U.S. GOVERNMENT ACCOUNTABILITY OFFICE
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May 14, 2015

The Honorable Ron Wyden
Ranking Member
Committee on Finance
United States Senate

The Honorable Patty Murray
Ranking Member
Committee on Health, Education, Labor, and Pensions
United States Senate

The Honorable Elizabeth Warren
United States Senate

401(K) PLANS: Frequent and Collective Trading Are Uncommon and Not a Significant Concern for Plan Participants, Sponsors, or Mutual Funds

In the early 2000s, federal regulators identified patterns of short-term trading abuses in mutual funds, including certain undisclosed market timing practices. Market timing involves frequent trading of shares of the same mutual fund to take advantage of temporary disparities in the value of a fund and its underlying assets in the fund's portfolio.[1] Such practices have the potential to compromise the savings of long-term investors, including retirement plan participants who own mutual fund shares.[2] Frequent trading occurs when a shareholder, including a retirement plan participant, trades (i.e., purchases, redeems/sells, or exchanges) shares in the plan's mutual funds repeatedly within a specified period of time, at times to take advantage of short-term price fluctuations. In response to these practices, federal regulators

[1] See: Mutual Fund Redemption Fees, 70 Fed. Reg. 13,328, n.4 (March 18, 2005)(adopting redemption fee rule) ("Redemption Fee Rule"). Market timing includes (a) frequent buying and selling of shares of the same fund or (b) buying or selling fund shares in order to exploit inefficiencies in fund pricing. See also: *GAO, MUTUAL FUNDS: Assessment of Regulatory Reforms to Improve the Management and Sale of Mutual Funds*. GAO-04-533T (Washington, D.C.: March 10, 2004). Market timing and frequent trading are distinct from high-frequency trading where professional traders act in a proprietary capacity to generate a large number of trades on a daily basis. These traders use extraordinarily high speed and sophisticated programs for generating, routing, and executing orders within very short time-frames to establish and liquidate positions.

[2] Market timing by investors, while not illegal per se, can harm other fund shareholders because (a) it can dilute the value of their shares, if the market timer is exploiting pricing inefficiencies, (b) it can disrupt the management of the fund's investment portfolio, and (c) it can cause the targeted fund to incur costs borne by other shareholders to accommodate the market timer's frequent buying and selling of shares. See: Redemption Fee Rule, n.4.

adopted regulatory changes requiring mutual funds to disclose any frequent trading policies[3] in their prospectuses and to permit the imposition of redemption (sales) fees of up to 2 percent of the sales price for fund shares redeemed within a short time period.[4] Frequent trading policies have become standard mechanisms plan sponsors and mutual funds use to enable them to limit frequent trading by investors, including plan participants.

Sponsors of 401(k) retirement plans have a fiduciary duty to operate and manage their plans prudently, at low cost, and solely in the interest of participants.[5] Some participants in 401(k) plans actively manage their retirement accounts to seek higher returns, and some may incur additional fees or face trading restrictions due to, for example, trades they make based on investment advice. At times, the objectives of plan fiduciaries and of mutual funds[6] may seem in conflict with those of plan participants. For example, to control costs, a mutual fund associated with a large 401(k) plan prohibited purchases and exchanges of mutual fund shares by certain participants who had engaged in collective trading based on advice from an investment newsletter.[7] Collective trading occurs when a number of shareholders, who may also be retirement plan participants, act together, knowingly or not, to order a specific trade of mutual fund shares at essentially the same time, often in response to investment advice from financial news sources or investment newsletters. Because these participants were found to have traded collectively—in violation of the mutual fund's excessive trading policy—they were prohibited from purchasing or exchanging shares in these funds for a minimum period of 90 days. In one case, a participant was prohibited from making purchases or exchanges of shares in the mutual fund for a full year.

This report updates information that you requested and that we initially provided to your staff at a briefing on March 31, 2015. The updated briefing slides in Enclosure I describe:

1. the types of trading restrictions that 401(k) plan participants typically face,
2. what is known about frequent or collective trading by plan participants and the effect of such trading on plan costs, and

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[3] Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, 69 Fed. Reg. 22,300 (April 23, 2004) (prescribing changes to Form N-1A).

[4] Mutual Fund Redemption Fees, 70 Fed. Reg. 13,328 (March 18, 2005) (codified at 17 C.F.R. § 270.22c-2).

