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## **Proposed Amendments to Rules Governing Pricing of Mutual Fund Shares (Release No. IC-26288; File No. S7-27-03)**

February 6, 2004

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

Submitted Electronically: [rule-comments@sec.gov](mailto:rule-comments@sec.gov)

Re: Proposed Amendments to Rules Governing Pricing of Mutual Fund Shares  
(Release No. IC-26288; File No. S7-27-03)

Dear Mr. Katz:

ASPPA appreciates this opportunity to comment on amendments recently proposed by the Securities and Exchange Commission ("Commission") to rule 22c-1 under the Investment Company Act of 1940, which would impose a "hard" 4 p.m. EST cut-off for submitting purchase and sale orders for mutual fund shares to a designated fund transfer agent or to a registered clearing agency (e.g., Fund/SERV). ASPPA strongly agrees with the Commission's purpose in proposing the rule amendments—to prevent late-day trading in shares of mutual funds. However, it is critical that the solution should not punish the millions of American workers who invest in mutual funds through their retirement plans and who, as a practical matter, do not even now have the opportunity to engage in late-day trading.

ASPPA has comments in three key areas of concern.

First, the proposed hard 4 p.m. close would have a significant, adverse impact on millions of retirement plan participants. In many cases, it will prevent participants from receiving the current day's prices when providing investment instructions on a business day, in effect making participants "second class" to investors dealing directly with mutual fund transfer agents (who will not be subject to early cut-off times for investment orders). Also, implementing the hard 4 p.m. close will mean dramatic changes in plan administration procedures at a substantial cost.

Second, ASPPA believes that the Commission should adopt, in lieu of the proposed hard 4 p.m. cut-off, the alternative approach described by H.R. 2420. Existing technology solutions or applications that may be easily adapted from existing technology can provide the confidence in mutual fund order processing systems that the Commission seeks.

Third, while the H.R. 2420 alternative approach is ASPPA's clear preference, our members have considered the retirement plan processing solutions proposed by the National Securities Clearing Corporation ("NSCC"). We believe that these processes would facilitate compliance with a hard 4 p.m. close rule. However, it is critical that Fund/SERV accept orders from all plan administrators and recordkeepers, regardless of size, and that all retirement plan administrators (including fund transfer agents providing these services) be subject to similar order processing rules to avoid unfair competitive advantage. We also suggest below some changes to the Commission's proposed rule amendments and the NSCC proposals that would make the NSCC proposals more workable.

Background

About ASPPA ASPPA is national organization of over 5,000 retirement plan

professionals who assist employers in establishing and maintaining retirement plans for their workers. The firms that ASPPA members work for administer virtually all the retirement plans in the United States. ASPPA's members include senior representatives from all sectors of the retirement plan marketplace, including independent third party plan administrators and recordkeepers, and banks, trust companies and insurance companies providing recordkeeping and other plan administration services (together, "plan recordkeepers and administrators").

Plan Administration Processes Today Plan recordkeepers and administrators are specialists in complying with the myriad of rules governing "tax-qualified" retirement plans under the Internal Revenue Code of 1986, as amended ("Code"), and the Employee Retirement Income Security Act, as amended ("ERISA"). These include complex plan rules that affect participant account records and transactions, including plan eligibility and contributions, vesting, loans, hardship withdrawals, and other plan distributions. Application of these rules requires sub-accounting for contributions to participants' accounts based on source (e.g., discretionary and matching contributions by employers, employee "pre-tax" and "post-tax" contributions and rollovers from other qualified plans) and the application of "hierarchies" specifying the order in which payments are charged to the various participant sub-accounts in the case of loans, hardship withdrawals and other distributions from a participant's account. Approximately 10-15 percent of daily plan transactions are "complex" plan transactions affected by these rules.

Plan recordkeepers and administrators employ sophisticated computer systems and procedures to receive, process and transmit plan transaction information on a daily basis while complying with these complex rules. The systems may be developed and maintained by the recordkeeper or procured from a third party vendor. On any business day, plan transactions may include—

- Participant-initiated transactions, including exchanges between plan investment options, loan requests and other withdrawals and distributions, and
- Plan transactions processed under plan rules and standing instructions, including periodic contributions, loan repayments and automatic distributions.

