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A legal update from Dechert's Financial Services Group

SEC Sanctions SSRM for Failure to Properly Implement Redemption Fee

On September 23, 2005, the Securities and Exchange Commission (the "SEC") issued an Order requiring State Street Research & Management Company ("SSRM") to pay $285,743 to State Street Research International Equity Fund (the "Fund"), and imposed a civil penalty of $300,000 on SSRM for failure to implement the Fund's redemption fee requirements properly (the "Order"). The Order also required SSRM to cease and desist violations of the anti-fraud provisions of Section 206(2) of the Investment Advisers Act of 1940 ("Advisers Act").[1]

Summary

SSRM was the investment adviser to seven mutual funds registered with the SEC, including the Fund. From April 2002 to April 2003, SSRM improperly transferred $156,128 in redemption fees collected on behalf of the Fund to its affiliated distributor, State Street Research Investment Services, Inc. ("SSRIS").

The SEC found that SSRM had willfully violated Section 206(2) of the Advisers Act because SSRM knew or should have known that the Fund's transfer agent used a computer system that inaccurately treated the redemption fees as contingent deferred sales charges. In this regard, the SEC noted that as used in the Order, "willfully means intentionally committing the act that constituted the violation.... There is no requirement that the actor be aware he is violating one of the Rules or Acts...."

Pursuant to its settlement with the SEC, SSRM paid $285,743 to the Fund—$156,128 for the redemption fees it transferred to SSRIS, $88,067 in "interest/performance," and $41,548 for expenses—as well as $300,000 in civil penalties.

Discussion

In April 2002, the Fund adopted a 1% redemption fee. The Fund's prospectus stated:

> Effective April 1, 2002, the Fund may impose a redemption fee of 1.00% of the total redemption amount (calculated at market value) if you sell or exchange your shares after holding them for less than 30 days. The redemption fee is paid directly to the Fund, and is not a sales load. The fee is designed to offset brokerage commissions, market impact, and other costs associated with short-term trading.[2]

The Order stated that SSRM relied upon a computer system that was designed to assess

[1] Rel. No. IA-2435, (September 23, 2005). Section 206(2) of the Advisers Act prohibits advisers from engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client. *See* also Sections 203(e) and 203(k) of the Advisers Act.

[2] The Fund adopted its redemption fee prior to the adoption of Rule 22c-2 under the Investment Company Act of 1940, which allows registered open-end investment companies to impose a redemption fee, not to exceed 2% of the amount redeemed, to be retained by the fund. The redemption fee is intended to allow funds to recoup some of the direct and indirect costs incurred as a result of short-term trading strategies such as market timing. Accordingly, the adopting release for Rule 22c-2 emphasized that "the proceeds of the redemption fee, in all cases, must be paid to the fund itself." *See* Rel. No. IC-26782 (March 11, 2005).

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contingent deferred sales charges ("CDSCs") to implement the Fund's redemption fee. It also stated that SSRM was aware that the computer system was capable of assessing either a CDSC or a redemption fee. Instead of creating a new system or modifying the existing system, SSRM allowed the Fund's transfer agent to rely on the existing computer system, code the fees as CDSCs, and transfer the money collected to the Fund's distributor instead of paying the fees to the Fund.

On the basis of these facts, the SEC determined that because of SSRM's awareness of the limitations in using the computer system to collect redemption fees, SSRM knew or should have known that, contrary to the terms of the Fund's prospectus, the redemption fees were not paid directly to the Fund. Instead, the redemption fees were paid to the Fund's distributor, an affiliate of SSRM, the Fund's advisor. As a result, the SEC found that SSRM had willfully violated Section 206(2) of the Advisers Act because SSRM engaged in transactions, practices, or a course of business that operated as a fraud or deceit upon the Fund.

Conclusion

The SSRM case is one of the first SEC administrative proceedings brought for failure to implement a fund's redemption fee policies properly. The SEC brought this case because the Fund's adviser and distributor are affiliated entities. Because scienter (*i.e.*, knowledge that the action violates laws or regulations) is not required to establish a Section 206(2) violation, care must be taken to ensure that redemption fees are returned to the underlying funds for which the fees are collected. Failure to do so could result in criminal as well as civil liabilities.

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