[5] 29 U.S.C. § 1104. Under the Employee Retirement Income Security Act of 1974, a fiduciary generally includes anyone who exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, or renders investment advice for a fee or compensation, direct or indirect, with respect to any moneys or other property of such plans, or has authority to do so, or has any discretionary authority or discretionary responsibility in the administration of the plan. 29 U.S.C. § 1002(21)(A).

[6] Although mutual funds can become plan fiduciaries, investment of retirement accounts in a mutual fund does not by itself cause a mutual fund to become a plan fiduciary. 29 U.S.C. § 1002(21)(B).

[7] In this case, the media reported that the publisher of an investment newsletter filed a complaint with the U.S. Securities and Exchange Commission (SEC) requesting a review and disposition on the mutual fund's excessive and short-term trading policies. It is the general policy of the SEC to conduct its investigations on a confidential basis to preserve the integrity of its investigative process as well as to protect persons against whom unfounded charges may be made or where the SEC determines that enforcement action is not necessary or appropriate. Subject to the provisions of the Freedom of Information Act, the SEC cannot disclose the existence or non-existence of an investigation and any information gathered unless made a matter of public record in proceedings brought before the SEC or in the courts.

3. how stakeholders view current regulation of a participant's ability to manage retirement accounts and the duties of plan fiduciaries and obligations of mutual funds.

To gather this information, we reviewed publicly available reports issued by federal agencies, retirement industry organizations, academics, and participant advocacy groups that describe the scope of frequent or collective trading by 401(k) plan participants and the type of trading restrictions currently used to address these trades. To identify and evaluate policies pertaining to excessive trading and use of redemption fees, we reviewed a nongeneralizable sample of 15 mutual fund prospectuses going back nearly 10 years representing different asset classes and levels of assets under management, and five summary plan descriptions representing several different industries. We interviewed retirement industry representatives, such as the Investment Company Institute (ICI)—a professional organization representing regulated mutual funds—and the Society of Professional Asset-Managers and Record Keepers (SPARK) about the prevalence of frequent or collective trading by 401(k) plan participants and the use of trading restrictions, including redemption fees, by mutual funds to curb these trades. We also interviewed select retirement industry experts (including a publisher of an investment newsletter—see encl. II), representatives at mutual funds, record keepers, academics, and federal officials. We also interviewed a nongeneralizable sample of five employers who were 401(k) plan sponsors representing a range of industries and plan sizes. We solicited participant perspectives through interviews with advocacy groups, such as the Pension Rights Center and a pilots union, which represent 401(k) plan participants, and the Coalition of Mutual Fund Investors, which represents mutual fund investors. We also reviewed relevant federal laws, regulations, and agency guidance identified through our fieldwork as relevant to frequent or collective trading by investors and 401(k) plan participants and the types of trading restrictions imposed by plan sponsors and mutual funds.

We conducted this performance audit from July 2014 through May 2015 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

BACKGROUND

Under Title I of the Employee Retirement Income Security Act of 1974 (ERISA), employers are permitted to sponsor defined contribution (DC) plans—typically 401(k) plans, the predominant type of DC plan in the United States—in which an employee's accumulated retirement savings depend on employee and, in some instances, employer contributions and the investment performance of the individual's account.[8] In 401(k) plans, participants specify the size of their contributions, within limits, and typically direct their assets to one or more mutual funds or other

[8] 29 U.S.C. § 1002(34).

investments offered within the plan.[9] As of 2012, U.S. employers sponsored more than 516,000 401(k) plans covering nearly 75 million participants and containing about $3.5 trillion in assets.[10]

We identified four federal regulations of particular relevance to our work that afford participants of 401(k) plans the opportunity to efficiently manage their retirement investments. These regulations are directed at ensuring that participants have the information they need to make informed decisions about the management of their accounts and to direct the investment of their retirement savings. Federal agencies have also issued regulations pertaining to the duties of plan fiduciaries and obligations of mutual funds.[11]

The regulations we reviewed include:

- **ERISA section 404(c) plans (29 C.F.R. § 2550.404c-1)** – applies to pension plans that provide individual accounts, such as 401(k) plans, and permits participants to control how account funds are invested.[12] It provides that sponsors of such plans and others who may otherwise be considered plan fiduciaries are generally shielded from liability for any loss resulting from a participant's exercise of control over account funds, if the plan meets certain conditions.[13] The regulation sets out conditions, which include that participants have a reasonable opportunity to give investment instructions to an identified plan fiduciary generally obligated to comply with them and may choose from a broad range of investment alternatives. It allows fiduciaries to charge reasonable expenses for carrying out participant investment instructions, to decline to implement certain participant investment instructions, and to impose reasonable restrictions on the frequency of investment instructions.[14] The regulations also specify that at least three investment alternatives within a plan's investment lineup must permit a participant to give investment instructions—such as a purchase, redemption, or exchange—at least once within any 3-month period.

