INVESTMENT COMPANY INSTITUTE

May 7, 2004

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0506

Re: Mandatory Redemption Fees for Redeemable Securities (File No. S7-11-04)

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to express its views on the Commission's proposed new Rule 22c-2 under the Investment Company Act of 1940.[2] The proposed rule 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 business days. Any redemption fees imposed pursuant to the rule are required to be retained by funds (and not their advisers) for the benefit of their long-term shareholders.

As discussed in the Proposing Release, some investors engage in frequent trading of mutual funds, which can disrupt portfolio management and adversely impact long-term fund shareholders by diluting the value of their shares. Experience suggests that existing methods to deter market timing may not be fully effective and that there is no one, all-encompassing solution to this issue. For example, as the Proposing Release recognizes, fair value pricing can reduce the impact of harmful short-term trading activity, but cannot by itself completely eliminate such trading. As a result, in an effort to protect the interests of long-term shareholders, many funds seek to prevent or deter this activity by taking a multifaceted approach that includes redemption fees, fair valuation and restricting the trading privileges of shareholders who engage in harmful trading activity.

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[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,632 open-end investment companies ("mutual funds"), 621 closed-end investment companies, 126 exchange-traded funds and 5 sponsors of unit investment trusts. Its mutual fund members manage assets of about $7.545 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 million households.

[2] SEC Release No. IC-26375A, 69 Fed. Reg. 11762 (March 11, 2004) ("Proposing Release").

The Institute has long recognized the need for such a multifaceted approach and advocated giving funds multiple "tools" to combat abusive short-term trading.[3] Most recently, the Institute has publicly supported the concept of a mandatory, industry-wide minimum two percent redemption fee on the sale of virtually all mutual funds (other than money market funds and funds designed for short-term trading) for a minimum of five days following a purchase.[4] Our support for this concept, in part, is based on the fact that the fund retains the redemption fee for the benefit of the shareholders remaining in the fund. In addition, a mandatory redemption fee will facilitate the imposition of redemption fees on transactions conducted through intermediaries.

We continue to support the concept of a mandatory, industry-wide redemption fee and the objectives of the proposed rule. We recommend a number of modifications, however, to ensure that the proposed rule achieves these objectives in the most efficient way possible.

In summary, the Institute's principal comments on the proposal are as follows:

- We recommend that the final rule require a mandatory *minimum* redemption fee of at least two percent on redemptions effected within seven calendar days following a purchase;

- We support the Commission's proposed use of a "first in, first out" (FIFO) accounting methodology to determine which redemptions are assessed a redemption fee;

- We believe that, with the foregoing parameters, transactional exceptions for unanticipated financial emergencies and *de minimis* redemptions are largely unnecessary, are susceptible to abuse, and will serve only to add complexity and cost to the implementation of the rule;

- We recommend that the exception for funds designed for active trading allow such funds the option of adopting a non-fundamental policy (as long as they also provide investors with notice of any change to that policy), rather than requiring them to adopt a fundamental policy as proposed;

- We recommend that the Commission modify the proposed rule to clarify that it is designed to "look through" intermediaries and require application of redemption fees to short-term trading by the underlying investors who are the intermediaries'

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[3] In 2002, in response to an Institute request, the Commission's staff issued a letter clarifying that funds may delay exchange transactions (*e.g.*, until the next business day) in order to deter abusive short-term trading. *See* Investment Company Institute (pub. avail. Nov. 13, 2002).

[4] *See, e.g.*, ICI press release dated October 30, 2003 (available at http://www.ici.org/statements/nr/2003/03_news_exec_comm.html#TopOfPage) and the testimony of ICI President Matthew P. Fink before the Subcommittee on Financial Management, the Budget, and International Security Committee on Governmental Affairs, United States Senate, November 3, 2003 (available at http://www.ici.org/statements/tmny/03_sen_fink_tmny.html#TopOfPage).

customers;

- We recommend that the proposed weekly information flow requirement be replaced with a requirement for a compliance attestation that would provide assurances to funds that intermediaries have the internal controls necessary to fulfill their contractual obligations related to the assessment of redemption fees and implementation of other market timing restrictions; and

- We recommend that a reasonable transition period be included in the final rule.

Our comments are discussed in more detail below.

I. <u>Proposed Redemption Fee</u>

A. Appropriate Level of the Redemption Fee

Under the proposal, new Rule 22c-2 would require mutual funds to impose a fee of two percent of the proceeds from certain fund share redemptions. The rule would not permit funds to impose a fee higher or lower than two percent on transactions subject to the rule.

The Institute recommends that the rule establish two percent as a *minimum* level for the required redemption fees, rather than a fixed level as proposed. As the Proposing Release notes, two percent reflects the level of redemption fees that many funds today impose and this fee level, while not eliminating all short-term trading, would serve as a significant disincentive to abusive market timing strategies. Some funds, however, may need to impose redemption fees of greater than two percent to effectively balance the interests of redeeming shareholders and those that remain in the fund.[5] Accordingly, two percent should serve as the minimum level, rather than as a fixed level, for the redemption fees required by Rule 22c-2.

