

MEMO# 17171

March 8, 2004

SEC PROPOSES RULE REQUIRING MANDATORY REDEMPTION FEES; CONFERENCE CALL ON MARCH 18

[17171] March 8, 2004 TO: BANK AND TRUST ADVISORY COMMITTEE No. 5-04
BROKER/DEALER ADVISORY COMMITTEE No. 8-04 OPERATIONS COMMITTEE No. 4-04
PENSION COMMITTEE No. 12-04 PENSION OPERATIONS ADVISORY COMMITTEE No. 22-04
SEC RULES COMMITTEE No. 22-04 SMALL FUNDS COMMITTEE No. 17-04 TAX COMMITTEE
No. 9-04 TRANSFER AGENT ADVISORY COMMITTEE No. 25-04 RE: SEC PROPOSES RULE
REQUIRING MANDATORY REDEMPTION FEES; CONFERENCE CALL ON MARCH 18 The
Securities and Exchange Commission has proposed new Rule 22c-2 under the Investment
Company Act that would require mutual funds (with certain limited exceptions) to impose a
two percent redemption fee on the redemption of shares purchased within the previous five
days.¹ The rule is designed to require short-term shareholders to reimburse the mutual
fund for costs incurred when they use the fund to implement short-term trading strategies,
such as market timing. The proposed rule is summarized below. Comments on the SEC
proposal must be filed by Monday, May 10, 2004. The Institute will hold a conference call on
Thursday, March 18 at 2:00 p.m. EST to discuss the Institute's comment letter on the SEC
proposal. The dial-in number for the call is (888) 425-4795, and the pass code is 22c-2. If
you plan to participate, please send an e-mail to Gail Robinson at grobinso@ici.org. If you
are unable to participate in the call, please provide your comments before the call, if
possible, to Bob Grohowski by phone (202- 371-5430), fax (202-326-5841) or e-mail
(rcg@ici.org). 1 See Mandatory Redemption Fees for Redeemable Securities, SEC Release
No. IC-26375 (March 3, 2004) ("Release"), available on the SEC's website at
<http://www.sec.gov/rules/proposed/ic-26375a.htm>. 2 A. Two Percent Redemption Fee
Proposed Rule 22c-2 would require mutual funds to impose a fee of two percent of the
proceeds from fund shares redeemed within five business days of their purchase. The rule
would not permit funds to impose a higher or lower fee than two percent. Each fund, unless
excepted, would have to impose the fee. According to the Release, the two percent fee is
designed to strike a balance between two competing policy goals of the Commission -
preserving the redeemability of mutual fund shares and reducing or eliminating the ability
of shareholders who frequently trade their shares to profit at the expense of their fellow
shareholders. It also reflects the level of redemption fees that many funds currently impose
and the maximum level the Commission's staff has viewed as consistent with provisions of
the Act that require mutual fund shares to be redeemable. The Release requests comment
on the proposed mandatory redemption fee, and asks a number of specific questions.
These include whether the redemption fee should be permissive rather than mandatory,
whether the level should be (or should be permitted to be) something other than two
percent, and whether the mandatory redemption fee should have to be disclosed as part of

the proposed new point-of-sale disclosure and/or mutual fund confirmation document provided to fund investors. The Release also specifically requests further data on the magnitude and types of costs that funds bear as a result of active trading by a small percentage of shareholders.

B. Five-Day Holding Period The proposed rule would include a minimum five-day holding period before an investor could redeem its shares without triggering the two percent redemption fee. The rule would not preclude a fund from instituting a holding period longer than five business days. The Release requests comment on the five-day holding period, specifically asking whether a five-day holding period would be sufficient to deter frequent trading, whether the period should be something other than five days, and whether the rule also should set a maximum holding period for imposing any redemption fee. The Release also asks whether the rule should contain a special exception for account transfers within the previous five days, such as rollovers from a 401(k) plan to an Individual Retirement Account, and whether the rule should apply to short-term transactions involving a redemption followed by a purchase within five days (i.e., the reverse of the type of transaction covered by the proposed rule).