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[9] 26 U.S.C. § 401(k)(2). In a 401(k) plan, a participant can typically make pre-tax contributions into the account, with the employee often choosing the investments based on options provided under the plan. In some plans, the employer (plan sponsor) also makes contributions, matching the employee's contributions up to a certain percentage, and regulation sets a dollar limit on the amount a participant may elect to defer each year and the amount that the employer may contribute on a participant's behalf.

[10] U.S. Department of Labor, Employee Benefits Security Administration, *Private Pension Plan Bulletin: Abstract of 2012 Form 5500 Annual Reports, Version 1.2* (Washington, D.C.: January 2015).

[11] Plan sponsors are typically named fiduciaries of their 401(k) plans, but others employed by sponsors to help manage plans or provide services to plans or participants may also become plan fiduciaries under ERISA should they perform functions that bring them within the definition of a plan fiduciary. The Department of Labor recently issued a proposed rule that would treat persons who provide investment advice or recommendations to an employee benefit plan, plan fiduciary, plan participant or beneficiary, individual retirement account (IRA), or IRA owner as fiduciaries under ERISA. Definition of the Term ''Fiduciary''; Conflict of Interest Rule—Retirement Investment Advice, 80 Fed. Reg. 21,928 (Apr. 20, 2015).

[12] 29 U.S.C. § 1104(c).

[13] Plan fiduciaries remain obligated by ERISA's fiduciary duties provisions to prudently select the investment options available under the plan and to monitor their ongoing performance.

[14] This provision further provides that in no event is such a restriction reasonable unless, with respect to each investment alternative made available by the plan, it permits participants to give investment instructions with a frequency appropriate in light of the market volatility to which the investment alternative may reasonably be expected to be subject. 29 C.F.R. § 2550.404c-1(b)(2)(ii)(C).

- **Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans (29 C.F.R. § 2550.404a-5)** – specifies plan fiduciary requirements for disclosure of information (including fee and expense information) to plan participants to ensure that all participants have the information needed to make informed decisions about the management of their individual accounts and the investment of their retirement savings. Disclosures must include an explanation of the circumstances under which participants may give investment instructions and any limitations on such instructions including restrictions on transfers to or from other investments.

- **Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings (17 C.F.R. §§ 239.15A and 274.11A)** – requires a mutual fund to disclose the risks to investors of frequent purchases and redemptions of mutual fund shares and the mutual fund's policies and procedures with respect to such transactions. If a mutual fund has not adopted a policy regarding frequent purchases and redemptions, it must provide the specific bases for the view of the mutual fund's board of directors that it is appropriate for the fund not to have such policies and procedures.[15]

- **Mutual Fund Redemption Fees (17 C.F.R. § 270.22c-2)** – prohibits a mutual fund from redeeming fund shares within 7 days of purchase unless the fund's board has specifically approved and set a redemption fee not to exceed 2 percent of the amount redeemed, and a holding period between purchase and redemption to trigger the imposition of the fee, or has specifically determined that imposition of a redemption fee is either not necessary or not appropriate. The amount of the fee and holding period are to offset the costs incurred as a result of short-term trading redemptions or to discourage frequent trading. The rule also requires mutual funds that redeem shares within 7 days to enter into written agreements with financial intermediaries—such as retirement plan administrators or record keepers that hold shares on behalf of other investors—to provide certain shareholder identity and transaction information so mutual funds can identify investors who may be violating fund policies on frequent trading.