We recognize that giving funds the flexibility to adopt redemption fees higher than two percent would lead to less uniformity, which could make it more difficult for intermediaries to properly impose these fees. We would expect, however, that the vast majority of funds would have no need for a fee higher than two percent, so the instances in which an intermediary would have to make an exception would be limited. Moreover, it is the mandatory nature of the redemption fee, rather than its level, that will foster across-the-board implementation by intermediaries. For example, if the final rule requires a mandatory, minimum two percent redemption fee, intermediaries will need to build the systems capability to collect redemption fees of at least two percent. It is our understanding that, once there is a system in place to collect that redemption fee, making an occasional exception to change the level of the fee should not be overly difficult.

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[5] For example, a fund received no-action assurances from the staff to impose a four percent redemption fee for a period of 200 days following the open-ending of a closed-end fund that invested primarily in thinly-traded Korean equities. *See* Fidelity Advisor Korea Fund, Inc. (pub. avail. March 7, 2001). Although this particular example did not involve short-term trading, it did involve the use of redemption fees to offset the harm that redeeming shareholders might cause to shareholders that remain in the fund. Other funds may similarly need to protect the interests of remaining shareholders from harmful redemptions based upon their particular vulnerabilities to abusive short-term trading.

We further recognize that there should be some limit on a fund's discretion to impose redemption fees of any level. Accordingly, we recommend that a fund's board be required to act before the fund could impose a redemption fee that exceeded either the level or duration set forth in Rule 22c-2. In extending the redemption fees used by a particular fund beyond those required by the rule, the board should consider factors such as the historical trading patterns of its shareholders, administrative costs incurred as a result of short-term trading, dilution caused by investors following short-term trading strategies, and relative needs of all of the fund's shareholders.[6] In general, we believe that this level of analysis by fund boards will effectively prevent funds from imposing excessive redemption fees.[7]

Consistent with these recommendations, we believe that two percent should be a presumptively acceptable level for all redemption fees, whether required by Rule 22c-2 or imposed as a result of longer holding periods adopted by particular funds.[8] As the Proposing Release notes, Commission staff historically have analyzed the level of redemption fees with reference to the definition of "redeemable security" in Section 2(a)(32) of the Investment Company Act.[9] The adoption of a mandatory two percent redemption fee (whether as a minimum, as we recommend, or as a fixed level, as proposed) would confirm the long-standing position of Commission staff that the imposition of a two percent redemption fee is not inconsistent with Section 2(a)(32) – *i.e.*, that an investor is receiving approximately his proportionate share of the issuer's net assets notwithstanding the imposition of a two percent fee. We see no reason under a Section 2(a)(32) analysis why there should be a different result for redemptions not covered by Rule 22c-2, inasmuch as the length of time during which redemptions are subject to such a fee should not affect the Section 2(a)(32) analysis.

Moreover, as the Proposing Release recognizes, the redemption fees covered by this rule are not strictly designed to offset the costs of short-term trading.[10] Instead, they "strike a

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[6] The board is in the best position to perform this analysis given the balancing of shareholder interests and that at least two costs associated with short-term trading – the cost of dilution and the drag on a fund's performance caused by holding higher cash balances to meet more frequent redemption requests – may be difficult or impossible to precisely quantify.

[7] If, however, the Commission decides that there should be a maximum upper limit, we would suggest a four percent level, which is the level the staff permitted in the Fidelity Advisor Korea Fund, Inc. no-action letter cited above.

[8] The Proposing Release indicates that a fund would have to justify the level of any redemption fee not covered by Rule 22c-2 against the costs associated with particular redemptions and, in any event, would be limited to the lesser of the actual costs of redemptions or two percent. *See* footnotes 10, 15 and 26 of the Proposing Release. While the Proposing Release may be reflective of the staff's historical position on redemption fees, that discussion fails to take into account the role of the board in balancing competing interests and taking into account costs that are difficult or impossible to precisely quantify, such as dilution and the drag on performance discussed above.

[9] *See* Proposing Release at n.20, 69 Fed. Reg. at 11764.

[10] For this reason, the Commission has attempted in the Proposing Release to clarify that redemption fees imposed pursuant to Rule 22c-2 will be permissible under Rule 11a-3 by amending Rule 11a-3(b)(2). We agree that conforming amendments to Rule 11a-3 are necessary in light of Rule 22c-2. We recommend, however, that the Commission revise the definition of "redemption fee" in Rule 11a-3(a)(7), rather than amend Rule 11a-3(b)(2), which relates only to scheduled variations of redemption fees imposed on exchanges. Rule 11a-3(a)(7) defines "redemption fee" to mean "any fee (other than a sales load, deferred sales load or administrative fee) that is paid to the fund and is reasonably intended to compensate the fund for expenses directly related to the redemption of fund shares." As the Proposing Release recognizes, not all funds that will be required to impose a redemption fee pursuant to Rule 22c-2 will have

balance between two competing policy goals of the Commission – preserving the redeemability of mutual funds shares and reducing or eliminating the ability of shareholders who frequently trade their shares to profit at the expense of their fellow shareholders."[11] We believe that the two percent level not only strikes this balance effectively for purposes of the short holding period required by the rule, but more generally for whatever holding period a fund's board determines is necessary to deter harmful short-term trading in that fund's shares.

