MEMO# 18841

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INSTITUTE COMMENT LETTER ON REDEMPTION FEE RULE

 [18841] May 11, 2005 TO: BROKER/DEALER ADVISORY COMMITTEE No. 19-05 BROKER/DEALER ASSOCIATE MEMBERS No. 8-05 COMPLIANCE ADVISORY COMMITTEE No. 38-05 OPERATIONS MEMBERS No. 7-05 PENSION MEMBERS No. 19-05 SEC RULES MEMBERS No. 59-05 SMALL FUNDS MEMBERS No. 42-05 TRANSFER AGENT ADVISORY COMMITTEE No. 21-05 RE: INSTITUTE COMMENT LETTER ON REDEMPTION FEE RULE Earlier this year, the Securities and Exchange Commission adopted new rule 22c-2 under the Investment Company Act and requested comment on the rule and related redemption fee issues.1 The Institute's comment letter is attached and briefly summarized below. COMMENTS ON RULE 22C-2 AS ADOPTED In the letter, the Institute expresses serious concerns that rule 22c-2, as adopted, is fundamentally flawed. We point out that the Commission has adopted a rule under which funds singularly bear all of the responsibilities and liabilities associated with imposing redemption fees. We suggest that the better approach is for regulatory responsibilities to be appropriately shared by funds and intermediaries, and urge the Commission to carefully consider whether and how such an approach might be implemented. The Institute also argues that the requirement under the rule that funds obtain written contracts with every "intermediary" is completely unworkable and that the Commission grossly underestimates the challenges, costs and burdens associated with this requirement.2 We urge the Commission to modify this part of the rule as soon as possible and recommend 1 See Memorandum No. 18647, dated March 18, 2005. 2 By October 16, 2006, every fund subject to rule 22c-2 is required to enter into a written agreement with each of its financial intermediaries. Under these contracts, intermediaries must agree to: (i) provide the fund with certain information upon request; and (ii) execute any instructions to restrict or prohibit further purchases or exchanges by a shareholder who has been identified by the fund as having engaged in transactions that violate the fund's short- term trading limits. The term "financial intermediary" is broadly defined under the rule to include, among other things, any entity that holds shares in nominee name or maintains records for a participant-directed retirement plan. 2 assembling a group of industry representatives to help address the difficult issues that the contract requirement raises. More specifically, we strongly recommend that the Commission modify the rule to require a fund to obtain a contract with an intermediary when it determines that doing so is necessary to address abusive market timing. We recommend that the rule continue to require any such contract, as well as any other written agreement with an intermediary that will be in force on or after the rule's compliance deadline, to include the provisions required under the rule. In the letter, the Institute also makes a series of specific recommendations with respect to the contract requirement.

These recommendations include: • Incorporating a good faith standard into the rule to ensure that funds that make reasonable efforts to obtain contracts with intermediaries will not violate the rule if intermediaries refuse to enter into contracts or if, for some other reason, funds are unable to obtain the required contracts by the compliance deadline; • Limiting the requirement to obtain a contract only to intermediaries with which the fund has a direct relationship (thereby addressing the “chain of intermediaries” problem); • Clarifying that contracts are required only when necessary to restrict abusive short-term trading and only for “true” omnibus accounts, where an intermediary is acting on behalf of multiple investors; and • Addressing the problems faced by funds underlying insurance company separate accounts by imposing a direct obligation on separate accounts to apply funds’ short-term trading limits.3 COMMENTS ON THE COMMISSION’S COST-BENEFIT ANALYSIS The Institute comments strongly on the Commission’s cost-benefit analysis of the new rule, arguing that the Commission has grossly failed to meet its obligations to properly assess the burdens of the contract requirement. The Institute states that this failure, coupled with the fact that the contract requirement was incorporated into the final rule without the benefit of industry comment, raises serious questions as to whether the Commission has satisfied its obligations under the Administrative Procedures Act in adopting rule 22c-2. In the letter, we argue that it will be considerably more time consuming and expensive than the Commission has estimated to obtain written agreements with intermediaries and obtain data from intermediaries. The letter questions the Commission’s estimate of the time involved in obtaining contracts (4.5 hours per fund), the total cost of that time ($275.99), and the characterization of the expense as a one-time cost. The letter also argues that the Commission grossly underestimates, and in some cases overlooks, the costs and technical difficulties in transmitting data from intermediaries to funds as contemplated by the rule. 3 We suggest that if the Commission is unwilling to take this step, it should at least carefully study this issue to find an alternative that will assist funds in limiting or eliminating market timing through variable insurance products. 3 COMMENTS ON STANDARDIZATION IN THE REDEMPTION FEE CONTEXT The Institute responds in the letter to the request for comment on whether the Commission should establish a set of uniform standards to facilitate the assessment of redemption fees by intermediaries on shares held through omnibus accounts. Based in part on recent meetings among the Institute, Securities Industry Association (SIA) and retirement plan recordkeeping community, we support the use of a “first in, first out” (FIFO) accounting methodology and the mandatory transfer of share aging histories, and we oppose an exception for unanticipated financial emergencies. We note that, while not unanimous, the vast majority of our members support limiting application of redemption fees to “participant-directed exchanges” in retirement plans. We strongly urge the Commission to act quickly and definitively on the issue of standardization. The letter notes that, in the meantime, we will continue to work with the SIA and the retirement plan community on finding ways to further enhance the effective implementation of redemption fees and rule 22c-2. These efforts may include working on model contractual clauses and standard conventions for data transmissions between funds and intermediaries. Robert C. Grohowski Associate Counsel Attachment (in .pdf format) Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (http://members.ici.org) and search for memo 18841, or call the ICI Library at (202) 326-8304 and request the attachment for memo 18841.