In summary, we found:

- 401(k) plan participants often face trading policies that restrict frequent or collective trading in mutual funds. The most common restrictions were (1) discretionary provisions found in mutual fund prospectuses that allow mutual funds to reject purchases or exchanges of mutual fund shares they find inappropriate or disruptive to the fund's investment and management strategy and (2) time limits on how quickly a participant can purchase additional shares after trading out of a fund. For example, most of the prospectuses we reviewed described time limits—usually 30 to 90 days—where a participant must wait to purchase additional shares after trading out of a fund. Restrictions have been in place for nearly 10 years in all of the fund prospectuses that we reviewed. Although U.S. Securities and Exchange Commission regulations allow mutual funds to assess redemption fees, in nearly all the prospectuses we reviewed, the

[15] In response to market timing abuses involving mutual funds in the early 2000s, regulatory changes were adopted to provide for the disclosure by mutual funds in their prospectuses of any frequent trading policies. These changes were adopted in the form of amendments to Form N-1A, which is required to be used in connection with the registration of mutual funds. Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, 69 Fed. Reg. 22,300 (April 23, 2004).

mutual fund did not impose such fees.[16] Mutual funds had initially instituted frequent trading policies to control costs and stem the potentially adverse effects of frequent trading on a fund's management activities. These policies may also affect collective trading by plan participants and investors. In addition, plan sponsors may apply similar trading restrictions to the investment options under their plan.

- Frequent and collective trading by plan participants are uncommon. Since the market timing abuses in mutual funds of the early 2000s, neither frequent nor collective trading by participants has been a concern for plan sponsors, mutual funds, or participant advocates we interviewed. In fact, some stakeholders expressed greater concern that 401(k) participants often fail to regularly rebalance their investments and trade too infrequently. Industry representatives we spoke to stated that there is no widely accepted definition of collective trading, nor could they speak authoritatively about how mutual funds specifically discuss collective trading in their prospectuses. However, one mutual fund representative said they use certain analytic methods to identify collective trading if it occurs and can take steps to curb such activity. To the extent that frequent or collective trading does occur, industry representatives reported that increased costs, such as higher administrative charges and fees, are typically shared by all shareholders who invest in the mutual fund—including participants who did not engage in these types of practices. Further, they said that such trading can also disrupt a mutual fund's investment strategy. For example, if a mutual fund did not anticipate large redemptions—such as those by investors acting collectively—the fund provider would be required to either liquidate a percentage of fund assets or take other steps to cover those trades.
- There was general agreement among industry representatives, participant advocates, and other stakeholders we interviewed that current regulation strikes an appropriate balance between a participant's ability to manage his or her retirement investments and the duty of plan fiduciaries to operate and manage their plans prudently, at low cost, and solely in the interest of participants and the obligations of mutual funds with respect to all their investors. As an example of that appropriate balance, several stakeholders cited ERISA provisions that provide for 401(k) plan participants to exercise control over their account and have access to a broad range of investment alternatives.[17] However, plan fiduciaries may override a participant's investment decisions under certain conditions. For example, plan fiduciaries may impose reasonable restrictions on the frequency of a participant's trades so long as the participant can continue to make trades with a frequency that is appropriate in light of market volatility.[18]

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[16] In a December 2013 study of over 6,300 mutual funds conducted by the Investment Company Institute, 21 percent of all long-term mutual funds were estimated to assess redemption fees.

[17] Stakeholders specifically referred to provisions related to ERISA section 404(c) plans, which apply to pension plans that provide individual accounts, such as 401(k) plans, and provide for participants to control how account funds are invested. These provisions provide that sponsors of such plans and others who may otherwise be considered plan fiduciaries are generally shielded from liability for any loss resulting from a participant's exercise of control over account funds, if the plan meets certain conditions. 29 C.F.R. § 2550.404c-1.

[18] 29 C.F.R. § 2550.404c-1.

AGENCY COMMENTS

We provided a draft of this report to the Department of Labor, the U.S. Securities and Exchange Commission, and the Department of the Treasury for review and comment. The agencies each provided technical comments that were incorporated, as appropriate.

As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to appropriate congressional committees, to the Department of Labor, the U.S. Securities and Exchange Commission, and the Department of the Treasury and other interested parties. In addition, the report will be available at no charge on GAO's website at http://www.gao.gov.

If you or your staff has any questions about this report, please contact me at (202) 512-7215 or Jeszeckc@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report were: Assistant Director David Lehrer, Analyst-In-Charge Ted Burik, Eric Anderson, and Joel Marus. Other contributors to this report include Susan Aschoff, Rachel DeMarcus, Monika Gomez, Nisha Hazra, Kathy Leslie, Jean McSween, Anne Stevens, Michelle Wilson, and Craig Winslow.