For both of these reasons, we encourage the Commission to recognize in the adopting release for Rule 22c-2 that two percent is a presumptively acceptable level for redemption fees. As an additional benefit, such a statement likely would encourage greater uniformity in the level of redemption fees generally, furthering the likelihood that intermediaries would properly impose redemption fees on transactions not subject to Rule 22c-2, as well as on those subject to the rule.

B. Use of FIFO

Under the proposed rule, funds would determine the amount of any fee using the FIFO method, by treating the shares held the longest time as being redeemed first, and shares held the shortest time as being redeemed last. We support this aspect of the proposal.

The Commission requested comment on whether the rule should instead require the use of a "last in, first out" (LIFO) method. While we recognize that LIFO may be somewhat more effective than FIFO at deterring harmful short-term trading during the short period covered by the rule, we believe that a FIFO approach is preferable for three reasons. First, almost all of the funds that have already adopted redemption fees use FIFO. Most funds also currently have FIFO-based systems in place in order to track holding periods for other purposes, such as contingent deferred sales charges (CDSCs) and tax reporting. As a result, implementing FIFO would be less costly to implement from a systems perspective because funds could leverage existing systems more effectively and easier from an investor education perspective because investors already understand, for example, how CDSCs are applied.

Second, FIFO would obviate the need for many exceptions. The Commission clearly is concerned about the application of redemption fees to transactions that do not involve abusive short-term trading, such as purchases of fund shares through periodic purchase plans and routine contributions to retirement accounts. We share these concerns and agree that these types of transactions do not warrant the imposition of a redemption fee. Inasmuch as accounts with these types of purchases almost always will have an existing balance, redemption within a week of one of these purchases rarely would trigger a redemption fee using FIFO. A LIFO approach, on the other hand, would require appropriate exceptions to be crafted. While either approach -- FIFO or LIFO with appropriate exceptions -- would protect shareholders from

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expenses directly related to the redemption of fund shares of two percent. *See* Proposing Release at n.15 ("the two percent fee . . . would not be limited to particular costs associated with particular redemptions"). Revising the definition of "redemption fee" in Rule 11a-3(a)(7) would eliminate any potential conflict between Rule 22c-2 and Rule 11a-3 for any such funds.

[11] Proposing Release, 69 Fed. Reg. at 11764.

paying a redemption fee on these types of transactions, we believe that the latter would add significant programming complexity, and thus significant costs, to the rule.

Third, we are concerned that a rule mandating a LIFO approach would prove to be extremely difficult to implement for firms that opt to impose redemption fees with longer holding periods. As noted in the Proposing Release, many funds that currently have redemption fees impose holding periods significantly longer than five days, typically ranging from 30 days to a year.[12] Most of these funds employ a FIFO approach. If the rule were to require LIFO, these firms would either have to adopt LIFO for the length of their holding periods or build the systems capability to use LIFO for the first week followed by FIFO thereafter. Neither option is appealing. LIFO for a 30-day or longer holding period would result in the application of redemption fees to far more transactions that do not involve abusive short-term trading than the rule intended. A LIFO/FIFO combination approach would be significantly more difficult to design than a straight FIFO system, and accordingly would entail substantial extra programming costs. As a result of these problems, the use of LIFO in the final rule could discourage funds from adopting longer holding periods and, thus, ultimately may limit the effectiveness of redemption fees for these funds.

C. Length of Holding Period

The proposed rule would apply to redemptions made within five business days of a purchase. We support this length of time for purposes of the rule, but request one slight modification. We recommend that the final rule incorporate a minimum period of seven *calendar* days rather than five *business* days as proposed. A standardized period based on calendar days would eliminate the need for funds and intermediaries and their respective systems to recognize bank holidays, government holidays, stock exchange closures, and other days that may be business days for some funds and holidays for others. It would thus be easier to administer. We also recommend that the Commission add examples, with specific dates and times, to clarify the starting and ending days of the period.[13]

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[12] *See* Proposing Release, 69 Fed. Reg. at n.26.

[13] For example, if the Commission agrees that the holding period should be seven calendar days, it could use the following scenarios to illustrate the rule:

1. Purchase order received at 3:30 p.m. Wednesday and redemption order received at 3:30 p.m. the following Wednesday: ***redemption fee applies***.
2. Purchase order received at 3:30 p.m. Wednesday and redemption order received at 4:30 p.m. the following Wednesday: ***no redemption fee applies***.
3. Purchase order received at 3:30 p.m. Wednesday and redemption order received at 3:30 p.m. the following Thursday: ***no redemption fee applies***.
4. Purchase order received at 4:30 p.m. Wednesday and redemption order received at 3:30 p.m. the following Thursday: ***redemption fee applies***.

