

SEC Approves Imposition of Redemption Fee for Mutual Funds Funds Are Permitted, Not Required, to Impose Charge

On March 3, 2005, the Securities and Exchange Commission ("SEC") approved new Rule 22c-2 under the Investment Company Act of 1940 ("1940 Act"), as well as a related amendment to Rule 11a-3, regarding exchange programs. The new rule permits the imposition of a redemption fee for mutual funds (other than money market funds, exchange-traded funds and funds specifically designed for market timers), while the amendment defines "redemption fee" as a fee imposed in accordance with Rule 22c-2.

Summary

At its March 3, 2005 open meeting, the SEC voted to approve new Rule 22c-2 under the 1940 Act and to approve a related amendment to Rule 11a-3, regarding exchange programs.¹ New Rule 22c-2 will:

- make it clear that a fund is permitted (not required) to impose a redemption fee of up to 2%, to be retained by the fund;²
- require fund boards to consider whether it is appropriate to impose a redemption fee—if a board determines a fee is advisable, it would determine what the fee should be (up to 2%) and what the holding period (no less than seven days) should be;
- require funds to enter into written agreements with intermediaries that hold fund shares on behalf of other investors,

under which the intermediaries must agree to: (a) provide funds with certain shareholder identity and transaction information *if the fund requests it*; and (b) implement any instructions from the fund to impose trading restrictions against traders the fund has identified as violating the fund's market timing policies;

- exempt money market funds, exchange-traded funds and funds specifically designed for market timers.

The Rule 11a-3 amendment defines "redemption fee" as a fee imposed in accordance with Rule 22c-2.³

The Adopting Release indicates that "[a]s a result of our adoption of this rule, ... the staff no-action positions concerning redemption fees have terminated." Thus, funds that have adopted redemption fee arrangements pursuant to no-action letters may wish to consider whether revisions and/or further board review are necessary. They will also have to enter into agreements with financial intermediaries, as required by the Rule.

The Adopting Release also requests comment on whether the SEC should adopt uniform requirements regarding certain features of redemption fees, such as methods for determining the holding period and mandatory *de minimis* and other exemptions. The SEC is concerned that intermediaries may not find it

¹ See Release No. IC-26782, March 11, 2005 ("Adopting Release").

² For purposes of Rule 22c-2, each series of a fund is a "fund."

³ See Rule 11a-3(a)(7), as amended.

advantageous to cooperate with funds in implementing the Rule and seeks comment on whether certain types of uniformity may make the rule more attractive to intermediaries. Thus the Rule, as adopted, may be changed before its effective date.

The effective date of new Rule 22c-2 is May 23, 2005. Compliance with the new rule is required by October 16, 2006.⁴ The deadline for comments regarding the desirability of adding certain uniform requirements to the Rule is May 9, 2005.

Following is a summary of the provisions of the new Rule. Certain of these provisions are further analyzed in the “Discussion” section below.

Rule 22c-2

Rule 22c-2 makes it unlawful for an open-end fund, its principal underwriter, or any securities dealer to redeem fund shares within seven calendar days after their purchase unless the following requirements are satisfied by October 16, 2006.

- The fund’s board of directors and a majority of the independent directors have either:
 - approved a redemption fee (to be retained by the fund), in an amount no greater than 2% of the value of the redeemed shares, to be imposed on shares that are redeemed within a time period (no less than seven calendar days);⁵ or
 - determined that a redemption fee is either not necessary or not appropriate.

The Rule does not prohibit including redemption fee waiver provisions in a fund’s redemption fee arrangement.

- The fund or its principal underwriter have entered into a written agreement with each “financial intermediary” of the fund, under which the financial intermediary has agreed to:

- promptly at the fund’s request provide Taxpayer Identification Numbers of all shareholders who have purchased, redeemed, transferred or exchanged fund shares through an account held by the financial intermediary, and the amount and dates of each such transaction; and
- execute any fund instructions to restrict or prohibit further purchases or exchanges of fund shares by shareholders identified as having engaged, directly or indirectly through the financial intermediary’s account, in transactions that violate the fund’s frequent transaction policies.

The fund must maintain an accessible copy of each agreement with a financial intermediary that was in effect at any time during the past six years.

