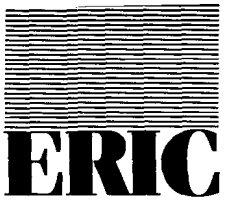

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THE
ERISA
INDUSTRY
COMMITTEE

May 10, 2004

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By Hand

The Honorable Jonathan G. Katz
Secretary
United States Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

File Number: S7-11-04

Dear Secretary Katz:

We are pleased to submit the enclosed comments of The ERISA Industry Committee ("ERIC")[1] on the proposed rule regarding mandatory 2% redemption fees for redeemable mutual fund securities.

If the Commission has any questions about our comments, or if we can otherwise be of assistance, please let us know.

Respectfully submitted,

Mark J. Ugoretz
President

cc: The Honorable William H. Donaldson
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
Shaswat K. Das
C. Hunter Jones
The Hon. Ann L. Combs (Assistant Secretary, Employee Benefits Security Administration, U.S. Department of Labor)

[1] ERIC is a nonprofit association committed to the advancement of the employee retirement, health, incentive, and welfare benefit plans of America's largest employers. ERIC's members provide comprehensive retirement, health care coverage, incentive, and other economic security benefits directly to some 25 million active and retired workers and their families. ERIC has a strong interest in proposals affecting its members' ability to deliver those benefits, their costs and effectiveness, and the role of those benefits in the American economy.

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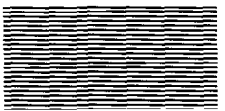

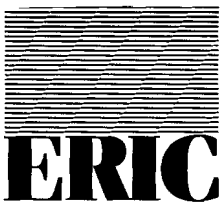

THE
ERISA
INDUSTRY
COMMITTEE

SUBMISSION OF THE ERISA INDUSTRY COMMITTEE TO THE SECURITIES AND EXCHANGE COMMISSION

COMMENTS ON THE PROPOSED RULE REQUIRING MANDATORY REDEMPTION FEES FOR REDEEMABLE MUTUAL FUND SHARES

File No.: S7-11-04

May 10, 2004

The ERISA Industry Committee ("ERIC")[1] is pleased to submit the following comments on the Commission's proposed rule under the Investment Company Act requiring mutual funds to impose a 2% fee on the redemption of mutual fund shares purchased within the previous five days. The redemption fee, which would be retained by the mutual fund, is intended to require short-term investors to reimburse the mutual fund for costs incurred by the fund when the investors use the fund to engage in market timing and other short-term trading strategies.

The proposed rule was published in the Federal Register on March 11, 2004. *See* 69 Fed. Reg. 11,761. The Commission's proposing release states that comments on the proposed rule must be received by May 10, 2004.

All of ERIC's members sponsor individual account retirement plans, including some of the largest individual account plans in the country, covering tens of thousands of employees and beneficiaries. These plans, most of which are § 401(k) plans, commonly give participants the right to direct the investment of all or part of the funds in their accounts.

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[1] ERIC is a nonprofit association committed to the advancement of the employee retirement, health, incentive, and welfare benefit plans of America's largest employers. ERIC's members provide comprehensive retirement, health care coverage, incentive, and other economic security benefits directly to some 25 million active and retired workers and their families. ERIC has a strong interest in proposals affecting its members' ability to deliver those benefits, their costs and effectiveness, and the role of those benefits in the American economy.

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These plans are extremely important to employers and employees alike. They provide valuable retirement and other benefits to employees and help employers to recruit, retain, and motivate employees. ERIC's members therefore have a vital interest in assuring that the rules achieve their objectives in a fashion that is consistent with sound plan design and administration.

In 1998, according to the U.S. Department of Labor, there were approximately 300,000 § 401(k)-type individual account plans, with over 37 million active participants and over $1.5 trillion in assets. The vast majority of these plans allow participants to direct the investment of all or part of the assets allocated to their accounts. Of the 300,000 § 401(k)-type individual account plans in 1998, over 238,000 were participant-directed plans, with nearly 31 million active participants and over $1.25 trillion in assets.[2] About one-third of all mutual fund shares are held by retirement plans.[3]

The § 401(k) plans sponsored by major employers typically offer participants and beneficiaries the opportunity to allocate their accounts among a number of different investment options, many of which are mutual funds sponsored by different mutual fund families. By offering a broad range of funds, sponsored by different mutual fund families and managed by different investment advisers, plans seek to implement the objectives of prudence and diversification reflected in the Employee Retirement Income Security Act of 1974 ("ERISA").[4]