II. Exceptions

A. Exceptions for Particular Types of Redemptions

The proposed rule contains two exceptions for particular types of redemptions: an exception for "unanticipated financial emergencies" and a *de minimis* exception. For the reasons expressed below, we recommend that the final rule not include either of these exceptions.

1. Unanticipated Financial Emergencies

The proposed rule would require a fund, upon written request of the shareholder, to waive redemption fees in the case of an unanticipated financial emergency if the amount of the shares redeemed is $10,000 or less. The fund would be permitted, but not required, to waive redemption fees for unanticipated financial emergencies if the amount of the shares redeemed is more than $10,000. The term "unanticipated financial emergency" is not defined in the proposed rule.

The Institute agrees that, ideally, redemption fees should not be imposed in cases of unanticipated financial emergencies. We believe, however, that the burdens associated with implementing the proposed exception far outweigh the benefits to those few shareholders who might utilize it. It would seem relatively rare for a legitimate emergency to arise within a week following a purchase, particularly under a FIFO system. On the other hand, this type of exception necessarily involves subjectivity and thus would not lend itself to automation, making it costly to implement.[14]

More importantly, instead of being used as envisioned by the Commission, we fear that the provision may be abused solely to avoid paying redemption fees. It would be difficult for any fund to deny a shareholder an exception for a claimed financial emergency, because in practice it may be impossible to distinguish legitimate claims from those that are not. As a result, funds may simply allow every claim to stand. Ironically, this may subject funds to second-guessing by the Commission's enforcement staff for wrongfully allowing a dishonest request.

In addition, we note that the redemption fees contemplated in the Proposing Release would not significantly impair the liquidity of a shareholder's investment. Instead, it gives the shareholder the option of either waiting a short time to receive 100% of his or her investment's value or receiving substantially all (typically 98%) of that value immediately. As a result, there

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[14] The incorporation of parameters in the final rule for the exception would not alleviate this problem. Even with rules that are more precisely defined, the determination of whether a particular case qualifies under the exception would require subjective analysis by an individual. For example, with the relatively defined standards for "hardship" distributions from certain retirement plans, IRS regulations provide that whether an individual has "an immediate and heavy financial need" for purposes of a distribution from a 401(k) plan must be "determined based on all the relevant facts and circumstances." Even for certain categories of "deemed" immediate financial needs in the IRS regulations (*e.g.*, payments necessary to prevent the eviction of the employee from the employee's principal residence), determining whether a particular situation meets the standard could require review of supporting documentation and potential further inquiry into the validity and/or extent of the financial need. *See* 26 C.F.R. §1.401(k)-1(d)(2).

is far less need for a hardship exception in the redemption fee context than, for example, in the context of qualified retirement plans where, in the absence of an exception, plan participants facing a hardship would either wait years until retirement age or pay significantly higher penalties associated with early withdrawals.

For all of these reasons, we recommend that the final rule *not* include an exception for unanticipated financial emergencies.

2. *De Minimis* Redemptions

The proposed rule includes a provision that would permit, but not require, funds to forego the assessment of a redemption fee if the amount of the shares redeemed is $2,500 or less. The benefit of such an exception would be that redemptions of shares purchased through automatic purchase programs, dividend reinvestments, retirement plan contributions, and other systematic or periodic investments would rarely be assessed a redemption fee.

The Institute agrees that redemption fees should not apply to these transactions. As mentioned above, however, the use of a short mandatory holding period and FIFO accounting achieve much the same result, inasmuch as only a complete liquidation within a week of one of those types of investments would trigger a redemption fee (and even then, only on the amount of the last purchase). Thus, if the final rule imposes a short mandatory holding period and uses FIFO, we believe that a *de minimis* exception is largely unnecessary. If, on the other hand, the final rule adopts either a longer mandatory holding period or requires the use of LIFO, a *de minimis* exception may be appropriate. In addition, we are concerned that a *de minimis* exception may encourage traders to attempt to structure multiple transactions in amounts just below the threshold in an effort to avoid the redemption fees.[15]

For both of these reasons, we recommend that the final rule *not* include a *de minimis* exception.[16]

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[15] For that reason, if such an exception is adopted in the final rule, the threshold should be no higher than the one proposed.

[16] If the Commission decides that the rule must contain either a *de minimis* exception or an exception for unanticipated financial emergencies, we believe that the *de minimis* exception would pose significantly fewer difficulties. Also, if a *de minimis* exception is included in the final rule, we would recommend one clarification. The Proposing Release interchangeably describes the threshold for this exception in terms of the amount of the redemption proceeds and the amount of the redemption fee that would be imposed. For clarity, we recommend that the adopting release and the final rule use the latter method, setting the threshold in terms of the amount of the redemption fee that would be imposed, inasmuch as some redemptions may be partially subject to a fee. For example, if an investor who owned $10,000 worth of shares purchased an additional $2,000 on January 15th and redeemed all $12,000 on January 16th, we assume that the $2,000 purchased on January 15th would be subject to a redemption fee of two percent, but that the $10,000 previously owned would not. The result is a redemption fee of $40 on $12,000 of redemption proceeds. Expressing the threshold in terms of the fee makes it clear that no redemption fee would be imposed on this redemption, whereas expressing it in terms of the amount of the redemption proceeds suggests that the fee would be imposed.

