All that's hot in the mutual fund industry

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401(k) Biz Awaits Scandal-Related Changes

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The fund scandal may have spawned regulatory upheaval in the fund world, but the biggest changes for the 401(k) industry are yet to come.

A handful of 401(k) administrators have initiated policies to discourage market timing and late trading. But many are holding off until the SEC and fund firms implement their own measures, observers say.

"I would suspect that people are in a holding pattern, waiting to see what's going to happen at the SEC," says **Profit Sharing/401(k) Council of America** vice president Ed Ferrigno.

Regardless, one thing is fairly certain: The 401(k) industry is being examined with an eye on regulatory change. That is evident by the SEC and Department of Labor's scrutiny of revenue sharing in 401(k)s and fee transparency.

Another source of pending change: two SEC rule proposals that would significantly affect how retirement plans process trades. The proposals, which have not been warmly embraced by plan recordkeepers and administrators, include the hard 4 p.m. close and mandatory redemption fee rule proposals.

The hard 4 p.m. close proposal aims to forestall late trading, but plan administrators say it would delay mutual fund trades in 401(k) plans by as many as three days. That's because trades in 401(k) plans have to wend their way through recordkeepers or third-party administrators before reaching the fund firm. The mandatory redemption fee would impose similar hurdles, administrators argue, because the trades are processed in bulk through omnibus accounts. That makes it difficult and costly for plan administrators to discern which individual plan participants are actually making the trades.

With many plan administrators waiting to see what the SEC decides to do, 401(k) plans remain a potential target for market-timing activity.

"There may be a couple of providers where it's not as easy as it once was, but in general, industry-wide, it's just as easy to do," says Sean Waters, president of 401(k) consultancy **Waters Associates**.

Very few 401(k) recordkeepers have instituted policies to combat market timing, he says.

But many fund shops have forged ahead of recordkeepers and regulators and are tacking on their own redemption fees to discourage market timing. For example, **Fidelity** recently bulked up its redemption fees' application, says spokesman Vin Loporchio. Previously the fees did not extend to people who traded through omnibus accounts, where most 401(k) transactions take place. In late 2003, Fidelity put omnibus account holders on notice that they would be required to collect and assess redemption fees on individual investors by Dec. 31, 2004.

But nearly three quarters of the 50 largest fund groups still can't stop timers who trade via omnibus accounts. That's according to a recent study by the **Coalition for Mutual Fund Investors**, a shareholder advocacy group.

Much of the trouble is technological, says CMFI president Niels Holch, a partner in the Washington law firm **McGuiness & Holch**. Because omnibus accounts bundle thousands of trades, it is difficult to monitor individual trades.

"Our proposal to fix this is to just have disclosure," Holch observes. "In other words, if you're a 401(k) and I'm a fund, you would tell me who the shareholders are and you'd also tell me what the transactions are so that I'd be able to make sure that the policies are being followed."

Yet individual funds' redemption fees could pose headaches of their own for plan administrators, sponsors and participants.

"Unfortunately at this point there is no standard for applying them," says Jeff Close, from the **Society of Professional Administrators and Recordkeepers** (Spark), a 401(k) trade and research group. "If you were an

administrator with 20 different fund companies on your trading platform, you could have 20 different sets of redemption fees. If you were a participant who wanted to trade out of one fund and into another, there are two sets of guidelines for their redemption fees."

Aside from the confusion this might cause, another worry is that these redemption fees might accidentally affect innocent investors.

"The people who get hurt are the participants," says employee benefits attorney Fred Reish, partner and managing director at **Reish Luftman Reicher & Cohen**. "You can figure that the active traders will figure out the rules, so they're not going to get hurt."

Reish calls for recordkeepers and fund shops to establish an industry standard on redemption fees.

One emerging industry norm would at least protect 401(k) participants from redemption fees in the case of automatic transactions, such as their retirement distribution. That's according to Charles Vieth, president of **T. Rowe Price** retirement plan services and head of the **National Defined Contribution Council**.

"We're only going to be assessing redemption fees on participant-driven transactions," Vieth explains.

As firms and regulators sort out their market-timing policies, the trading scandal's impact has been felt most profoundly on the 401(k) side by plan sponsors.

"The whole mutual fund scandal has had the effect of causing plan sponsors to take a fresh look at fee arrangements involving mutual fund providers," says William Schmidt, an Erisa lawyer at **Kirkpatrick & Lockhart**.

As a result of the fund scandal, plan sponsors "now know what they don't know," observes **401kExchange** president and CEO Fred Barstein. Sponsors haven't been alone. Congress, the SEC and Department of Labor are all taking a tougher look at 12b-1 fees, revenue sharing and other fund expenses.

That increased fee scrutiny is the latest outgrowth of the trading scandal, whatever regulators and legislators ultimately decide, many say.

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