C. Smaller Investors The proposed rule includes three provisions that are intended to diminish the effect of the redemption fee on the accounts of smaller investors. First, funds would determine the amount of any fee using the “first in, first out” (“FIFO”) accounting method (i.e., by treating the shares held the longest time as being redeemed first, and shares held the shortest time as being redeemed last). Second, funds would be permitted, but not required, to impose the redemption fee on redemptions of \$2,500 or less.² Third, the rule would provide for the waiver of redemption fees in the case of an unanticipated financial emergency, upon written request of the shareholder. As proposed, the fund would be required to waive the fee on redemptions of \$10,000 or less and permitted to waive the fee on redemptions greater than \$10,000 in these emergency circumstances. The term “unanticipated financial emergency” is not defined in the proposed rule. There are a number of specific requests for comment in this section, particularly with respect to the alternative approaches to the de minimis exception and the costs of administration for these exceptions. The Release also specifically asks whether it should define the circumstances that would constitute an “unanticipated financial emergency.”

D. Shareholder Accounts and Intermediaries Proposed Rule 22c-2 would give the fund and financial intermediaries through which investors purchase and redeem shares three methods of assuring that the appropriate redemption fees are imposed. Each fund would be able to select the method(s) to use. Under the first method, the fund intermediary must transmit to the fund (or its transfer agent) at the time of the transaction the account number used by the intermediary to identify the transaction. According to the Release, this information will permit the fund to match the current transaction with previous transactions by the same account and assess the redemption fee when it is applicable. Under the second method, the intermediary would enter into an agreement with the fund requiring the intermediary to identify redemptions of account holders that would trigger the application of the redemption fee, and transmit holdings and transaction information to the fund (or its transfer agent) sufficient to allow the fund to assess the amount of the redemption fee. Under this approach, the intermediary would be required to submit substantially less data along with each transaction than under the first method. Under the third method, the fund would enter into an agreement with a financial intermediary requiring the intermediary to impose the redemption fee and remit the proceeds to the fund. This approach would require the intermediary to determine which transactions are subject to the fee, and assess the fee. This method would alleviate the burden on intermediaries to transmit shareholder account and transactional information to the funds on a transaction-by-transaction basis. Regardless of which of the three methods described above are used to collect the redemption fee, the proposed rule also would require that, on at least a weekly basis, the financial intermediary provide to the fund the

Taxpayer Identification Number (“TIN”) and the amount and dates of all purchases, redemptions, or exchanges for each shareholder within an omnibus account during the previous week. This information is designed to enable the fund to 2 The Release asks for comment on whether, as an alternative to this approach, the rule should require funds to forego the assessment of redemption fees if the amount of the shares redeemed is \$2,500 or less. This mandatory approach would prohibit funds from collecting redemption fees of \$50 or less under any circumstance. 4 confirm that fund intermediaries are properly assessing the redemption fees and detect previously restricted market timers attempting to enter the fund through a different account.3 The Release asks a number of specific questions about the parameters for this part of the proposed rule, including whether intermediaries should provide shareholder identity and transaction information to the fund or its transfer agent more (or less) frequently than weekly and whether the rule should require funds to match shareholder purchases and redemptions that occur through multiple accounts or intermediaries. E. Exceptions Proposed Rule 22c-2 would provide four exceptions to the mandatory redemption fee. As proposed, the rule: 1. Would not require funds to collect redemption fees on redemptions of \$2,500 or less or in the case of financial emergencies (as discussed above under the “Smaller Investors” heading); 2. Would not apply to money market funds; 3. Would not apply to exchange-traded funds; and 4. Would not apply to any fund that (i) adopts a fundamental policy to affirmatively permit short-term trading in all of its redeemable securities, and (ii) discloses in its prospectus that it permits short-term trading of its shares and that such trading may result in additional costs for the fund. The Release requests comment on whether there should be additional exceptions in the rule. F. Request for Comment on Fair Value Pricing and Other Methods to Deter Market Timing The Release notes that, in connection with the Commission staff’s consideration of abusive market timing, they will be seeking additional comment on specific issues related to fair value pricing. At this time, however, the Release limits its request for comment on fair value pricing to general topics, such as whether the implementation of effective fair value pricing would make a mandatory redemption fee unnecessary to address abusive market timing. The Release also asks whether there are additional tools that the Commission should consider to combat harmful market timing transactions. Robert C. Grohowski Associate Counsel 3 The Release notes that, in addition, this information may help funds determine whether shareholders received appropriate breakpoint discounts on purchases of fund shares sold with a front-end sales load.