B. Exceptions for Particular Types of Funds

The proposed rule would not apply to money market funds, exchange-traded funds, or funds designed for short-term trading. We support these exceptions, with one recommended change.

The change we recommend concerns the exception for funds designed for frequent trading. As proposed, this exception would require funds to adopt a fundamental policy to affirmatively permit short-term trading of their securities. We recommend that the final rule allow a fund that wishes to avail itself of this exception to either adopt a fundamental policy (as proposed) or adopt a non-fundamental policy and be required to provide at least sixty days' notice to investors before changing that policy.[17] Changing a fundamental policy requires shareholder approval, which is time-consuming and costly. Ultimately, these costs are borne by shareholders. Funds that avail themselves of this exception, but later determine that a more restrictive policy towards short-term trading is warranted, should be able to change that policy without imposing these costs on their shareholders.

The approach that we propose would allow for such a change to be made without incurring the costs associated with changing a fundamental policy, while preserving the principle of preventing funds from taking actions that would be inconsistent with shareholders' expectations. Under this approach, every shareholder would have the opportunity to redeem without paying a redemption fee before a new policy concerning short-term trading took effect. As under the fund name rule, a notice requirement should afford shareholders sufficient protection in the event of a change in policy.

III. Issues with Intermediaries

A. General

As is clearly recognized in the Proposing Release, most fund shares are not sold directly to the public. Instead, most investments in fund shares are made through a nominee, such as a broker-dealer, or through two-tier structures, such as a retirement plan, fund of funds, master-feeder, variable annuity, or 529 plan (which, for these purposes, we will collectively refer to as "intermediaries"). In each of these cases, mutual fund shares are not held directly in the name of the person ultimately making the investment decision – the broker-dealer's client, 401(k) plan participant,[18] shareholder in a fund of funds or feeder fund, holder of a variable annuity

[17] The Commission took this approach in the fund name rule, Rule 35d-1 under the Investment Company Act. That rule generally requires funds with a name that suggests that they focus investments in a particular type of investment or industry to invest at least 80% of their assets in the type of investment suggested by the name. Funds are permitted to implement the 80% investment requirement either as a fundamental policy or a policy that requires the fund to provide notice to shareholders at least sixty days prior to any change to its 80% investment policy. In adopting the rule, the Commission noted that a minimum of sixty days prior notice "will ensure that when shareholders purchase shares in an investment company based on its name, and with the expectation that it will follow the investment policy suggested by that name, they will have sufficient time to decide whether to redeem their shares in the event that the investment company decides to pursue a different investment policy." SEC Release No. IC-24828 (March 31, 2001).

[18] We refer to 401(k) plans (and 401(k) plan participants) throughout this section, but the issues raised relate equally to all retirement plans that provide for individual accounts and participant direction of investments.

contract, and the holder of a 529 plan account. Instead, fund shares are either held in the name of the intermediary (as is the case with broker-dealers holding shares in street name) or owned by the intermediary (as is the case with 401(k) plans, state trusts set up for 529 plans, insurance company separate accounts funding variable annuities, funds of funds and feeder funds).

The clear intent of the proposed rule is to deter harmful short-term trading in mutual fund shares by the persons ultimately making investment decisions, not the intermediaries through which those persons have invested. We support this application of the rule. To serve as a meaningful deterrent, redemption fees must be imposed on investors uniformly regardless of the method they choose to invest.

We are concerned, however, that the rule as proposed in some instances might inadvertently require funds to impose redemption fees on redemptions by intermediaries rather than (or in addition to) on redemptions by the ultimate investor.[19] Redemptions by intermediaries often are conducted in net amounts, reflecting all of the exchanges and redemptions by each intermediary's investors on a given day. For example, in the 401(k) plan, 529 plan, variable annuity and master-feeder contexts, each trading day, the intermediary submits either a purchase order or redemption request to the mutual fund reflecting a net figure based on the purchases, redemptions and exchanges of all of its investors – the 401(k) plan participants, 529 plan account holders,[20] variable annuity contract holders, or feeder fund shareholders. The transaction orders submitted by an intermediary to a fund undoubtedly will involve redemptions within a short period of time of purchases.

