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A legal update from Dechert's Financial Services Group

SEC Votes to Amend and Clarify Operation of Redemption Fee Rule

On September 26, 2006, the Securities and Exchange Commission ("SEC" or the "Commission") voted to adopt amendments to Rule 22c-2 (the "Rule"), the redemption fee rule, to make it easier for mutual funds to comply with the Rule that is designed to prevent improper market timing and similar abusive transactions. The Rule, which the SEC originally adopted in 2005, requires most mutual funds to enter into shareholder information agreements with intermediaries, such as broker-dealers, that hold shares on behalf of other investors; thus permitting the fund to identify market timer.[1]

The Rule, as originally adopted, had a compliance date of October 16, 2006. In response to industry complaints that the terms were too onerous in that some funds would need to adopt written agreements with hundreds or thousands of intermediaries to share information about investors, the Commission adopted the amendments to simplify the Rule and reduce the number of shareholder agreements into which funds must enter.[2]

The SEC also extended the date for entering into shareholder information agreements by six months to April 16, 2007, and the date by which funds must be able to obtain information from intermediaries under those agreements for one year to October 16, 2007. The original compliance date for section 22c-2(a)(1), which requires a fund's board to consider the adoption of a redemption fee policy by October 16, 2006, remains in effect.

Background

Amid growing concern about the damage posed by market timing and other abuses associated with short-term trading of fund shares, the SEC adopted the Rule under the Investment Company Act of 1940 on March 11, 2005. Under the Rule, the fund boards of most mutual funds[3] are required to consider whether to implement a fee of up to 2% of the value of any shares redeemed by a customer from a fund within a short time after purchase.

The Rule also requires funds to enter into agreements with their intermediaries that would grant access to information concerning the trading patterns and practices of customers of the intermediaries. In response to industry comments, the proposed amendments to the Rule were an attempt to reduce the costs to mutual fund firms as they work to comply with the current rule while preserving the Rule's intended objective.[4]

On September 26, 2006, the SEC voted to adopt these amendments to the Rule substantially as proposed. In its release, the Commission said that the Rule changes "clarify the operation of the rule, and reduce the number of shareholder information agreements

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1 *See* Rel. No. IC-26782 (Mar. 11, 2005) (the "Adopting Release").

2 *See* Rel. No. IC-25704 (Sept. 27, 2006) (the "Release").

3 The Rule applies to all open-end funds (i.e., mutual funds) other than money market funds, ETFs, and funds with a disclosed policy of permitting short-term trading. Accordingly, this alert generally will describe funds as being required to comply with the rule.

4 *See* Release No. IC- 27255 (Feb. 28, 2006). *See also Dechert OnPoint* March 2006/Issue 3 *SEC Proposes Amendments to Redemption Fee Rule for Mutual Funds*.

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that funds must enter into with their intermediaries."[5] Specifically, these Rule amendments:

- Limit the types of intermediaries with which the funds must enter into shareholder information agreements
- Address the Rule's application when there are chains of intermediaries
- Clarify the effect of a fund's failure to obtain an agreement with any of its intermediaries

Definition of ''Financial Intermediary''

As originally adopted, the Rule prohibits a fund from redeeming shares within seven days unless, among other things, the fund enters into written agreements with its "financial intermediaries" that hold shares on behalf of other investors. Under those agreements, the intermediaries must agree to provide, at the fund's request, shareholder identity (i.e., taxpayer identification number or "TIN") and certain transaction information, and to restrict further transaction from shareholders the fund identifies as being in violation of its market timing policies. Because the Rule defines "financial intermediary"[6] very broadly, many commenters expressed concern that the Rule would require them to look at a large number of shareholder accounts[7] in order to determine which shareholders are "financial intermediaries" and that such task would be costly and burdensome.

In response to these concerns, the SEC amended the definition of "financial intermediary" to exclude from the definition those intermediaries that the fund treats as an "individual investor" for purposes of the fund's frequent trading and redemption fee policies. The SEC explains that when a fund places restrictions on transactions at the intermediary level (i.e., when the fund treats the intermediary itself as an individual investor), the fund is unlikely to need data about frequent trading by individual shareholders who hold shares through that intermediary, because abusive short-term trading by the individual shareholders holding through the omnibus account would ordinarily trigger application of those policies to the intermediary's trades.