For purposes of the foregoing:

- a “financial intermediary” includes: (i) any broker, dealer, bank or other entity that holds fund shares in nominee name; (ii) an insurance separate account organized as a unit investment trust, a fund that invests in the fund in reliance on Section 12(d)(1)(E) of the 1940 Act (a master-feeder fund or a fund that invests in the fund other than pursuant to Section 12(d)(1)(G) of the 1940 Act); and (iii) either the administrator or record keeper of a participant-directed retirement plan that holds fund shares; and
- a “shareholder” includes: (i) a beneficial owner of securities held in nominee name; (ii) a participant in a participant-directed employee benefit plan, and (iii) a holder of interests in a master-feeder fund or insurance company separate account organized as a unit investment trust. The term does *not* include: (i) a fund that invests in affiliated funds pursuant to Section 12(d)(1)(G); or (ii) a Section 529 account or an interest holder in such an account.⁶

The Rule’s requirements do not apply to money market funds, funds whose shares are listed on a national securities exchange, or funds that affirmatively permit short-term trading if their prospectuses clearly and prominently disclose their policy to permit such trading, as well as the additional costs to the fund of such

⁴ The Adopting Release does not mention an effective date for the amendment to Rule 11a-3.

⁵ The redemption fee should be an amount that is appropriate (i) to recoup costs incurred by the fund attributable to those redemptions or (ii) to eliminate or to reduce any resulting dilution of fund share value.

⁶ The SEC believes these excepted categories have no incentive to engage in frequent trading.

trading.⁷ However, any such fund that does adopt a redemption fee must comply with the other requirements of Rule 22c-2.

Discussion

The SEC believes that redemption fees, in combination with fair value pricing, have been shown to be effective in reducing or eliminating market timing.⁸ In adopting Rule 22c-2, the SEC has, however, backed away from its original proposal, which would have required funds to impose a 2% redemption fee on redemptions within 5 days of purchase.⁹ Rule 22c-2 reflects the SEC's conclusion that a mandatory 2% redemption fee might not be appropriate for all funds, and that the decision whether to adopt a redemption fee and, if so, the amount of the fee, should be left to fund boards. However, the SEC has continuing concerns as to whether intermediaries will deal with funds that have redemption fees. (See "Request for Additional Comment," below.)

This section discusses certain features of the Rule in more detail.

Board Review

The Adopting Release states that "[a] fund that currently has a redemption fee would meet the rule's requirement [regarding board review], although the fund's directors may choose to review the redemption fee to determine whether the amount of the fee and the holding period continue to meet the fund's needs." Therefore, if a fund has adopted a redemption fee that satisfies the other requirements of Rule 22c-2, it would not have to reconsider the issue. However, if the fund's redemption fee does not satisfy the conditions of the Rule, the board must consider how to revise the fee to bring it into

⁷ Note that, unlike the proposed rule, final Rule 22c-2 does not require a fund that permits short-term trading to have a fundamental policy to that effect.

⁸ The SEC is expected to issue an interpretive relief giving guidance on fair value pricing in the very near future.

⁹ See Release No. IC-26375A, March 5, 2004 ("Proposing Release"). Nearly 400 comments were received on the original proposal. Eighty-five percent of comments opposed the mandatory fee requirement, and most comments from individual investors were negative. Comments from funds and intermediaries recognized the need to develop measure to address market timing, but offered a variety of ideas.

compliance with the Rule.¹⁰ Moreover, the board would have to conduct the required review for any new series. Finally, the board of a fund that has not adopted a redemption fee, unless it has previously considered the question, would be required to consider, in advance of the compliance deadline whether the fund should have a redemption fee. At the SEC open meeting at which the Rule was adopted, Paul Roye, Director of the SEC's Division of Investment Management, suggested that the elements of such a review could include:

- analysis of share trading information to determine whether the fund has been subject to frequent trading by particular shareholders;
- consideration of alternate means of controlling frequent trading, if any, such as through fair valuation, delaying payment of proceeds of redemptions and exchanges for up to seven days, or redeeming in kind;
- whether the costs of implementing controls outweighs anticipated benefits to the fund and its shareholders.

Redemption Fee Amount

Rule 22c-2 makes it clear that the amount of the redemption fee need not be dependent on the level of administrative and processing costs incurred in processing redemptions, as had been suggested in previous no-action letters.¹¹ Instead, Rule 22c-2 permits "redemption fees to be based on the judgment of the fund and its board." The Adopting Release states that a fund board, in determining the level of the redemption fee (which may not, in any case, exceed 2%), might, for example, consider indirect costs of short-term trading, such as costs of maintaining higher cash positions. The related amendment to Rule 11a-3 incorporates these concepts into redemption fees imposed on exchanges.