Clearly, however, these are not the types of transactions that were intended to be covered by the rule. A simple example illustrates this point. Assume that on January 2nd three participants in a particular 401(k) plan requested exchanges of $10,000 each into an equity fund option in their plan, and that a fourth plan participant requested a $15,000 exchange out of the equity fund option into another option in the plan. If those were the only transactions by plan participants involving that fund on that day, the plan would submit a single, net purchase order to the equity fund for $15,000 ($30,000 in purchases less $15,000 in redemptions). Assume further that on the next day (January 3rd), a fifth plan participant requested an exchange for $20,000 out of the equity fund into another plan option, and a sixth participant requested a $5,000 exchange into the equity option. If those were the only transactions by plan participants involving that fund on that day, the plan would submit a single, net redemption request to the equity fund for $15,000. From the fund's perspective, the January 3rd redemption would look

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[19] The proposed rule would make it unlawful for a fund, its principal underwriter or any dealer "to redeem a redeemable security issued by the fund, within five business days after the security was purchased, unless the fund imposes a redemption fee of two percent of the amount redeemed." Without further clarification, this language would appear to require the imposition of redemption fees on redemptions by intermediaries.

[20] It does not appear that the rule as proposed would apply to transactions by 529 plan account holders within those accounts. In almost all 529 plans, account holders own a municipal security issued by the state trust formed for purposes of that state's 529 plan. The trust is not a "fund" as defined in paragraph (f)(2) of the proposed rule, so no redemption fees would be required by paragraph (a) (which is only applicable to funds, their principal underwriters and certain dealers). We would recommend that the final rule similarly not apply to these accounts. There is very little, if any, risk of their being used for abusive short-term trading of mutual fund shares, because changing investments in the account more than once per year would result in the loss of tax benefits.

like a short-term trade. Imposing a two percent redemption fee in this situation, however, would be both unfair and illogical because there were no short-term trades by plan participants.

The sale of fund shares through broker-dealers and other intermediaries using omnibus accounts gives rise to similar issues, although in that context the intermediary may submit aggregate, rather than net, redemption requests.[21] These aggregate transactions may or may not include redemptions reflective of harmful short-term trading by the intermediary's clients along with other redemptions. As with the other structures described above, the rule seems to be clearly intended to apply to short-term redemptions by the intermediary's clients. Indeed, the entire purpose of the information sharing provisions in paragraph (b) of the proposed rule (discussed below) appears to be to ensure that either the intermediary or the fund impose the fee on redemptions at that level. Requiring the imposition of a redemption fee on the aggregate redemptions by the intermediary as well would be duplicative and unnecessary to achieve the purposes of the rule.

In order to ensure that the rule is applied as intended, we recommend that the Commission revise the rule to clarify that funds are not required to assess redemption fees on redemptions by participant-directed retirement plans, 529 plans, and funds relying on either Section 12(d)(1)(G)[22] or Section 12(d)(1)(E)[23] of the Investment Company Act. The Commission also should consider whether an additional revision or clarification in the final release is necessary with respect to omnibus accounts.

The Commission likewise should clarify that redemption fees *do* apply in each of these contexts to transactions by persons making the investment decisions (with the exception of 529 plan account holders), and should be remitted to the fund for the benefit of remaining shareholders.

In connection with clarifying the application of the rule to transactions involving intermediaries, certain definitions may need to be revised or added. For example, proposed

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[21] In some cases, broker-dealers may transact with funds on a net basis. To the extent that the broker-dealer is netting its clients' transactions, only the clients' transactions, and not the broker-dealers' transactions with the fund, should be subject to the rule. This result would be very similar to the application of the rule to 401(k) plans and the other contexts described above.

[22] We recommend limiting the exception for funds of funds to those relying upon Section 12(d)(1)(G) of the Investment Company Act. That section allows a fund to invest substantially all of its assets in shares of other funds in the same group of investment companies under certain circumstances. These funds are often used as asset allocation models, periodically allocating and reallocating investments in other funds in the same complex. As a result, these funds are often used as a conduit, offering shareholders the ability to invest in multiple funds in the same complex through a single investment. As such, it would be unfair to assess redemption fees both on shareholders' transactions in the fund and the fund's transactions with the underlying (acquired) funds in the same complex. We would not extend this exception to funds relying on 12(d)(1)(F) of the Act, which provides for unaffiliated funds of funds. From the perspective of the underlying (acquired) fund, redemptions by those types of funds of funds should be treated just like redemptions by any other shareholder, with the imposition of redemption fees as required by Rule 22c-2.

[23] Section 12(d)(1)(E) permits arrangements under which a registered fund invests all of its assets in shares of one other fund so that the acquiring fund is, in effect, a conduit through which investors may access the acquired fund. This Section is relied upon by most master-feeder funds and insurance company separate accounts that issue variable annuity and variable life insurance contracts.

Rule 22c-2(f)(1) defines "financial intermediary" to mean "a record holder as defined in rule 14a-1(i) under the Securities Exchange Act of 1934 (17 CFR 240.14a-1(i)) and an insurance company that sponsors a registered separate account organized as a unit investment trust." Rule 14a-1(i) under the Exchange Act in turn defines "record holder" as "any broker, dealer, voting trustee, bank, association or other entity that exercises fiduciary powers which holds securities of record in nominee name or otherwise or as a participant in a clearing agency registered pursuant to section 17A of the Act." We note that, in the retirement plan context, the plan recordkeeper typically is the party that has the participant-level information and, in some circumstances, may be the appropriate entity to have responsibility for supplying information to funds to facilitate the application of redemption fees and other market timing restrictions to transactions by plan participants. It is not entirely clear, however, that the proposed definition of "financial intermediary" would cover retirement plans or their recordkeepers. We recommend that the Commission clarify that the party that maintains a retirement plan's participant records is intended to be considered a "financial intermediary" under the proposed definition.

