

**MEMO# 18647**

March 18, 2005

## **SEC ADOPTS REDEMPTION FEE RULE AND REQUESTS ADDITIONAL COMMENT ON THE NEED FOR FURTHER STANDARDIZATION**

[18647] March 18, 2005 TO: BROKER/DEALER ADVISORY COMMITTEE No. 8-05  
BROKER/DEALER ASSOCIATE MEMBERS No. 4-05 COMPLIANCE ADVISORY COMMITTEE No.  
23-05 OPERATIONS MEMBERS No. 4-05 PENSION MEMBERS No. 12-05 SEC RULES MEMBERS  
No. 38-05 SMALL FUNDS MEMBERS No. 25-05 TRANSFER AGENT ADVISORY COMMITTEE No.  
9-05 RE: SEC ADOPTS REDEMPTION FEE RULE AND REQUESTS ADDITIONAL COMMENT ON  
THE NEED FOR FURTHER STANDARDIZATION The Securities and Exchange Commission has  
adopted new rule 22c-2 under the Investment Company Act and conforming amendments  
to rule 11a-3 under the Act authorizing fund directors to impose redemption fees of up to  
two percent of the amount redeemed when they determine that such a fee is in their fund's  
best interests.<sup>1</sup> The new rule will take effect on May 23, 2005. Compliance will be required  
by October 16, 2006. In addition to adopting the new rule and rule amendments, the  
Commission also requested comment on whether it should adopt a uniform redemption fee  
for those funds deciding to impose such a fee and, if so, the terms of such a fee. Comments  
must be submitted by May 9, 2005 The most significant aspects of the new rule and the  
Commission's request for additional comment are summarized below. 1 See Mutual Fund  
Redemption Fees, Inv. Co. Act Rel. No. IC-26782 (March 11, 2005), 70 Fed. Reg. 13328  
(March 18, 2005). The Release can be found on the SEC's web site at  
<http://www.sec.gov/rules/final/ic-26782.pdf>. As a result of the adoption of this rule, SEC staff  
no-action positions concerning redemption fees have terminated. 2 Funds Subject to Rule  
22c-2 Rule 22c-2 applies to all funds except money market funds, exchange-traded funds,  
and funds that affirmatively permit market timing of fund shares.<sup>2</sup> Any fund not subject to  
the rule that voluntarily elects to impose a redemption fee would need to comply with the  
other requirements of the rule. Elements of Rule 22c-2 Rule 22c-2 prohibits any fund,  
unless excepted, from redeeming shares within seven days after the share purchase unless  
the fund meets three conditions: • First, the board of directors must either (i) approve a  
redemption fee, or (ii) determine that imposition of a redemption fee is either not necessary  
or not appropriate; • Second, the fund (or its principal underwriter) must enter into a  
written agreement with each financial intermediary under which the intermediary agrees to  
(i) provide, at the fund's request, identity and transaction information about shareholders  
who hold their shares through an account with the intermediary, and (ii) execute  
instructions from the fund to restrict or prohibit future purchases or exchanges; and • Third,  
the fund must maintain a copy of each written agreement with a financial intermediary for