Holding Period

Rule 22c-2 permits a fund to impose a redemption fee on shares redeemed within seven or more calendar days of their purchase. This is a slight change from the proposal, which required a 2% fee to be imposed on redemptions within five *business* days of purchase. The rule permits a fund board to adopt a longer-than-seven-

¹⁰ This point was verified with William Middlebrooks of the SEC staff on March 24, 2005.

¹¹ See, e.g., John P. Reilly & Associates, SEC Staff No-Action Letter (July 12, 1979).

day minimum holding period and/or a lower-than-2% fee, in appropriate cases.

Note that the Rule, unlike the original proposal, does *not* (a) mandate how the amount of the fee should be calculated,¹² or (b) establish mandatory fee waiver categories. Thus, these features may be determined by each fund. The SEC is seeking comment on whether it should adopt such requirements. (See “Request for Additional Comment,” below.)

Written Agreements with Financial Intermediaries

Rule 22c-2 requires that each fund, regardless of whether it has adopted a redemption fee, to enter into a written agreement with each financial intermediary that holds shares of the fund in nominee name, each unit investment trust or fund that invests in the fund in reliance on Section 12(d)(1)(E) of the 1940 Act and each participant-directed retirement plan administrator or record keeper for a plan that holds fund shares. The agreements must be maintained with the fund’s records. No agreement would be required with an intermediary who holds shareholder accounts only on a fully disclosed basis, in which the identity of the shareholder and other information are readily available to the fund.

Each agreement must oblige the intermediary to provide, at the fund’s request, the Taxpayer Identification Number, and amounts and dates of transactions by each shareholder who purchased, redeemed, transferred or exchanged fund shares.¹³ The “on request” provision, according to the Adopting Release, makes funds responsible for determining when they need the assistance of a financial intermediary in monitoring and enforcing the fund’s market timing policies.

Each agreement must also oblige the intermediary to implement instructions from the fund to restrict or prohibit further purchases or exchanges by specified shareholders who have been identified by the fund as having engaged in transactions that violate the fund’s

¹² The proposal would have required that (a) shares held the longest be redeemed first, (b) the amount of the fee must be based on proceeds *before* the deduction of deferred sales load or administrative fees, and (c) the fee could either reduce redemption proceeds or increase the number of shares redeemed.

¹³ The “on request” provision is a change from the proposed rule, which would have required intermediaries to provide this information every week.

market timing policies, directly or through the intermediary.

The Adopting Release acknowledges that this requirement will impose substantial “one-time” costs on financial intermediaries, who must develop systems to collect the required information. However, the SEC believes the resulting consistency in applying market timing policies to shareholders who hold fund shares directly and those who hold through omnibus accounts justifies the expense. The Adopting Release also acknowledges that it may not always be clear to a fund whether shares are held through an intermediary. The SEC “expects that funds and their transfer agents will use their best efforts to ascertain which record shareholders are holding shares as intermediaries.”

Request for Additional Comment

The SEC seeks further comment on whether it should establish uniform standards for funds that decide to impose redemption fees. The issue here is the cost to funds and intermediaries of dealing with a wide variety of arrangements. The SEC is also concerned that certain intermediaries may either provide funds with incentives to waive fees or may refuse to deal with funds that impose redemption fees, at least on omnibus accounts. Additionally, no consensus developed during the comment period on redemption fee features, perhaps because some funds view redemption fees as a cost recovery mechanism, while others view the fee as a deterrent.

Areas in which comment is requested are outlined below.

Advantages of a Uniform Standard for Redemption Fees

The SEC asks whether uniformity would decrease costs and encourage intermediary cooperation, or merely reduce fund flexibility.

Share Accounting

Should the Rule require that the length of time a share is held be determined by considering that shares held the longest are redeemed first (“FIFO”), or by some other method?

De Minimis Waivers

Should the rule require, or permit, a redemption fee waiver for a redemption that would result in a fee of \$50 or less? For a fund imposing a 2% redemption fee, the

waiver would apply to redemptions of \$2,500 or less. A mandatory requirement would simplify implementation by intermediaries. However, some comments on the original proposal suggested that timers might place multiple small transaction orders to avoid the fee.

Amount of Redemption Fee & Length of Holding Period

The SEC understands that intermediaries can more easily handle variations in the amount of a redemption fee (except for different fees charged by the same fund) and length of the holding period than other aspects of these fees. Thus, the SEC does not contemplate establishing uniform fee amounts or holding periods. The SEC asks for comment on whether it would be easier for intermediaries to administer redemption fees if the elements discussed below were fixed, while amount and holding period were decided by each fund, than if all the elements were variable.