In addition, the terms "shareholder" and "account" are used in Rule 22c-2, but are not defined for purposes of the rule, which raises technical issues. For example, as discussed above, we believe it is appropriate and consistent with the Commission's intent for redemption fees under the rule to be imposed, where triggered, on transactions by retirement plan participants. Such participants typically are not "shareholders" and do not have "shareholder accounts."[24] The Commission should indicate that a retirement plan participant is to be considered a "shareholder" for the limited purposes of the rule, even though he or she does not own shares of the funds through the plan. Alternatively, the Commission should use and define other appropriate terms to address this matter. Similar issues arise in all of the two-tier structures discussed above.

B. Assessment of Redemption Fees

The Proposing Release notes that, at present, intermediaries holding omnibus accounts often do not provide funds with enough information for the fund to apply redemption fees to transactions effected by persons who own fund shares through such accounts. The proposed rule seeks to alleviate this problem and facilitate the application of redemption fees to transactions in omnibus accounts by providing, in paragraph (b), three alternative ways for funds and intermediaries to share information and/or assign responsibility for assessing redemption fees. Specifically, a fund would have to either (1) require the financial intermediary to provide the fund, at the time of a transaction, with the account number used to identify the transaction, (2) enter into an agreement with the intermediary requiring the intermediary to identify redemptions that would trigger the application of the redemption fee, and transmit holdings and transaction information to the fund sufficient to allow the fund to assess the fee, or (3) enter into an agreement with the intermediary requiring the intermediary to assess the fee.[25]

[24] Conversely, a retirement plan may be the legal and beneficial owner of fund shares, but it should not be considered the "shareholder" for these purposes.

[25] *See* proposed Rule 22c-2(b).

The Institute agrees that it is important for the rule to provide mechanisms to facilitate the proper assessment of redemption fees in the omnibus account context. We also support providing flexibility to funds and intermediaries to craft arrangements for assessing redemption fees that are appropriate and effective in the particular circumstances, as contemplated by paragraph (b).

Regardless of which of the three alternatives in paragraph (b) is used, the proposed rule also would require each intermediary to provide the fund or its transfer agent a complete set of transaction information and taxpayer identification numbers at least weekly, in order to allow the fund "to determine whether the redemption fee is properly assessed."[26] We support the basic objective of the requirement, but believe that the proposed approach is problematic. For example, the provision could be read to require funds to develop shadow recordkeeping systems to house the information and procedures to reconcile that information against the information on their primary systems, which we understand would be extremely costly and burdensome to implement.[27] In addition, we believe the rule should seek to facilitate implementation in the omnibus account context of other restrictions relating to abusive short-term trading that have been adopted by a fund and are disclosed in its prospectus. (For example, in addition to imposing redemption fees, some funds may limit the number of "round trips" that an investor can make within a specified period. In order to be effective in deterring abusive market timing, these restrictions need to be applied to persons who invest in funds through intermediaries.)

To address these concerns, we recommend an alternative approach. In particular, we recommend that the rule be revised to require that agreements between funds (or fund underwriters)[28] and intermediaries include provisions that:

(1) Require the intermediary to take the steps described in paragraph (b)(1), (b)(2) or (b)(3) of the rule to implement or facilitate implementation of the redemption fee (*i.e.,* transmit account numbers to the fund, transmit holdings and transaction information to the fund, or impose the redemption fee and transmit the proceeds to the fund);

(2) Require the intermediary to take reasonable steps to implement other restrictions imposed by the fund on short-term trading;[29] and

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[26] *See* proposed Rule 22c-2(c).

[27] To the extent that technological or systems enhancements are developed that would significantly reduce these costs, it may be appropriate for the Commission to revisit the advisability of this provision.

[28] We note that it is common practice for fund underwriters, rather than funds themselves, to enter into agreements with dealers that spell out the dealers' responsibilities. We recommend that the Commission clarify that the agreements under Rule 22c-2 may run between either funds and dealers or fund underwriters and dealers. This would allow funds and dealers to achieve compliance with Rule 22c-2 by adding provisions to existing agreements, thus avoiding the burden of creating new agreements solely for this purpose. We further note that funds in some cases may not have direct contractual relationships with retirement plan recordkeepers or other parties who may be in a position to facilitate the assessment of redemption fees and/or implementation of other market timing restrictions in the retirement plan context. This, combined with the fact that the Commission does not have jurisdiction over all of these parties, may complicate implementation of the Institute's recommendation in that context. We have urged the Department of Labor to provide guidance in this area.

