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February 6, 2004

The Honorable Jonathan G. Katz
Secretary
Securities and Exchange Commission
Mailstop: 0609
450 Fifth Street, NW
Washington, DC 20549
hand delivered

Dear Mr. Katz

Re: Comment on proposed amendment to rules governing pricing of mutual fund shares; File No. S7-27-03.

Hewitt Associates is a global outsourcing and consulting firm that delivers a complete range of human capital management services to companies, including outsourcing of defined contribution plan administration. We are the second largest employee benefits consulting firm in the world[1]. We are the largest independent recordkeeper—i.e., not an affiliate of an investment management organization—for 401(k) retirement plans. In that capacity, Hewitt serves 5.5 million defined contribution participants, representing $200 billion in assets[2].

Hewitt respectfully submits this comment in response to proposed regulation "Amendments to Rules Governing Pricing of Mutual Fund Shares," File No. S7-27-03, published on December 11, 2003.

SUMMARY

Hewitt commends the Commission for its efforts to protect mutual fund investors from illegal after-hours trading, and to restore investor confidence in mutual funds. Nevertheless, we are concerned that the proposed hard 4:00 p.m. E.T. close will seriously disadvantage defined contribution plan participants and that better alternatives exist.

We understand that the hard 4:00 p.m. E.T. cut-off proposal is designed to address late-trading abuses by requiring mutual fund trade orders to be received by (1) the mutual fund, (2) the fund's principal transfer agent, or (3) a registered clearing agency by the time set for calculating the fund's net asset value (NAV) in order to receive that day's price (which, for most mutual funds, is when the major U.S. stock exchanges close at 4 p.m. E.T.). Hewitt is concerned that the hard 4:00 p.m. close rule will require trades for retirement plan participants to be cut off much earlier than trades of other

[1] *Business Insurance Magazine*, July 28, 2003.
[2] *Plansponsor.com's America's Top 10 Recordkeepers* survey.

investors, causing significant issues for retirement plans where participants direct investments.

In particular, Hewitt would like to comment on the following primary areas:

- **Same day pricing when conducting transactions is highly valued and important to retirement plan participants** even though, like many investors, they understand the value of long-term investing. The proposed rule will result in many plan participants making less efficient investment decisions because they will no longer have the ability to act on the most current market information up to the market close.

- **The proposed rule will interfere with the 401(k) plan market by 1) giving a strong competitive edge to service providers that offer bundled services, and 2) giving a strong competitive edge to mutual funds in bundled offers.** This competitive bias toward bundled providers and mutual funds within bundled providers is neither necessary nor appropriate, as better alternatives exist to stop illegal late-day trading. This will also result in a disadvantage to participants in terms of costs and total returns.

- **The definition of "order" (that must be received by 4 p.m.) needs to be further clarified or, as necessary, expanded to include percentage-based transfers.** If the order definition is not expanded, the ability for many defined contribution participants to make basic fund transfers will be impaired. Today, participants can elect that amounts be transferred between plan funds, even when the funds are managed by different fund companies. The amounts for the "buys" into new funds are based on the proceeds of the "sells" from the old ones. Today, this processing occurs as of the same day and is determined after fund NAVs are known. It is not clear how or whether this capability could be preserved under the regulations.

- **It is important to determine if a single clearing agency—which has been discussed as a way of offering assurance that no late trading is occurring—is technically viable.** Much discussion has taken place among key providers in the 401(k) industry about procedures to be used in the clearing process specified in the proposed regulations. Agreement has not been reached about a practical model to minimize disruption to current processes while ensuring the level of control sought by the Commission. The clearinghouse approach is also certain to result in additional costs for investors and it still will result in an early cut-off for defined contribution plan participants. In addition, unless the mutual fund companies are required to submit their trades to the same clearinghouse in the same manner, it will create a competitive disadvantage for independent 401(k) recordkeepers.

- **Hewitt suggests three alternatives for the Commission to consider:**

  1. **The Commission is seeking comments on an approach that would allow fund intermediaries to submit orders to a designated transfer agent or clearing agency after closing time if certain verifiable procedures are implemented to prevent late trading. These procedures include tamper proof time-stamping, certification policies, and independent audits. Hewitt recommends implementation of such a system by the Commission.** We are confident that technology exists today to assure that trades are made in compliance with rules the Commission may issue under this approach.

