Nationwide Retirement Education Institute
Panel of Advisors

ANALYSIS OF THE PROPOSED SEC RULES
Re: MUTUAL FUND TRADING PRACTICES

January 20, 2004

The following has been prepared to document the issues that were discussed by the members of the Panel of Advisors of the Nationwide Retirement Education Institute concerning the SEC proposed rules to enforce a 4:00 p.m. deadline on mutual fund trading through a public sector defined contribution retirement plan.

SEC Proposed Rules: Impact on Public Sector Retirement

The Security and Exchange Commission (SEC) has issued proposed rules that would impose a 4:00 p.m. deadline on all trades that are executed with mutual funds through an intermediary, such as a third party administrator of a defined contribution plan. It is further anticipated that the SEC will soon release additional proposed rules to address excessive trading practices. Although efforts to safeguard investor interests are commended, it is important to ensure the suggested solution to a specific problem (pertaining to a small minority of all investors) does not create an adverse affect on the millions of employees who are investing for retirement through their employer-sponsored plans.

Many organizations have focused on the specifics of the proposed rules and how they impact the mechanics of trading in mutual funds through employer plans. This analysis has been prepared to discuss the impact (real and perceived) on state and local government employees should these rules be instituted. Statistics identified in this review regarding public employee activity in defined contribution plans are from the report *Public Sector Retirement –Yesterday, Today and Tomorrow*, which is scheduled to be released in February 2004 by the Nationwide Retirement Education Institute.

Creates a Second Class of Investors –

Because individuals who contribute to an employer sponsored retirement plan will be imposed restrictions not applied to other investment opportunities (such as IRAs directly through a mutual fund company), investing through the employer plan will not appear to be as attractive as other options. Even though few individuals may see an impact from the earlier trading deadlines (only 11% of public sector plan participants requested any trades of existing assets between investment choices through their defined contribution retirement account last year), their employer sponsored plan will appear to be "second rate" compared to other types of investment opportunities.

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As a result of this perception, there is a very real possibility that public employer benefit plans will not be able to compete with the marketing abilities of mutual fund companies who offer investment opportunities not impacted by the 4:00 p.m. hard close deadline. Employees may forego the convenience and tax advantage of payroll deferrals through their employer plan with the expectation that they will make IRA contributions for retirement, often planning to delay until that year's tax deadline. Without the ease and habit of on-going deferrals from their paychecks into a retirement account, many may never make planned retirement contributions. Therefore, the potential affect of creating a second-class investor in the employer-sponsored plan could mean that Americans are even less prepared for retirement than most reports and analyses are showing today.

For example, statistics show that only between 31% and 50% of employees participate in their public sector employer defined contribution plan today,[1] with the average participant deferral of $3,000 per year and account balance of $24,000. Additionally, a recent survey showed that less than one in four respondents between the ages of 40 and 59 had saved as much as 25% of the amount they needed for retirement.[2] With the perception that contributing after-tax money (outside of the automatic deduction approach used in employer plans) is more attractive, this picture could be even worse in the future.

Potentially Less Attractive Plan Design

Public employers offering defined contribution plans to their employees to help them invest for retirement typically follow a competitive bidding process to select one or more contained plans from a single mutual fund company (with all investment choices being within that fund family) or an administrator [stand alone third party administrator (TPA) or a mutual fund company] that offers investment options from an array of providers (publicly traded mutual funds and/or separate accounts). Although each employer's needs are unique, the trend over the past few years is towards a single plan that includes investment choices from multiple mutual fund families.

In a multi-fund family arrangement, the TPA or mutual fund company provides record-keeping and customer services to participants and the plan sponsor/employer will typically retain some level of responsibility for decisions about the investment choices that will be offered to employees. This approach uses a single omnibus account for the investment options that are offered through the plan and the administrator records and batches all participant buys/sells requested before the day's trading deadline and transmits these orders to investment companies after the close of the market each day.

Because of this plan approach, the plan sponsor/employer has more flexibility in deciding what investment options are the most appropriate for their employees. Should the proposed rules be

[1] The higher percentage is seen when public sector employers use a small, incentive match contribution to a 401(a) defined contribution plan based on the voluntary contributions that employees make to a 457 plan.

[2] GE Financial's Wealth & Income Management Division Study, March, 2003.

