

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 270

[Release No. IC-26375A; File No. S7-11-04]

RIN 3235-AJ17

### Mandatory Redemption Fees for Redeemable Fund Securities

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Securities and Exchange Commission ("Commission" or "SEC") is proposing a new rule 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. The redemption fee would be retained by the fund. 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.

**DATES:** Comments must be received on or before May 10, 2004.

**ADDRESSES:** To help us process and review your comments more efficiently, comments should be sent by one method only. Comments in paper format should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Comments in electronic format should be submitted to the following E-mail address: [rule-comments@sec.gov](mailto:rule-comments@sec.gov). All comment letters should refer to File No. S7-11-04; if E-mail is used, this file number should be included on the subject line. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549, and also will be available on the Commission's Internet Web site (<http://www.sec.gov>).<sup>1</sup>

**FOR FURTHER INFORMATION CONTACT:** Shaswat K. Das, Senior Counsel, or C. Hunter Jones, Assistant Director, Office of Regulatory Policy, (202) 942-0690, Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0506.

**SUPPLEMENTARY INFORMATION:** The Commission today is requesting public

<sup>1</sup> We do not edit personal, identifying information, such as names or E-mail addresses, from electronic submissions. Submit only information you wish to make publicly available.

comment on proposed rule 22c-2 [17 CFR 270.22c-2] and proposed amendments to rule 11a-3 [17 CFR 270.11a-3] under the Investment Company Act of 1940 [15 U.S.C. 80a] (the "Investment Company Act" or the "Act").

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### I. Background

Mutual funds are attractive to even the smallest investors because they offer easy access to national and international securities markets.<sup>2</sup> Mutual funds allow investors to pool their savings with those of other investors so that they may benefit from professional investment management, diversification, and liquidity. Fund shareholders share the losses and the gains of the fund, and also share its costs.

Some fund investors take advantage of this collective relationship by frequently buying and redeeming fund shares. These investors may frequently buy shares and soon afterwards sell them, in reaction to market news or because of a change of heart. Such excessive trading occurs at the expense of long-term investors, diluting the value of their shares.<sup>3</sup> It also may disrupt the

<sup>2</sup> In this release, we use the term "mutual fund" or "fund" to mean an open-end investment company that is registered or required to register under section 8 of the Investment Company Act [15 U.S.C. 80a-8], and includes a series of a registered investment company that is a series company. See proposed rule 22c-2(f)(2).

<sup>3</sup> See Jason Greene & Charles Hodges, *The Dilution Impact of Daily Fund Flows on Open-end Mutual Funds: Evidence and Policy Solutions*, 65 J. Fin. Econ., 131-158 (2002) (estimating annualized dilution from frequent trading, based on market timing, of 0.48% in international funds: "the dilution impact has brought about a net wealth transfer from passive shareholders to active traders in international funds in excess of \$420 million over a 26-month period."). See also Roger M. Edelen, *Investor Flows and the Assessed Performance of Open-end Mutual Funds*, 53 J. Fin. Econ. 439, 457 (1999) (quantifying the costs of liquidity in mutual funds as \$0.017 to \$0.022 per dollar of liquidity-motivated trading). See also Ken Hoover, *Why mutual funds discourage timers; Two forms of practice; They increase expenses, can disrupt portfolios and rob other investors*, Investor's Business Daily, Sept. 17, 2003, at A09.

management of the fund's portfolio and raise a fund's transaction costs because the fund manager must either hold extra cash or sell investments at inopportune times to meet redemptions.<sup>4</sup>

Some frequent fund traders seek short-term profits by buying and selling shares in anticipation of changes in market prices, e.g., market timing.<sup>5</sup> Some have exploited pricing inefficiencies in which the price of mutual fund shares does not accurately reflect the current market value of the securities held by the fund, i.e., time-zone arbitrage.<sup>6</sup> Mutual funds are a

<sup>4</sup> Frequent trading also may result in unwanted taxable capital gains for the remaining fund shareholders.

<sup>5</sup> The Commission has settled a number of enforcement actions alleging federal securities law violations by investment advisers who permitted market timing transactions in a manner inconsistent with the funds' stated policies. See, e.g., In re Massachusetts Financial Services Co., Investment Company Act Release No. 26347 (Feb. 5, 2004) (finding that investment adviser and two of its executives violated federal securities laws by allowing widespread market timing trading in certain funds in contravention of those funds' prospectus disclosures); In re Alliance Capital Management, L.P., Investment Company Act Release No. 26312 (Dec. 18, 2003) (finding that investment adviser violated federal securities laws by allowing market timing in certain of its mutual funds in exchange for fee-generating investments, or "sticky assets," in its hedge funds and other mutual funds); In re Putnam Investment Management, LLC, Investment Company Act Release No. 26255 (Nov. 13, 2003) (finding that investment adviser violated Investment Advisers Act and antifraud provisions of the federal securities laws by failing to disclose potentially self-dealing short-term trading of mutual fund shares by several of its employees, failing to take adequate steps to detect and deter such trading activity, and failing to supervise employees who committed violations); In re Connelly, Jr., Investment Company Act Release No. 26209 (Oct. 16, 2003) (finding that an executive of an investment adviser to a fund complex, in derogation of fund disclosures, violated federal securities laws by approving agreements that allowed select investors to market time certain funds in the complex).

We also have recently instituted numerous enforcement actions involving market timing. See, e.g., SEC v. Mutuals.com, Inc., Civil Action No. 303 CV 2912D (N.D. Tex. Dec. 4, 2003) (alleging that dually registered broker-dealer and investment adviser, three of its executives, and two affiliated broker-dealers assisted institutional brokerage customers and advisory clients in carrying out and concealing thousands of market timing trades and illegal late trades in shares of hundreds of mutual funds); SEC v. Invesco Funds Group, Civil Action No. 03-N-2421 (PAC) (D. Colo. Dec. 2, 2003) (alleging that investment adviser, with approval of its president and chief executive officer, entered into market timing arrangements with more than sixty broker-dealers, hedge funds, and advisers without disclosing these arrangements to the affected mutual funds' independent directors or shareholders); SEC v. Pilgrim, Baxter & Associates, Ltd., Civil Action No. 03-CV-6341 (E.D. Penn. Nov. 20, 2003) (alleging that investment adviser and two senior executives had permitted a hedge fund, in which one of the executives had a substantial financial interest, to engage in repeated short-term trading of several mutual funds). A number of state actions are also pending.

<sup>6</sup> See Bridget Hughes, *Deterring Market-Timers in International Funds*, Morningstar.com (Sept. 24,

prime vehicle for abusive market timing activity because they provide for daily redemptions and the long-term investors bear the transactional costs of those redemptions.

Many funds have taken steps to deter excessive trading or have sought reimbursement from traders for the costs of their excessive transactions.<sup>7</sup> These steps frequently include imposing redemption fees.<sup>8</sup> Today, funds that impose a redemption fee often charge a two percent fee for redeeming fund securities that are held for less than a certain amount of time, as described in the fund's prospectus.<sup>9</sup> These funds therefore have generally estimated their redemption-related costs to be at least two percent of amounts redeemed.<sup>10</sup>

2003) (available at <http://news.morningstar.com/doc/news/0,2,96909,00.html>); Elliot Blair Smith, *Investor Took Advantage of Time-Zone Lag*, USA Today, Sept. 15, 2003, at 3B; Kathleen Gallagher, *In Funds, It Can Be a Matter of Timing; Arbitrageurs Take Advantage of Price Inefficiencies*, Milwaukee Journal Sentinel, Nov. 30, 2003, at O1D. See also Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)] (adopting rule 38a-1 under the Investment Company Act) at nn. 40-42 and accompanying text ("When fund shares are mispriced, short-term traders have an arbitrage opportunity they can use to exploit a fund and disadvantage the fund's long-term investors by extracting value from the fund without assuming any significant investment risk.").

<sup>7</sup> Some of the approaches that funds have adopted include: (i) restricting exchange privileges, including delaying both the redemption and purchase sides of an exchange; (ii) limiting the number of trades within a specified period; (iii) delaying the payment of proceeds from redemptions for up to seven days (the maximum delay permitted under section 22(e) of the Act); and (iv) identifying market timers and restricting their trading or barring them from the fund. See also Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Investment Company Act Release No. 26287 (Dec. 11, 2003) [68 FR 70402 (Dec. 17, 2003)] (Commission proposed to require that funds provide specific disclosure regarding their market timing policies and practices concerning "fair valuation" of their portfolio securities).

<sup>8</sup> See Whitney Dow, *Redemption Fees Surge 82% Since 1999: Assessment Periods Lengthen, While Fees Remain Constant*, Financial Research Corporation (June 2001) (available at [http://www.frcnet.com/research/articles/art\\_prc\\_fee.asp](http://www.frcnet.com/research/articles/art_prc_fee.asp)) (stating that the number of funds that charge redemption fees nearly doubled from 2000 to March 2001). The Commission noted the use of redemption fees by funds in a 1966 report to Congress. *Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 89-2337, at 58, n.156 (1966) ("Redemption fees serve two purposes: (1) They tend to deter speculation in the fund's shares; and (2) they cover the fund's administrative costs in connection with the redemption.").

<sup>9</sup> Funds often provide disclosures describing the redemption fee in footnotes to the fee table of the prospectus. See Item 3 of Form N-1A. We anticipate that funds will continue to do so under the proposed rule.

<sup>10</sup> Because funds are limited to the lesser of the actual costs of redemptions or two percent, and

The Investment Company Act was enacted to protect the interests of mutual fund investors. Many provisions of the Act guard against overreaching by the fund's adviser. Other provisions, however, protect fund shareholders from each other.<sup>11</sup> One of the most important of these is section 22(c), which, together with our rule 22c-1, requires that each redeeming shareholder receive his pro rata portion of the fund's net assets. These provisions are designed to prevent dilution of the interests of fund shareholders.<sup>12</sup>

Today, we are using our authority under section 22(c) of the Act to propose a new rule requiring funds (with certain exceptions) to impose a two percent redemption fee on shares held for five business days or less.<sup>13</sup> Proposed rule 22c-2, which we describe in more detail below, is designed to reduce or eliminate the opportunity of short-term traders to exploit other investors in the mutual fund by (i) requiring them to reimburse the fund for the approximate redemption-related costs incurred by the fund as a result of

most funds that impose redemption fees charge a two percent fee, such funds must have redemption costs of at least two percent. See *infra* note 15.