A § 401(k) plan sponsored by a major employer typically engages in many thousands of transactions each month, including --

(a) accepting employee contributions, which are typically made by payroll deduction;

(b) accepting employer contributions, which are often made on a matching basis throughout the year, with the employer matching each employee's contribution based on a formula set forth in the plan (*e.g.*, a matching contribution of 50% of the employee's contribution);

(c) accepting rollover contributions that employees make from plans sponsored by their prior employers and from IRAs;

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[2] Pension and Welfare Benefits Administration, U.S. Dep't of Labor, Private Pension Plan Bulletin Abstract of 1998 Form 5500 Annual Reports, Table D6 (Winter 2001-2002).

[3] 69 Fed. Reg. 11,764 n.17.

[4] ERISA § 404(a)(1).

(d) distributing benefits to terminated and retired employees and their beneficiaries (some of which are made by direct rollover to another employer-sponsored plan or to an IRA);

(e) distributing benefits to employees who make withdrawals from their accounts because of hardship or other reasons before terminating employment;

(f) distributing loans to employees and receiving loan payments (generally by payroll deduction) from employees;

(g) receiving funds from other plans in the case of plan mergers and spin-offs from other plans;

(h) distributing funds to other plans in the case of plan mergers and spin-offs to other plans;

(i) making automatic investment transfers from one investment fund to another pursuant to plans' automatic rebalancing features; and

(j) making participant-directed investment transfers from one investment fund to another within the plan.

Of the ten transaction categories we have listed, **only one** -- participant-directed investment transfers -- is typically used to implement the short-term trading strategies that are the target of the proposed rule. For a variety of reasons, the transactions in the other categories do not lend themselves to short-term trading strategies. For example, the income tax consequences of distributions, withdrawals, and loans (including the 10% tax on early distributions[5]), and participants' lack of control over the timing of rollovers, plan transactions, and automatic rebalancing, generally make such transactions unsuitable vehicles for implementing short-term trading strategies.

Because the proposed rule fails to focus on participant-directed investment transfers, the proposed rule is far broader than required to accomplish its objective, and the proposed rule will impose excessive and unnecessary costs on the very investors whom the Commission seeks to protect: long-term investors who do not pursue short-term trading strategies.[6] In addition, because the proposed rule penalizes individuals who pursue long-

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[5] *See* Int. Rev. Code § 72(t).

[6] We recognize that the proposed FIFO rule and the proposed $2,500 de minimis rule are designed to limit the application of the redemption fee. Although we appreciate the Commission's effort to limit the application of the fee, the proposed rule still applies too broadly to retirement plans.

term investment strategies to save for retirement, the proposed rule conflicts with the national retirement security policy reflected in ERISA.

Summary of Comments

1. The Commission should exempt from the proposed rule all transactions by participant-directed individual account retirement plans other than participant-directed investment transfers. For example, the rule should not apply to purchases and redemptions attributable to --

   (a) the plan's receipt of employee and employer contributions, rollovers, and loan payments,

   (b) distributions, withdrawals, rollovers, and loans from the plan,

   (c) plan mergers, spin-offs, and terminations and plan-to-plan transfers, and

   (d) automatic portfolio rebalancing.

2. The Commission should exempt a participant-directed individual account retirement plan from the proposed rule if the plan meets the requirements of a "safe harbor" prescribed by the Commission.

3. The Commission should work with the Department of Labor to provide participant-directed individual account retirement plans with assurance that neither the mandatory redemption fee nor compliance with the "safe harbor" referred to in paragraph 2, above, will cause the plan to fail to qualify as a participant-directed plan under ERISA § 404(c).

4. The Commission should forbid a mutual fund from using, directly or indirectly, any information that a retirement plan furnishes to it in accordance with the rule for any purpose other than the Commission's stated purposes: assuring that the redemption fee is being applied correctly, detecting market-timers, and determining whether shareholders have received appropriate breakpoint discounts on shares sold with a front-end sales load. The Commission should require each mutual fund to adopt rigorous polices and procedures, and to subject itself to annual audits, to assure compliance with this restriction.

5. The Commission should continue to require a mutual fund to determine the value of purchase and redemption orders at the net asset value ("NAV") calculated the next time the mutual fund calculates its NAV, rather than the day after the mutual fund receives the orders.

ERIC reserves the right to supplement these comments in the future as ERIC and its members continue to analyze the proposed rule.