Investor Initiated Transaction

Should redemption fees be limited to transactions initiated by investors? This approach would exempt shares purchased by reinvestment of dividends and distributions and shares purchased or sold through automatic or non-discretionary purchase, rebalancing or redemption plans. The SEC asks whether a combination of FIFO and a *de minimis* exemption would satisfy concerns regarding these non-discretionary transactions. Would a fund and/or intermediaries be able to identify qualifying transactions? If not, should the exemption be mandatory only as to retirement plan investments? Should the non-discretionary exemption be optional, with terms to be worked out by a fund and its intermediaries?

Financial Emergencies

The SEC “envisions” that the Rule would permit funds to grant waivers for financial emergencies. It notes that comments on the proposed rule objected to a mandatory waiver for emergency redemptions because it would be difficult to verify that such requests are legitimate and to define “emergency.”¹⁴ The SEC seeks comment on whether a mandatory waiver for emergency redemptions would discourage funds from adopting redemption fees. It also seeks comment on how to define “financial emergency.”

¹⁴ At least one comment suggested using the Internal Revenue Code standards for hardship withdrawals from 401(k) plans.

Other Exceptions and Waivers

Comments are also requested on such issues as:

- Should the Rule require redemption fees to be applied to all share accounts, including sub-accounts of omnibus accounts? If so, would a fund need other information from an intermediary than what the current Rule requires, such as when one financial intermediary (such as a retirement plan administrator) submits a net fund order through a dealer that holds fund shares in an omnibus account?
- Should the Rule permit case-by-case waivers only in accordance with policies and procedures approved by the fund’s board of directors, including a majority of the independent directors?
- Should funds be required to keep records of waivers?
- Should there be exemptions for special types of funds, such as funds that invest in other funds pursuant to Section 12(d)(1)(F) under the 1940 Act,¹⁵ or unit investment trusts? Should 529 plans be exempted, as they are in the current Rule?

Variable Insurance Contracts

The SEC asks for comment on whether the Rule should contain a mandatory prohibition on imposing redemption fees on full or partial contract withdrawals from insurance company separate accounts organized as unit investment trusts. Under the Rule as adopted, a fund would be permitted, but not required, to adopt such an exemption. Among other things, a redemption fee would interfere with contract-holders’ “free look” privilege and a mandatory fee could conflict with state law. The SEC asks whether other provisions are needed to address the special circumstances of insurance company separate accounts.

Methods of Implementation by Financial Intermediaries

The Proposing Release suggested three methods for assuring the imposition of redemption fees in accounts held through financial intermediaries. First, intermediaries could provide account numbers for each transaction, which could be matched by the fund or its transfer agent against previous transactions by that

¹⁵ Section 12(d)(1)(F) permits a fund (and its affiliates) to purchase up to 3% of an unaffiliated fund’s shares, subject to certain conditions.

account. Second, intermediaries could be contractually required to identify redemptions to which the fee would apply and to provide information to the fund or its transfer agent sufficient to permit assessment of the fee. Third, the intermediary could be required to impose and remit redemption fees to the fund. Some comments applauded this flexibility, while others objected that it would be too expensive for intermediaries to accommodate all three options. The SEC asks for comment on whether the proposed flexibility is desirable, and if so, which entity should determine the option to be used.

Recordkeeping

The SEC asks whether, in addition to agreements with intermediaries, a fund should be required to maintain copies of board materials used in connection with approving a redemption fee.

Timing Considerations

The conclusion of agreements with financial intermediaries is likely to be time-consuming. However, it is not clear whether the Rule will remain in its present form after the SEC reviews comments on the uniformity

question. Financial intermediaries may delay putting in place the technologies necessary to honor their obligations under the required agreements until they are sure about the final provisions of the Rule. It may be premature to revise a current frequent trading or redemption fee policy or to develop a policy anew when there is a significant likelihood the Rule will be revised before compliance is required.

Fund management faces difficult timing questions as to when it may be advisable to recommend that a fund's board undertake to develop a redemption fee policy, develop a form of agreement for financial intermediaries and begin negotiating agreements with financial intermediaries.

Funds that have adopted redemption fees in reliance on previous SEC staff no-action letters that, according to the Adopting Release, are "terminated" due to the adoption of Rule 22c-2, may wish to consult with counsel about what action they should take.

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