  2. **If the hard 4:00 p.m. E.T. cut off is enacted, and even if the clearinghouse approach is imposed, Hewitt recommends that 401(k) recordkeepers who are in the unique position of not engaging in any trades—but only processing 401(k) transactions (e.g., single-purpose defined contribution recordkeepers)—should be granted an exception that would permit continuation of after-hours processing by such recordkeepers.**

  3. **Hewitt also believes strongly that if the 401(k) recordkeepers can comply with the same policies and procedures as will be stipulated by the SEC for mutual fund transfer agents, then 401(k) recordkeepers should be permitted to follow the same policies and procedures.**

The Current 401(k) Marketplace

Mutual fund investments are offered in the vast majority of employer-provided defined contribution plans. According to the Investment Company Institute, 62 percent of fund-owning households owned mutual funds in their defined contribution plans, and nearly half viewed the workplace as their primary purchase channel for mutual funds[3].

In the defined contribution plan environment, processing retirement plan investment instructions is a complex and time-consuming process that requires ensuring that a myriad of laws and regulations and the plan's unique design specifications are followed before a trade is forwarded to a fund. For example, one prerequisite under the existing system is the release of the net asset value (NAV) before an order can be finalized. NAVs are released well after a fund's closing time, necessitating after hours processing.

Mutual funds are provided as plan investment options in defined contribution plans through bundled and unbundled arrangements. Bundled providers are recordkeepers

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[3] ICI's 2003 *Mutual Fund Fact Book.* 43rd Edition.

who are also affiliates of fund management companies and bundle together their recordkeeping and fund management services. Under a "bundled provider arrangement," the plan's investments usually include funds managed by an affiliate of the same company providing the recordkeeping and trading services. In some instances, the funds managed by the recordkeeper are the only investments included in the plan.

Unbundled recordkeepers are providers who do not offer fund management services and offer investments from a wide range of fund companies. An unbundled recordkeeper may allow plans to offer any mutual fund available for 401(k) investments.

Detrimental Impact of Proposed Rule on Participants

Defined contribution plan participants are no less sensitive to—and no less deserving of—the advantages of same-day pricing than investors who purchase fund shares via other avenues. Indeed, defined contribution participants are accustomed to, expect, and value the same trading advantages that other investors enjoy. Hewitt's 2003 401(k) survey finds that 93 percent of plans offer the ability for participants to make daily transfers without restrictions[4].

But in essence, the hard 4:00 p.m. cut-off creates an uneven playing field for these investors. In the event of potential large market moves, defined contribution participants who might elect to delay or reconsider reallocation or rebalancing decisions would not be able to do so with the same freedom as direct mutual fund investors. Given that for many Americans, their 401(k) plan is the single most important retirement asset they own, reducing their ability to make as informed investment decisions as other investors, could have serious consequences. Although the vast majority of investment decisions that participants make in connection with their 401(k) are long-term in nature, in many cases, an investment decision, such as when to take a plan distribution, have the same short-term implications as one made by a retail investor.

For example, consider an investor who is preparing to purchase an immediate annuity. It is not uncommon for such an investor to transfer into cash equivalent investments prior to initiating the annuity purchase in order to lock in the amount available for annuitization. Clearly, in this case, the timing of the transfer will be critical, as poor timing can reduce the lifetime income for the participant. In particular, if a major economic event were to occur subsequent to the participant's timing decision but having a negative impact on that day's pricing, the participant will suffer a significant impact to his or her retirement savings. Under the proposed regulations, if the participant is unable to obtain same-day pricing, the participant's ability to make a

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[4] Hewitt's 2003 *Trends and Experience in 401(k) Plans* survey.

decision based on knowledge that other investors are free to act upon is impaired. While same-day pricing cannot prevent unexpected economic events, in volatile market circumstances, it does enable a participant to implement or change financial decisions with the same level of current information as other investors.