The staff has stated that a redemption fee may recoup or offset the following expenses that are directly related to processing shareholder redemption requests: (i) Brokerage expenses incurred in connection with the liquidation of portfolio securities necessitated by the redemption; (ii) processing or other transaction costs incident to the redemption and not covered by any administrative fee; (iii) odd-lot premiums; (iv) transfer taxes; (v) administration fees; (vi) custodian fees; and (vii) registrar and transfer-agent fees. See Separate Accounts Funding Flexible Premium Variable Life Insurance Contracts, Investment Company Act Release No. 15651 (Mar. 30, 1987) [52 FR 11187 (April 8, 1987)] at text following n.74 (noting positions in SEC staff no-action letters).

<sup>11</sup> Many of the Act's prohibitions, such as the affiliated transaction provisions, apply to an "affiliated person" of a fund, which includes any person owning five percent or more of the outstanding voting securities of the fund. See section 2(a)(3) of the Act [15 U.S.C. 80a-2(a)(3)] (definition of "affiliated person"); section 17 of the Act [15 U.S.C. 80a-17] (prohibiting an affiliated person of a fund, and an affiliated person of such a person, from engaging in the purchase or sale of assets with the fund). Therefore, the Act prevents large shareholders from taking advantage of the fund and its other shareholders.

<sup>12</sup> See sections 22(a) and (c) of the Act [15 U.S.C. 80a-22(a) and (c)] (authorizing Commission rules "for the purpose of eliminating or reducing so far as reasonably practicable any dilution of the value of other outstanding securities of [a fund] or any other result of [a] purchase, redemption, or sale which is unfair to holders of such other outstanding securities \* \* \*").

<sup>13</sup> The proposed rule also applies to exchanges of securities issued by one fund for securities issued by another, because these transactions involve a redemption and purchase. See rule 11a-3 under the Act [17 CFR 270.11a-3] (regulating exchanges of fund securities, including the imposition of redemption fees). We also are proposing a conforming amendment to rule 11a-3.

their trades, and (ii) discouraging short-term trading of mutual fund shares by reducing the profitability of the trades.

Our proposal supplements the other measures the Commission has recently taken to address short-term trading, including abusive market timing activity.<sup>14</sup> As discussed in Section II.F., of this Release, our proposals are not designed to be an exclusive cure for the problem of abusive market timing, which often (but need not) involves rapid trading strategies. Conversely, our proposal is not designed to solely address large traders. The costs imposed on long-term investors in funds by the cumulative effect of many smaller short-term traders may be greater than those imposed by a few large traders. If adopted, the proposal would allow funds to recoup some, if not all, of these costs.

## II. Discussion

### 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.<sup>15</sup> Each fund, unless excepted, would have to impose the fee.<sup>16</sup>

<sup>14</sup> See, e.g., Compliance Programs of Investment Companies and Investment Advisers, *supra* note, (adopting new rules requiring funds and advisers to adopt and implement policies and procedures designed to prevent violations of the federal securities laws, including policies to assure that the fund complies with existing obligations to establish fair value for securities in appropriate circumstances); see also Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, *supra* note (proposing disclosure amendments concerning fund policies to detect and deter market timing activities).

<sup>15</sup> Although the two percent fee is designed to reimburse funds for the approximate costs associated with frequent trading, the fee itself would not be limited to particular costs associated with particular redemptions. Cf. John P. Reilly & Associates, SEC Staff No-Action Letter (July 12, 1979) (the staff would not recommend enforcement action if the redemption fee, subject to the at-cost standard, does not exceed two percent of the NAV of the redeemed shares); Separate Accounts Funding Flexible Premium Variable Life Insurance Contracts, *supra* note, at n. 74 (recognizing that staff informally has taken a position that a fund may impose a limited redemption fee to cover "legitimate expenses that may be incurred to make the payment in cash to a redeeming shareholder"); see also section 10(d)(4) of the Act [15 U.S.C. 80a-10(d)(4)] (providing that a fund may have a board consisting of all interested persons of the fund, except one independent director, if, among other things, "any premium over net asset value charged [by the fund] upon the issuance of any security, plus any discount from net asset value charged on redemption thereof, shall not in the aggregate exceed 2 per centum.").

<sup>16</sup> See *infra* Section II.E. for a discussion of the exceptions in proposed rule 22c-2.

The two percent redemption fee would therefore be both mandatory and uniform. It is mandatory because it would apply to all fund shares, including shares held by financial intermediaries, which will prevent funds from creating exceptions for certain intermediaries, such as broker-dealers, banks, and retirement plans.<sup>17</sup> The uniformity of the two percent fee is designed to simplify the implementation of the rule and better enable intermediaries that hold shares in omnibus accounts to establish and maintain systems to collect these fees. Moreover, absent a mandatory and uniform redemption fee, small funds may feel competitive pressures not to impose redemption fees, which could impose costs on their long-term investors and attract market timers to their funds. This proposed rule would place all funds (unless excepted) on an equal footing with respect to charging redemption fees. The rule also would apply to short-term transfers among subaccounts within variable annuity contracts.<sup>18</sup>

The two percent fee is designed to strike a balance between two competing

<sup>17</sup> According to the Investment Company Institute ("ICI"), 85 to 90 percent of mutual fund purchases are made through intermediaries. See Mutual Funds: Trading Practices and Abuses That Harm Investors, Testimony of Matthew Fink, President, ICI, before the Senate Subcommittee of Financial Management, the Budget and International Security, Committee on Government Affairs, 108th Cong., 1st Sess., 8 n.6 (Nov. 3, 2003) (available at <http://www.ici.org/statements/tmny.html>). A large portion of these fund investors invest through tax-advantaged retirement plans, such as 401(k) accounts. About one-third of all mutual fund shares are held through retirement accounts. See Investment Company Institute, *Mutual Funds and the U.S. Retirement Market in 2002*, Fundamentals, June 2003, at 1, 2.

<sup>18</sup> The ability to transfer assets among subaccounts on a tax-deferred basis makes variable annuities attractive to market timers. See Ian McDonald, *Mutual Fund Scrutiny Spreads to Annuities*, *The Wall Street Journal*, Nov. 7, 2003, at C1 ("[I]t is becoming clear that fund accounts that are part of the investment options for variable annuities also have been used by market timers to make profitable trades at the expense of long-term investors."); Stephen Schurr, *Annuities: The Other Variable in Abusive Fund Trading*, *TheStreet.com* (Nov. 14, 2003) (available at <http://www.thestreet.com/tscs/funds/stephenschurr/10125895.html>) ("[I]ndustry participants and watchers say a growing number of institutional clients have jumped in variable annuity contracts in recent years for market-timing purposes, because such contracts allow investors to move freely among funds on a tax-deferred basis."). See also Karen L. Skidmore, *Handling Market Timer Issues in Variable Insurance Products Through Cooperative Arrangements Between Insurance Company and Mutual Fund Sponsors*, Practising Law Institute at 380 (2001) ("Market timing has also become a prevalent issue in the variable annuity industry where investors are permitted to make a certain number of transfers per year among different sub-accounts within the insurance company separate account, without generating a commission fee.").

policy goals of the Commission—preserving the redeemability of mutual fund shares,<sup>19</sup> and reducing or eliminating the ability of shareholders who frequently trade their shares to profit at the expense of their fellow shareholders. It reflects the level of redemption fees that many funds today impose, and the maximum level our staff has long viewed as consistent with provisions of the Act that require mutual fund shares to be redeemable.<sup>20</sup> A higher fee could be more effective at stopping rapid trading,<sup>21</sup> but at a cost to ordinary investors who may be called upon to redeem to meet financial exigencies.

We request comment on the proposed mandatory redemption fee.

• Should the rule permit, rather than require, funds to charge a two percent redemption fee on the redemption of all securities held five days or less? If so, would funds have enough information to assess those fees on accounts held through financial intermediaries such as broker-dealers and banks?<sup>22</sup>

<sup>19</sup> During the legislative hearings on the Act, the Commission noted that "the most important single attribute which induces purchases of the securities of open-end companies by the public is the so-called 'redemption feature' of such securities—that is, the assurance that the shareholder may tender his shares to the company and receive at once, or in a very short time, the approximate cash asset value of such shares as of the time of tender." Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. On Banking and Currency, 76th Cong., 3d Sess. at 985 (1940) (memorandum introduced by David Schenker, Chief Counsel, SEC Investment Trust Study).

<sup>20</sup> Section 2(a)(32) of the Act [15 U.S.C. 80a-2(a)(32)] defines the term "redeemable security" as a security that entitles the holder to receive approximately his proportionate share of the fund's net asset value. The Division of Investment Management informally took the position that a fund may impose a redemption fee of up to two percent to cover the administrative costs associated with redemption, "but if that charge should exceed 2 percent, its shares may not be considered redeemable and it may not be able to hold itself out as a mutual fund." See John P. Reilly & Associates, SEC Staff No-Action Letter (July 12, 1979). This position is currently reflected in our rule 23c-3(b)(1) under the Act [17 CFR 270.23c-3(b)(1)], which permits a maximum two percent repurchase fee for interval funds and requires that the fee be reasonably intended to compensate the fund for expenses directly related to the repurchase of fund shares.

<sup>21</sup> See, e.g., Letter from Steve Bartlett, The Financial Services Roundtable, to Paul F. Roye, Director, Division of Investment Management, SEC (Nov. 10, 2003); Letter from Geof Gradler, Senior Vice President and Head, Office of Government Affairs, Charles Schwab & Co., Inc., to Paul F. Roye, Director, Division of Investment Management, SEC (Oct. 27, 2003); Letter from David B. Yeske, President, The Financial Planning Association to William H. Donaldson, Chairman, SEC (Nov. 7, 2003). These letters are available in File No. S7-11-04.