Each business day, the computer systems and procedures employed by plan recordkeepers and administrators audit, reconcile and batch that day's plan transactions, a process that may take up to 4 to 6 hours. Typically, this processing depends upon the availability of the current day's mutual fund share prices to process exchanges between plan investment options and certain other plan transactions, including rebalancing instructions for a participant's account, and loan payments and withdrawals that are subject to hierarchy rules. Today, plan recordkeepers and administrators require participants to submit their participant instructions no later than a cut-off time of between 2 and 4 p.m. EST, to ensure that their instructions will be processed at mutual fund share prices determined for that day.

As participant-directed retirement plans have developed over the last two decades, plan recordkeepers and administrators acting as intermediaries for receiving mutual fund orders have played a critical role in two ways. First, many plan recordkeepers and administrators are not affiliated with mutual fund investment managers and have made available to retirement plans a broad, diversified selection of investment options, including mutual funds from different mutual fund companies and other, non-mutual fund, investment vehicles appropriate for retirement plan participants. The important role played by independent plan recordkeepers and administrators has led the retirement industry as a whole toward "open architecture" service models. Indeed, today, even plan recordkeepers and administrators that are affiliated with large mutual fund complexes typically make their competitors' mutual funds available to retirement plan clients.

Second, plan recordkeeping and order processing systems developed by plan administrators and recordkeepers allow cost-effective delivery of services even where participants have small account balances or are making small periodic contributions. On their own, many 401(k) plan participants with small account balances or who could only make small periodic contributions would not be eligible to invest with mutual funds, which typically impose minimum account size

on investors opening retail accounts. Also, by participating in a retirement plan, participants are often permitted to invest in lower-cost institutional share classes not otherwise available to investors with small account balances. Because of these developments, American workers who might not otherwise save for their retirement are encouraged and able to do so.

#### Adverse Impact of Hard 4 p.m. Close

As proposed, the hard 4 p.m. close rule amendments would have a dramatic, adverse impact on the millions of Americans investing in mutual funds through their retirement plans and threaten their retirement security, for several reasons.

Earlier Cut-off Times for Participant Instructions First, in order to submit trades to fund transfer agents or Fund/SERV by 4 p.m., recordkeepers will be required to establish cut-off times for participant-initiated transactions on most business days by 10 a.m. to noon EST. (This early close requirement would not be completely resolved by the proposed NSCC processing solutions, discussed below.) In the case of participants on the west coast, this would mean that the cut-off time to request a transaction at the price determined on a particular business day could be as early as 7 a.m. This would be a dramatic and unfavorable change in retirement plan participants' ability to make decisions about the investment of their participant accounts with complete information. Indeed, as a practical matter, the rule would force many retirement plan participants into "next-day" trading status and offer them only "second class" rights as compared to investors dealing directly with a mutual fund's designated transfer agent.

In comments to the proposed rule amendments, the Commission suggests that retirement plan participants are long-term investors who are not sensitive to the time at which their purchase or redemption orders are priced. This may be a reasonable conclusion with respect to the plan transactions that are effected automatically based on plan rules and standing instructions, such as periodic contributions. However, participants are sensitive to short-term market volatility at any point in time when they are ready to make a change in investments for their account, or when taking a plan loan, withdrawal or distribution. Recent events have proved that there can be significant market change during a 24-hour period. Retirement plan participants should not be put at a disadvantage relative to other mutual fund investors who will be able under the proposed rule amendments to submit an order directly to a fund transfer agent up until 4 p.m. and receive that day's price.

Substantial Administrative Costs Imposing the 4 p.m. hard close will add additional administrative and other costs to plan administration and recordkeeping. Initially, there will be substantial costs to reprogram recordkeeping and order processing systems to provide for plan transaction processing under a regime in which the current day's price for mutual funds is not available until after the time when investment orders must be determined and submitted to mutual funds. Further, since plan procedures and participant investment rights would be affected, there will additionally be substantial plan sponsor training and participant education costs. In some cases, these costs may mean that small businesses providing recordkeeping and other services will not be able to continue in the business. Ultimately, these costs will likely be passed through to plan participants.

Anti-Competitive Consequences ASPPA also believes that the proposed hard 4 p.m. close will have significant anti-competitive consequences. As noted, small businesses providing recordkeeping and other plan administration services may be forced to exit the business. Also, barriers to entry into the recordkeeping and plan administration business may be increased, reducing industry competition and innovation.