Detailed Comments

1. The Commission should exempt from the proposed rule all transactions by participant-directed individual account retirement plans[7] other than participant-directed investment transfers. For example, the rule should not apply to purchases and redemptions attributable to --

   (a) the plan's receipt of employee and employer contributions, rollovers, and loan payments,

   (b) distributions, withdrawals, rollovers, and loans from the plan,

   (c) plan mergers, spin-offs, and terminations and plan-to-plan transfers, and

   (d) automatic portfolio rebalancing.[8]

As the Commission recognized in the proposing release, the vast majority of mutual fund investors do not pursue short-term trading strategies; a small percentage of shareholders account for most of the active trading in mutual fund shares.[9]

Nevertheless, the proposed rule applies to many routine transactions that are not used to implement short-term trading strategies, such as (a) purchases and redemptions attributable to the plan's receipt of contributions, rollovers, and loan payments, (b) distributions, withdrawals, rollovers, and loans from the plan, (c) plan mergers, spin-offs, and terminations and plan-to-plan transfers, and (d) automatic portfolio rebalancing. Because of the breadth of the proposed rule, each plan would be required to transmit to each fund, on at least a weekly basis, the taxpayer identification number and the amount and dates of all

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[7] When we refer to a "participant-directed individual account plan," we refer to any individual account retirement plan (or the portion of such a plan) that allows a participant to direct the investment of the funds in his or her account -- regardless of whether the plan qualifies as a participant-directed plan under ERISA § 404(c).

[8] In general, when a fund includes an automatic rebalancing feature, the fund invests in two or more funds (*e.g.*, an equity fund and a bond fund), and automatically rebalances its portfolio whenever the total fund diverges from its target allocation (*e.g.*, 70% equities, 30% bonds) by more than a prescribed margin (*e.g.*, 5 percentage points). Some funds are designed to meet the needs of participants expecting to retire in a specified year and automatically rebalance as the scheduled retirement year draws closer (*e.g.*, by allocating an increasing percentage of the portfolio to bonds and money market funds and a declining percentage to equities). Although an individual participant can decide whether the participant wishes to allocate a portion of his or her account to such a fund, the participant has no control over the operation of the fund's portfolio rebalancing feature.

[9] 69 Fed. Reg. 11,764 n.24.

purchases and redemptions or exchanges for each participant within the previous week. Moreover, each plan would be required to comply with the method designated by each mutual fund for assuring that the appropriate redemption fees were imposed, and if -- as is frequently the case -- the plan offered funds sponsored by different mutual fund families -- the plan could be required to use **three different methods** for providing this assurance.

The costs of compliance with the proposed rule will be enormous. Each plan will be required to track the date when each share was acquired, the number of shares acquired on each date, which participant or beneficiary acquired the shares, and the date when each share is deemed redeemed. Moreover, because the proposed rule allows each fund (a) to set a holding period of longer than five days, (b) to waive the redemption fee for redemptions of $2,500 or less,[10] (c) to waive the redemption fee for financial emergency withdrawals of more than $10,000, and (d) to define "emergency" as it chooses, funds are bound to apply the redemption fee differently. The computer programming, recordkeeping, and other administrative costs that will be borne by plans that must accommodate the demands of each mutual fund that they offer will be staggering.

These costs will be borne by plan participants -- the vast majority of whom do not pursue short-term trading strategies. ERISA allows reasonable plan administration expenses to be paid by the plan.[11] If an individual account plan pays administration expenses, as is typically the case, the expenses borne by the plan reduce the value of each participant's and beneficiary's plan account. Even if the employer bears these expenses, the employer's expenses will inevitably reduce what the employer can spend on employee compensation and benefits since employers have limited amounts that they can spend on compensation and benefits.

Because the enormous compliance costs imposed by the proposed rule will reduce the retirement income of millions of retirement plan participants, the Commission should do everything it can to reduce those costs and to avoid reducing the retirement income of millions of retirees. As we have noted, the vast majority of retirement plan participants do not engage in short-term trading; indeed, retirement plan participants are among the intended beneficiaries of the proposed rule. The Commission should not harm the millions of retirement plan participants whom the rule is designed to protect.

If the Commission targets the types of transactions that are used to implement short-term trading strategies -- participant-directed investment transfers -- the rule will be better focused on short-term trading activity, compliance with the rule will be simplified, plan costs will be reduced, and plan participants' retirement savings will be protected, all

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[10] We recognize that the Commission is also proposing to make the waiver of fees on redemptions of $2,500 or less mandatory rather than discretionary. 69 Fed. Reg. 11,773 n.109.