<sup>22</sup> See *infra* Section II.D.

• Is two percent the appropriate level for the mandatory redemption fee? Should it be higher or lower?

• Available data indicate that active trading in fund shares imposes significant costs on mutual funds.<sup>23</sup> We request further data on the magnitude and types of costs that funds bear as a result of the active trading by a small percentage of shareholders.<sup>24</sup>

• Does the two percent level approximate the transactional costs that funds incur as a result of frequent trading?

• Should the rule permit funds to impose a higher or lower fee? Would greater flexibility make it more costly for financial intermediaries to determine the applicability and amount of the fee? How would a higher fee affect the "redeemability" of the shares?

• Should redemption fees in excess of two percent be allowed only for certain types of funds?

• Should funds be permitted to voluntarily impose a fee higher than two percent outside the mandatory redemption fee period discussed below?

• We recently proposed a new point-of-sale disclosure rule, and changes to the rule governing the mutual fund confirmation document provided to fund investors.<sup>25</sup> Should the mandatory redemption fee be disclosed as part of either or both of these proposals?

### 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 days.<sup>26</sup> For example, funds that are particularly susceptible to abusive market timing activities may want to impose a longer

<sup>23</sup> See Roger M. Edelen, *Investor Flows and the Assessed Performance of Open-End Mutual Funds*, *supra* note 3 (estimating costs of the liquidity provided to investors by mutual funds).

<sup>24</sup> See Investment Company Institute, *Redemption Activity of Mutual Fund Owners*, Fundamentals, March 2001, at 1-3 (stating that the vast majority of fund shareholders do not frequently redeem their shares, and that a small percentage of shareholders account for the most active trading).

<sup>25</sup> See Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form of Mutual Funds, Investment Company Act Release No. 26341 (Jan. 29, 2004) [69 FR 6438 (Feb. 10, 2004)].

<sup>26</sup> Many funds that impose redemption fees require holding periods significantly longer than five days, typically ranging from 30 days to a year. For periods longer than five days, funds would continue to be limited to the lesser of the actual costs of redemptions or two percent. See *supra* note 15.

holding period.<sup>27</sup> A five-day holding period may be sufficient to deter much of the rapid trading activities we have seen, including those involving time-zone arbitrage, without imposing too heavy a burden on regular fund transactions.<sup>28</sup>

- Would a five-day holding period be sufficient to deter frequent trading, especially frequent trading due to abusive market timing?

- Should we prescribe a longer minimum holding period? Would there be less incentive to engage in abusive market timing if a longer holding period were imposed?<sup>29</sup> Would a shorter holding period be sufficient?

- Instead of only setting a *minimum* holding period, should the rule also set a *maximum* holding period for imposing any redemption fee?

- Would the flexibility the proposed rule gives to funds to determine the length of the holding period make it more difficult for financial intermediaries to determine the applicability of the fee?

- Should the rule contain a special provision addressing account transfers within the previous five days, *e.g.*, rollovers from a 401(k) plan to an Individual Retirement Account, to prevent the imposition of the redemption fee in those circumstances?

- Should the rule also apply to short-term transactions involving a redemption followed by a purchase within five days?

### C. Smaller Investors

We are sensitive to the potential effect of the proposed rule on smaller investors who may redeem their shares shortly after they purchase them because of unanticipated personal

<sup>27</sup> See Whitney Dow, *Redemption Fees Surge 82% Since 1999: Assessment Periods Lengthen, While Fees Remain Constant*, *supra* note 8 (study finding that, as of March 2001, the number of funds charging redemption fees increased 82% in the previous fifteen months, the size of the fee remained constant, and the length of the holding period increased from 7.5 months to 9.4 months).

<sup>28</sup> The vast majority of investors hold shares of their funds for more than five days. See Investment Company Institute, *Redemption Activity of Mutual Fund Owners*, *supra* note 24 at 2 (“vast majority of equity fund investors did not make a single redemption during the 12-month period ending January 1999”).

<sup>29</sup> See William Samuel Rocco, *Fighting Redemptions*, MORNINGSTAR.com (July 30, 2001) (available at <http://news.morningstar.com/doc/article/0,1,5086,00.html>) (Morningstar study found that a longer redemption fee holding period would make redemption fees more effective in deterring market timers during a market downturn: “[I]nvestors are only subject to [redemption fees] if they redeem within a specified period, which is often fairly short \* \* \* [which] suggests fund companies that are concerned about withdrawals during tough markets should consider redemption fees with longer holding periods.”).

financial circumstances. Therefore, we have included three provisions in the proposed rule that would diminish the effect of the redemption fee on the accounts of smaller investors.

First, funds would determine the amount of any fee by treating the shares held the longest time as being redeemed first, and shares held the shortest time as being redeemed last.<sup>30</sup> Also known as the “first in, first out” (“FIFO”) method, this is the method commonly employed by funds that charge redemption fees.<sup>31</sup> Use of the FIFO method would trigger redemption fees when large portions of an account are rapidly purchased and redeemed (a characteristic of abusive market timing transactions), but not when small portions of an account held over a longer period are redeemed.<sup>32</sup> Thus, most transactions normally made by most investors would not be subject to the fee.

- Would use of a LIFO method of determining the redemption fee be more effective in combating market timing transactions?<sup>33</sup> Would the answer turn on the amount of the *de minimis* exception, which we discuss below? Are there other methods of accounting for shares that are preferable?

Second, funds would be required to impose the redemption fee only on redemptions if the amount of the shares redeemed is greater than \$2,500.<sup>34</sup> As a result, an investor could redeem shares without paying a fee if the fee would be \$50 or less. We are proposing this threshold amount to allow the fund not to charge the fee for smaller redemptions that may not be disruptive to the fund, including redemptions of

<sup>30</sup> See proposed rule 22c-2(d).

<sup>31</sup> See NASD, Report of the Omnibus Account Task Force Members, Jan. 30, 2004, at 8 (“Omnibus Report”) (available in File No. S7-11-04).

<sup>32</sup> The application of the FIFO method also has the advantage of eliminating the need to include in the rule exceptions for numerous types of transactions in shareholder accounts that might regularly result if we used the last in, first out (“LIFO”) method, but which do not bear the characteristics of market timing transactions. These transactions include redemptions subsequent to purchases pursuant to dividend reinvestment plans, automatic purchase plans, and automatic account rebalancing arrangements. The \$2,500 *de minimis* provision discussed below would prevent the application of the redemption fee when a redemption of all shares (including the most recently purchased shares) occurs shortly after a purchase of such shares as a result of one of these arrangements.

<sup>33</sup> Investors could use multiple accounts to circumvent a redemption fee based on a LIFO method of accounting for the holding of shares. Therefore, use of such an approach might require intermediaries to transmit the account holder’s taxpayer identification number (“TIN”) and require the fund to match transactions with the same TIN to determine the applicability of the redemption fee.

<sup>34</sup> See proposed rule 22c-2(e)(1)(i).

shares purchased during the previous five days through a dividend investment plan or some other automatic investment plan.<sup>35</sup> This approach permits a fund to perform its own cost-benefit analysis and determine whether the costs of collecting redemption fees in small amounts are worth the benefits.

This *de minimis* provision therefore 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. We also propose—as an alternative to this approach—that the rule *require* funds to forego the assessment of redemption fees if the amount of the shares redeemed is \$2,500 or less.<sup>36</sup> This mandatory approach thus would prohibit funds from collecting these smaller redemption fees of \$50 or less, under any circumstance. The uniformity of this approach across all funds may be advantageous for intermediaries who collect redemption fees on behalf of funds.

- Do these provisions sufficiently address the concerns of small investors?

- Do they sufficiently distinguish harmful rapid trading from occasional financial transactions that may involve a purchase of fund shares followed by a redemption?

- Conversely, would the thresholds permit a substantial amount of harmful rapid trading to occur?

- Many funds that currently impose redemption fees do not allow for any *de minimis* waivers of the fees to reimburse the fund for the costs of a relatively small number of shareholders that actively trade their shares.

- Would a mandatory *de minimis* exception serve to remove the reimbursement arrangements and protections against short-term trading that these funds have already established?

- Would a *de minimis* threshold of \$2,500 limit the effectiveness of the rule in reimbursing the fund for the costs of rapid trading by smaller investors?

- Would the failure of the Commission to adopt a mandatory *de minimis* threshold allow funds to unfairly deny smaller shareholders the ability to actively trade their funds?

- Should the *de minimis* threshold be higher (*e.g.*, \$5,000 or \$10,000) or lower (*e.g.*, \$2,000 or \$1,000)?

- Should the *de minimis* threshold be mandatory at one level (*e.g.*, \$2,500) and

<sup>35</sup> The exception also is designed to allow funds to avoid the administrative cost of imposing a redemption fee when the costs of collecting the fee may outweigh the amount of the fee itself.

<sup>36</sup> If we were to adopt this alternative approach, paragraph (e)(1) of the proposed rule would be revised accordingly.

voluntary up to another level (e.g., \$10,000)?

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.<sup>37</sup> The fund would be *required* to waive the fee on redemptions of \$10,000 or less. The fund also would be *permitted* to waive the fee on redemptions greater than \$10,000 in these emergency circumstances. This exception is designed to permit shareholders access to their investment when they need to meet unforeseen financial demands, such as payment for emergency surgery, soon after they purchased their shares. We request comment on this exception.

- Should this exception be mandatory rather than discretionary, on the part of the fund, regardless of the amount of the shares redeemed?

- Should the rule define the circumstances that would constitute an unanticipated financial emergency?<sup>38</sup>

- If so, what should those circumstances include? Should they include, for example, (i) death, disability, or other specific personal emergencies, (ii) personal economic hardship or unanticipated changes in personal circumstances, or (iii) emergencies such as market breaks or major political or economic events?

- What are the likely costs to funds of administering the financial emergency exception?

- Should the rule limit the number of emergency waivers that a shareholder may request, or that a fund may grant?

- Should funds be permitted to waive the redemption fee in other circumstances, such as purchases made in error, or purchases within the five-day period due to automatic investment or reinvestment programs?

