

Can exchange traded funds (ETFs) be traded just like mutual funds?

In response to a claim that Exchange Traded Funds (ETFs) can be traded in 401(k) plans just like mutual funds, Darwin Abrahamson, CEO of Invest n Retire, LLC, a record keeper in Portland, Ore., submitted a list of questions plan sponsors should ask any firm making a similar claim.

Mid Atlantic Trust Company (“MATC”)¹

According to **Mid Atlantic Trust**,² “Fractional share positions and dollar based trading are standard for mutual funds, and the systems used by record keepers are built around that model.”

Mutual Funds are regulated by the Securities and Exchange Commission (SEC)

Mutual funds are regulated by Securities and Exchange Commission (SEC) and are referred to as Forty Act Funds which allow the fund managers to accept cash from multiple investors, which the managers use to invest in underlying securities which make up the mutual funds. When a mutual fund buys and sells the underlying securities, the manager purchases and sells whole shares of the underlying securities and retains any residual cash within the fund. Since the investors own whole and fractional shares of the mutual fund, each investor owns the underlying securities and the residual cash.

Buying and Selling Exchange Traded Funds (ETFs)

ETFs are structured much like mutual funds in that they hold an underlying basket of securities in which investors have proportional ownership stakes. But when it comes to buying and selling ETFs, they are more akin to stocks requiring investors to purchase and sell whole shares.³

Can any type of record keeping system efficiently process ETF trades for 401(k) plans?

The answer to the question is obvious when you weigh the facts. Exchange traded funds trade like stocks throughout the day at market price and can only be purchased and sold in whole shares.

In contrast, mutual funds trade at net asset value (NAV) closing price and can be purchased or sold in fractional shares. Since old legacy record keeping systems were built to trade mutual funds in dollar certain orders, these antique systems have no ability to (a) buy in share certain orders or (b) track residual cash which makes these antiquated systems inadequate for trading ETFs.

A few record keepers, such as **BenefitStreet** (2008), attempted to trade ETFs in Defined Contribution (DC) plans by adding manual inefficient processes outside their record keeping system. Those efforts proved costly and unsuccessful.

Trading and Recordkeeping ETFs in Tax-Deferred Plans Using Modern Technology

Since 2004 Invest n Retire, LLC (INR) has been record keeping and cost effectively trading ETFs in tax-deferred retirement plans. INR approached the problems inherent in trading and record keeping ETFs in tax-deferred plans by building its patented record keeping and trading system (pat. US 8,060,428), using the latest software which runs in an enterprise environment making it scalable. Through **Invest n Retire**® participants own whole and fractional shares of ETFs, with residual cash allocated to each respective participant.

MATC discusses the ETFxChange program which it uses to buy and sell ETFs in DC plans

“ETFxChange . . . allows record keepers to operate ETFs using the same systems and processes already in place for mutual funds. Using the Mid Atlantic ETFxChange approach . . . the plan is fully invested . . . there is no residual cash in the plan for which to account.”

Holding Fractional Shares as Necessary

“As custodian, we support dollar certain transactions of our clients by buying and selling whole shares in the market and holding fractional shares as necessary. All ETF shares trading on this platform are held in one master . . . Mid Atlantic Trust account. Each plan’s shares are held in book entry form at Mid Atlantic.”

How does MATC make this work?

1. **Allocate whole and fractional shares of ETFs to each respective plan (book entry)** based on **dollar certain orders** received from each record keeper on behalf of plans. To complete buy transactions, the entity that maintains the Master account or other third party,⁴ may provide cash to the account to round up ETF buy transactions in order to purchase whole ETF shares at market, with the remaining fractional shares, which are not allocated to a plan, allocated to the entity that provided cash. An alternative method may involve the third party selling fractional shares from its inventory in exchange for cash in order to exhaust cash remaining after purchasing whole ETF shares at market. **ERISA §406(a)(1)**⁵
2. **MATC maintains that each plan is fully invested and there is no residual cash** in the plans to account for. To accomplish the necessity to exhaust cash for dollar certain buy orders, the party facilitating the completion of dollar certain buy transactions may: (a) provide cash to the account in order to complete whole ETF buys at market (round up) or (b) provide fractional ETF shares from its inventory in exchange for cash remaining after completing whole ETF buys at market. **ERISA §406(a)(1)**⁶
3. Since fractional ETF share sell transactions cannot be placed at market, for any fractional ETF shares remaining after aggregation and netting across plans, the party facilitating the completion of sell transactions⁷ may supply ETF fractional shares from its inventory in order round up to a whole ETF share in order to complete whole ETF share sells at market.⁸ An alternative method may involve the third party purchasing any remaining fractional ETF shares, which cannot be aggregated to round up to a whole ETF share for sell at market or netted internally across plans, with the cash delivered to the plan. **ERISA §406(a)(1)**⁹

Banks and trust companies are regulated by the Banking Authorities

The banking authority permits banks and trust companies to establish collective trusts. While mutual funds are SEC-registered, collective investment trusts are managed by a bank trust department and falls under the jurisdiction of the Office of the Comptroller of the Currency. A collective trust can be established by a trust company in order to permit commingling of funds of multiple pension plans, with each plan owning whole and fractional shares of the trust.¹⁰

Since collective trusts can be a retirement plan option, the trusts are also regulated by the IRS, Employee Retirement Income Security Act (ERISA), and the Department of Labor.

MATC's View of Collective Trusts and Unitized Funds

“Why ETFxChange instead of a collective fund: Other solutions available in the market have the plan owning shares in a collective fund . . . Collective and unitized funds are created using the underlying ETF as well as a cash vehicle to provide daily liquidity and reduce the cost of trading. Administrative and audit fees are charged against the fund, while commissions and trading fees are netted out of trades. The combination of liquidity drag, expenses, and trading fees can cause the fund performance to substantially deviate from the actual performance of the ETF.”