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Enclosures – 2

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401(K) PLANS: Frequent and Collective Trading Are Uncommon and Not a Significant Concern for Plan Participants, Sponsors, or Mutual Funds

Information Provided to Congressional Requesters

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Introduction

- In the early 2000s, federal regulators identified patterns of short-term trading abuses in mutual funds. These abuses included market timing, which involves frequent trading by investors, including some participants in retirement savings plans, such as 401(k) plans.
- Frequent trading occurs when any shareholder, including a retirement plan participant, trades (i.e., purchases, redeems, or exchanges) mutual fund shares repeatedly within a specific period of time, at times to take advantage of short-term price fluctuations.
- In response, federal regulators adopted regulatory changes to require mutual funds to disclose and describe their frequent trading policies and, at their discretion, to impose redemption fees.
- Plan fiduciaries—401(k) plan sponsors (typically employers)—and mutual funds often have frequent trading policies, described in plan documents and fund prospectuses, to limit these trades, which can adversely affect fund costs and fund management.
- GAO and retirement industry representatives have previously reported that some individual plan participants actively manage their retirement accounts to seek higher returns. Some participants may be charged extra fees or face restrictions imposed by plans or mutual funds for their trading behavior, as described in plan documents and fund prospectuses.

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Introduction

At times, participant objectives may conflict with those of plan fiduciaries and mutual funds.

- For example, to control costs, a mutual fund for a large 401(k) plan recently prohibited purchases or exchanges of mutual fund shares by participants who had traded collectively based on advice from an investment newsletter.
- Collective trading occurs when a group of shareholders, who may also be retirement plan participants, act together, knowingly or not, to order a specific trade of mutual fund shares—often in response to investment advice from financial news sources or investment newsletters.
- Because participants were found to have violated the mutual fund's trading policy, which included provisions on frequent and collective trading, they were prohibited from purchasing or exchanging shares in these funds for a minimum period of 90 days. At least one participant was barred from making purchases or exchanges in the fund for a full year.

Objectives

You requested that GAO examine:

1. the types of trading restrictions that 401(k) plan participants typically face,
2. what is known about frequent or collective trading by plan participants and the effect of such trading on plan costs, and
3. how stakeholders view current regulation of a participant's ability to manage retirement accounts and the duties of plan fiduciaries and obligations of mutual funds.

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Methodology

To answer these questions, we reviewed and analyzed:

- publicly available reports issued by federal agencies, retirement industry organizations, academics, and participant advocacy groups;
- a nongeneralizable sample of 15 mutual fund prospectuses representing different asset classes and levels of assets under management and five 401(k) plan summary plan descriptions representing several different industries; and
- select relevant federal laws, regulations, and agency guidance.

In addition, we interviewed retirement industry experts, including plan sponsors, mutual funds, record keepers, academics, investment advisors, and federal officials, all of whom we selected on the basis of their knowledge of retirement savings plans. We also interviewed participant advocacy groups representing 401(k) plan participants.

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Summary of Findings

- 401(k) plan participants often face trading policies that restrict both frequent and collective trading in mutual funds. The trading restrictions we found were plan or mutual fund policies for rejecting purchases or exchanges of mutual fund shares deemed inappropriate and imposing time limits on how quickly a participant can purchase additional shares after trading out of a fund.
- Frequent and collective trading by plan participants are uncommon. Since the early 2000s, neither frequent nor collective trading by participants have been a concern for plan sponsors, mutual funds, or participant advocates with whom we spoke. However, they said that such trading can increase costs for plans and funds—these costs can be shared by all shareholders who invest in the mutual fund—including participants who did not engage in these types of trades.
- There was general agreement among these stakeholders that current regulation of trading restrictions strikes an appropriate balance between a participant's ability to manage his or her retirement accounts and the duties of plan fiduciaries to act prudently and in the best interest of all plan participants and the obligations of mutual funds with respect to all their investors.

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Background: Defined Contribution and 401(k) Retirement Plans

- Under the Employee Retirement Income Security Act of 1974 (ERISA), employers can sponsor defined contribution (DC) plans. In a DC plan, an employee saves for retirement in individual accounts and may in most instances direct how their savings are invested among options such as mutual funds available through their plan to increase returns. 401(k) plans are the most common type of DC plan.
- As of 2012, U.S. employers sponsored 401(k) plans numbering more than 516,000 with nearly 75 million participants and about $3.5 trillion in plan assets, according to the Department of Labor.
- Sponsors of retirement plans contract to have mutual funds included among plan investment options as well as with service providers to perform services such as record keeping.