#### D. Shareholder Accounts and Intermediaries

Many investors' holdings in mutual funds are through accounts held by broker-dealers, banks, insurance companies, and retirement plan administrators. Many of these holdings are on the books of the fund (or its transfer agent) in the name of the intermediary, rather than in the name of

the fund shareholder. Intermediaries controlling these so-called "omnibus accounts" often provide the fund with insufficient information for the fund to apply redemption fees. Indeed, today many funds choose not to apply redemption fees, or their policies against market timing, to shares held through these omnibus accounts. A number of the market timing abuses identified through our examinations and investigations reveal that certain shareholders were concealing abusive market timing trades through omnibus accounts.<sup>39</sup> As a result, those shareholders have often been beyond the reach of fund directors' efforts to protect the fund and its shareholders from the harmful effects of short-term trading.<sup>40</sup>

Last year, to address this serious and growing problem, Chairman Donaldson requested that the NASD convene a panel of experts from the brokerage, money management and retirement plan communities to create greater transparency of shareholder account activities.<sup>41</sup> Its findings have been very useful to us in fashioning provisions of today's proposal on redemption fees.

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.<sup>42</sup> 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.<sup>43</sup> This information will

<sup>39</sup> See, e.g., SEC v. Security Trust Company, *et al.*, Civil Action No. 03-2323 (D. Ariz. Nov. 24, 2003) (alleging that Security Trust Company ("STC"), an unregistered financial intermediary, in an attempt to conceal a hedge fund's market timing activities from mutual funds, opened five omnibus accounts for the hedge fund through which the hedge fund's trades were rotated to evade detection by the mutual funds. STC also allegedly opened mirror accounts for the five omnibus accounts using STC's taxpayer identification number, which approach was intended to impede efforts by mutual fund companies to detect market timers by their tax identification numbers).

<sup>40</sup> The state civil complaint in *New York v. Canary Capital Partners, LLC, Canary Investment Management, et al.*, (N.Y.S. Ct. filed Sept. 3, 2003) at para. 46, illustrates this practice: "Timers \* \* \* trade through brokers or other intermediaries \* \* \* who process large numbers of mutual fund trades every day through omnibus accounts where trades are submitted to mutual fund companies *en masse*. The timer hopes that his activity will not be noticed among the 'noise' of the omnibus account."

<sup>41</sup> See Letter from William H. Donaldson, Chairman, SEC, to Mary L. Schapiro, Vice Chairman and President, NASD (Nov. 17, 2003). This letter is available in File No. S7-11-04.

<sup>42</sup> See proposed rule 22c-2(b).

<sup>43</sup> See proposed rule 22c-2(b)(1).

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.<sup>44</sup> 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 fees and remit the proceeds to the fund.<sup>45</sup> 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.<sup>46</sup>

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.<sup>47</sup> This information is designed to enable the fund to confirm that fund intermediaries are properly assessing the redemption fees.<sup>48</sup> It also would

<sup>44</sup> See proposed rule 22c-2(b)(2).

<sup>45</sup> See proposed rule 22c-2(b)(3). The Omnibus Account Task Force found this method to be the most viable approach. See Omnibus Report, *supra* note 31, at 2.

<sup>46</sup> Under the second and third methods, funds would be responsible for ensuring that intermediaries are properly determining the fee, or assessing it.

<sup>47</sup> See proposed rule 22c-2(c). This proposed approach was recommended by the Omnibus Account Task Force. See Omnibus Report, *supra* note , at 7. See also, e.g., Letter from Niels Holch, Executive Director, Coalition of Mutual Fund Investors, to William H. Donaldson, Chairman, SEC (Dec. 12, 2003) (available in File No. S7-11-04). A fund that receives this information pursuant to the proposed rule would not be able to use the information for its own marketing purposes, unless permitted under the intermediary's privacy policies. See sections 248.11(a) and 248.15(a)(7)(i) of Regulation S-P [17 CFR 248.11(a) and 248.15(a)(7)(i)].

<sup>48</sup> See, e.g., Jonas Max Ferris, *Next Scandal: Brokers?*, *The Street.com*, Nov. 26, 2003, (available

<sup>37</sup> See proposed rule 22c-2(e)(1)(ii).

<sup>38</sup> See, e.g., 26 CFR 1.457-6(c)(2)(i) (2003) ("An unforeseeable emergency must be defined in the plan as a severe financial hardship of the participant or beneficiary resulting from an illness or accident of the participant or beneficiary, the participant's or beneficiary's spouse, or the participant's or beneficiary's property due to casualty \* \* \* or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant or the beneficiary \* \* \*").

permit funds to detect market timers who a fund has prohibited from purchasing fund shares and who attempt to enter the fund through a different account. In addition, this may in some cases be helpful to funds that would be able to use the information to determine whether shareholders received appropriate breakpoint discounts on purchases of fund shares sold with a front-end sales load.<sup>49</sup>

- Would the account information provided by the intermediaries to the funds be sufficient for the funds to properly assess the fees?
- Should financial intermediaries provide shareholder identity and transaction information to the fund or its transfer agent more (or less) frequently than weekly?
- Should the rule limit the number of ways that redemption fees may be assessed, in order to promote greater uniformity in the enforcement of redemption fees across funds and their intermediaries?
- Should the rule require funds to match shareholder purchases and redemptions that occur through multiple accounts or intermediaries?
- With respect to foreign shareholders, who do not have a TIN, what alternative shareholder identity information should financial intermediaries send to funds?
- Should we require that funds retain their agreements with the financial intermediaries as part of their recordkeeping obligations?
- Are there additional ways to identify market timing trades that are executed through the use of multiple accounts, multiple customer account numbers, intermediaries, or any other means designed to evade detection?

at <http://www.thestreet.com/tscs/jonasmxferris/10128667.html>) ("Could a discount broker "forget" to collect a fund's short-term redemption fee as stated in the fund's prospectus? "Omnibus accounting offers interesting ways to cloak illicit trades from a fund, including matching retail buys and sells against big-money accounts taking the opposite trade at opportune times."). In addition, more than one individual may trade through a particular account, in which case more than one TIN may be associated with the account. Providing this TIN information to the fund may enable the fund to determine whether a redemption fee should be charged on a redemption in that account.

<sup>49</sup> See Disclosure of Breakpoint Discounts by Mutual Funds, Investment Company Act Release No. 26298 (Dec. 17, 2003) [68 FR 74732 (Dec. 24, 2003)] (proposed amendments to Form N-1A to require that funds disclose sales load breakpoint discount arrangements and methods for calculating discounts, based on recommendations of Joint NASD/Industry Task Force on Breakpoints and results of a joint examination sweep by the Commission, NASD, and NYSE of broker-dealers revealing that most firms in some instances did not provide investors with breakpoint discounts for which they appeared to have been eligible).

• We also request comment on the administrative and legal issues that insurance companies and their underlying funds would face as a result of this rule.<sup>50</sup>

#### E. Exceptions

Proposed rule 22c-2 would include four exceptions to the mandatory redemption fee.<sup>51</sup> First, as discussed above,<sup>52</sup> the rule would not require funds to collect redemption fees on redemptions of \$2,500 or less, and would provide for fee waivers in the case of financial emergencies.<sup>53</sup> Second, the rule would exempt money market funds from its scope.<sup>54</sup> Money market funds seek to obtain a stable net asset value of one dollar per share, and often are used for short-term investments. They are therefore designed to accommodate frequent purchases and redemptions, and do not appear to be susceptible to the harms caused by excessive trading; in fact, they are designed to facilitate frequent trading.

Third, the rule would not apply to exchange-traded funds ("ETFs").<sup>55</sup> Shares issued by ETFs are listed on stock exchanges and, like the shares of other listed operating companies, trade at negotiated prices on securities exchanges. An ETF redeems shares or units in large blocks, or "creation units," and redemptions of these units serve to correct the price of individual shares on the secondary market.<sup>56</sup> These

<sup>50</sup> See Letter from Stephen E. Roth and W. Thomas Conner, Sutherland, Asbill & Brennan LLP, to Paul F. Roye, Director, Division of Investment Management, SEC (Feb. 10, 2004). This letter is available in File No. S7-11-04.

<sup>51</sup> See proposed rule 22c-2(e). The rule would not permit funds to exclude other types of funds or redemptions during the five-day holding period. (Funds that establish longer holding periods, however, would be free to provide exceptions from redemption fees imposed on shares held longer than five days.) Thus, a fund could not waive redemption fees for some investors (e.g., favored institutional clients, fund employees, or fund directors) but apply them to others. See Testimony of Don Phillips, Managing Director, Morningstar Inc., on "Mutual Funds: Who's Looking Out for Investors," Before the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services, 108th Cong., 1st Sess. (Nov. 4, 2003) (available at <http://news.morningstar.com/doc/article/0,1,99258,00.html>) ("From our conversations with fund managers, it is clear that they believe that redemption fees are the best deterrent to market timers. Of course, a fee is only effective if it is enforced. We think that funds must be much less lax in waiving fees for bigger accounts or for 401(k) plans, and that directors should be informed when and under what conditions these fees may be waived.").

<sup>52</sup> See *supra* Section II.C.

<sup>53</sup> See proposed rule 22c-2(e)(1).

<sup>54</sup> See proposed rule 22c-2(e)(2)(i).

<sup>55</sup> See proposed rule 22c-2(e)(2)(ii).

<sup>56</sup> See Actively Managed Exchange-Traded Funds, Investment Company Act Release No. 25258, at nn.

redemptions therefore are unlikely to pose risks of harm to the fund.<sup>57</sup>

Finally, proposed rule 22c-2 would not apply to any fund that (i) adopts a fundamental policy to affirmatively permit short-term trading in all of its redeemable securities,<sup>58</sup> 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.<sup>59</sup> This exception is designed to permit funds and investors the freedom to invest in funds that affirmatively disclose their intent to allow short-term trading. Some short-term traders find these types of funds to be attractive vehicles. We are reluctant to propose a rule that would prohibit such funds and investors from achieving their objectives by requiring the funds to impose a redemption fee.

- Should other types of funds also be excepted from the rule?