The Commission should avoid solutions that cause defined contribution plan participants to be "second class citizens" when it comes to investing. This is particularly true given the fact that in the illegal after-hours trading cases that have been reported, it is invariably large, sophisticated investors, such as hedge funds, that are at issue. 401(k) participants—with an average plan balance of under $50,000 and a median plan balance of $16,000—are not the individuals engaging in illegal after-hours trading.

Hindering Competition

As the proposed rule notes, Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. Section 2(b) of the Securities Act, Section 3(f) of the Exchange Act and Section 2(c) of the Investment Company Act require the Commission, when engaging in rulemaking, to consider or determine whether an action is necessary or appropriate in the public interest, and consider whether the action will promote efficiency, competition, and capital formation. However, the proposed rule will create competitive advantages for certain plan service providers and funds, and Hewitt believes that such competitive advantages are neither necessary nor appropriate to stop illegal late-day trading.

The Commission notes that in order to enjoy same day pricing, third-party intermediaries will have to place their orders earlier in the day than investors who conduct business directly with the fund's designated transfer agent. In other words, the ability to offer same-day pricing to plan participants will be determined by the selection of plan recordkeepers and plan investments.

Under the proposed rule, if a plan's recordkeeper is affiliated with a fund management company, the recordkeeper is designated by the fund as its designated transfer agent, and plan investments are made in funds managed by the same company, then the proposed amendment will not disrupt the ability to offer same-day pricing to participants.

On the other hand, unbundled recordkeepers would need to implement complex, costly, and time-consuming system changes to accommodate the hard 4 p.m. cut off and, even with such changes, they would still be at a competitive disadvantage. Employers could be influenced to adopt the bundled service provider arrangement, undoubtedly forcing a number of unbundled providers out of the market. Participants, in turn, would be influenced to invest in the proprietary funds of the bundled recordkeeper in order to maintain same-day pricing privileges, potentially forcing funds that are unaffiliated with bundled providers out of the 401(k) market.

If completely bundled arrangements gain market share as a result of the proposed rule, there will also be disadvantages to plan participants. Participants will have a narrower range of investment choices (e.g., only those of the bundled provider) from which to choose. This could also ultimately have cost implications for participants, as the environment becomes less competitive for funds in unbundled arrangements.

We note the Commission mentioned that competition might help solve the dilemma of early cut-off times as recordkeepers would design more efficient systems that would permit investors to trade closer to the 4:00 p.m. cut-off. However, we believe that—despite significant pressures to change systems to meet the new rules—any competitive improvements in cut-off times could be several years away, given the required changes to technology. Furthermore, in the context of the significant additional regulatory controls the Commission intends to bring to this process, we question the appropriateness of leveraging market forces to speed up the process of technology change relating to sending trade information to the fund companies. Although improved processes would be helpful, improved speed at the expense of hastily and poorly implemented processes is a real risk and cannot be tolerated, especially to the extent that such risks may not be prevented until after participants have been unduly harmed.

At present, Hewitt estimates that the increase in administration costs that will result from moving to new system that accommodates the hard 4:00 p.m. cut off is 3-4 percent of current costs in the first several years of implementation.

Expansion of "Order" Definition

Hewitt believes there needs to be clarification—and possibly expansion—of the definition of "order" in the proposed rule in order reduce the problems that will be faced by retirement plan participants under the hard 4:00 p.m. close.

Under the proposed rule, the definition of "order" would include the direction to purchase or sell (1) a specific number of shares of a fund (e.g., all the shares held in the account) and (2) an indeterminate number of shares of a specific value (e.g., $10,000 of shares of the fund). In addition, the definition of "order" would include a direction to purchase securities of a fund using proceeds of a contemporaneous order to redeem a specific number of shares of another fund.

This definition does not clearly provide an exception for transfers within 401(k) plans that are submitted based on the percentage of holdings—where the amount to be purchased is not known prior to the completion of the sale. For example, say a participant wishes to transfer 35% of his or her total portfolio from Fund A to Fund B. In this very common example, the dollar value or share amount purchased of Fund B is not known until after the sale of Fund A. Without clarification, the hard 4:00 p.m. close could result in the transfer taking effect over multiple days—in other words, eliminating same-day pricing even for transactions that are submitted well before 4:00 p.m. Under the current definition of "order," plan sponsors who wish to afford same-day transfers are forced to change the available percentage-based approach to an approach whereby participants can transfer only specific shares or dollar amounts. Eliminating percentage-based transfers eliminates a transfer approach that is perceived by many participants as intuitive, and as an effective way to implement traditional asset allocation approaches.