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implemented, plan sponsors may be forced to revert to a single-fund family approach to ensure it can remain competitive with outside investment opportunities.

This could result in a less attractive employer sponsored benefit than currently afforded through the multi-fund family plan design because the plan sponsor will no longer have control to:

- Select investments from the entire universe of mutual fund choices based on criteria that is based on an evaluation of performance and internal expense charges.
- Make changes to the investments choices when deemed appropriate (typically based on an investment policy that establishes performance and other measurement criteria).
- Monitor and control costs associated with plan administration and investment management, through separate contracts initiated with the TPA and investment companies.

As to the impact to individual participants, a switch to defined contribution plans that are offered through a single fund family will potentially translate to:

- Limited investment choices that may change on a periodic basis, thus reducing the benefits of long-term investing. This is because most public employers are required to competitively bid contracts (e.g., every three to five years) and this reoccurring process could result in changing the plan to other mutual fund family options every contract period.
- Potentially higher internal expense charges (investment management fees) for certain asset classes of investments. This would result because under a single fund family option, an employer would not be able to only pick the most appropriate (based on performance and fees) funds from the universe of available options. Instead, they would need to review the fund family options as a whole and some asset classes may be more expensive (and less attractive) than others that could be found outside the selected fund family.
- Less motivation to provide comprehensive participant education and personal customer service, as the single fund family option will already have a significant competitive advantage over a multi-fund arrangement that will be forced to execute trades on a delayed pricing basis.

The effect of a less attractive employer plan and new limitations for administering these plans could ultimately result in dramatically lowering current participation rates. The advantages of investing through an employer sponsored plan, such as the employer monitoring investments and offering choices from multiple mutual fund families, will be eliminated. With fewer employees participating in the employer's retirement plan, the "per participant" cost for administration and services will likely increase.

The need to educate individuals about the importance of saving and investing for retirement has never been more important than evidenced today. Public employers, as well as their private sector counterparts, are facing serious budgetary concerns today and struggling to find ways to "do more with less" in terms of staffing and resources. Although there typically are education and communication programs (print materials and workshops) in place to inform employees about these benefits and the need to save for retirement, should these rules be implemented, these resources will likely need to be redirected to explain the new trading restrictions and how they differ between other investment opportunities. The results of this will be a reduction to the time and resources that are dedicated to current education efforts.

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Excessive Trading in a Retirement Plan

Another area that the SEC is expected to address through proposed rules is excessive trading in mutual fund accounts. Although some mutual fund companies prohibit this in their prospectus, their restrictions are not uniform among all funds and types of funds and often they are difficult to enforce.

Public employers who sponsor defined contribution plans have been trying to address the few participants who abuse trading privileges through the adoption of formal policies that govern individual's actions. These policies include enforcing specific restrictions on individuals who have executed multiple trades between the same fund within a set period of time, such as ceasing further trading privileges within this fund or restricting the identified individual's ability to request trades to a paper based request (such as by forms submitted through the mail).

Participants who abuse these trading privileges are an extremely small percentage of the entire employee population (for example, in one large plan of 150,000 participants, less than 50 excessive traders were identified). This is further evidenced by the statistic pointed out earlier that only 11% of all public employees participating in their retirement plan have any trading activity. If you compare this to private sector 401(k) plans, this number only slightly increases to 17%.

Education around retirement investing is encouraging participants to take a more active role in monitoring their portfolio and periodically (at least annually) executing trades to re-balance their holdings to meet their risk profile and investment time horizon. For this reason, it is extremely important to ensure any future rules proposed to address the excessive trading issue do not adversely affect an individual's ability to appropriately re-balance their retirement assets.

CONCLUSIONS

Safeguarding investors and their rights to a fair and appropriate return on their investment dollars is an absolute priority. However, creating rules and restrictions that will harm the millions of participants who are contributing for retirement through their employer-sponsored plan should not be a solution to the recent late- and excessive-trading violations. In addition, a cost/benefit analysis of any potential restrictions should be taken into consideration, since higher administration expenditures for these retirement benefit plans would ultimately mean higher fees to participants.

Alternative approaches to these rules should be considered, such as through technology solutions, to adequately safeguard investors and detect potential after-hour trading, but would not have a significant detrimental impact on defined contribution retirement plans and their participants.

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