Dechert LLP

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update

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SEC Proposes Rule Imposing Mandatory Redemption Fees to Combat Short-Term Trading in Mutual Fund Shares

On February 25, 2004, the Securities and Exchange Commission (the "Commission") proposed for public comment new Rule 22c-2 under the Investment Company Act of 1940 (the "Rule"), which would require open-end investment companies to impose a 2% redemption fee on shares redeemed within 5 business days of purchase[1]. The new rule is designed to further measures taken by the Commission to address abusive market timing transactions in shares of mutual funds that have a negative impact on the returns of long-term shareholders. Unlike other rules recently proposed by the Commission to combat abusive mutual fund trading practices[2], the Rule was not unanimously approved with several of the Commissioners requesting public comment on its likely impact on ordinary shareholders.

Background

Abusive market timing transactions in shares of mutual funds, such as late trading and short-term trading, impose costs on mutual funds and their long-term shareholders. Market timers and late traders seek to extract profits from mutual funds by trading in and out of a mutual fund's shares in order to take advantage of perceived variances in the pricing of the fund's shares and the value of the fund's underlying portfolio holdings. In addition, day traders may engage in short term trading of mutual fund shares in an effort to profit from expected day-to-day market movements. These trading strategies may harm long-term shareholders of a mutual fund by increasing the fund's administration expenses, disrupting management of the fund's portfolio by requiring the mutual fund to hold extra cash reserves or to liquidate portfolio holdings in order to meet redemptions, and causing the recognition of unwanted taxable gains.

The Commission believes that the adoption of fair value pricing practices by mutual funds is

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1 Release No. IC-26375A, March 5, 2004. Unit investment trusts also issue redeemable securities, but the Rule would not apply to them because it excludes unit investment trusts by defining "fund" to mean a management investment company.

2 *See* Proposed Rule: Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Release No. IC-26287 (December 11, 2003), requiring enhanced disclosures by mutual funds of their policies and procedures relating to market timing, fair value pricing and disclosure of portfolio holdings; *See also* Proposed Rule: Amendments to Rules Governing Pricing of Mutual Fund Shares, Release No. IC-26288 (December 11, 2003), proposing an amendment to Rule 22c-1, requiring, among other things, that orders for purchases and sales of funds be received by the mutual fund, its transfer agent, or NSCC's Fund/SERV by 4:00 p.m.

the principal solution for preventing abusive market timing transactions. However, fair value pricing alone, in many cases, may be insufficient to prevent all types of abusive market timing transactions. For example, fair value pricing is by its nature subjective, and thus arbitrageurs may continue to perceive opportunities to exploit the stale pricing of mutual fund shares. Additionally, fair value pricing may not serve as an impediment to day trading of mutual fund shares based upon expected market movements. In recognition of the foregoing concerns, the Commission believes a combination of fair value pricing and the imposition of a redemption fee is necessary to further reduce, if not eliminate, opportunities for market timers to extract profits from mutual funds and to compensate mutual funds and their long-term shareholders for costs associated with these trading strategies. The redemption fee targets not just the largest traders but the cumulative effects of many smaller short-term traders.

Overview of the Proposed Rule

As proposed, the Rule would require investment companies that issue redeemable securities (*i.e.*, open-end mutual funds) to charge investors a 2% redemption fee[3] on any redemption of shares held for 5 days or less[4]. The fee would be payable to the mutual fund and is intended to discourage short-term trading by reducing the profitability of the trades and, to the extent short-term trading occurs, to reimburse the fund for any direct and indirect costs incurred in connection with such trading. The Rule excepts money market funds and exchange-traded funds from the mandatory redemption fee requirement because these types of funds are designed to facilitate frequent trading by shareholders. In addition, any mutual fund wishing to encourage active trading of its shares may opt out of the Rule's mandatory redemption fee requirement by adopting a fundamental policy to affirmatively permit short-term trading in all of its redeemable securities and disclosing in its prospectus that the fund permits short-term trading of its shares, that such trading may result in additional costs to the fund.

Omnibus Account Considerations

Many mutual funds use a network of financial intermediaries such as broker-dealers, banks, insurance companies, and retirement plans to sell shares to investors. The financial intermediaries frequently open omnibus accounts with the mutual fund through which they aggregate the shareholdings of their clients with investments in the same fund. Due to competitive concerns, financial intermediaries typically do not provide mutual funds with a sufficient level of detail on the transactions within an omnibus account to enable mutual funds to detect abusive market timing activities and assess redemption fees.