[11] ERISA §§ 403(c)(1), 404(a)(1)(A).

without undermining the rule's objective of protecting long-term investors from bearing the costs of other investors' short-term trading strategies.

Targeting participant-directed investment transfers will have an important advantage in addition to cost-savings: participants will understand the rule. If the proposed rule applies only to participant-directed investment transfers, the proposed redemption fee will apply to very few participants, and it will be easy to explain to affected participants why the fee applies to them. On the other hand, as it is currently written, the proposed rule would apply to many more transactions and to many more participants, who will be bewildered by the application of the redemption fee to such routine transactions as plan distributions, contributions, and automatic portfolio rebalancing. By contrast, the approach that we recommend will not confuse plan participants and beneficiaries.

2. The Commission should exempt a participant-directed individual account retirement plan from the proposed rule if the plan meets the requirements of a "safe harbor" prescribed by the Commission.

Many retirement plans have already adopted rules that limit participants' ability to engage in short-term trading. Many plans are likely to find it easier and less costly to enforce such rules than to implement the more cumbersome reporting requirements and 2% redemption fee that the Commission has proposed -- especially because the Commission's proposed rule will require plans to accommodate the variety of ways in which mutual funds implement the rule.

Accordingly, we urge the Commission to exempt a retirement plan from the proposed rule if the plan adopts and implements adequate restrictions on participant-initiated short-term trading. For example, the Commission might provide that if a plan forbids a participant or beneficiary from directing an investment transfer that results in the redemption of shares purchased within the preceding five days, the plan will be exempt from the rule's reporting and fee collection requirements.[12]

3. The Commission should work with the Department of Labor to provide participant-directed individual account retirement plans with assurance that neither the mandatory redemption fee nor compliance with the "safe harbor" referred to in paragraph 2, above, will cause the plan to fail to qualify as a participant-directed plan under ERISA § 404(c).

Under ERISA § 404(c), if a participant or beneficiary of an individual account retirement plan exercises control over assets in his or her account, (1) the participant or beneficiary is not deemed a fiduciary by reason of exercising control and (2) no person who is otherwise a fiduciary is liable under ERISA's fiduciary responsibility provisions for any

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[12] The rule might provide that this exception applies only if the plan satisfies annual certification and audit requirements.

loss, or by reason of any breach, that results from the participant's or beneficiary's exercise of control.

According to the Labor Department regulation under § 404(c), the relief provided by § 404(c) applies only to individual transactions that meet the requirements of § 404(c), *i.e.,* the transaction must be executed pursuant to the kind of plan described in § 404(c) and the participant or beneficiary must actually have exercised control with respect to the transaction.[13] Under the § 404(c) regulation, a plan does not fail to provide an opportunity for a participant or beneficiary to exercise control over his or her individual account merely because, among other things, the plan --

- charges participants' and beneficiaries' accounts for the "reasonable expenses" of carrying out their investment instructions, and

- imposes "reasonable restrictions" on the frequency with which participants and beneficiaries may give investment instructions.[14]

Many participant-directed individual account plans sponsored by major employers are designed to qualify for the protection that § 404(c) provides. Qualification under § 404(c) is extremely important to these plans and their fiduciaries because § 404(c) protects the plans' fiduciaries from being held responsible for the results of plan participants' investment elections.

Because § 404(c) provides this protection, many employers have concluded that it is appropriate to design their plans to allow participants (a) to control the investment of their accounts and (b) to tailor their accounts to their individual investment and retirement needs and objectives. Without § 404(c) protection, many employers would be less willing to allow participants to exercise investment control over their accounts -- resulting in retirement plans that are less responsive to individual participants' needs, less effective at promoting retirement savings, and less popular among employees.

The proposed 2% redemption fee -- as well as any safe-harbor plan design prescribed by the Commission in response to the preceding comment -- raise the question whether either the 2% redemption fee or any restrictions on investment transfers imposed by

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[13] 29 C.F.R. § 2550.404c-1.