A fund typically exempts from its frequent trading policies the transactions of an intermediary that holds fund shares, on behalf of its customers, in an omnibus account with the fund. A fund exempts the intermediary because the daily changes in the intermediary's position, on behalf of its various customer's purchases and redemptions result in a single purchase or redemption each day in the intermediary's omnibus account. If the intermediary were not exempt, its daily net trades would likely subject it to redemption fees or trading limitations.[8]

To clarify, the SEC states, as an example, that if a fund applies a redemption fee or exchange limits to transactions by a retirement plan (an intermediary) rather than to the purchases and redemptions of the employees in the plan, then the plan would not be considered a "financial intermediary" under the Rule, and the fund would not be required to enter into an agreement with that plan. Thus, a fund would have the option of applying its redemption fee policies to participant-directed pension plans in which the participants may direct individual purchases and sales of fund shares in their accounts. It is difficult to predict how many funds would choose this option.

Also, in response to comments that it is unclear whether an order submitted by an agent of an intermediary would be covered by the Rule, the Commission revised the Rule to provide that funds must enter into agreements with "each financial intermediary that submits orders, itself or through its agents, to purchase or redeem shares directly to the fund."[9]

Intermediary Chains

In response to concerns how a fund, as a practical matter, could obtain shareholder information through multiple layers of intermediaries, the SEC amended the Rule to clarify the operation of the Rule as it ap-

5 SEC Press Release 2006-167, September 27, 2006.

6 "Financial Intermediary" is defined in rule 22c-2(c)(1).

7 These accounts include, for example, small business retirement plans that hold mutual fund shares on behalf of only a few employees and that are traditionally not considered to be financial intermediaries.

8 *See* Release at n 15.

9 *See* Rule 22c-2(a)(2).

plies to "chains of intermediaries." As revised, the Rule requires a fund or, on the fund's behalf, its principal underwriter or transfer agent[10] to enter into a shareholder information agreement[11] only with those financial intermediaries that submit purchase or redemption orders directly to the fund, its principal underwriter or transfer agent, or a registered clearing agency ("first tier intermediaries"). The Rule does not require first-tier intermediaries to enter into shareholder information agreements with any indirect intermediaries.

Further, the SEC also amended the definition of "shareholder information agreement" to clarify that a fund, after receiving initial transaction information from a first-tier intermediary, must make a specific further request to the first-tier intermediary if it desires information on certain shareholders.[12] Pursuant to the amended Rule, rather than having to perform a complete review of its books and records to identify all indirect intermediaries, a first-tier intermediary must use its best efforts to identify whether or not certain specific accounts identified by the fund are indirect intermediaries. It is only after an indirect intermediary does not provide the requested information that the fund can further request that the first-tier intermediary restricts or prohibits that indirect intermediary from purchasing additional shares of the fund on behalf of other investors.[13]

Effect of Lacking an Agreement

Under the Rule, if a fund does not have an agreement with a particular intermediary, the fund thereafter must prohibit that intermediary from purchasing securities issued by the fund.[14] In its amendment, the SEC clarified that this prohibition only applies to the intermediary with which the fund does not have an agreement and that purchases from other intermediaries will not be effected. Additionally, the SEC revised the Rule to provide that, if there is no shareholder information agreement with a particular intermediary, the fund must prohibit the intermediary from purchasing the fund's securities only "in nominee name on behalf of other persons" and that this prohibition does not apply to the intermediary purchases of fund securities on behalf of the intermediary itself.[15]

Operation of the Rule and Redemption Fees

Despite several commenters' request for the imposition of limits on the frequency of information requests made by funds pursuant to the shareholder information agreements, the SEC declined, and instead stated that a fund, in determining the frequency with which it should seek information from intermediaries, could consider:

- Unusual trading patterns, such as abnormally large inflows or outflows, that may indicate the existence of frequent trading abuses
- The risks that frequent trading poses to the fund and its shareholders in light of the nature of the fund and its portfolio
- The risks to the fund and its shareholders of frequent trading in light of the amount of assets held by, or the volume of sales and redemptions through, the financial intermediary
- The confidence the fund (and its chief compliance officer)[16] has in the implementation

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10 This revision also includes the addition of a fund's transfer agent as an entity that may enter into a shareholder information agreement on the fund's behalf.

