

January 21, 2004

Mr. Alan D. Lebowitz  
Deputy Assistant Secretary  
for Program Operations  
Employee Benefits Security Administration  
U.S. Department of Labor  
200 Constitution Avenue, NW, Suite N-5677  
Washington, DC 20210

Re: Market Timing in Retirement Plans

Dear Alan:

Thank you for the opportunity to meet with you and your colleagues to discuss issues surrounding market timing in retirement plans. The Investment Company Institute<sup>1</sup> submits this letter to summarize our views and to request guidance that we believe is necessary to assist plan fiduciaries in responding to market timing, by participants in defined contribution plans, that has been determined by a plan investment option or its manager to be harmful. As discussed in greater detail below, market timing by participants can be harmful to other plan participants, but unique challenges in this area have hindered efforts to curb such activity. Clarifying guidance from the Department could effectively address these difficulties.

### Overview of Market Timing

While “market timing” is not a precisely defined term, it generally refers to a trading strategy that involves frequent purchases and sales of securities (with the securities often held for only very short periods) in an effort to anticipate changes in market prices. There is nothing inherently illegal or improper about such activity. In the mutual fund context,<sup>2</sup> however, it can

---

<sup>1</sup> The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,601 open-end investment companies (“mutual funds”), 604 closed-end investment companies, 110 exchange-traded funds and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about \$7.240 trillion, accounting for approximately 95% of total industry assets. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 million households.

<sup>2</sup> Other pooled investment vehicles may also have policies to limit market timing that may be harmful to investors. While mutual funds hold about 45% of 401(k) plan assets (see *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2002*, Sarah Holden, Investment Company Institute, and Jack VanDerhei, Employee Benefit Research Institute, *PERSPECTIVE* Vol. 9, No. 5 (Sept. 2003)), holdings in other pooled investment vehicles (e.g., bank collective trusts, separate accounts) comprise a significant portion of the balance of 401(k) plan investments.

nevertheless be disruptive to portfolio management. For example, market timing may compel portfolio managers either to hold excess cash or sell holdings at less-than-ideal times in order to meet redemptions, which can adversely impact the fund's performance. Additional trading and administrative costs likewise can result from market timing. Such costs ultimately are borne by other fund investors (including retirement plan participants).

Whether, and at what level, certain trading activity may be harmful to fund investors is a question of facts and circumstances. (Among other things, relevant factors include the size and frequency of the transactions and the types of securities held by the fund.) A fund (or its manager) typically would be in the best position to make this determination for the fund; many funds have policies in place to address market timing activity that may be harmful to shareholders.

Mutual funds have utilized various methods to limit disruptive trading activity, such as imposing redemption fees, restricting exchange privileges and/or limiting the number of permissible trades within a specified period. The Securities and Exchange Commission ("SEC") recently issued proposed rules to address market timing in mutual funds which, among other things, would require funds to disclose their policies on restricting frequent purchases and redemptions, if any.<sup>3</sup> The SEC staff is also studying an Institute proposal that would impose a mandatory minimum redemption fee of 2 percent, which would be paid to the fund, on "round-trip" purchases and sales within five business days or less; exceptions from the mandatory redemption fee would be provided for money market funds and funds specifically designed for timers.

### Market Timing in Retirement Plans

In those circumstances where market timing activity in a mutual fund has been determined by the fund to be harmful to the interests of other fund investors, participants that invest in that fund through a retirement plan are likewise harmed. Such is the case whether the harmful timing activity is undertaken by another plan participant<sup>4</sup> or by some other fund investor.

Market timing by a small number of participants can harm others in different ways. Perhaps most directly, such trading can disrupt various aspects of portfolio management, as discussed above, and thereby diminish the returns in other plan accounts. Market timing also can harm the plan if a plan sponsor refuses a request by a fund to limit the participant's market timing activity. In this case, as discussed below, a fund may be put in the position of needing to restrict access by the entire plan, as the fund would not have the authority to restrict an individual participant (without the approval of the plan sponsor or another authorized fiduciary). Thus, the actions of a small percentage of individuals (particularly those with larger account balances) can potentially harm the interests of the vast majority of plan participants.