In recognition of this lack of transparency, the Commission requested that the National Association of Securities Dealers, Inc. (the "NASD") convene a working group of industry experts (the "Omnibus Task Force") to consider how a mandatory redemption fee could be implemented for omnibus accounts in a comprehensive, cost-effective manner. Following the recommendations of the Omnibus Task Force[5], the Rule would require intermediaries to disclose to mutual funds, on at least a weekly basis, information necessary for the mutual fund to identify individual shareholder transactions occurring during the previous week, including taxpayer identification numbers and the amounts and dates of all purchases and redemptions or exchanges of shares. Redemption fees may be assessed either by the mutual fund or its transfer agent or by the intermediary. If the mutual fund or the transfer

[3] Mutual funds are currently permitted to charge redemption fees in an amount equal to the lesser of actual costs associated with redemptions or 2%. *See* John P. Reilly & Associates, SEC Staff No Action Letter (July 12, 1979).

[4] The Rule permits a mutual fund to impose a holding period of longer than 5 days where the mutual fund deems a longer period appropriate for discouraging market-timing activities. A mutual fund may not, however, charge a redemption fee below or in excess of 2%.

[5] *See* Report of the NASD Omnibus Account Task Force (January 30, 2004).

agent is to assess the fee, the intermediary is required to either (i) contemporaneously with any transaction within the omnibus account provide the mutual fund or transfer agent the account number of the client effecting the transaction in order to permit the mutual fund or the transfer agent to make a determination as to whether a redemption fee is applicable; or (ii) enter into an agreement with the mutual fund whereby the intermediary agrees to monitor transactions within the omnibus account for compliance with the Rule and to identify and disclose such information as may be required for the mutual fund or transfer agent to assess applicable redemption fees. In the alternative, the intermediary may agree, subject to the supervision of the mutual fund, to impose the redemption fees on client transactions within the omnibus account and to remit the proceeds to the mutual fund.

Calculating the Holding Period

The Rule would require that mutual funds assess the redemption fee on a first-in, first-out basis. Under this method, the oldest shares held by a shareholder would be considered to be the shares redeemed first, and the most recently acquired shares would be considered the shares redeemed last. Although this method may not capture all short-term trading[6], the Commission believes it will minimize the likelihood that ordinary shareholder redemptions would be assessed a redemption fee.

Small Transaction Exemption

In addition to the relief provided by assessing redemption fees on a first-in, first-out basis, the Rule would provide mutual funds with the option of exempting shareholder redemptions within the 5-day period involving $2,500 or less in fund shares. This approach would permit a mutual fund to forego the collection of redemption fees of $50 or less should the mutual fund determine that the cost of collecting such small amounts exceeds the likely benefits of collection.[7]

Emergency Exemption

In the case of an occurrence of unexpected financial emergency, a shareholder may request a waiver of the redemption fee from a mutual fund. The mutual fund is required to waive the redemption fee on redemptions of $10,000 or less and has the option of waiving the fee on amounts greater than $10,000. The Rule does not define the term "unexpected financial emergency," but the proposing release uses the example of a short-term redemption for the purpose of paying for an emergency surgery. In a footnote, the proposing release further refers to the definition of the term "unforeseeable emergency" adopted by the Internal Revenue Service in connection with distributions from deferred compensation plans[8]. The Commission has requested public comment on

[6] As noted by Commission Atkins, market timers who maintain a balance in a mutual fund for over 5 days may engage in market timing activities without the imposition of a redemption fee to the extent of their balance in the mutual fund.

[7] The Commission has specifically requested comment on whether small transactions should be uniformly exempt from the assessment of redemption fees in order to permit a uniform assessment of fees.

[8] *See* 26 CFR 1.457-6(c)(2)(i) (2003), which defines an "unforeseeable emergency" 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 dependent (as defined in section 152(a)); loss of the participant's or beneficiary's property due to casualty (including the need to rebuild a home following damage to a home not otherwise covered by homeowner's insurance, e.g., as a result of a natural disaster); or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant or the beneficiary. For example, the imminent foreclosure of or eviction from the participant's or beneficiary's primary residence may constitute an unforeseeable emergency. In addition, the need to pay for medical expenses, including non-refundable deductibles, as well as for the cost of prescription drug medication, may constitute an unforeseeable emergency. Finally, the need to pay for the funeral expenses of a spouse or a dependent (as defined in section 152(a)) may also constitute an unforeseeable emergency. Except as otherwise specifically provided in this paragraph (c)(2)(i), the purchase of a home and the payment of college tuition are not unforeseeable emergencies under this paragraph (c)(2)(i).

whether the Rule should define the circumstances that would constitute an unanticipated financial emergency.