#### F. Request for Further Comment on Rule 22c-2

The proposed mandatory redemption fee is designed to work together with our other regulatory initiatives and with tools fund managers already have at their disposal to curb harmful market timing transactions.<sup>60</sup> Fund managers can use information they receive about transactions in omnibus accounts to take steps to better enforce market timing policies, including barring market timers from the fund. Tighter controls on information about portfolio holdings will make successful market timing transactions more difficult.<sup>61</sup> While a mandatory redemption fee would reduce the profitability of abusive market timing trades, standing

6-8 and accompanying text (Nov. 8, 2001) [66 FR 57614 (Nov. 15, 2001)].

<sup>57</sup> In addition, redeeming shareholders generally pay transaction fees to the ETF to cover the costs associated with redemptions. See Gary L. Gastineau, *The Exchange-Traded Funds Manual* (2002).

<sup>58</sup> A fundamental policy can be changed only by a majority vote of the outstanding voting securities of the fund. See section 8(b) of the Act [15 U.S.C. 80a-8(b)].

<sup>59</sup> See proposed rule 22c-2(e)(2)(iii).

<sup>60</sup> See *supra* note 7 and accompanying text.

<sup>61</sup> See Compliance Programs of Investment Companies and Investment Advisers, *supra* note 6, at nn. 54-56 and accompanying text (a fund's compliance policies and procedures should address potential misuses of nonpublic information, including the disclosure to third parties of material information about the fund's portfolio); see also Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, *supra* note 7, at nn. 52-67 and accompanying text (proposal to require open-end management investment companies and insurance company managed separate accounts that offer variable annuities to disclose their policies and procedures with respect to the disclosure of their portfolio securities, and any ongoing arrangements to make available information about their portfolio securities).

alone it would be unlikely to deter abusive market timing transactions in which the profits are expected to exceed the fee, or that do not involve short-term transactions.<sup>62</sup>

A significant proportion of abusive market timing has been designed to exploit systematic pricing discrepancies between the value assigned to a fund's portfolio securities for purposes of calculating the fund's net asset value and the "fair value" of those portfolio securities. We believe that the use of fair value pricing, as required by the Act,<sup>63</sup> can reduce or eliminate the arbitrage opportunities that these market timers seek, and that the primary response of funds and fund managers must, therefore, be to more accurately calculate the daily net asset value of the fund by using fair value pricing methods when closing prices are unreliable.<sup>64</sup>

Recent experience has shown, however, that the requirement to implement fair value pricing has not always been sufficient to eliminate these arbitrage opportunities. One possible reason is that fair value pricing involves subjective judgments that leave open the possibility of market timing, albeit at reduced profits.<sup>65</sup> Another possibility is

<sup>62</sup> See Conrad S. Ciccotello, Roger M. Edelen, Jason T. Greene and Charles W. Hodges, *Trading at Stale Prices and Modern Technology: Policy Options for Mutual Funds in the Internet Age*, 7 VA J.L. & Tech. 6, at nn. 141-144 and accompanying text ("Redemption fees can be quite effective in reducing stale price trading." However, "redemption fees cannot address the problems caused by large market moves. For example, in the 1997 Asian Crisis, a fourteen-percent overnight return was available based on the Hong Kong market. At that point, even a two-percent redemption fee would not deter stale price traders.").

<sup>63</sup> The Investment Company Act requires funds to calculate their net asset values using the market value of portfolio securities when market quotations are readily available. Section 2(a)(41) [15 U.S.C. 80a-2(a)(41)] of the Investment Company Act and rule 2a-4 [17 CFR 270.2a-4]. If a market quotation for a portfolio security is not readily available (or is unreliable), the fund must establish a "fair value" for that security, as determined in good faith by the fund's board. See Pricing of Redeemable Securities for Distribution, Redemption, and Repurchase, Investment Company Act Release No. 14244 (Nov. 21, 1984) [49 FR 46558 (Nov. 27, 1984)] at n. 7 (proposing amendments to rule 22c-1).

<sup>64</sup> Fair value pricing takes after-market-close events into account in determining the fund's daily net asset value. In a release recently adopting rule 38a-1, we reiterated the obligation of funds to fair value their securities under certain circumstances to reduce market timing arbitrage opportunities and to have procedures to meet these obligations. See Compliance Programs of Investment Companies and Investment Advisers, *supra* note 6.

<sup>65</sup> See Frederick C. Dunbar and Chudozie Okongwu, (*Market Timing is (Not) Everything*, Wallstreetlawyer.com, Oct. 2003. ("There are many possible ways to adjust pricing. The goal is to adjust the stale prices of the securities held by a fund by the predicted effect of the information that becomes known between each security's last trade and the

that some funds have applied fair value pricing inconsistently, or only to the most egregious pricing discrepancies. While a mandatory redemption fee may reduce, or eliminate, arbitrage profit opportunities, we are also actively considering ways in which the implementation of fair value pricing could be improved.

Our examination staff is in the process of gathering information about funds' current fair value pricing practices, and we have directed the staff of the Division of Investment Management to examine the fair value pricing methodologies used by the funds and the quality of pricing those methodologies yield, for purposes of evaluating whether there are additional measures that we could take to improve funds' fair value pricing. In connection with our consideration of these issues, we will be seeking additional comment on specific issues related to fair value pricing.<sup>66</sup> However, at this time we ask commenters to address generally fair value pricing as it relates to abusive market timing. What areas of uncertainty do funds face when trying to fair value their portfolio securities? Are there areas of uncertainty that could be resolved with further guidance from us? If funds implement fair value pricing effectively, is a mandatory redemption fee unnecessary to address abusive market timing?<sup>67</sup>

After reviewing all information, we will consider whether to issue additional interpretive guidance or undertake further rulemaking with respect to fair value pricing. Those additional comments and information will be relevant to our decision whether a mandatory redemption fee is necessary or appropriate to deter abusive market timing.

We request comment on whether there are additional tools that the Commission should consider to combat harmful market timing transactions.

- Should the Commission require that funds determine the value of purchase and redemption orders at the net asset

pricing of the fund. However, such adjustments are costly to produce and inexact at best.").

<sup>66</sup> Such a request for comment could include, for example, whether we should adopt a rule requiring funds to regularly review the appropriateness and accuracy of methods used in valuing securities. Currently such a practice must be a part of a fund's compliance policies and procedures. See Compliance Policies and Programs of Investment Companies and Investment Advisers, *supra* note 14 at Section II.A. In addition, we could request comment on whether we should adopt a rule clarifying when a fund must re-calculate its net asset value when it has re-priced portfolio securities.

<sup>67</sup> We recognize, however, that a redemption fee may nonetheless be necessary to address the costs of short-term trading discussed previously.

value calculated the *next* day after it receives those orders, rather than at the time that the fund next calculates its NAV? Under such an approach, market timers would not be able to predict whether the next day's NAV would be higher or lower and, therefore, would not be able to trade profitably. On the other hand, such an approach would diminish ordinary investors' ability to promptly effect their mutual fund investment decisions.

- Are there other means to discourage abusive market timing that we should consider?

### III. General Request for Comment

The Commission requests comment on proposed rule 22c-2, suggestions for additions to the proposed rule, and comment on other matters that might have an effect on the proposal contained in this Release. We note that comments are more helpful if they include supporting data and analysis.

### IV. Cost-Benefit Analysis

The Commission is sensitive to the costs and benefits imposed by its rules. As discussed above, proposed rule 22c-2 would require that funds impose a two percent redemption fee on the redemption of fund shares within five days of purchase.

#### A. Benefits

We anticipate that funds and shareholders would benefit from the proposed rule. The rule is designed to reimburse a fund for the costs of short-term trading in fund shares. Short-term trading can raise transaction costs for the fund, disrupt the fund's stated portfolio management strategy, require maintenance of an elevated cash position, and result in lost investment opportunities and forced liquidations. Short-term trading also can result in unwanted taxable capital gains for fund shareholders and reduce the fund's long-term performance. Excessive trading also can dilute the value of fund shares held by long-term shareholders if a short-term trader, or "market timer," buys and sells shares rapidly to take advantage of market inefficiencies when the price of a mutual fund does not reflect the current market value of the stocks held by that mutual fund. Dilution could occur if fund shares are overpriced and short-term traders receive proceeds based on the overvalued shares. Although short-term traders can profit from engaging in frequent trading of fund shares, the costs associated with such trading are borne by all fund shareholders.

To the extent that the rule discourages short-term trading, long-term investors

may have more confidence in the financial markets as a whole, and funds in particular. Funds would benefit by the increase in investor confidence because long-term investors would be less likely to seek alternative financial products in which to invest. Because the fund retains the redemption fee, long-term shareholders are essentially reimbursed for some, if not all, of the redemption costs caused by the short-term traders.

#### B. Costs

Currently, some funds already impose redemption fees on redemptions made within a specified period of time, often thirty days to a year. The proposed rule would likely result in minimal costs for those funds. With respect to funds that do not currently impose redemption fees, the proposed requirement of a mandatory two percent redemption fee also would likely result in a minimal burden.

With respect to omnibus accounts, we recognize that the proposed rule, if adopted, may result in costs for funds and their intermediaries. The costs to a fund's transfer agent to store the shareholder information and track the trading activity may be significant, and those costs may ultimately be passed on to investors.<sup>68</sup> In some cases, the transfer agent will have to upgrade its recordkeeping systems; however, some transfer agents may have software that can be used, or modestly modified, to accommodate the matching of purchases and redemptions. In addition, with respect to funds and their transfer agents, the costs of storing the data will be mitigated because the proceeds of the two percent redemption fee will be retained by the funds for the benefit of their long-term shareholders. We seek comments on these costs, and whether they are justified by the benefits of the proposed rule.

We also recognize that the proposed rule, if adopted, may impose some costs on financial intermediaries that will have to upgrade their software or other technology because their systems currently may not be able to either transmit the shareholder data or track trading patterns of individual accountholders.<sup>69</sup> If financial

intermediaries, such as retirement plan administrators, find it too expensive to upgrade their systems, potential investors may end up investing in alternative financial products. In some cases, however, the costs may be substantially less for broker-dealers and other intermediaries that already have transfer agent systems in place that can be modified to identify short-term trading.<sup>70</sup> We seek comments on these costs, and whether they are justified by the benefits of the proposed rule.

