Publications

Court Upholds Plan's Rules Restricting Frequent Trading of Individual Plan Accounts

ATTORNEYS & PROFESSIONALS
Michael Prame
mprame@groom.com
202-861-6633

PUBLISHED
04/18/2003

SERVICES

The court upheld a defined contribution plan's rules imposing trading restrictions on participant-directed accounts in Straus v. Prudential Employee Savings Plan, No. CB023067 (RJD) (E.D.N.Y. March 25, 2003). Rejecting plan participants' challenge, the court found that the plan's rules limiting the participants' trading among the plan's mutual fund investment options did not violate ERISA nor was the plan estopped from enforcing the rules.

The plan in the Straus case permitted daily trades in individual accounts, reserving the right to adopt rules governing the plan's operations and to reject trades. Because of time zone differences, the plan participants had been using end-of-trading-day information from Asian or European markets that became available while the American markets were still open to determine whether the plan's international fund would experience a gain. Based on this information, the participants transferred millions of dollars from their plan accounts into the international fund on a particular day to capture the predicted gains, then moved the assets out of the international fund the next day.

Most mutual funds have rules that restrict this type of trading because they hurt the value of the fund for more traditional buy and hold investors. The harm arises because the market timers move their assets into and out of the fund so quickly that the mutual fund can not earn significant returns on the their assets. This, in turn, reduces the mutual fund's earnings. Of additional concern to pension plans, because plans generally send investment instructions to mutual funds on an aggregate basis, when a mutual fund rejects a plan's aggregate trade, all participants suffer, not just those engaged in market timing.

To stop the market timing trades, the plan in Straus adopted rules limiting the aggregate amount ($75,000) and frequency of participants' trades (two round trips within 30 days). A participant who violated the rules still was permitted to issue instructions for the daily trades, but the instructions were required to be sent to the plan in writing, not by facsimile or e-mail. This prevented the participants from knowing whether their trades would be executed on a particular day and, thereby, eliminated their ability to engage in market timing.

Because the plan document and summary plan description permitted trading restrictions and permitted the plan's administrative committee to adopt rules governing the plan's operations, the court rejected the participants' claim that the plan's rules violated ERISA. For the same reason, the court rejected their claim that the plan was estopped from enforcing the market timing rules.

As discussed above, the key to restricting market-timing or frequent trading of individual plan accounts is making sure that the plan documents either expressly include such restrictions or give the plan administrator the right to adopt such restrictions. Plan sponsors, therefore, should make sure that the underlying plan documents, including the SPD, expressly restrict such activity or permit actions to be taken to restrict trades.