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Background: Regulations Related to Participant Account Management and Fiduciary Obligations

- Federal laws and regulations are directed at ensuring that 401(k) plan participants have the information needed to make decisions about the management of their accounts and investment of their retirement savings when participants have investment discretion.
- They also require plan fiduciaries to act prudently and solely in the interest of the plan's participants and mutual funds to fulfill certain obligations to investors.
- Regulations we reviewed include:
  - **ERISA section 404(c) plans** (29 C.F.R. § 2550.401c-1)
  - **Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans** (29 C.F.R. § 2550.404a-5)
  - **Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings** (17 C.F.R. § § 239.15A and 274.11A)
  - **Mutual Fund Redemption Fees** (17 C.F.R. § 270.22c-2)

Objective 1: 401(k) Plan Participants May Face Policies That Restrict Frequent or Collective Trading

Summary:

- Mutual funds and plan sponsors may impose trading restrictions on frequent trading, collective trading, or both.
- Most mutual fund prospectuses we reviewed did not expressly discuss collective trading.
- Restrictions on frequent or collective trading have long been in use by mutual funds and plan sponsors.

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Objective 1: Mutual Funds and Plan Sponsors May Impose Restrictions on Frequent Trading, Collective Trading, or Both

The trading restrictions we found were:

Discretionary Limits

- In all 15 of the mutual fund prospectuses we reviewed, the fund maintains a discretionary policy to reject any purchases or exchanges of mutual fund shares, including those resulting from collective trading, it finds inappropriate or disruptive to the management of the fund.

Time Limits

- In 12 of the prospectuses, the mutual fund described time limits (purchase blocking periods)—typically 30 to 90 days—that a participant must wait before purchasing additional shares after trading out of the fund. In three of these funds, participants who violate the time limits policy may be restricted from making purchases or exchanges in the fund temporarily—and possibly permanently.
- Less common in the prospectuses we reviewed were the use of holding periods, which require participants to hold shares for a certain amount of time to avoid paying a redemption fee upon the sale of shares. Only one fund had a holding period, which was for 90 days. Other research found most holding periods for about 2,400 funds ranged from 30 to 90 days.

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Objective 1: Mutual Funds and Plan Sponsors May Impose Restrictions on Frequent Trading, Collective Trading, or Both

Redemption Fees – Mutual funds may also use redemption fees to discourage frequent trading and recoup costs:

- Fees can be up to 2 percent of a trade's value.
- A study of over 6,300 mutual funds found that 21 percent of all long-term mutual funds were estimated to assess redemption fees (Investment Company Institute, December 2013); however, 14 of the 15 prospectuses we reviewed did not include any provisions for assessing redemption fees.

Plan Specific Protections – Plan sponsors may also apply their own trading restrictions:

- All of the five 401(k) summary plan documents we reviewed included such restrictions. For example, one summary describes a 30-day purchase blocking policy for investing in the plan sponsor's company stock fund—participants are blocked for 30 days from making purchases back into the fund after they have sold fund shares. Mutual fund prospectuses would not typically include information on plans that include the fund in their investment line-up.

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Objective 1: Mutual Funds and Plan Sponsors May Impose Restrictions on Frequent Trading, Collective Trading, or Both

Federal regulations require mutual funds to disclose the risks of frequent trading and the fund's frequent trading policies to investors. Among the prospectuses and other data we reviewed, restrictions were typically comprehensive and usually applied to all funds offered by a mutual fund.

- One prospectus described potential adverse long-term effects resulting from frequent trading, a 90-day purchase blocking policy, and its discretionary authority to prohibit trades that indicate market timing.
- Another prospectus described its discretionary policy to reject trades, and a 60-day purchase blocking policy, and it urged market timers not to invest in the fund.

The mutual fund prospectuses and 401(k) plan summary plan descriptions we reviewed describe criteria used to assess whether a participant is trading too frequently.

Many of the prospectuses we reviewed stated that funds:

- monitor trading activity to identify and prevent frequent trading, and
- institute restrictions to support fund management and to control costs.

