much preferable, and the only one that is truly workable.

1. Recordkeepers either need the option to choose which of the three approaches will apply, or will need a uniform approach. Once again, programming time and costs will multiply if multiple approaches will apply fund family by fund family or fund by fund.

2. Under the first approach, the only viable way to match transactions is not at a plan level, but at a participant level. In this regard, with respect to the first approach, as well as the required weekly data transmission, passing participants' social security numbers to the

fund family is troubling from a confidentiality of client data viewpoint (note that the owner of the fund position is the plan; participant data belongs to the plan and recordkeeping agreements provide that recordkeepers agree to keep participant data confidential). We suggest that report be monthly in any case, which should be sufficient.

3. If the Commission's final rule were to require funds (or recordkeepers) to match shareholder purchases and redemptions that occur through multiple accounts or intermediaries, such a comparison on a daily basis would be a virtually impossible task, because of the overwhelming number of participants, transactions and accounts that would have to be compared. This would not permit funds to delegate to recordkeepers completely the assessment of redemption fees. The recordkeeper would be responsible for matching inter-fund purchases and redemptions, and then the fund family would have to do a second check. How could the recordkeeper inform the participant up front that the transaction would be subject to a redemption fee? The fund would have to assess the fee, and inform the recordkeeper that the fee would apply on the back end. It is not clear how tax withholding on plan distributions would be calculated. Depending on how this issue is resolved, it could cause difficulty for the recordkeeper in calculating tax withholding on the distribution, and could delay or disrupt the nightly processing cycle. It also could mean that we could have calculation errors, resulting in assets erroneously leaving the trust, corrective amounts coming back into the trust—a lot more activity leaving plan records more prone to error, making recordkeeping more complex and costly.

E. Any approach that requires recordkeepers to transmit data to a fund family in order to process a purchase or redemption request provides an unfair advantage to mutual fund families that also are retirement plan recordkeepers. It will always be easier and significantly less costly for those recordkeepers to communicate with a fund family than it would be for "intermediary" retirement plan recordkeepers.

F. The proposed regulation provides that on at least a weekly basis, the recordkeeper would provide to the fund each participant's taxpayer identification number (i.e. their social security number), and the amount and dates of all transactions for each "shareholder" within an omnibus account during the previous week. The proposed rule does not clearly identify the obligations of funds to use this data to identify market timing.

VI. Financial Burdens

A. A meaningful estimate of the cost of implementing the proposed rule cannot be given until a final rule is promulgated. Of course, the costs of programming will go up or down depending upon how much flexibility the proposed regulations provide to fund families regarding the amount of fees, the holding periods, de minimis rules, etc. If the rules simply set a "baseline" and funds can impose any set of rules they determine, it is safe to say that the programming effort will cost each recordkeeper millions of dollars. In addition, if transactions other than participant initiated exchanges and transfers are not exempted, programming time and costs will increase substantially. It is worth noting that programming for redemption fees by recordkeepers will likely to be occurring at the same time as programming regarding the 4 p.m. hard close regulations. Substantial lead times may be needed to reprogram for both at the same time; this also argues for uniform redemption fee rules.

B. The following areas of a recordkeeper's business, operations and systems most likely will have to be reviewed and modified in order to handle the imposition or redemption fees, resulting in substantial costs to recordkeepers:

1. Contract renegotiations with fund families by recordkeepers will be burdensome. We estimate that it will require approximately 4 hours per attorney and two hours for business associates per contract, as was estimated for the fund families.

2. The basic recordkeeping system will need to be reprogrammed, among other things, to measure holding periods, impose fees, and produce reports.

3. Participant web sites and telephonic voice response units will need to be reprogrammed to notify participants of redemption fees, and calculate redemption fee estimates and communicate them to participants.

4. Participant call center representatives will have to be trained to answer participant inquiries regarding redemption fees, and provided with software tools in order to have access to appropriate information.

5. Retirement plan documentation, including but not limited to client agreements, plan documents, summary plan descriptions and plan administration manuals will have to be reviewed to determine whether changes will be needed.

6. Extensive participant and plan sponsor communication pieces will have to be written and sent.

C. The Commission asks whether the costs are justified by the benefits of the proposed rule. We take this opportunity to reiterate our position that the proposed rule will result in investor costs that far exceed any benefits with respect to retirement plan participants. Much of the cost would be to capture redemption fees on transactions that are not prone to the types of abuses the Commission seeks to prevent. Investors will be injured twice—once to absorb unnecessary additional administrative costs and once to pay redemption fees on activities unrelated to market timing.

D. The Commission states that it recognizes that the proposed rule, if adopted, may impose some costs on financial intermediaries that will have to upgrade their software or other technology and goes on to state that, "If financial intermediaries, such as retirement plan administrators, find it too expensive to upgrade their systems, potential investors may end up investing in alternative products[9]." While it is not clear what the Commission means by this comment, for many employer provided retirement plan participants, no "alternative product" exists. One has only to look at the minimum opening balances and minimum additional contribution limits for mutual funds to realize that lower-paid American workers have no other opportunity to save for retirement. PSCA and the U.S. Chamber fervently hope that the Commission understands the unique and valuable role that employer provided plans provide to America's "investor

[9] 69 Fed. Reg. at 11769

class." While some claim that mutual funds are responsible for the democratization of the American investor, it's critically important to remember that employers are, at a minimum, equally responsible for this major socio-economic event.

Thank you again for this opportunity to share our concerns with the Commission. If you have any questions, or if we can be of any assistance, please call David L. Wray at 312-419-1863 or Randel Johnson at 202-463-5448.

Sincerely,

Signed	*Signed*
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