Moreover, over time, the hard 4 p.m. close may change plan sponsors' preference from open architecture service models, which allow plans to provide participants a broad selection of funds from different fund complexes. This would be a step backward for the retirement services industry. In this regard, the proposed rule amendments will allow a mutual fund's designated transfer agent flexibility to offer plans and plan participants recordkeeping and plan administration services and accept participant instructions up to a cut-off time shortly before 4 p.m., if plan investment options are restricted to mutual funds for which the transfer agent is designated. In comparison, other plan recordkeepers

and administrators will be required to cut-off receipt of participant instructions far earlier in the business day to complete plan transaction processing and submit the orders before 4 p.m. Therefore, plan sponsors seeking more timely order processing may select a fund's designated transfer agent to perform plan administration and recordkeeping services and limit plan investments to a single mutual fund complex. Ultimately, this trend could reduce industry competition and increase administrative and investment management fees charged to participants.

#### Alternative Approach

Given the dramatic impact that the proposed hard 4 p.m. close would have on participants in retirement plans, ASPPA urges the Commission to adopt an alternative approach that would allow fund intermediaries, including plan recordkeepers and administrators, to submit orders to transfer agents or to Fund/SERV after 4 p.m. Specifically, ASPPA strongly supports the approach of H.R. 2420, which would allow intermediaries to transmit orders received before 4 p.m. to Fund/SERV or to a transfer agent after hours. This approach would be available only if the intermediary's activities are subject to policies and procedures designed to protect against late trading, including an independent annual audit to verify that the procedures do not permit the intermediary to accept any trades after the 4 p.m. close.

The Commission has explained that an alternative approach allowing fund intermediaries to submit orders to transfer agents or to Fund/SERV after 4 p.m. must provide protections designed to prevent late trading, including—

- Electronic or physical time stamping of orders in a manner that cannot be altered or discarded once the order is entered into the trading system;
- Annual certification that the intermediary has policies and procedures in place designed to prevent late trades, and that no late trades were submitted to the fund or its designated transfer agent during the period; and
- Submission of the intermediary to an annual audit of its controls conducted by an independent public accountant who would submit his report to the fund's chief compliance officer.

ASPPA believes that the first requirement, for a "tamper proof" system of electronic or physical time stamping of orders that cannot be altered or discarded, can be provided by technology solutions that are already available or can be easily adapted from existing technology. For example, ASPPA has reviewed patented technology, which validates the creation time and contents of records with an electronic time stamp and notarization supplied by an independent third party. This technology relies on two cryptographic processes, hashing and linking, to ensure that electronic records are not tampered with or back-dated since time of creation and notarization. The validation system can be permanent to provide for later review and examination. ASPPA believes that this technology would be a basis for strong internal control systems that provide confidence in the integrity of electronic records maintained by plan recordkeepers and administrators. Other technology solutions also may be available or may be developed that will perform similar functions.

With respect to certification and audit requirements, H.R. 2420 would permit firms that use computer systems and procedures provided by unaffiliated entities to meet these requirements by reliance on an independent audit obtained by the unaffiliated entity. Importantly, this provision under H.R. 2420 will allow small businesses providing plan recordkeeping and administration services to implement control procedures and obtain the required audits cost-effectively, while still ensuring appropriate protections to prevent late-trading in mutual funds. ASPPA strongly encourages the Commission to allow plan recordkeepers and administrators using computer systems and procedures provided by unaffiliated vendors to rely on independent audits obtained by those vendors with respect to the computer systems and procedures.

#### Proposed NSCC Processing Solutions

ASPPA has been actively involved in working groups established by the NSCC to consider processing solutions for retirement plan transactions in the event that the Commission imposes a hard 4 p.m. close. We commend the NSCC staff for its hard work to develop processes to facilitate order transmission under the

proposed hard 4 p.m. close regime and its efforts to seek comment from a broad range of retirement industry representatives.

Based on a review of the most recent proposals developed by the NSCC, ASPPA believes that the processing solutions proposed by the NSCC would address some of the problems that would result if the Commission imposes a hard 4 p.m. close. In particular, the proposed NSCC processes would allow intermediaries to process participant exchanges between plan investments on the same day rather than over two to three days, avoiding potential problems such as large cash balances held uninvested and certain reconciliation issues.

However, the proposed NSCC processing solutions, as we currently understand them, are certainly not a complete panacea. As discussed below, the NSCC proposals do not completely resolve other, equally significant concerns about the impact of the hard 4 p.m. close, and we suggest some changes to help ameliorate these concerns. We also believe that the Commission should make some changes to its proposed rule amendments to make the NSCC processing solutions more workable, if a hard 4 p.m. close is adopted. These issues are discussed below.