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Objective 1: Most Mutual Fund Prospectuses We Reviewed Did Not Expressly Discuss Collective Trading

- With few exceptions, the 15 mutual fund prospectuses and five summary plan descriptions we reviewed did not separately define collective trading or outline restrictions aimed specifically at preventing these trades.
  - One mutual fund prospectus we reviewed specifically described how the fund could reject any purchase or exchange from an investor whose trading activity could dilute the value of the fund's shares, including trading by investors acting collectively, for example, by following the advice of an investment newsletter.
- However, some stakeholders we spoke with told us that collective trading could be restricted under a fund's discretionary policy to reject any purchases or exchanges it finds inappropriate.

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Objective 1: Restrictions on Frequent or Collective Trading Long Used by Some Mutual Funds and Plan Sponsors

Restrictions on frequent or collective trading by shareholders and plan participants have long been used by some mutual funds and plan sponsors. For example, for the 15 mutual fund prospectuses we reviewed, we compared the 2014 prospectuses and earlier versions of the prospectuses from 2006 or 2007 to identify changes in the fund's frequent or collective trading policies and found:

- three funds decreased the number of days in their required purchase blocking period between trades; and
- more significantly, 3 funds we reviewed stopped assessing redemption fees.

Objective 2: Frequent and Collective Trading Are Uncommon but Can Affect All Investors

Summary:

- Frequent and collective trading by retirement plan participants are uncommon.
- All mutual fund investors may bear the costs resulting from frequent or collective trading.

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Objective 2: Frequent and Collective Trading Are Uncommon

According to those we interviewed, neither frequent nor collective trading is currently a concern for plan sponsors, mutual funds, or participant advocates:

- Stakeholders we spoke with said that the adoption of mutual fund trading policies and—as required by regulations—their disclosure appear to have curbed frequent and collective trading by plan participants.
- Some plan sponsors and plan service providers told us they have implemented automated systems to monitor and block frequent trades by participants.
- Stakeholders said that collective trading by plan participants is rare. However, no widely accepted definition of collective trading was offered by industry representatives.
- Mutual funds use a more manual process to identify rare instances of collective trading. To do so, they:
  - request data from record keepers on individual participant trades, and
  - determine if a group of participants has acted collectively.

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Objective 2: Frequent and Collective Trading Are Uncommon

Stakeholders reported low prevalence of frequent trading:

- One plan sponsor reported that 400 of the plan's participants received initial warning letters about frequent trades, and 10 participants were restricted from trading in 2013. The plan currently has 64,000 participants.
- A large record keeper issued 441 warnings and 253 restrictions to its more than 3 million participants since the beginning of 2013, according to the Society of Professional Asset Managers and Record Keepers.

Some stakeholders said participants should make more frequent changes to their retirement accounts.

- In the first 3 quarters of 2014, 8.1 percent of all participants in DC plans changed the asset allocation of their accounts, according to the Investment Company Institute. Financial experts recommend plan participants regularly adjust their investment allocations to address changing market conditions and investment goals.

Stakeholders reported being generally unaware of collective trading occurring with any regularity within retirement plans or among shareholders.

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Objective 2: All Mutual Fund Investors May Bear the Costs Resulting from Frequent or Collective Trading

Industry representatives stated that when frequent or collective trading occur, they can disrupt a mutual fund's investment strategy and increase costs for all shareholders in the fund.

- **Increased transaction costs** – funds incur additional administrative expenses and commissions/fees paid to brokers for executing trades and (in some cases) transfer taxes
- **Increased liquidity demands** – funds must increase cash holdings or prematurely sell strongly performing assets to cover large redemptions, as would occur with collective trading

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Objective 3: Current Regulations Balance Fiduciary Duties and Participants' Ability to Direct Investments

Summary:

Stakeholders we spoke with, including industry representatives and participant advocacy groups, generally agreed that:

- current laws and regulations recognize participants' ability to direct their retirement investments,
- plan sponsors and mutual funds may sometimes override participant investment decisions, and
- balance is provided through various regulations weighing the duties of plan fiduciaries and the obligations of mutual funds against participants' ability to direct investments.

Objective 3: Regulations Recognize Participants' Ability to Direct Their Retirement Investments

Regulations generally provide that in order for plan fiduciaries to obtain certain fiduciary relief, participants must have the opportunity to exercise control over their retirement accounts. This includes:

- receiving the information they need to make informed decisions about the management of their individual accounts,
- generally being able to sell mutual fund shares at any time, and
- having access to a range of investment alternatives permitting them to trade at least once within any 3-month period.

Objective 3: Plan Fiduciaries and Mutual Funds May Sometimes Override Participant Investment Decisions

Pension plan sponsors owe a fiduciary duty to plan participants and must

- act prudently and solely in the interest of such participants and
- defray reasonable expenses of administering the plan.