---

<sup>3</sup> See SEC Release No. IC-26287 (Dec. 11, 2003).

<sup>4</sup> Indeed, market timing can be more attractive to participants in qualified plans because the tax-advantaged status of such plans prevents the market timing participant from suffering any tax burden from this trading.

While the approaches permitted and/or mandated by the SEC may enable mutual funds to restrict timers that invest directly in the funds, these methods (in the absence of guidance from the Department) may have limited effect in the context of participant-directed defined contribution plans. A mutual fund generally does not have access to participant-level trading information or know the identities of plan participants, as it receives one purchase or sale order for each plan after the plan recordkeeper or third-party administrator “batches” investment instructions received from various plan participants. Further, plan recordkeepers and third-party administrators often hold the positions of multiple plans through omnibus accounts.

Even where a fund company becomes aware of a participant that is engaged in harmful market timing, the fund’s ability to restrict only the participant (and not the entire plan) is limited — as the plan is the record owner of the fund shares. Some plan fiduciaries, however, may be reluctant to restrict participants from excessive trading without express regulatory guidance. Other plan fiduciaries believe that ERISA somehow prohibits them from restricting market timers. Many other fiduciaries are concerned that they might lose relief under ERISA section 404(c) by selecting investment options that impose trading limitations designed to restrict market timing. And as noted above, if a plan sponsor refuses to act to stop a participant timer, a fund may be put in the position of having to restrict access by the entire plan — thereby impacting all participants because of the actions of one or a few.

#### Market Timing and Plan Fiduciary Responsibilities

ERISA requires plan fiduciaries to act prudently and solely in the interest of plan participants. Recent events have demonstrated the potentially harmful impact of certain market timing activity. As this impact has become widely known to plan fiduciaries, more have begun to act. However, express guidance is not provided by ERISA regarding the steps a plan fiduciary may or should take with regard to participant market timers.

#### *Summary of Recommendations*

To provide guidance to plan fiduciaries, and thereby protect plan participants from any negative impact that timing activity may have on plans and their participants, we urge the Department to issue clarifying guidance in this area. In particular:

- We recommend that the guidance be issued in the form of an interpretive bulletin, advisory opinion or another statement of general application, that it be prospective in scope, and that plan fiduciaries be given a reasonable period of time to implement it.
- We further recommend that any clarification of a plan fiduciary’s responsibilities in this area apply to the entire range of pooled investments (*e.g.*, mutual funds, bank collective trusts, separate accounts) that have instituted policies to limit market timing activity.<sup>5</sup>

---

<sup>5</sup> A recent federal district court decision involved market timing by a 401(k) plan participant with regard to insurance company separate accounts. *Borneman v. Principal Life Insurance Co.*, 2003 U.S. Dist. LEXIS 21453 (S.D. Iowa Nov. 25, 2003).

- Finally, we recommend that the guidance address the following issues:
  - First, the guidance should clarify that nothing in ERISA prohibits plan fiduciaries from restricting the activities of participants who engage in market timing of plan investment alternatives.
  - Second, the guidance should clarify that a plan sponsor should take into account and, under ordinary circumstances, be entitled to rely upon a determination made by an investment vehicle (or its manager) that certain trading activity is harmful to the interests of other shareholders (and, therefore, other plan participants).
  - Third, the guidance should clarify that it is consistent with ERISA's fiduciary rules for a plan sponsor to take reasonable steps to facilitate the application of any restrictions imposed at the fund level to plan participants.
  - Finally, the guidance should clarify the continued availability of section 404(c) relief for plan fiduciaries who select an investment option that imposes measures to restrict market timing and apply such restrictions to individual participants.

*Fiduciary Responsibilities Regarding Market Timing*

The recent focus on market timing has raised a number of issues for plans investing in mutual funds. We urge that the Department issue guidance to clarify a plan fiduciary's responsibilities regarding market timing that has been determined by a fund or its manager to be harmful. This guidance should cover both restrictions imposed on a specific participant determined to be engaging in market timing activity, as well as generally-applicable limitations designed to deter timing activity by all participants.

