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

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.

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.

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.

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.

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.

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.

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.

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.

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.

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.

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.

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.

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

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.

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.