This may require plan sponsors to

- consider the nature of alleged abuses—such as frequent or collective trading—within funds on plan investments, their economic impact, and the steps taken to limit future abuses.

Plan sponsors and mutual funds are also required to

- disclose if they reserve the right to override a participant's investment decisions under certain conditions.

As a result, they may sometimes decline to implement a participant's investment instructions or impose reasonable restrictions on the frequency of a participant's trades as long as the participant can continue to make trades with a frequency that is appropriate in light of market volatility.

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Objective 3: Balance Provided through Various Regulations

Stakeholders we spoke to generally agreed that current regulation of trading restrictions:

- strikes an appropriate balance,
- protects participants' ability to freely direct their retirement investments,
- provides the means for plan fiduciaries to fulfill their duties to plan participants and mutual funds to fulfill their obligations to investors, and
- curbs frequent and collective trading.

Enclosure II: Case Study – *EZTracker* Investment Newsletter and American Airlines Employees

EZTracker Investment Newsletter: Services Provided to American Airlines Employees

EZTracker is a monthly investment newsletter founded by a former American Airlines pilot and a former advertising executive to provide investment advice to American Airlines pilots and flight attendants for use in managing the investment holdings in their 401(k) plans. It subsequently expanded to provide a similar newsletter for employees from Southwest Airlines, JetBlue Airlines, United Airlines, and the United Parcel Service. It has developed model investment portfolios (e.g., conservative, moderate, and aggressive) and a method for evaluating all of the mutual funds provided through the airlines' 401(k) plans. The advice *EZTracker* provides is aimed at maximizing returns in the model portfolios and each newsletter makes trading recommendations for the mutual funds held in these plans' investment line-ups.

T. Rowe Price Action on American Airlines Employees' Trading Practices

T. Rowe Price, one of the fund companies included in American Airlines' 401(k) plan, discovered that significant numbers of American Airlines employees were making similar trades in one of its funds in violation of the firm's excessive and short-term trading policy, which included specific provisions regarding collective trading. In 2010, T. Rowe Price, through its record keeper at the time, began sending warning letters to American Airlines employees notifying them they were violating its excessive and short-term trading policy and that further action would be taken if they continued doing so. In 2011, T. Rowe Price began sending letters to some American Airlines employees notifying them that they were restricted from purchasing shares in any of its mutual funds because they had violated its excessive and short-term trading policy by acting collectively to execute trades; in some cases, the restrictions barred the employees from purchasing shares for up to 1 year.

EZTracker's U.S. Securities and Exchange Commission (SEC) Complaint

According to media reports and discussions with *EZTracker* officials, in May 2012, *EZTracker* submitted a complaint to the SEC requesting a review and disposition on T. Rowe Price's[1] mutual fund excessive and short-term trading policies, which it claimed violated section 22(f) of the Investment Company Act of 1940[2] and SEC's rule 22c-2.[3] It is the general policy of the SEC

[1] GAO attempted to contact T. Rowe Price representatives for comment but received no response.

[2] 15 U.S.C. § 80a-22(f). Under section 22(f), no registered open-end investment company (i.e., mutual fund) may restrict the transferability or negotiability of any security of which it is the issuer except in conformity with the statements with respect thereto contained in its registration statement nor in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe in the interests of the holders of all of the outstanding securities of such investment company.

to conduct its investigations on a confidential basis to preserve the integrity of its investigative process as well as to protect persons against whom unfounded charges may be made or where the SEC determines that enforcement action is not necessary or appropriate.[4]

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[3] 17 C.F.R. § 270.22c-2. Rule 22c-2 prohibits a mutual fund from redeeming fund shares within 7 days of purchase unless the fund has specifically approved and set a redemption fee on participants not to exceed 2 percent of the amount redeemed, and the holding period between purchase and redemption that will trigger imposition of the fee, or has specifically determined that imposition of a redemption fee is either not necessary or not appropriate. The rule also requires such a fund to enter into agreements with its intermediaries that provide fund management the ability to identify investors whose trading violates fund restrictions on short-term trading (“shareholder information agreements”).

[4] Subject to the provisions of the Freedom of Information Act, the SEC cannot disclose the existence or non-existence of an investigation and any information gathered unless made a matter of public record in proceedings brought before the SEC or in the courts.

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