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Paul F. Roye, Director
Cynthia M. Fornelli, Deputy Director
Division of Investment Management
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

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Dear Mr. Roye and Ms. Fornelli:

On behalf of the SPARK Institute, thank you for providing us the opportunity to meet with you to discuss how regulatory action to address abuses in connection with late trading and market timing of mutual fund shares may affect the retirement services industry. As you may be aware, 401(k) and other defined contribution benefit plans ("plans") are major investors in mutual funds. These plans held more than $3.2 trillion in assets as of year end 2002. Approximately 45 percent of the assets of 401(k) plans are mutual fund investments. SPARK members administer 95 percent of these plans.

. As requested, this letter provides additional information about the trade processing procedures typically employed by recordkeepers and other plan service providers and the reasons why a "hard" 4 p.m. cut-off for delivery of mutual fund orders to funds could result in significant, adverse consequences for plan participants as well as for the retirement services industry.

A. <u>Trade Processing Procedures</u>

As we discussed at our meeting, recordkeeping and trade processing procedures for participant-directed plans involve three systems.

- The "front-end" processing system accepts plan transactions that generate investment instructions, including participant instructions for the allocation of periodic plan contributions, requests for exchanges among plan investment choices, requests for loans, benefits and other distributions, and plan sponsor instructions as to the investment of amounts participants do not direct, plan conversions, and other sponsor-level transactions. The transactions may be received directly to the processing system through an intranet or web-based internet system or automated voice response unit, or received through a telephone call center or on paper and entered into the processing system by an operator. As transactions are entered to the front-end processing system they are tested to ensure that certain plan rules are satisfied. Once accepted, the transactions are electronically date-time stamped and held for later processing, generally on a daily cycle in the case of "daily valued" plans that permit participants to provide investment instructions on any business day. Applicable plan rules always provide that any investment instructions received after a cut-off time (which may not be later than 4 p.m. EST on a business day if the plan invests in any mutual funds that impose a 4 p.m. cut-off time) are held for processing on the next business day.

- The "primary" recordkeeping system maintains participant and plan records and applies various plan rules. On a periodic cycle (daily in the case of plans), transactions that have been posted to the front-end system by a designated cut-off time are transferred to the primary recordkeeping system for processing and entry onto the system. Many recordkeeping systems require fund price information to perform the daily processing, which allows the system to price and process participant instructions to make exchanges between plan investment options on the same day. In the case of large plans or where service provider systems process a large number of plans, this processing can take several hours or longer. The primary recordkeeping system is also reconciled with trade confirmations, trust records and fund reports as part of the daily processing cycle.

- The "back-end" processing system processes "outputs" of the primary recordkeeping system. In particular, this system receives and transmits trade orders as required to effect transaction instructions provided to the core recordkeeping system by participants and plan sponsors, as well as other reports. Because primary recordkeeping systems typically require fund price information and require several hours to perform their processing, the back-end portion of the system typically receives and transmits trade orders after markets close on **a** business day. However, controls on the front-end and primary recordkeeping systems would ensure that trade orders received and transmitted represent plan transactions received before the required cut-off times under plan rules and before the 4 p.m. EST cut-off time imposed by most mutual funds for receipt of orders by any agent to the fund.

All of these systems are subject to internal control procedures designed to ensure the integrity and effective operation of the systems. In this regard, we are separately providing information from "SAS-70" reports to illustrate typical plan recordkeeping and transaction processing procedures and the types of internal procedures and controls that are typically monitored by outside auditors.

B. Impact of a "Hard" 4 p.m. Cut-off

We understand that the Division of Investment Management is considering whether a fund (rather than an intermediary or agent for the find) must receive an order for fund shares before the fund prices its shares for the investor to receive that day's price. Generally, this would mean that a fund would have to receive the order by approximately 4:00 p.m. EST for the investor to receive that day's price. The objective of such a rule would be to effectively eliminate the potential for late trading through intermediaries that sell fund shares. Such a rule, however, would have significant adverse consequences for participants in 401(k) and similar plans, as follows.