[14] 29 C.F.R. § 2550.404c-1(b)(2)(ii). The regulation further provides that a restriction on the frequency of investment instructions is not reasonable unless it allows participants and beneficiaries to give investment instructions with a frequency that is appropriate in light of the market volatility of the investment alternative and only if, among other things, at least three investment options, which constitute a brad range of investment alternatives, allow participants and beneficiaries to give investment instructions no less frequently than once within any three-month period.

the safe-harbor plan design would cause the plan to fail to qualify under § 404(c). It is difficult to believe, however, that any fees or restrictions mandated by the Commission would cause a participant to fail to have control over his or her plan account. In fact, the Department of Labor has already issued an informal statement that is generally supportive of our view:

> "[Q]uestions have been raised as to whether a plan's offering of mutual fund or similar investments that impose reasonable redemption fees on sales of their shares would, in and of itself, affect the availability of relief under section 404(c) of ERISA[1]. Similarly, questions have been raised as to whether reasonable plan or investment fund limits on the number of times a participant can move in and out of a particular investment within a particular period would, in and of itself, affect the availability of relief under section 404(c).
>
> "Without expressing a view as to any particular plan or particular investment options, we believe that these two examples represent approaches to limiting market-timing that do not, in and of themselves, run afoul of the 'volatility' and other requirements set forth in the Department's regulation under section 404(c), provided that any such restrictions are allowed under the terms of the plan and clearly disclosed to the plan's participants and beneficiaries."[15]

We urge the Commission to work with the Department of Labor to formalize and to elaborate upon this position.

4. The Commission should forbid a mutual fund from using, directly or indirectly, any information that a retirement plan furnishes to it in accordance with the rule for any purpose other than the Commission's stated purposes: assuring that the redemption fee is being applied correctly, detecting market-timers, and determining whether shareholders have received appropriate breakpoint discounts on shares sold with a front-end sales load. The Commission should require each mutual fund to adopt rigorous polices and procedures, and to subject itself to annual audits, to assure compliance with this restriction.

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[15] Statement of Ann L. Combs, Assistant Secretary, Employee Benefits Security Administration, "Duties of Fiduciaries in Light of Recent Mutual Fund Investigations" (Feb. 17, 2004) (footnote omitted).

In the proposing release, the Commission stated that --

> "[a] fund that receives this information [from an intermediary, such as a retirement plan] pursuant to the proposed rule will not be able to use the information for its own marketing purposes, unless permitted under the intermediary's privacy policies. *See* sections 248.11(a) and 248.15(a)(7)(i) of Regulation S-P [17 CFR 248.11(a) and 248.15(a)(7)(i)]."[16]

The proposed rule should go much farther. Mutual funds should be barred from using the information furnished to them by retirement plans **for any purpose whatever** other than the application of the 2% redemption fee, detecting market-timers, and determining whether shareholders have received appropriate breakpoint discounts on shares sold with a front-end sales load.[17]

Employers and employees assign great value to employee privacy. The information furnished by a retirement plan to a mutual fund in accordance with the proposed rule should not be used by the mutual fund **for any purpose** other than the limited purposes that it was designed to serve. Broader use would infringe on employee privacy and would not serve any objective of either the Investment Company Act or ERISA. Employees should not be required to surrender their privacy in order to invest their retirement savings in a mutual fund.

The Commission should require mutual funds to be vigilant in protecting employee privacy. Each mutual fund should be required to adopt rigorous polices and procedures, and to subject itself to annual audits, to assure that employees' privacy interests are protected.

5. <u>The Commission should continue to require a mutual fund to determine the value of purchase and redemption orders at the NAV calculated the next time the mutual fund calculates its NAV, rather than the day after the mutual fund receives the orders</u>.

In the proposing release, the Commission posed the question whether it should require a mutual fund to determine the value of purchase and redemption orders at the NAV calculated the day after the mutual fund receives such orders, rather than at the time the mutual fund next calculates its NAV. Our answer to this question is an emphatic "No."

As we explained in our comments on the Commission's proposed amendments to the rules governing the pricing of mutual fund shares, retirement plan

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[16] 69 Fed. Reg. 11,766 n.47.

[17] These are the purposes that the Commission identified in the proposing release. Id. at 11,766-67.

participants and beneficiaries highly value, and rely on, their ability to have their purchase and redemption orders executed at the current day's NAV. Requiring purchase and redemption orders to be executed at the next day's price would deprive plan participants and beneficiaries of valuable rights that they now have. A next-day rule would prevent participants and beneficiaries from being able to implement investment decisions based on current market information, would undermine the confidence that participants and beneficiaries have in their retirement plans, and would create a substantial risk of significantly reducing retirement plan participation and plan participants' retirement income. The Commission should not propose a rule with the potential for such deplorable consequences.

We very much appreciate the opportunity to submit these comments. ERIC reserves the right to supplement these comments to reflect any additional views that ERIC and its members develop regarding the proposed rule. We look forward to working with the Commission on this very important subject.

THE ERISA INDUSTRY COMMITTEE