

MEMO# 20421

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SEC Adopts Amendments to the Redemption Fee Rule; Extends Compliance Date for Agreements by Six Months

©2006 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [20421] September 28, 2006 TO: BANK, TRUST AND RECORDKEEPER ADVISORY COMMITTEE No. 28-06 BROKER/DEALER ADVISORY COMMITTEE No. 38-06 CHIEF COMPLIANCE OFFICER COMMITTEE No. 14-06 COMPLIANCE MEMBERS No. 39-06 OPERATIONS MEMBERS No. 19-06 PENSION MEMBERS No. 59-06 SEC RULES MEMBERS No. 84-06 SMALL FUNDS MEMBERS No. 68-06 TECHNOLOGY ADVISORY COMMITTEE No. 17-06 TRANSFER AGENT ADVISORY COMMITTEE No. 64-06 RE: SEC ADOPTS AMENDMENTS TO THE REDEMPTION FEE RULE; EXTENDS COMPLIANCE DATE FOR AGREEMENTS BY SIX MONTHS As we previously informed you, earlier this year the Securities and Exchange Commission proposed revisions to the recently adopted redemption fee rule, Rule 22c-2.1 These amendments were intended to narrow the number of financial intermediaries with which funds are required to have shareholder information agreements. The SEC has approved revisions to the rule and provided additional clarification regarding the rule's application.² With minor changes, the Commission approved the amendments as proposed. The Commission also extended until April 17, 2007 the compliance date for the shareholder information agreement portion of the rule. The compliance date for the board determination required by the rule remains October 16, 2006. The revisions to the rule and the clarifications included in the Release are briefly summarized below. 1 See Institute Memorandum to Chief Compliance Officer Committee No. 5-06, Compliance Members No. 14-06, Operations Members No. 6-06, Pension Members No. 14-06, SEC Rules Members No. 26-06, Small Funds Members No. 20-06, Broker Dealer Advisory Committee No. 9-06, Bank, Trust and Recordkeeping Advisory Committee No. 10-06, Transfer Agent Advisory Committee No. 16-06, and Technology Advisory Committee No. 4-06 [Nos. 19800 and 19800], dated March 3, 2006. 2 See Mutual Fund Redemption Fees, SEC Release No. IC-27504 (Sept. 27, 2006) (the "Release"), which is available on the SEC's website at: <http://www.sec.gov/rules/final/2006/ic-27504.pdf>. 2 INTERMEDIARIES WITH WHICH A FUND MUST HAVE A SHAREHOLDER INFORMATION AGREEMENT The SEC has revised the rule to narrow the scope of financial intermediaries with which a fund must have a shareholder information agreement. In particular, the definition of "financial intermediary" has been revised to exclude persons the fund treats as an "individual investor" for purposes of the fund's frequent trading and redemption fee policies. The Commission has also addressed "chain of intermediary" situations through amendments to

the shareholder information agreement portion of the rule. Pursuant to these amendments, a fund is required to have a shareholder information agreement only with the first-tier intermediary. Intermediaries the Fund Treats as Individuals The Commission has determined not to specify the circumstances under which a fund may treat an intermediary as an individual investor. According to the Release, funds are in the best position to make this determination. However, if a fund has not established frequent trading policies, it cannot take advantage of this exclusion. The Release provides an example of how this exclusion might work with respect to a retirement plan: If a fund treats a retirement plan as the purchaser under its market timing policies rather than the employees in the plan, the plan would not be considered a financial intermediary under the rule and the fund would not be required to enter into an agreement with the plan. Chain of Intermediaries Situations The definition of “shareholder information agreement” in Rule 22c-2 has been revised to expressly address “chain of intermediaries” situations. As revised, in situations where a financial intermediary holds shares on behalf of other financial intermediaries, the rule requires the fund to have an agreement only with the financial intermediary that submits orders directly to the fund, its principal underwriter or transfer agent or a registered clearing agency (i.e., the first-tier intermediary). The agreement must require the first-tier intermediary to agree to use best efforts to determine, promptly upon request of the fund, whether any specific person about whom it has received identification and transaction information pursuant to a previous request for data from the fund under the agreement is a financial intermediary. If such person is an indirect intermediary, the first-tier intermediary must either provide to the fund (or arrange to have provided) the identification and transaction information regarding shareholders who hold an account with an indirect intermediary or restrict or prohibit the indirect intermediary from purchasing, in nominee name on behalf of other persons, securities issued by the fund.³ Footnote 22 to the Release provides greater insight regarding how this provision may operate in practice.