1. Substantial systems modification costs to plan participants. **As** noted, many recordkeeping systems use daily price information in performing the processing of investment instructions before trade orders are generated for execution. If plan orders for mutual fund investments must be provided to the fund before **4** p.m., these systems must be reconfigured to process transaction instructions without price information. Because of the volume of transactions undertaken, the complexity of plan and fund rules applied, and the variety of reconciliations with trustees and funds performed, modifications to these systems are extremely complex; it is possible that the cost of reconfiguring these systems could put many plan service providers out of business. Ultimately, the costs to reconfigure plan recordkeeping and trade processing systems will be paid by participants, directly through recordkeeping charges or indirectly through additional fund-level charges.

2. Delayed participant transaction processing, especially for exchanges. **As** noted, processing of participant and plan transactions requires substantial processing time to ensure that transactions satisfy plan rules and reconcile with the plan's records. To deliver plan-level trade orders ahead of a 4 p.m. cut-off time at a fund, participant-level transaction instructions under a plan generally would have to be cut-off well before a fund's 4 p.m. EST cut-off time. This means that most plan participants would likely receive "next day" prices for their plan investment instructions. This places plan participants at a significant disadvantage vis-a-vis other investors.'

Moreover, without fund price information, participant requests for exchanges between funds would have to be executed over a 2 day period, *i.e.*, by a sale of shares on Day 1 and a corresponding purchase on Day 2. While the sale and purchase transactions settle, other participant investment instructions may be suspended. This would be a significant hardship for participants in most 401(k) and similar plans.

Where a plan's investment options are limited to a single fund complex, a fund complex may be capable of continuing to offer plan participants "same day" trading services by, in effect, providing the participant with a level of service similar to that received by shareholders maintaining an account with a fund transfer agent. However, these services are likely to be far more expensive to participants than currently available arrangements. In this regard, plans are typically eligible for less expensive fund share classes; these discounts may not be available if the fund is responsible for maintaining individual participant records. Further, this "retail" shareholder level of service may not be offered to plan participants who maintain very small account balances. Indeed, the services provided to 401(k) and similar plans developed in part to address the problem that fund transfer agents typically are not willing to hold and process orders for very small accounts (*e.g.*, new investments of only a few dollars, small account balances). In comparison, the 401(k) recordkeeping industry has been very successful in providing individuals with only small dollar amounts a means to invest in mutual funds at a reasonable cost.

3. <u>Lost earnings resulting from uninvested funds</u>. Efficiencies allowed by daily trading through 401(k) and similar plans has substantially eliminated legal and fiduciary prudence issues relating to plan funds held uninvested for short periods of time. Delays in participant transaction processing, especially in the case of exchanges, would result in more plan funds held uninvested. Handling and disposition of earnings on uninvested plan assets is an important plan fiduciary compliance issue.

4. <u>Impact on participant expectations</u>. Most plan participants currently have access to daily trading, as if investing on a retail basis. A change to next day pricing in plan accounts would be viewed as a significant adverse change by participants.

It is also worth noting that, even if plan participants are generally supposed to be "long-term" investors, plan participants remain sensitive to short-term price volatility.

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[1] From a practical standpoint, this requirement would only serve to speed up a trend within the retirement services industry to rely on other forms of collective investment to meet participant needs. Mutual funds could be replaced by collect investment trusts and pooled separate accounts that could be daily priced.

For example, in plans with an employer stock investment option, delays in mutual fund trading would also delay participant trades in employer stock through the plan.[2]

Moreover, plan participants become "short-term" investors whenever they become eligible to receive plan benefits, *e.g.*, if they are considering a plan loan, or approaching termination of employment or retirement. Given the volatility of today's markets, even a one day delay in trading could mean a significant difference in the value of the plan benefits a participant may receive.

C. Alternative Approaches

At our meeting, you asked whether internal controls and procedures imposed in connection with plan recordkeeping and trade processing services would provide "certainty" against the possibility of late trading abuses in connection with after-hours trade processing on behalf of 401(k) and similar plans. We believe that internal controls and procedures included in most plan recordkeeping and trade processing systems already provide the certainty you seek or could be modified at reasonable cost to produce the controls and procedures that are needed. Critical controls could include the following.