As noted above, we understand that some plan sponsors confronted with concerns about the trading activity of one or more plan participants have suggested that ERISA prevents them from restricting market timing. This position is inconsistent with a recent federal district court ruling (dismissing an ERISA claim by participants challenging a plan's terms and practice that restricted excessive trading in plan accounts<sup>6</sup>) and, we submit, the clear dictates of ERISA to act solely in the interest of plan participants. To eliminate any confusion regarding ERISA's dictate, we urge a strong statement by the Department affirming that ERISA contains no prohibition on restrictions imposed by plan fiduciaries to deter market timing in their retirement plans.

We also believe that a plan sponsor, as part of its fiduciary duty to consider a broad range of factors in selecting and monitoring plan investment alternatives, should take into account and, under ordinary circumstances, be entitled to rely upon, a determination made by a fund or its manager that certain trading activity is harmful to the interests of other shareholders

---

<sup>6</sup> See *Straus v. Prudential Employee Savings Plan*, 253 F. Supp. 2d 438 (E.D.N.Y. Mar. 24, 2003); see also *Borneman v. Principal Life Insurance Co.*, *supra* note 5.

(and, therefore, other plan participants).<sup>7</sup> As the fund or its manager typically would be in the best position to determine what types of trading activity are likely to be harmful to other investors, the plan sponsor should be permitted, as a general matter, to rely upon this determination.

Further, we believe that the Department should state that it is consistent with ERISA's fiduciary obligations for a plan sponsor to take reasonable steps to facilitate the application of any restrictions (*e.g.*, redemption fees, limits on the number of trades within a given period) imposed at the fund level to plan participants. Plans that choose to do so would benefit from the measures taken by the fund or other investment vehicle to combat market timing on behalf of all of its shareholders.

*Availability of Section 404(c) Relief*

Concerns have been raised about the possible loss of fiduciary relief under ERISA section 404(c) if restrictions designed to curb market timing were imposed.<sup>8</sup> Such restrictions imposed by a fund, however, should not affect the relief provided to a fiduciary under section 404(c). For example, a fund's imposition of redemption fees on short-term trades should not impact section 404(c) relief, as the regulations under section 404(c) do not preclude the assessment of reasonable penalties for early or premature withdrawals from investment alternatives.<sup>9</sup> Other types of fund-level restrictions designed to protect investors from harmful trading activity, including frequency limitations on "round-trip" purchases and sales with regard to an investment alternative, likewise should not have any bearing on a plan's status under section 404(c). Frequency limitations, in particular, have been identified as an important alternative tool for combating market timing and should not be discouraged by uncertainty regarding their impact on section 404(c) relief.

Accordingly, we ask the Department to clarify that a fiduciary's selection of a fund that imposes measures to restrict market timing would not in itself affect the fiduciary relief provided by ERISA section 404(c). We similarly request that the Department clarify that a fiduciary's action to implement such restrictions on individual participants also would not in itself affect the relief afforded by section 404(c).

\* \* \*

---

<sup>7</sup> This is not to imply that plan sponsors are under any obligation to select and/or retain a fund with any particular market timing policy. Plan sponsors are entitled to take into account various factors in determining which investment options should be made available to participants.

<sup>8</sup> As you are aware, section 404(c) of ERISA provides that if a pension plan that provides for individual accounts permits a participant to exercise control over assets in that account and that individual in fact exercises control, then no person who is otherwise a fiduciary shall be liable for any loss, or by reason of any breach, which result from such exercise of control.

<sup>9</sup> See Preamble to 29 C.F.R. § 2550.404c-1, 57 Fed. Reg. 46906, 46915 (Oct. 13, 1992).

Letter to Mr. Alan D. Lebowitz  
January 21, 2004  
Page 6

The Institute appreciates the Department's consideration of our recommendations and would be pleased to work with the Department in developing such guidance. If you have any questions concerning our views or recommendations, please do not hesitate to contact me at (202) 326-5815, Keith Lawson (ICI Senior Counsel) at (202) 326-5832, or Thomas Kim (ICI Associate Counsel) at (202) 326-5837.

Sincerely,

Craig S. Tyle  
General Counsel

cc: Ann L. Combs  
Robert J. Doyle  
Louis J. Campagna  
Ivan Strasfeld  
Joe Piacentini  
Timothy D. Hauser