With respect to the method of determining which shares are subject to the redemption fees, we considered the benefits and costs associated with adopting a LIFO method compared to a FIFO approach, the current method used by most funds to impose redemption fees. We understand that the LIFO method may entail substantially greater costs than FIFO. Moreover, unlike FIFO, the use of LIFO may warrant the exclusion of certain transactions, such as investments made through a periodic purchase plan. Thus, the use of LIFO may add a level of complexity to the administration of the redemption fee, particularly in omnibus accounts, which could result in additional costs.

#### C. Request for Comment

The Commission requests comment on the potential costs and benefits of the proposed rule. We also request comment on the potential costs and benefits of any alternatives suggested by commenters. We encourage commenters to identify, discuss, analyze, and supply relevant data regarding any additional costs and benefits. For purposes of the Small Business Regulatory Enforcement Act of 1996,<sup>71</sup> the Commission also requests information regarding the potential annual effect of the proposals on the U.S. economy. Commenters are requested to provide empirical data to support their views.

#### V. Paperwork Reduction Act

Certain provisions of proposed rule 22c-2 would result in new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.<sup>72</sup> The Commission is submitting this proposal to the Office of Management and Budget ("OMB") for

[redemption] fees will raise additional costs to plan participants."

<sup>68</sup> Many funds already pay the intermediaries who sell their funds for the recordkeeping they perform for omnibus accounts.

<sup>69</sup> See, e.g., Letter from Edward L. Yingling, American Bankers Association, to Paul F. Roye, Director, Division of Investment Management, SEC (November 12, 2003) (available File S7-11-04). The American Bankers Association noted that redemption fees would increase 401(k) plan costs: the "need to set accounting processes for those accounts and to administer the movement of

review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title for the collection of information requirements is "Rule 22c-2 under the Investment Company Act of 1940, 'Redemption fees for redeemable securities.'" An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

#### A. Omnibus Accounts

As discussed above, we are proposing rule 22c-2 to require a mandatory two percent redemption fee to be applied on all redemptions of fund shares held five business days or less, subject to certain narrow exceptions. To ensure that the redemption fees are applied uniformly, fund shares held by financial intermediaries in omnibus accounts must be subject to the fee.

The rule would provide three methods by which a fund could assess and collect the redemption fees on shares held through omnibus accounts. The fund could direct the financial intermediary to: (i) Provide the fund, upon submission of each purchase and redemption order, the account number used by the financial intermediary to identify the shareholder (paragraph (b)(1)); (ii) provide the fund, as to redemption orders upon which the fund must charge a redemption fee, transaction and holdings information sufficient to permit the fund to assess the amount of the redemption fee (paragraph (b)(2)); or (iii) assess the redemption fee and remit the fee to the fund (paragraph (b)(3)). In addition, regardless of the approach selected above, at least once weekly, the fund must receive from the financial intermediary the TIN of all shareholders that purchased or redeemed shares held in omnibus accounts, and the amount and dates of such shareholder purchases and redemptions (paragraph (c)).

The Commission staff estimates that there are currently 3,100 active registered open-end investment companies and that each fund (or its transfer agent) would be required to collect redemption fees on transactions in omnibus accounts. We also estimate that about (i) 15 percent of all funds would receive information from intermediaries according to the approach set forth in paragraph (b)(1), (ii) 35 percent of all funds would receive information from intermediaries according to the approach set forth in paragraph (b)(2), and (iii) 50 percent of all funds would arrange for intermediaries to assess the redemption fees, pursuant to paragraph (b)(3). These collection of information requirements

<sup>70</sup> Broker-dealers using National Securities Clearing Corporation already transmit TINs to fund transfer agents for certain types of "networking" arrangements. See Omnibus Report, *supra* note 31, at 4, n. 6.

<sup>71</sup> Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996).

<sup>72</sup> 44 U.S.C. 3501-3520.

would be mandatory because a fund must receive the above information from the financial intermediary to ensure that redemption fees are properly assessed in omnibus accounts.

Regardless of the approach selected, we anticipate that all funds would have to modify their agreements or contracts with their intermediaries. This modification would create a one-time burden of 4.5 hours per fund (4 hours by in-house counsel, .5 hours by support staff)<sup>73</sup> for a total burden of 13,950 hours.<sup>74</sup>

#### 1. Funds: Paragraph (b)(1)

As noted above, 15 percent of all funds (*i.e.*, 465 funds) are expected to select the option set forth in paragraph (b)(1). The Commission staff estimates, based on information provided by funds, that the one-time burden on a fund to develop or upgrade its systems for the storage of information received from intermediaries, evaluate transactional data to match purchases and redemptions within a shareholder's account, and assess redemption fees would be 300 burden hours, for an aggregate burden of 139,500 hours for all funds.<sup>75</sup> We estimate the start-up costs required to store and process information necessary to assess redemption fees to be \$560,000 per fund, for an aggregate cost of \$260,400,000 for all funds.<sup>76</sup>

In addition, funds also would have an ongoing burden to operate and maintain systems to store and process information necessary to impose redemption fees in omnibus accounts. Based on information provided by funds, we estimate this burden to be 300 hours annually per fund, for an aggregate burden of 139,500 hours.<sup>77</sup> The operation and maintenance costs would be \$6,640 per fund, for an aggregate cost of \$3,087,600 for all funds.<sup>78</sup>

#### 2. Funds: Paragraph (b)(2)

As noted above, 35 percent of all funds (*i.e.*, 1,085 funds) are expected to select the option set forth in paragraph (b)(2). Under paragraph (b)(2) of the rule, the Commission staff estimates, based on information provided by funds, that the one-time burden on funds to develop or upgrade their systems for the storage of information received from intermediaries, evaluate

transactional data to match purchases and redemptions within a shareholder's account, and assess redemption fees would be 300 burden hours per fund, for an aggregate burden of 325,500 hours for all funds.<sup>79</sup>

We estimate the start-up costs required to store and process information necessary to assess redemption fees to be \$560,000 per fund, for an aggregate cost of \$607,600,000 for all funds.<sup>80</sup> We estimate the annual ongoing operation and maintenance costs would be \$6,640 for an aggregate cost of \$7,204,400 for all funds.<sup>81</sup> We estimate the ongoing collection of information burden on funds to be 300 hours per fund, for an aggregate burden of 325,500 hours.<sup>82</sup> The operation and maintenance costs would be \$6,640 per fund for an aggregate cost of \$7,204,400 for all funds.<sup>83</sup>

#### 3. Funds: Paragraph (b)(3)

As noted above, 50 percent of all funds (*i.e.*, 1,550 funds) are expected to select the option set forth in paragraph (b)(3). Under paragraph (b)(3), the fund and intermediary would enter into an agreement whereby the intermediary itself would assess the fee. Under this approach, funds would not receive any shareholder data from intermediaries. Therefore, there would be no collection of information requirements for funds.

#### 4. Intermediaries: Paragraphs (b)(1)–(3)

The Commission staff estimates that there are currently approximately 6,800 financial intermediaries (2,203 broker-dealers classified as specialists in fund shares, 2,400 banks,<sup>84</sup> 196 insurance companies sponsoring registered separate accounts organized as unit investment trusts, and approximately 2,000 retirement plan administrators) that would be required to transmit

certain transactional and periodic information to the fund as outlined in Section II.D. For the purpose of these estimates, with respect to the transaction information under paragraph (b), we have assumed that about 15 percent of intermediaries would supply the transactional information to the fund pursuant to paragraphs (b)(1), 35 percent of intermediaries would supply the transactional information pursuant to paragraph (b)(2) of the proposed rule, and about half of the intermediaries themselves would assess the redemption fee pursuant to paragraph (b)(3) of the rule.

Under paragraph (b)(1), the Commission staff estimates that the one-time capital cost to financial intermediaries to develop or upgrade their software or other technological systems to collect, and store the required transactional information to be \$100,000 per intermediary for an aggregate cost of \$102,000,000 for all intermediaries.<sup>85</sup> The Commission staff also anticipates an ongoing burden for financial intermediaries to comply with the transactional information requirements set forth in the rule. We estimate the annual burden to be 240 hours for an aggregate burden of 244,800 hours.<sup>86</sup> The operation and maintenance costs would be \$100,000 per intermediary for a total cost of \$102,000,000 for all intermediaries.<sup>87</sup>

Under paragraph (b)(2), the Commission staff estimates that the one-time capital cost to financial intermediaries to develop or upgrade their software or other technological systems to collect, and store the required transactional information to be \$10,000 per intermediary for an aggregate cost of \$23,800,000 for all intermediaries.<sup>88</sup> The Commission staff also anticipates an ongoing burden for financial intermediaries to comply with the transactional information requirements set forth in the rule. We estimate the annual burden to be 24 hours per intermediary for an aggregate burden of 57,120 hours.<sup>89</sup> The operation and maintenance costs would be \$10,000 per intermediary for a total cost of \$23,800,000 for all intermediaries.<sup>90</sup>

<sup>85</sup> (\$100,000 per intermediary × 1,020 intermediaries = \$102,000,000).

<sup>86</sup> (240 hours per intermediary × 1,020 intermediaries = 244,800 hours).

<sup>87</sup> (\$100,000 per intermediary × 1,020 intermediaries = \$102,000,000).

<sup>88</sup> (\$10,000 per intermediary × 2,380 intermediaries = \$23,800,000).

<sup>89</sup> (24 hours per intermediary × 2,380 intermediaries = 57,120 hours).

<sup>90</sup> (\$10,000 per intermediary × 2,380 intermediaries = \$23,800,000).

<sup>73</sup> These estimates are based on discussions with fund representatives.

<sup>74</sup> (3,100 funds × 4.5 hours = 13,950 hours).

<sup>75</sup> (300 hours × 465 funds = 139,500 hours).

<sup>76</sup> (\$560,000 per fund cost × 465 funds = \$260,400,000).