Pros and Cons of a Clearing Agency

With respect to the 4:00 p.m. cut-off, Hewitt recognizes that an alternative proposal has been noted by the Commission whereby mutual fund trades would be processed through a registered clearinghouse. Orders submitted to the clearinghouse by the 4:00 p.m. close would be processed at that day's price. The trade information would be provided in raw data form prior to 4:00 p.m., followed by more specific information when NAVs become available.

While this proposal (along with the expansion of the definition of "order" discussed above) would shorten the early closing disadvantage for plan participants, the disadvantage would still exist unless all trades, including trades placed directly with the mutual funds, are required to go through the clearinghouse. Under the proposal, it is estimated that recordkeepers would still need several hours for the necessary reconciliation and other administrative activities (e.g., participants trades would be cut off at 1:00 p.m. or 2:00 p.m. E.T. instead of 10:00 a.m. to 12 noon E.T.).

Further, it is not clear if such a system is technically viable. The clearinghouse approach is certain to result in additional costs for investors. Moreover, unless the proposed rule is amended to eliminate the option for funds to receive orders directly, the previously discussed issues of competitiveness and efficiency will remain unresolved because of cost and time-lag disadvantages related to dealing with a clearing agency.

While the clearinghouse approach, if modified to include direct mutual fund transactions, has its potential merits, Hewitt believes that a better method exists to address the illegal late trading problem.

Hewitt Recommends Alternative Approaches

First Alternative
In its request for comments, the Commission asked for input on an approach that would allow fund intermediaries to submit orders to a designated transfer agent or clearing agency after closing time if certain verifiable procedures are implemented to prevent late trading. We support that approach. These procedures include tamper-proof time-stamping, certification policies, and independent audits. Hewitt recommends implementation of such a system by the Commission. We are confident that technology exists today to assure that trades are made in compliance with rules the Commission may issue under this approach.

The Commission questions how it would police compliance by fund intermediaries over which it currently has no regulatory authority. Hewitt suggests that it is appropriate to require all 401(k) recordkeepers operating under this alternative approach (and not already subject to the Commission's jurisdiction) to agree to the Commission's jurisdiction for the purpose of ensuring that late trading is not occurring.

As mentioned, we are confident that technology exists today to assure that trades are made in compliance with rules that the Commission may issue under this approach. In fact, Hewitt and other such recordkeepers have the ability to adhere to the same safeguards as mutual funds. For example, currently, each day Hewitt synchronizes its processing clock with the atomic clock in Greenwich, England. Each transaction is automatically time-stamped. Hewitt uses automated system procedures that electronically block submission of trades or cancellation of trades after the market close. Our customer representatives who interface with 401(k) participants are subject to the same electronic system controls that bar submission or cancellation of trades after hours. In addition to our own operations controls, Hewitt has a SAS 70 audit performed annually. Our clients also audit our systems and operations to make sure that after-hours activities are not permitted. As sponsors of qualified retirement plans under ERISA, our clients see it as part of their fiduciary responsibility to ensure there are adequate controls in place to bar after-hours trading.

Hewitt also proposes ways to augment existing processes:

1. ***Electronic time-stamping of orders in a manner that cannot be altered or discarded once the order is placed.*** As mentioned above, traceability of transfer requests is already a fundamental part of any sound processing system.

   Hewitt recommends that time stamping could be augmented by being performed by an outside provider. There are a number of possible providers—whose mission it is to enable regulated industries to guarantee the trustworthiness of their electronic records (e.g., Surety). These providers offer secure hashing algorithms and independent validation to further tamper-proof trades. Hewitt believes this is an avenue worth exploring.