(3) Require the intermediary to obtain a "compliance attestation" from an independent accountant.

The specific criteria for a compliance attestation engagement for this purpose would be set forth in a Statement of Position ("SOP") developed by the AICPA.[30] The SOP would outline the objectives of the engagement and the specific procedures that the accountant would be required to follow, such as examining whether the intermediary had adequate controls in place to ensure that redemption fees were properly applied to all transactions that triggered such fees under Rule 22c-2 and other restrictions on short-term trading were applied where appropriate.[31] The criteria could include, for example, a requirement that the compliance attestation engagement be performed on a "surprise" basis, without prior notice to the intermediary.

Under our recommended approach, the compliance attestation requirement would replace the proposed weekly information flow requirement. It would serve the same purpose as the weekly information flow requirement – to provide assurances to funds that intermediaries are complying with their contractual obligations related to the assessment of redemption fees. It would do so in a far more efficient and effective way, however, for two reasons. First, SOPs can be uniquely tailored to test for the presence of controls, policies and procedures designed to ensure compliance with one or more particular obligations. As a result, a compliance attestation based on one or more SOPs is a highly focused type of audit.[32] Second, our recommended approach significantly reduces the potential for unnecessary duplication of efforts in the auditing or testing of intermediaries' controls in this area. Under the proposed rule, hundreds (if not thousands) of funds each might have separate legal obligations to ensure that a particular intermediary is properly imposing redemption fees. Our recommended approach would allow an intermediary's receipt of a compliance attestation to satisfy the contractual obligations imposed through Rule 22c-2 for every fund with which it has an agreement.[33] For both of these reasons, we believe it would achieve the Commission's objectives in a more cost-effective manner than the proposed weekly information flow requirement.

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[29] Under our recommendation, the rule would expressly contemplate obligations for intermediaries that would extend beyond facilitating the proper assessment of redemption fees to cover the implementation of other fund restrictions on abusive short-term trading.

[30] The AICPA develops SOPs in accordance with the Statement on Standards for Attestation Engagements (SSAE) No. 10, Compliance Attestation: Revision and Codification (AICPA, Professional Standards, vol. 1, at Section 601). An SOP can instruct an auditor to review systems of internal controls and compliance with statutory, regulatory and contractual requirements, among other things.

[31] We recognize that crafting an SOP relating to such other restrictions on short-term trading may be challenging, but we believe incorporating an express requirement in the rule that facilitates the application of these restrictions would greatly enhance the ability of funds to curb abusive short-term trading. We believe this is consistent with what the Commission intended in proposing the weekly information flow requirement.

[32] This makes a compliance attestation preferable for these purposes to, for example, a "SAS 70" report, which is much broader in scope and thus less targeted to specific, relevant matters.

[33] Among other things, AICPA standards classify the accountant's report on its compliance attestation engagement as a "general use" report, meaning that it can be used by anyone. This is another advantage over a "SAS 70" report, which is a restricted use report that can be used only by customers of the entity that is the subject of the report.

IV. Transition Period

The Proposing Release does not specify the length of a transition period the Commission would expect to provide in the event it adopts the proposed new rule. Implementing a system for collecting redemption fees may entail changes to both funds' and intermediaries' policies, procedures, systems, disclosure documents and agreements. Accordingly, the Institute strongly recommends that the Commission provide a sufficiently long transition period prior to enforcing compliance with the new rule.

The length of time necessary to implement these changes largely will depend on the elements of the final rule. For example, far more time would be needed to implement a LIFO approach than a FIFO approach (for reasons discussed above). In addition, to the extent that the final rule requires agreements between funds and intermediaries to contain certain terms, appropriate time should be allowed to amend existing agreements and enter into agreements where necessary.

The Commission also should take into account other recent Commission initiatives that are either impacting or, upon adoption, will likely impact, funds' and intermediaries' systems, policies, and procedures. The cumulative effect of all of these initiatives will be to extend the length of time necessary to implement each one, including Rule 22c-2.

Finally, if the Commission agrees with our recommended compliance attestation approach, there would need to be a reasonable period after the final rule takes effect before the first compliance attestations would be required, simply because they could not be performed until after the final rule is in place and there is sufficient experience and data for the independent accountants' tests to be meaningful. We would recommend that this subsequent period be one year.[34]

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[34] It is our understanding that an SOP for Rule 22c-2 likely could be developed within a relatively brief time period, and in any event could be crafted after the final rule is adopted but before compliance is required. A compliance attestation requirement therefore would not be expected to cause any delays in the implementation of Rule 22c-2.

The Institute appreciates the opportunity to comment on this significant proposal. If you have any questions or need additional information, please contact me at (202) 326-5824, Frances M. Stadler at (202) 326-5822 or Robert C. Grohowski at (202) 371-5430.

Sincerely,

Amy B. R. Lancellotta
Acting General Counsel

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The Honorable Paul S. Atkins, Commissioner
The Honorable Roel S. Campos, Commissioner
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Harvey J. Goldschmid, Commissioner

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