<sup>77</sup> (300 hours × 465 funds = 139,500 hours).

<sup>78</sup> (\$6,640 per fund × 465 funds = \$3,087,600).

<sup>79</sup> (300 hours × 1,085 funds = 325,500 hours).

<sup>80</sup> (\$560,000 per fund × 1,085 funds = \$607,600,000).

<sup>81</sup> (\$6,640 per fund × 1,085 funds = \$7,204,400).

<sup>82</sup> (300 hours × 1,085 funds = 325,500 hours).

<sup>83</sup> (\$6,640 per fund × 1,085 funds = \$7,204,400).

<sup>84</sup> The Commission staff estimates that for the quarter ending September 30, 2003, about 2,400 banks reported to the Federal Financial Institutions Examination Council (on their Reports of Condition and Income) that they sell private label or third party mutual fund shares or variable annuity contracts ("annuities"). Unregistered annuities would not be subject to proposed rule 22c-2. This number may be an over-estimate of the number of banks that would be affected by the proposed rule because some of these banks may only sell annuities not required to register under the Investment Company Act of 1940. The number of banks selling funds or annuities may also count some banks selling on the banks' premises through registered broker-dealers. These banks have already been counted in the estimate of the number of broker-dealer respondents.

Under the approach set forth in paragraph (b)(3) of the proposed rule, there would be no collection of information requirements on intermediaries.

#### 5. Funds and Intermediaries: Paragraph (c)

With respect to the periodic information, including the TIN of the shareholder, to be provided on at least a weekly basis as set forth in paragraph (c) of the proposed rule, we estimate that there would be a burden on funds to collect and evaluate the data, and intermediaries to transmit it. However, that burden is reduced because we are requiring the data to be provided on at least a weekly basis, rather than on a transaction-by-transaction basis. We estimate the annual burden on a fund to be 2,080 hours<sup>91</sup> for a total burden of 6,448,000 hours for all funds.<sup>92</sup> We estimate the capital costs to be \$100,000 per fund for an aggregate cost of \$310,000,000 for all funds,<sup>93</sup> and the ongoing yearly cost to be \$20,584,000.<sup>94</sup> We estimate the annual burden to be 240 hours per intermediary for a total burden of 1,632,000 hours for all financial intermediaries.<sup>95</sup> We estimate the capital costs to be \$150,000 per intermediary for an aggregate cost of \$1,020,000,000,<sup>96</sup> and an ongoing cost to be \$100,000 per intermediary for an aggregate yearly cost of \$680,000,000 for all intermediaries.<sup>97</sup>

#### B. Emergency Exception

The proposed rule also would contain an exception that would permit a shareholder, in case of an unanticipated financial emergency, to make a written request to the fund to waive the redemption fee if the amount of the shares redeemed is \$10,000 or less. We estimate that each fund would receive approximately ten waiver requests on an annual basis. Therefore, the aggregate number of requests would be 31,000.<sup>98</sup> We estimate that it will take each shareholder 10 minutes to prepare a

waiver, with an aggregate burden on shareholders of 5,167 hours.<sup>99</sup>

#### C. Aggregate Hours and Cost Burdens

To arrive at the total information collection burden for all 9,900 respondents (*i.e.*, 3,100 funds + 6,800 intermediaries) under the proposed amendments to rule 22c-2, an average of the first year burden and the subsequent annual burdens must be calculated. Over the three-year period for which we are seeking approval, the weighted average aggregate annual information collection burden would be 8,856,737 hours.<sup>100</sup> The Commission estimates that there will be a total of 155,592,600 responses annually, which includes responses by funds, intermediaries, and fund shareholders.<sup>101</sup>

To arrive at the total annual cost of the new information collection

<sup>99</sup> (31,000 requests per year × 10 minutes = 310,000 minutes or 5,167 hours).

<sup>100</sup> In the first year after adoption: (i) The aggregate burden for funds is expected to be 6,926,950 hours (13,950 hours for contract modifications + 139,500 hours for funds relying on paragraph (b)(1) + 325,500 hours for funds relying on paragraph (b)(2) + 6,448,000 hours for the information collection requirements in paragraph (c) = 6,926,950 hours); (ii) the aggregate burden for intermediaries is expected to be 1,933,920 hours (244,800 hours for intermediaries relying on paragraph (b)(1) + 57,120 for intermediaries relying on paragraph (b)(2) + 1,632,000 hours for the information collection requirements in paragraph (c) = 1,933,920 hours); and (iii) the aggregate burden for redeeming shareholders is expected to be 5,167 hours. Thus, in the first year after adoption, the aggregate burden for all respondents is expected to be 8,866,037 hours (6,926,950 hours for funds + 1,933,920 hours for intermediaries + 5,167 hours for redeeming shareholders = 8,866,037 hours). In the second and third years after adoption, the annual burden for respondents is expected to fall to 8,852,087 hours, because the burden attributable to one-time contract modifications will no longer be incurred by funds. Thus, the average annual burden over the three-year period for which we are seeking approval is expected to be 8,856,737 hours (8,866,037 first year's burden + 8,852,087 second year's burden + 8,852,087 third year's burden/3 = 8,856,737 hours).

<sup>101</sup> Specifically, the staff estimates that annually there will be: (i) 150,000,000 responses under paragraph (b)(1) (1 response for each of the 15% of the estimated 1 billion purchase and sale transactions in fund shares that we assume will be subject to paragraph (b)(1) = 150,000,000 responses); (ii) 5,208,000 responses under paragraph (b)(2) (1 response for each of the estimated 35% of the approximately 14,880,000 affected redemption transactions per year (3,100 funds × 4,800 affected redemptions per fund per year = 14,880,000 affected redemptions) that are subject to paragraph (b)(2) = 5,208,000 responses); (iii) 353,600 responses under paragraph (c) (6,800 intermediaries × 52 responses per year = 353,600 responses); and (iv) 31,000 responses by shareholders seeking a financial emergency exception under the rule. Thus, we anticipate that there will be a total of 155,592,600 annual responses (150,000,000 responses under (b)(1) + 5,208,000 responses under (b)(2) + 353,600 responses under (c) + 31,000 responses for the emergency exception = 155,592,600 responses).

requirements for all 9,900 respondents (*i.e.*, 3,100 funds + 6,800 intermediaries), an average of the first year cost and the subsequent annual costs must be calculated. Over the three-year period for which we are seeking approval, the weighted average aggregate annual cost would be \$1,053,492,000.<sup>102</sup>

#### D. Request for Comments

We request comment on whether these estimates are reasonable. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments in order to: (i) Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements of the proposed

<sup>102</sup> In the first year after adoption: (i) the aggregate cost burden for funds is expected to be \$1,178,000,000 (\$260,400,000 for funds relying on paragraph (b)(1) + \$607,600,000 for funds relying on paragraph (b)(2) + 310,000,000 for the information collection requirements in paragraph (c) = \$1,178,000,000); and (ii) the aggregate cost burden for intermediaries is expected to be \$1,145,800,000 (\$102,000,000 for intermediaries relying on paragraph (b)(1) + \$23,800,000 for intermediaries relying on paragraph (b)(2) + \$1,020,000,000 for the information collection requirements in paragraph (c) = \$1,145,800,000). Thus, in the first year after adoption, the aggregate cost burden for all respondents is expected to be \$2,323,800,000. In the second and third years after adoption, the annual cost burden for respondents is expected to fall to \$836,676,000, because funds and intermediaries will incur only the ongoing operation and maintenance costs of systems that have been put in place during the first year. Specifically, in each of the second and third years after adoption: (i) The aggregate cost burden for funds is expected to be \$30,876,000 (\$3,087,600 for funds relying on paragraph (b)(1) + \$7,204,400 for funds relying on paragraph (b)(2) + \$20,584,000 for the information collection requirements in paragraph (c) = \$30,876,000); and (ii) the aggregate cost burden for intermediaries is expected to be \$805,800,000 (\$102,000,000 for intermediaries relying on paragraph (b)(1) + \$23,800,000 for intermediaries relying on paragraph (b)(2) + \$680,000,000 for the information collection requirements in paragraph (c) = \$805,800,000). Thus, the average annual cost burden over the three year period for which we are seeking approval is expected to be \$1,053,492,000 (\$1,178,000,000 first year's burden + \$805,800,000 second year's burden + \$805,800,000 third year's burden/3 = \$1,053,492,000).

<sup>91</sup> (40 hours per week × 52 weeks = 2,080 hours per year).

<sup>92</sup> (2,080 hours per fund × 3,100 funds = 6,448,000 hours per year).

<sup>93</sup> (\$100,000 per fund × 3,100 funds = \$310,000,000).

<sup>94</sup> (\$6,640 per fund × 3,100 funds = \$20,584,000).

<sup>95</sup> (240 hours per intermediary × 6,800 intermediaries = 1,632,000 hours).

<sup>96</sup> (\$150,000 per intermediary × 6,800 intermediaries = \$1,020,000,000).

<sup>97</sup> (\$100,000 per intermediary × 6,800 intermediaries = \$680,000,000).

<sup>98</sup> (10 requests per year × 3,100 funds = 31,000 requests per year).

amendments should direct them to the Office of Management and Budget, Attention Desk Officer of the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 10102, New Executive Office Building, Washington, DC 20503, and should send a copy to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609, with reference to File No. S7-11-04. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this Release; therefore a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this Release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-11-04, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services.

## VI. Initial Regulatory Flexibility Analysis

This Initial Regulatory Flexibility Analysis ("IRFA") has been prepared in accordance with 5 U.S.C. 603. It relates to rule 22c-2 and amendments to rule 11a-3 under the Investment Company Act, which we are proposing in this Release.

### A. Reasons for the Proposed Action

As discussed more fully in Section I of this Release, the reason for the proposed action is that short-term trading of fund shares, including market timing activity, imposes costs on funds that are borne by long-term shareholders.

### B. Objectives of the Proposed Action

As discussed more fully in Section II of this Release, the objective of the proposed rule is to require shareholders to reimburse the fund for costs incurred by the fund when they engage in short-term trading in fund shares, and to deter short-term trading.