2. ***Annual audit of the 401(k) recordkeeper's controls conducted by an independent public accountant and made available to mutual funds' compliance department.*** Hewitt recommends strengthening existing auditing processes for the defined contribution environment as a way of verifying that the procedures in place do not permit the acceptance of trades after the time at which such NAV was determined. Most defined contribution recordkeepers are currently subject to outside audit, but likely not specifically tied to compliance with late trading rules. We believe the existing outside audit process could be modified to review the processes and procedures that are designed to eliminate the ability to process late trades in order to ensure that no late trades have taken place.

3. ***Annual certification that the 401(k) recordkeeper has policies and procedures in place to prevent late trades, and that no late trades were processed.*** Hewitt recommends that senior managers of 401(k) plan recordkeepers be required to certify that policies and procedures are in place and no late trading has occurred. This could be equivalent to the types of standards now impacting publicly traded companies under the Sarbanes-Oxley Act.

Under this alternative approach Hewitt believes that by allowing 401(k) recordkeepers to volunteer to be regulated by the Commission, and by augmenting processing systems in the ways outlined above, many of the downsides of 4 p.m. cut off are addressed.

- Under this arrangement, the Commission will address its concerns about not being able to ensure compliance by third-party recordkeepers not presently regulated by the Commission.

- Competitiveness issues will disappear because such entities will be free to decide to offer same-day pricing if they wish.

- Employers will be able to structure their employee retirement plans without concern about impacting the ability to offer same-day pricing.

- Cost increases will be minimized.

- Most importantly, 401(k) investors will be free to enjoy the advantages of same-day pricing if they so choose.

Second Alternative
If the hard 4:00 p.m. cut off is enacted, and even if the clearinghouse approach is imposed, Hewitt recommends that 401(k) recordkeepers who are in the unique position of not engaging in any trades—but only process 401(k) transactions (e.g., single-purpose defined contribution recordkeepers)—should be granted an exception that would permit continuation of after-hours processing by such recordkeepers. Hewitt and other such entities do not engage in trades or process transactions for entities other than defined contribution plans, and they would not be in a position to submit non-401(k) plan trades after 4 p.m. Hewitt has no financial incentive and does not stand to gain whatsoever from late-day trading. Because we only process 401(k) trades, there is no opportunity to illegally bundle late-day trades with 401(k) trades. As further assurance as to the integrity of the system, 401(k) plans are regulated by ERISA, which imposes fiduciary responsibilities on plan sponsors. The violation of late-day trading rules could result in a potential fiduciary breach and the associated penalties under ERISA. In addition, some of these single-purpose 401(k) recordkeepers are already subject to SEC regulation.

Hewitt notes that a similar exception to the one outlined above for single-purpose defined contribution recordkeepers was included in the Commission's original proposal. This exception addressed "conduit" funds, which invest all their assets in another fund and therefore must calculate their NAV on the basis of the other fund's NAV. The Commission noted in its proposal that since these funds are registered investment companies and are subject to regulation and oversight by the Commission, an exception would permit a conduit fund—such as a "master-feeder" fund or an insurance company separate account—to submit its orders based on the NAV established by the other fund on the same day. Hewitt commends this approach and recommends similar consideration and regulation for single-purpose defined contribution recordkeepers in light of the reasons outlined above, and in light of the fact that transfer agents—such as Hewitt and other such defined contribution recordkeepers—are already regulated by the Commission.

Third Alternative

Third, Hewitt also believes strongly that if the 401(k) recordkeepers can comply with the same policies and procedures as will be stipulated by the SEC for mutual fund transfer agents, then 401(k) recordkeepers should be permitted to follow the same policies and procedures. Hewitt is confident that we could meet the same procedural standards as the mutual funds' primary transfer agents.

Conclusion

In closing, we submit this comment in the best interest of our retirement savings plan participants. We urge the Commission to give serious consideration to allowing adequate alternatives to the hard 4:00 p.m. cutoff. We support the alternatives outlined in the proposed regulations and we are confident that they will fulfill the Commission's objective of drastically limiting the opportunity for illegal late-day trading while still preserving the right of 401(k) participants to place trades up until the market close and get that same day's price, and keeping a level playing field for 401(k) participants.

Sincerely,

Hewitt Associates LLC

E. Scott Peterson

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