**Issues Not Resolved by the NSCC Solutions** It is important to recognize that the NSCC proposal will still require earlier cut-off times for participant instructions than as required currently, although it will certainly be better than a pure hard 4 p.m. close. Many of our members believe a cut-off of at least 2 p.m. EST/11a.m. PST will probably be necessary under the NSCC proposal. Consequently, the NSCC processing solutions still do not completely resolve the most significant problem that results from a hard 4 p.m. close, which is that participants will become "second class" investors who do not have the same access to the market as mutual fund investors who deal directly with mutual funds' designated transfer agents.

In addition, unless the Commission requires all retirement plan trades (whether received by an intermediary or a fund transfer agent) to be processed through Fund/SERV, the anti-competitive issues raised by the proposed hard 4 p.m. close will not be resolved. Specifically, designated fund transfer agents providing plan recordkeeping and administrative services will continue to enjoy a competitive advantage in that they will be able to offer plan participants later cut-off times for participant instructions as compared to intermediaries that are not designated transfer agents and must submit all instructions before 4 p.m. through the NSCC.

Further, changes to accommodate the NSCC processing solutions and enforce the "hard" 4 p.m. close will still require dramatic changes in plan administration and involve substantial up-front costs. Substantial changes in plan recordkeeping and order processing systems will be required, involving significant design and reprogramming costs for plan administrators and recordkeepers. For some of our members, these costs will amount to millions of dollars. In particular, plan procedures governing "complex" plan transactions and in some instances, plan terms, also must be changed so that these plan transactions can be calculated and processed under one of the two processes offered by the NSCC. For example, rules governing the calculation of rebalancing transactions and hierarchies for loan payments, hardship distributions and other plan withdrawals must be changed so that calculations can be performed without information about current mutual fund price. These changes will require revisions to the plan disclosure materials provided to participants and, in some cases, retirement plan amendments, adding substantially to the costs of implementing these solutions that plans will bear directly.

Finally, there also will be ongoing recordkeeping costs arising from new trade submission requirements under the NSCC's proposed processing solutions. For example, to process exchanges, intermediaries will be required to submit information showing each combination of fund exchanges required on a business day (i.e., Fund A to B, A to C, A to D, etc., and B to A, C to A, D to A, etc.). These exchange records would be submitted in addition to daily purchase and sale orders for each fund determined based on dollar or share value, and must be resubmitted after-hours so that the "buy" side of the exchange will be processed. The NSCC suggests that up to 30 possible exchange records would be needed for a plan offering six investment options. Many plans offer participants ten or more investment options and many intermediaries offer plans access to hundreds of mutual funds. Although intermediaries could aggregate

exchange records, the result still will be that intermediaries will be required to process, reconcile and submit to the NSCC substantially more information on a daily basis than currently required. Ultimately, the cost of the extra processing will be borne by retirement plan participants.

Specific Comments on Proposed Rules/NSCC Solutions Notwithstanding the foregoing, if the Commission rejects the alternative approach allowing intermediaries to process and submit orders after 4 p.m., ASPPA strongly believes the Commission should adopt an alternative along the lines of the proposed NSCC processing solutions. However, ASPPA recommends the following changes to improve the workability and fairness of the proposed rule 22c-1 rule amendments and the proposed NSCC processing solutions.

First, additional revisions are needed to the definition of "order" so that the rule will accommodate exchanges among all types of retirement plan investment options. In this regard, the Commission proposes to facilitate same-day exchange order processing by defining "order" to include a direction to purchase redeemable securities of a fund using the proceeds of a contemporaneous order to redeem a specific number of shares of another fund. For purposes of this definition, a "fund" is "any registered investment company issuing redeemable securities."

However, retirement plans commonly offer participants the opportunity to select investment vehicles other than shares of registered investment companies, including units of "stable value funds" (usually structured as bank collective trust funds), employer securities funds maintained under plans, and plan investment options based on a separate account managed for the plan by an independent investment manager. Therefore, ASPPA requests that the Commission revise the proposed definition of "order" to include directions to purchase using the proceeds of these other types of plan investment options. Without this change, proposed NSCC processing solutions for exchanges will not allow exchanges between mutual funds and these other plan options, a problem that would impact most retirement plans.