11 *See* Rule 22c-2(c)(5) (agreement must be in writing, and may be part of another contract or agreement, such as a distribution agreement).

12 *See* Rule 22c-2(c)(5)(iii) Shareholder information agreement defined as an agreement under which a financial intermediary agrees to "[u]se best efforts to determine, promptly upon request of the fund, *whether any specific person about whom it has received the identification and transaction information* [emphasis added] . . . is itself a financial intermediary."

13 *See* Rule 22c-2(c)(5)(iii)(B).

14 *See* Rule 22c-2(a)(2)(ii). For purposes of this provision, a "purchase" does not include the automatic reinvestment of dividends.

15 *See* Rule 22c-2(a)(2)(ii), (c)(5)(iii)(B).

16 *See* Compliance Programs of Investment Companies and Investment Advisors, Rel No. IC- 26299, at n.69 and accompanying text (Dec. 17. 2003). "[U]nder rule 38a-1, a fund must have procedures reasonably designed to ensure compliance with its disclosed policies regarding market timing. These procedures should provide for

by an intermediary of trading restrictions designed to enforce fund frequent trading policies or similar restrictions designed to protect the fund from abusive trading practices

The SEC also noted that some intermediaries have enforced their own frequent trading policies, and that a fund may in appropriate circumstances reasonably conclude that such policies sufficiently protect fund shareholders. If so, the fund is required to describe in its prospectus the types of intermediaries and refer the shareholders to any disclosures provided by the intermediary that may impose frequent trading restrictions that differ from those of the fund. A fund is also required to describe with specificity the circumstances, if any, under which trading restrictions apply to trades that occur through omnibus accounts at intermediaries.

In response to suggestions that the Rule allow for the use of alternate forms of identification in cases where TINs may not be available (e.g., foreign shareholders), the Commission revised the Rule to all for the use of TINs or other government issued identifiers when a TIN is not available.[17]

Compliance Costs

In its statutorily required cost-benefit analyses, the SEC distinguished between two distinct "collections of information" for purposes of the Paperwork Reduction Act of 1995. The first relates to the shareholder information agreements, including the costs and time related to identifying the relevant intermediaries, drafting the agreements, negotiating new agreements or modifying existing ones, and maintaining the agreements in an easily accessible place. The second relates to the costs and time of developing, maintaining, and operating the systems to collect, transmit, and receive the information required under the shareholder information agreements.

Based on an estimate of approximately 900 funds and 7,000 intermediaries that may provide information pursuant to the Rule, the SEC estimated one-time start-up costs of $444 million to both funds and intermediaries—comprised of (i) the costs to funds and their intermediaries of negotiating and entering into the Rule's required information sharing agreements at $53.5 million, (ii) the cost of entering into separate agreements between direct and indirect intermediaries at $63 million, and (iii) the up-front costs of building the necessary industry-wide systems infrastructure to accommodate the new information sharing rules at $327.5 million ($47.5 borne by funds and $280 million borne by intermediaries)—and annual operation costs of $215.1 million ($22.6 million borne by funds and $192.5 million borne by intermediaries).

Extended Compliance Date

In the Release, the SEC extended the compliance date by 6 months to April 16, 2007, the date by which funds must enter into shareholder information sharing agreements with their intermediaries. To allow additional time for funds, intermediaries, and others to revise their systems and to accommodate the request, provision, and use of information from intermediaries, the Commission also extended by 12 months, until October 16, 2007, the date by which funds must be able to implement the provisions of the shareholder information agreements.

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monitoring of shareholder trades or flows of money in and out of the funds in order to detect market timing activity, and for consistent enforcement of the fund's policies regarding market timing."

[17] *See* Rule 22c-2(c)(5)(i).

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