### C. Legal Basis

As indicated in Section VII of this Release, new rule 22c-2 and amendments to rule 11a-3 are proposed pursuant to the authority set forth in sections 11(a), 22(c) and 38(a) of the Investment Company Act.<sup>103</sup>

### D. Small Entities Subject to the Proposed Rule and Amendments

A small business or small organization (collectively, "small entity") for purposes of the Regulatory Flexibility Act is a fund that, together with other funds in the same group of related investment companies, has net assets of \$50 million or less as of the end of its most recent fiscal year.<sup>104</sup> Of approximately 3,925 funds (3,100 registered open-end investment companies and 825 registered unit investment trusts), approximately 163 are small entities.<sup>105</sup> A broker-dealer is considered a small entity if its total capital is less than \$500,000, and it is not affiliated with a broker-dealer that has \$500,000 or more in total capital.<sup>106</sup> Of approximately 6,800 registered broker-dealers, approximately 880 are small entities, with approximately 400 of these classified as specialists in funds. A transfer agent is considered a small entity if it has: (i) Received less than 500 items for transfer and less than 500 items for processing during the preceding six months (or in the time that it has been in business, if shorter); (ii) transferred items only of issuers that would be deemed "small businesses" or "small organizations" as defined in rule 0-10 under the Securities Exchange Act of 1934; (iii) maintained master shareholder files that in the aggregate contained less than 1,000 shareholder accounts or was the named transfer agent for less than 1,000 shareholder accounts at all times during the preceding fiscal year (or in the time that it has been in business, if shorter); and (iv) is not affiliated with any person (other than a natural person) that is not a small business or small organization under rule 0-10.<sup>107</sup> We estimate that 40 out of approximately 208 registered fund transfer agents qualify as small entities.

As we discussed above, under the proposed rule, any redemption of fund shares (with certain limited exceptions) held for five business days or less would be subject to a two percent redemption fee. This rule would apply to all transactions, including those in omnibus accounts. The Commission staff expects that this rule would require that funds and intermediaries develop or upgrade software or other technological systems to impose redemption fees in omnibus accounts.

<sup>104</sup> 17 CFR 270.0-10.

<sup>105</sup> Some or all of these entities may contain multiple series or portfolios. If a registered investment company is a small entity, the portfolios or series it contains are also small entities.

<sup>106</sup> 17 CFR 240.0-10.

<sup>107</sup> 17 CFR 240.0-10(h).

Because the Commission and its staff are not familiar with the full range of available technologies associated with these upgrades, we request that commenters address the cost of such upgrades, including specific data when available.

### E. Reporting, Recordkeeping, and Other Compliance Requirements

The proposal would not contain new mandatory reporting or recordkeeping requirements.

### F. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission has not identified any federal rules that duplicate, overlap, or conflict with the proposed rule.

### G. Significant Alternatives

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. Alternatives in this category would include: (i) Establishing different compliance or reporting standards that take into account the resources available to small entities; (ii) clarifying, consolidating, or simplifying the compliance requirements under the rule for small entities; (iii) using performance rather than design standards; and (iv) exempting small entities from coverage of the rule, or any part of the rule.

The Commission does not presently believe that the establishment of special compliance requirements or timetables under the proposal for small entities is feasible or necessary. The proposed rule arises from enforcement actions and settlements that underscore the need to reimburse funds so that long-term shareholders will not be disadvantaged by shareholders that engage in frequent trading and fund managers that selectively permit such short-term trading. Excepting small entities from the proposed rule could disadvantage fund shareholders of small entities and compromise the effectiveness of the proposed rule. Nevertheless, we request comment on whether it is feasible or necessary for small entities to have special requirements or timetables for compliance with the proposed rule. Should the proposed rule be altered in order to ease the regulatory burden on small entities, without sacrificing its effectiveness?

With respect to further clarifying, consolidating or simplifying the compliance requirements of the proposed rule, using performance rather than design standards, and exempting small entities from coverage of the rule

<sup>103</sup> 15 U.S.C. 80a-11(a), 80a-22(c), and 80a-37(a).

or any part of the rule, we believe such changes are impracticable. Small entities are as vulnerable to the problems uncovered in recent enforcement actions and settlements as large entities; shareholders of small entities are equally in need of protection from short-term traders. We believe that a mandatory redemption fee will serve as a useful tool to discourage short-term trading. Exempting small entities from coverage of the rule or any part of the rule could compromise the effectiveness of the proposed rule.

#### H. Solicitation of Comments

The Commission encourages the submission of comments with respect to any aspect of this IRFA. Comment is specifically requested on the number of small entities that would be affected by the proposed rule, and the likely impact of the proposals on small entities. Commenters are asked to describe the nature of any impact and provide empirical data supporting its extent. These comments will be considered in connection with any adoption of the proposed rule and amendments, and reflected in the Final Regulatory Flexibility Analysis.

Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Comments also may be submitted electronically to the following E-mail address: [rule-comments@sec.gov](mailto:rule-comments@sec.gov). All comment letters should refer to File No. S7-11-04, and this file number should be included on the subject line if E-mail is used.<sup>108</sup> Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549-0102. Electronically submitted comment letters also will be posted on the Commission's Internet Web site (<http://www.sec.gov>).

#### VII. Statutory Authority

The Commission is proposing rule 22c-2 and amendments to rule 11a-3 pursuant to the authority set forth in sections 11(a), 22(c) and 38(a) of the Investment Company Act [15 U.S.C. 80a-11(a), 80a-22(c) and 80a-37(a)].

#### List of Subjects in 17 CFR Part 270

Investment companies, Reporting and recordkeeping requirements, Securities.

#### Text of Proposed Rule

For reasons set out in the preamble, Title 17, Chapter II of the Code of

<sup>108</sup> Comments on the IRFA will be placed in the same public file that contains comments on the proposed rule.

Federal Regulations is proposed to be amended as follows:

#### PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

1. The authority citation for Part 270 continues to read in part as follows:

**Authority:** 15 U.S.C. 80a-1 *et seq.*, 80a-34(d), 80a-37, and 80a-39, unless otherwise noted.

\* \* \* \* \*

#### § 270.11a-3 [Amended]

2. Section 270.11a-3 is amended by revising the undesignated paragraph following (b)(2) to read as follows:

\* \* \* \* \*

(b) \* \* \*  
(2) \* \* \*

Any scheduled variation of a redemption fee, other than pursuant to § 270.22c-2, must be reasonably related to the costs to the fund of processing the type of redemptions for which the fee is charged;

\* \* \* \* \*

3. Section 270.22c-2 is added to read as follows:

#### § 270.22c-2 Redemption fees for redeemable securities.

(a) *Redemption fee.* It is unlawful for any fund issuing redeemable securities, its principal underwriter, or any dealer in such securities 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, which fee shall be retained by the fund.

(b) *Transaction information required for assessment of fee.* For the purpose of imposing the fee required pursuant to paragraph (a) of this section, a fund must, with respect to each shareholder account held by a financial intermediary:

(1) Require the financial intermediary to provide the fund, upon submission of each purchase and redemption order, the account number used by the financial intermediary to identify the shareholder;

(2) Have entered into an agreement with the financial intermediary under which the intermediary must provide the fund, as to redemption orders upon which the fund must charge a redemption fee under paragraph (a) of this section, transaction and holdings information sufficient to permit the fund to assess the amount of the redemption fee; or

(3) Have entered into an agreement with the financial intermediary under which the intermediary must assess the

redemption fee required in paragraph (a) of this section.

(c) *Periodic information required.* In order to determine whether the redemption fee is properly assessed under paragraph (a) of this section, a fund must require each financial intermediary, as described in paragraph (b) of this section, to provide it no less frequently than once each week.

(1) The Taxpayer Identification Number of all shareholders that purchased or redeemed shares held through an account with the financial intermediary for the time period submitted; and

(2) The amount and dates of such shareholder purchases and redemptions for the time period submitted.

(d) *Calculation of the redemption fee.* In determining the amount of the redemption fee under paragraph (a) of this section, the fund must treat the shares held in the account (or an account to which the account is the successor) the longest period of time as the first shares redeemed (first in, first out or FIFO). The fund must determine the amount of the redemption fee on the basis of proceeds payable to the shareholder before the imposition of any deferred sales load or administrative fee. The fee may either reduce the amount of the proceeds to the shareholder or increase the number of shares redeemed.

(e) *Exceptions.*—(1) *Waiver of fees.* Notwithstanding paragraph (a),

(i) A fund may waive the redemption fee if the amount of the shares redeemed is 2,500 dollars or less;<sup>109</sup> and

(ii) In the case of an unanticipated financial emergency, upon written request of the shareholder,

(A) A fund must waive the redemption fee if the amount of the shares redeemed is 10,000 dollars or less; and

(B) A fund may waive the redemption fee if the amount of the shares redeemed is more than 10,000 dollars.

(2) *Excepted funds.* The requirements of paragraphs (a) through (c) of this section do not apply to:

(i) Money market funds;

(ii) Any fund that issues securities that are listed on a national securities exchange; and

(iii) Any fund that has adopted a fundamental policy to affirmatively

<sup>109</sup> As discussed in the preamble to this Release, the Commission also is proposing, as an alternative to this paragraph (e)(1)(i), that the waiver of fees on redemptions of \$2,500 or less be mandatory rather than discretionary on the part of the fund. See *supra* note 36 and accompanying text. If we were to adopt this alternative approach, paragraph (e)(1)(i) of the proposed rule would be revised accordingly.

permit short-term trading of its securities, if its prospectus clearly and prominently discloses that the fund permits short-term trading of its securities and that such trading may result in additional costs for the fund.

(f) *Definitions.* For the purposes of this section,

(1) *Financial intermediary* means 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.

(2) *Fund* means an open-end management investment company that is registered or required to register under section 8 of the Investment Company Act (15 U.S.C. 80a-8), and includes a separate series of such an investment company.

(3) *Money market fund* means an open-end management investment

company that is registered under the Act and is regulated as a money market fund under § 270.2a-7.

By the Commission.

Dated: March 5, 2004.

**Margaret H. McFarland,**

*Deputy Secretary.*

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