1. Controls to ensure that each plan and participant account is a valid, properly classified account. Virtually all plan service providers maintain controls to ensure that customer accounts are valid and identified as an appropriate client of the service provider. Each trade order placed also must be identified to a known, valid customer account. Generally, these controls include documentation and supervisory control of account authorization, and for any tax-qualified plan, validation of plan and plan administrator identification numbers against Labor Department Form 5500 records.

2. Procedures that provide' for an electronic date-time stamp of all investment instructions. Virtually all commercial plan recordkeeping systems already place an electronic date-time stamp and unique transaction identification on each transaction record generated by the system and retain this information through the processing cycle. All commercial voice response units and web-based applications for participant investment instructions also date-time stamp any instructions received. In addition, all instructions processed from paper instructions are typically scanned into processing systems and date-time stamped in the scanning process.

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[2] Indeed, the delay in the purchase of employer stock after an exchange from a mutual fund could be more than the 3-day period that would (if not imposed as a standard plan rule) constitute a suspension in trading for purposes of rules under the Sarbanes-Oxley Act of 2002 prohibiting insiders from trading in employer stock during "black-out" periods in which plan participants ability to trade employer stock is suspended.

3. Control of the timely cut-off of investment instructions provided for processing. The cut-off of participant instructions for a business day is typically controlled automatically by a controlling computer routine or it may be initiated by an established administrative process that is applied consistently within an organization. Internal control and audit programs can be used to ensure that daily cut-offs are made in a timely manner each business day.

4. Auditability of transactions from point of origination through receipt by a fund company. Plan service providers that contract with intermediaries or funds to transmit orders typically must agree to make their books and records available upon request by the intermediary or fund. These contractual rights to inspect books and records could be expanded to include obligations to establish audit chains for trade instructions, including transactions represented by aggregated or "omnibus" orders. Each service provider's processing systems would provide the ability to track transactions from origination to transmittal to an intermediary or fund company.

5. Control over exceptions, corrections and cancellations. It is inevitable that mistakes may occur in processing the large volume of daily transactions typically for many plan recordkeepers. (Indeed, many may process hundreds of thousands of transactions each day). Errors are typically identified by exception reports generated by recordkeeping systems. Internal controls typically require that any corrections or cancellations must be identified to a specific plan and participant account, documented as a correcting trade with a clear and comprehensive description of the error being corrected, and approved by a supervisor and reviewed by an independent compliance officer within a period of time.

6. Effective daily share position and reconciliation processes. Fund company confirmations and holdings reports as of a specific date generally are reconciled to corresponding positions on the primary recordkeeping system on a trade-by-trade basis. This control ensures that unauthorized transactions cannot be processed and remain detected because not posted to the recordkeeping system.

Some of these critical controls are already specifically identified and subject to review by internal or external audits of the plan service provider organizations. While other controls are not specifically identified and tested in all service provider organizations, it would be possible to improve these practices.[3] Funds could confirm that such controls are in place by requiring that, where a plan service provider will act as the

[3] Generally, mutual funds and intermediaries receiving fund orders from plan service providers already have contractual rights to review the books and records of their plan service provider agents, and could seek to require plan service providers to provide detailed internal control reports, but have not yet done so.

fund's agent to accept orders before 4 p.m. EST for processing after the fund's 4 p.m. cut-off time, the service provider's principal executive officer or officers, and its principal financial officer or persons performing similar functions, must certify to the fund company that internal controls designed to achieve these control objectives have been implemented and are followed.

D. Market 1 4

We appreciated hearing your comments on the issues raised by market timing by participants of 401(k) and similar plans. As discussed, we believe that plan service providers and plan sponsors are willing to address market timing by plan participants by imposing reasonable restrictions on frequent participant trading, if such restrictions can be implemented by objective rules.

We also believe that plan recordkeeping systems already contain the data needed to impose reasonable, objective rules that discourage market timing and systems can be modified to impose such rules. Efforts by plan service providers and plan sponsors to discourage market timing by participants would be made far easier, however, if funds adopt uniform approaches for addressing this issue.

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We hope that this information is helpful. We appreciate having the opportunity to participate in this process and hope that you will continue to allow us to work with you in crafting ways to address concerns about potential late trading and market timing of mutual funds that will also be supportive of participants of 401(k) and similar plans.

Sincerely,

Robert G. Wuelfing

Robert G. Wuelfing