Commissioner Comments

The proposed Rule was approved for public comment by a vote of 4 to 1, with Commissioner Atkins voting against the Rule. Commissioner Atkins did not vote for the proposal principally because mutual funds are now permitted to voluntarily assess redemption fees, and the imposition of a mandatory redemption fee, even with the built-in protections to ordinary shareholders, will impose an additional level of fees on certain ordinary shareholder transactions. In his conclusion, Chairman Donaldson noted that each of the Commissioners approving the proposal believes that fair value pricing should be the primary method used for preventing abusive trading practices in mutual fund shares, and were interested in receiving feedback from the public on the imposition of mandatory redemption fees, especially with respect to whether the costs of imposing such fees is likely to exceed the benefits conferred to ordinary shareholders.

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The deadline for comments on the Rule is 60 days from its publication in the *Federal Register*. Dechert LLP will continue to monitor the proposal and related developments and will issue Financial Services Updates when warranted. Meanwhile, if you have any questions concerning this memorandum, please contact Alan Rosenblat at +1.202.261.3332 or arosenblat@dechert.com, or the Dechert LLP attorney with whom you are in regular contact.

Please visit us at www.dechert.com/financialservices.

BOSTON 200 Clarendon Street • 27th Floor • Boston, MA 02116-5021 • Tel: +1.617.728.7100 • Fax: +1.617.426.6567 **BRUSSELS** 480 Avenue Louise, Box 13 A • 1050 Brussels • Belgium • Tel: +32 2 535 5411 • Fax: +32 2 535 5400 CHARLOTTE Bank of America Corporate Center • 100 North Tryon Street • Suite 4000 • Charlotte, NC 28202 • Tel: +1.704.339.3100 • Fax: +1.704.339.3101 **FRANKFURT** Trianon • Mainzer Landstrasse 16 • 60325 Frankfurt a.M. • Germany • Tel: +49 69 971 68 245 • Fax: +49 69 971 68 371 **HARRISBURG** Thirty North Third Street • Harrisburg, PA 17101-1603 • Tel: +1.717.237.2000 • Fax: +1.717.237.2040 **HARTFORD** 90 State House Square • Hartford, CT 06103-3702 • Tel: +1.860.524.3999 • Fax: +1.860.524.3930 **LONDON** 2 Serjeants' Inn • London EC4Y 1LT • UK • Tel: +44 20 7583 5353 • Fax: +44 20 7353 3683 • DX 30 London **LUXEMBOURG** Dechert Luxembourg • Avocats A La Cour • 10 rue de Vianden • B.P. 709 • L-2017 Luxembourg • Tel: +352.45.62.62 • Fax: +352.45.94.95 MUNICH Theresienstrasse 6 • 80333 München • Germany • Tel: +49 89 21 21 63 0 • Fax: +49 89 21 21 63 33 NEW YORK 30 Rockefeller Plaza ● New York, NY 10112-2200 ● Tel: +1.212.698.3500 ● Fax: +1.212.698.3599 **NEW YORK** 30 Rockefeller Plaza • New York, NY 10112-2200 • Tel: +1.212.698.3500 • Fax: +1.212.698.3599 **NEWPORT BEACH** 4675 MacArthur Court • Newport Beach, CA 92660 • Tel: +1.949.442.6000 • Fax: +1.949.442.6010 **PALO ALTO** 975 Page Mill Road • Palo Alto, CA 94304-1013 • Tel: +1.650.813.4800 • Fax: +1.650.813.4848 **PARIS** 55, avenue Kléber • 75116 Paris • France • Tel: +33 1 53 65 05 00 • Fax: +33 1 53 65 05 05 • Palais D 1816 **PHILADELPHIA** 4000 Bell Atlantic Tower • 1717 Arch Street • Philadelphia, PA 19103-2793 • Tel: +1.215.994.4000 • Fax: +1.215.994.2222 **PRINCETON** Princeton Pike Corporate Center • P.O. Box 5218 • Princeton, NJ 08543-5218 • Tel: +1.609.620.3200 • Fax: +1.609.620.3259 **SAN FRANCISCO** One Maritime Plaza • Suite 1510 • San Francisco, CA 94111-3404 • Tel: +1.415.262.4500 • Fax: +1.415.262.4555 **WASHINGTON** 1775 I Street, NW • Washington, DC 20006-2401 • Tel: +1.202.261.3300 • Fax: +1.202.261.3333