six years. The required board determinations and intermediary agreements are described in greater detail below. Required Board Action. Rule 22c-2 requires that each fund's board of directors (including a majority of independent directors) either (i) approve a redemption fee that in its judgment is necessary or appropriate to recoup costs the fund may incur as a result of redemptions, or to otherwise eliminate or reduce dilution of the fund's outstanding securities, or (ii) determine that imposition of a redemption fee is not necessary or appropriate. This determination must be made before the rule's compliance date of October 16, 2006.<sup>3</sup> A fund board that chooses to impose a redemption fee must determine, based on its own judgment, the appropriate level and holding period for the fee. In a departure from prior SEC staff "no-action" positions, the level of the fee does not need to be based upon a strict assessment of administrative and processing costs related to short-term trading. Instead, a fund <sup>2</sup> The exception in the final rule for funds that actively permit market timing does not require that a fund's treatment of short-term trading be a fundamental policy (i.e., one that may be changed only with shareholder approval), but rather that the fund's prospectus clearly and prominently discloses that it permits short-term trading of its securities and that such trading may result in additional costs for the fund. <sup>3</sup> The board for a fund that currently has a redemption fee in place will have already satisfied this requirement. The Release noted, however, that such a board may choose to review the existing redemption fee to determine whether the amount of the fee and the holding period continue to meet the fund's needs. <sup>3</sup> board setting the amount of the redemption fee could take into consideration indirect costs to the fund that arise from short-term trading of fund shares, such as liquidity costs, i.e., the cost of investing a greater portion of the fund's portfolio in cash or cash equivalents than would otherwise be necessary. The maximum level of any redemption fee under the rule is two percent. The rule is similarly flexible with respect to the applicable holding period. Rule 22c-2 establishes a minimum holding period of seven calendar days, but permits a fund board that adopts a redemption fee to determine, in its judgment, whether a period longer than seven calendar days is necessary or appropriate for the fund to protect its shareholders. The proceeds of the redemption fee, in all cases, must be paid to the fund itself. Required Agreements with Intermediaries. Regardless of whether the fund imposes a redemption fee, rule 22c-2 requires every fund (unless excepted) to enter into written agreements with its financial intermediaries. The agreement must contain two provisions: • A provision requiring the intermediary to provide, promptly upon request by the fund, the Taxpayer Identification Number of all shareholders that purchased, redeemed, transferred, or exchanged shares held through an account with the financial intermediary, and the amount and dates of such shareholder purchases, redemptions, transfers, and exchanges, providing the fund with access to information about transactions by fund shareholders; and • A provision requiring the intermediary to execute any instructions from the fund to restrict or prohibit further purchases or exchanges of fund shares by a shareholder who has been identified by the fund as having engaged in transactions of fund shares (directly or indirectly through the intermediary's account) that violate policies established by the fund for the purpose of eliminating or reducing any dilution of the value of the outstanding securities issued by the fund. For these purposes, the rule defines "financial intermediary" to include: (1) any broker, dealer, bank, or other entity that holds securities of record issued by the fund, in nominee name; (2) a unit investment trust or fund that invests in the fund in reliance on section 12(d)(1)(E) of the Act (e.g., insurance company separate accounts funding variable insurance products); and (3) in the case of a participant-directed employee benefit plan that owns the securities issued by the fund, a retirement plan's administrator under section 3(16)(A) of the Employee Retirement Income Security Act of 1974 (ERISA) or any entity that maintains the plan's participant records. In the Release, the Commission stated that "funds have flexibility to request information periodically, or when circumstances suggest that a

financial intermediary is not assessing redemption fees or that abusive market timing activity is occurring.” The Commission also expressed its expectation, however, that funds that are susceptible to market timing will request such information “regularly.” 4 Additional Comment Requested In addition to adopting the new rule and rule amendments, the SEC also requested comment on whether it should adopt a uniform redemption fee for those funds deciding to impose such a fee and, if so, the terms of such a fee. More specifically, the Commission requested additional comment on whether the rule should require uniformity in one or more of the following areas: • Share accounting (i.e., whether the rule should mandate the use of the “LIFO” or “FIFO” method); • The amount of the redemption fee and/or the length of the holding period; • The types of transactions potentially subject to redemption fees (i.e., whether redemption fees should be limited to “investor initiated” transactions); • Waivers and exceptions (both specifically with respect to de minimis waivers and exceptions for financial emergencies and more generally with respect to all types of mandatory waivers and exceptions); • Variable insurance contracts and insurance company separate accounts; • Intermediary collection of redemption fees (i.e., whether the rule should limit the ways that redemption fees may be assessed to promote greater uniformity in the enforcement of redemption fees across funds and their intermediaries); and • Recordkeeping (i.e., whether the rule should require that a fund retain copies of the materials provided to the board in connection with the board’s approval of a redemption fee). Effective and Compliance Dates Rule 22c-2 will take effect on May 23, 2005. Compliance will be required by October 16, 2006. The Release notes that the transition period is intended to give funds and their financial intermediaries ample time to make needed contractual amendments and system enhancements. Robert C. Grohowski  
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