3 ADDITIONAL AMENDMENTS TO THE RULE OR CLARIFICATIONS OF ITS APPLICATION

Amendments to the rule or clarifications concerning its application provided in the Release include:

- Taxpayer Identification Numbers (“TINs”) – At the request of the Institute, the rule now clarifies that if a TIN is not available for non U.S. shareholders, the Individual Taxpayer Identification Number (ITIN) or other government issued identifier is permitted.
- Agents of Financial Intermediaries – At the request of the Institute, the rule now clarifies that, in lieu of entering into a shareholder information agreement with a financial intermediary directly, the fund may enter into the agreement with the intermediary’s agent.
- Transfer Agents – The rule now clarifies that, on behalf of a fund, its transfer agent may enter into the required shareholder information agreement with financial intermediaries, though such agreement must require the intermediary to provide any requested information to the fund upon the fund’s request.
- Form of Agreement – The Release clarifies that the shareholder information agreement, which must be in writing, may be part of another contract or agreement, such as a distribution agreement.
- Effect of Lacking an Agreement – The rule now clarifies that if a fund does not have an agreement with a particular intermediary, the fund is only required to prohibit that intermediary from purchasing the fund’s securities “in nominee name on behalf of other persons.” As such, the intermediary may continue to purchase shares on its own behalf or on behalf of individuals.
- Treatment of Reinvested Dividends – As recommended by the Institute, the rule has been revised to expressly exclude the automatic reinvestment of dividends from those purchases from an intermediary that the fund must prohibit if it does not have a shareholder information agreement with that intermediary.
- ERISA Concerns – The Release responds to concerns raised by some commenters regarding a fund’s ability under the shareholder information agreements to restrict or prohibit trading in a retirement account without violating ERISA. According to the Release, the Commission’s staff who have

conferred with the Department of Labor (DOL) staff have been advised that these concerns have been addressed in guidance issued by the DOL. A link to this guidance is included in footnote 33 of the Release.

□ Frequency of Requesting Data – The Release discusses factors a fund may want to consider in determining the frequency with which it requests trading data from financial intermediaries. 4 These factors include: (1) unusual trading patterns that might indicate market timing (e.g., abnormally large inflows or outflows); (2) the risks that frequent trading poses to the fund and its shareholders in light of the nature of the fund and its portfolio; (3) the risks to the fund and its shareholders from market timing; and (4) the confidence the fund (and its chief compliance officer) has in the implementation of trading restrictions by an intermediary. The Release notes that, in some cases, funds may seek transaction information only occasionally to determine whether an intermediary is, in fact, enforcing trading restrictions or imposing redemption fees on behalf of the fund.

□ Relying on an Intermediary’s Market Timing Policies – The Release expresses the Commission’s view that a fund, in appropriate circumstances, could reasonably conclude that an intermediary’s market timing policies sufficiently protect fund shareholders and could, therefore, defer to the intermediary’s policies rather than implementing the fund’s policies through that intermediary. The Release discusses the disclosure that funds should include in their prospectuses under these circumstances.

□ Privacy – The Release reiterates the views previously expressed by the Commission that the exceptions in the federal privacy laws and rules cover the information that a fund would request from an intermediary under Rule 22c-2. It further affirms that a fund receiving shareholder information pursuant to these exceptions may not disclose the information for other purposes, such as marketing, unless permitted under the intermediary’s privacy policy.

□ Variable Annuity Issues – The Release responds to commenters concerns that a number of state insurance and contract law issues might arise in connection with charging a redemption fee to or imposing trading limits or restrictions on investors who invest in funds through insurance company separate accounts. According to the Release, “nothing in this rule would preclude a fund that is concerned about the legality under existing contracts of imposing these limits or fees on certain insurance contractholders, from choosing not to impose them with regard to investors whose policies would not permit imposition of such limits or fees.”

COMPLIANCE DATES As noted above, the Commission has extended the compliance date for the shareholder information agreement portion of the rule by 6 months – i.e., until April 16, 2007. In addition, the Commission has extended by twelve months (until October 16, 2007), the date by which funds must be able to request and promptly receive shareholder identity and transaction information pursuant to the required shareholder information agreements. The compliance date for the provisions in the rule 5 requiring fund boards to determine whether to impose a redemption fee remains October 16, 2006. None of those provisions have been impacted by the Release. Tamara K. Salmon Senior Associate Counsel