Second, given that intermediaries will be required to submit all orders daily to Fund/SERV no later than 4 p.m., it is critical that the intermediaries are protected in the event of a Fund/SERV failure that prevents them from timely submitting their order information. Emergency exceptions in the proposed rule would permit orders to be deemed to have been timely received even if an emergency prevents Fund/SERV from receiving the order. However, the Commission's comments suggest that an "emergency" might not include "internal operational difficulties." ASPPA believes that the rule should allow the emergency exception to apply to orders not timely received by Fund/SERV due to any Fund/SERV failure, whether resulting from an "external" emergency such as a natural disaster, or from an internal operational Fund/SERV failure.

Third, ASPPA urges the Commission to consider amending its proposed rules to provide an exemption from the hard 4 p.m. close for "complex" plan transactions (i.e., loan payments, hardship withdrawals and other distributions that are subject to hierarchy rules and rebalancing transactions). As noted earlier, these transactions are subject to strict ERISA rules and plan document requirements. Consequently, these transactions are not subject to the same potential for manipulation that give rise to concerns about late-day trading. Such an exemption could provide substantial relief from the expense of accommodating the NSCC processing solutions, since it would reduce the cost and burden of amending plan provisions, changing plan procedures, and systems reprogramming with respect to these complex plan transactions. This exception also could be easily monitored, since it would apply to a fraction of daily plan transaction volume—as noted, these "complex" plan transactions account for only about 10-15 percent of daily plan transactions.

Fourth, processing solutions available through the NSCC will not be viable unless the NSCC is willing to accept mutual fund orders from all plan recordkeepers and administrators that can establish the necessary electronic communications with the NSCC. Therefore, the NSCC must accept orders from plan recordkeepers and administrators, regardless of their organizational size or the volume of transactions that they may submit. In addition, ASPPA believes the Commission should permit other regulated entities, including mutual fund companies if they choose, to serve the same role as the NSCC in processing retirement plan transactions. By fostering competition for this service, we believe

this will lead to greater accessibility and ultimately lower costs for plan sponsors and participants.

Fifth, the NSCC processing solutions will take a great deal of time and expense to implement. Major systems changes will be required not only by plan recordkeepers and administrators, but also by the NSCC itself. As an active participant in the working groups developing the NSCC proposed solutions, we can attest to the significant challenges that will be faced in creating these systems. If the Commission incorporates the proposed NSCC processing solutions in its final rule, ASPPA requests that the final rule provide for a transition period sufficient for such systems to be properly built and adequately tested. Our members believe that 18 months would constitute such a sufficient period of time.

Finally, as discussed, allowing mutual fund transfer agents to accept fund orders on more favorable terms than other intermediaries will result in substantial competitive disadvantages for plan recordkeepers and administrators that are not designated as fund transfer agents. It may also favor the limiting of plan investment options to a single fund complex. Therefore, ASPPA believes that, if the Commission imposes a hard 4 p.m. close, designated transfer agents of mutual funds should also be required to submit orders pertaining to retirement plan transactions through the same NSCC processing solutions that would be used by plan recordkeepers and intermediaries. In addition to ensuring a level regulatory playing field, this will ensure that orders received by the designated transfer agent are in fact timely received. This is important since ASPPA understands that the Commission's investigations so far have detected late trading abuses among regulated entities—it would seem unreasonable to impose new, burdensome regulatory requirements on intermediaries while allowing designated fund transfer agents to continue their operations without any new regulation to address the late trading issue.

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In conclusion, ASPPA agrees that it is important to address illegal conduct such as late-trading. But it is critical that any proposed solution should recognize the special administrative requirements of retirement plans, be reasonably tailored to address the potential for abuse, and avoid imposing unnecessary costs or making retirement plan participants "second class" investors compared to investors dealing directly with mutual fund transfer agents. ASPPA believes that available technology solutions can provide the protections necessary to prevent late-trading, in a way that does not require dramatic changes in the administration of retirement plans. Therefore, we strongly urge the Commission to consider these technology solutions and implement rules following the approach of H.R. 2420. If the Commission chooses not to take this approach, we respectfully request that you incorporate our suggested changes to the proposed NSCC processing solutions in your final rule.

Thank you for your consideration of these comments. We commend the Commission and its staff for your efforts to combat illegal late-trading and taking into account the concerns of the retirement plan industry. We are available to discuss these comments and any other questions that may arise as you continue to consider these issues.

Sincerely,

Brian H. Graff, Esq.  
Executive Director