Transparency in Fees

According to MATC the fee for ETFxChange is transparent. “This platform covers all commissions, SEC fees, and sub-custody charges incurred by Mid Atlantic Trust Company. Other solutions . . . pass on these fees, or net them from trade proceeds . . . When using the Mid Atlantic ETFxChange solution, costs are predictable, explainable, and transparent, all of which are important factors for fiduciaries and service providers, especially under the new fee disclosure rules.”

How is MATC reimbursed for the commissions, sub-custody charges, and other costs?

“From the plan sponsor’s perspective, the only costs are the expense ratio of the ETF plus the fees charged by the record keeper. Mid Atlantic covers all commissions, SEC fees, and other trading and brokerage costs. **We charge the record keeper . . . an asset based fee for access to the ETFxChange platform, which is passed onto the plan sponsor or the participants . . .**”

It is unclear whether the record keeper, who passes on the fee for access to the ETFxChange platform, charges the fee to all of the participants in the plan, irrespective of whether the participant elected to add ETF(s) to his or her investment account.

What is the cost for access to the ETFxChange platform?

Building a 401(k) Plan with iShares®¹¹ Funds, Evaluating the iShares 401(k) Plan preferred providers and preferred networks: Mid Atlantic Financial Platforms, Inc.¹² **ETFxChange** program asset based fees and commissions for custody and trading is **16-21 basis points (bps)**.¹³

MATC: “The ETFxChange platform fee is an asset-based fee, with one rate for pre-market close orders and a higher rate for late day processing orders. This fee is charged on your Mid Atlantic invoice in addition to any trading, custody, directed trustee and cashiering fees.”

How do the new fee disclosure regulations affect the ETFxChange program?

New Department of Labor (DOL) fee disclosure regulations require that compensation paid on behalf of a plan must be disclosed to plan sponsors (408)(b)(2)) and reported to the Government on Form 5500, Schedule C. The ETFxChange fee would be considered a reportable fee and, as such, would require a review for reasonableness by the plan sponsor; including, a description of the service the fee represents and an explanation of the need for the service.

About Invest n Retire, LLC

Darwin Abrahamson is the CEO and founder of Invest n Retire, LLC (INR) located in Portland, Ore. INR is a recordkeeping and transaction processing service provider for tax-deferred retirement plans. Since 2004 INR has been recordkeeping and cost-effectively trading ETFs in 401(k) plans. INR approached the problems inherent in trading and record keeping ETFs in tax-deferred plans by building its patented record keeping and trading system (pat. US 8,060,428), using the latest software which runs in an enterprise environment making it scalable.

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¹ Mid Atlantic Trust Co. (MATC) is not a subsidiary or control affiliate of Mid Atlantic Capital Corporation, a registered Broker Dealer (MACC), or Mid Atlantic Financial Management, Inc. (MAFM) a SEC Registered Investment Adviser.

² Trust services offered through Counsel Trust Company, dba as Mid Atlantic Trust Company (MATC)

³ **10 Tips for placing ETF orders - It's not as easy as buying or selling mutual funds**, by Esko Mickels, fund analyst with Morningstar Canada, July 24, 2009

⁴ "Party in interest" is defined to include persons providing services to a plan. **ERISA §3(14)(B)**

⁵ Unless an exemption applies, **prohibited transactions under Section 406(a)(1) of ERISA** provides that a fiduciary with respect to a plan shall not cause the plan to engage in certain direct or indirect transactions with a party in interest, including sales or exchanges of property between the plan and a party in interest, and transfers to or use by or for the benefit of a party in interest of any assets of the plan.

The remedy for a prohibited transaction may be harsh. Typically, the transaction must be "undone" and the plan returned to the position it would have been in had the prohibited transaction not occurred. The Department of Labor or a plan participant may sue any fiduciary or party in interest who engages in a prohibited transaction. In addition, if a tax-qualified retirement plan enters into the transaction, a 15% annual excise tax applies for every year until the plan corrects the transaction, with an additional 100% penalty if it does not correct the transaction following an IRS assessment of the 15% excise tax.

⁶ Ibid

⁷ MATC requires that buy transactions must be in dollar certain orders. MATC will accept sell transactions as dollar certain orders or whole and fractional ETF shares.

⁸ Reference **Wallman U.S. Patent no. 6,996,539**, "Method and apparatus for enabling smaller investors or others to create and manage a portfolio of securities or other assets . . . **method using aggregation** . . . aggregating the plurality of transactions for the user with a plurality of transactions for one or more other users . . . **comprising the step of netting buy orders against sell orders** . . ."

⁹ Ibid. 5

¹⁰ *SEC's Top Cop Says Agency to Police Collective Investment Trusts*, The Trust Advisor Blog, April 17, 2010, Collective funds are by law on the turf of bank regulators. But the SEC's new anti-Madoff crusade wants to put collective products on the SEC's hit list. SEC Buddy Donohue fired a warning shot at bank regulators by threatening to go after the advisors who sell collective investment trusts. In an off-script comment after his speech before the Practising Law Institute's Investment Management Department, Donohue elaborated, "**I can't get into the bank. But I can get into the advisors.**"

¹¹ iShares is a registered trade mark of Blackrock Institutional Trust Company, N.A. (BTC)

¹² Mid Atlantic Financial Platforms, Inc., merged into Mid Atlantic Capital Group, Inc., and maintains an operating agreement with **Counsel Trust Company, dba Mid Atlantic Trust Company**, to perform its institutional retirement plan reporting and administration.

¹³ Building a 401(k) Plan with iShares® http://www.ishares401k.com/downloads/building_a_401k_plan.pdf