DechertOnPoint

March 2006 / Issue 3

A legal update from Dechert's Financial Services Group

SEC Proposes Amendments to Redemption Fee Rule for Mutual Funds

Introduction

In response to industry comments, the Securities and Exchange Commission ("SEC") has proposed amendments to the controversial redemption fee rule, in an attempt to reduce the costs to mutual fund firms as they work to comply with the current rule before its effective date, while preserving the rule's intended objectives.[1]

The Current Rule

To combat market timing and other abuses associated with short-term trading of mutual fund shares, the SEC adopted Rule 22c-2 (the "Rule") under the Investment Company Act of 1940 on March 11, 2005.[2] Under the Rule, the boards of directors or trustees 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. The purpose of this provision is to ensure that mutual funds have access to the information necessary to determine whether their customers are violating the funds' restrictions (if any) on short-term trading.

The Proposed Amendments

After the initial adoption of the Rule, the SEC solicited comments on several subjects, including whether commenters anticipated any problems with the Rule's implementation. In response to this request, several commenters claimed that implementing the rule would be more costly for fund groups than the SEC anticipated, principally due to the requirement that funds enter into agreements with any fund customers that invest on behalf of others, regardless of how small these intermediaries may be.

In response to these comments, the SEC has proposed to amend the Rule in three ways:

- To limit the number of intermediaries with which a fund must enter into agreements
- To address the Rule's application to "strings of intermediaries"
- To clarify the effect of a fund's failure to obtain required agreements with intermediaries

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1 *See* Mutual Fund Redemption Fees, Investment Company Act Release No. 27255 (February 28, 2006). The Rule currently is scheduled to go into effect on October 16, 2006. However, in conjunction with the release of the proposed amendments to the Rule, the SEC has requested comment as to whether the effective date should be extended. The deadline for comments on the proposed amendments themselves is April 10, 2006.

2 *See* Mutual Fund Redemption Fees, Investment Company Act Release No. 26782 (Mar. 11, 2005).

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.

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With What Intermediaries Must a Fund Enter into Agreements?

Under the current version of the Rule, mutual funds will be required enter into written agreements with their financial intermediaries (including, for example, broker-dealers and retirement plan administrators) that hold shares on behalf of other investors, regardless of whether the intermediary is a small employee benefit plan investing on behalf of three employees, or a large broker-dealer investing on behalf of thousands. These agreements must require financial intermediaries to provide, at a fund's request, the identity of the shareholder and certain transaction information, and to restrict further transactions from shareholders the fund identifies as being in violation of its market timing policies.

Many commenters were concerned that requiring mutual funds to identify and enter into agreements with such a large number of intermediaries would be costly, time-consuming, and not in keeping with the true meaning of the Rule. In the Release accompanying the proposed amendments to the Rule, the SEC indicates that this is an unintended consequence of the Rule.

Therefore, the proposed amendments would exclude from the definition of "financial intermediary" any intermediary a mutual fund treats as a single customer for purposes of its frequent trading and redemption fee policies. For example, under the proposed amendments, if a fund's policies would call for a redemption fee to be assessed or a trading frequency limitation to be assessed against an employee benefit plan, as opposed to its employees, the plan itself would be the customer of the fund, and the fund would not be required to enter into an agreement with that plan.

The SEC believes that this will prevent funds from having to engage in the costly and cumbersome process of identifying all its financial intermediaries, because funds should already have identified all the relevant intermediaries during the process of implementing and enforcing their policies on short-term trading. Furthermore, the SEC believes that the aims of the Rule will not suffer as a result of this modification, because by placing restrictions on trading at the intermediary level, a fund would allow the intermediary's own policies on abusive trading to govern.

Chains of Intermediaries

Some financial intermediaries may purchase shares of a mutual fund for other financial intermediaries. It was unclear how the Rule would apply to those situations. Some commenters feared that the Rule would require a fund to sift through several layers of intermediaries to uncover information pertaining to the "true" shareholder.

In response to these comments, the proposed amendments to the Rule would require a mutual fund to enter into shareholder information agreements only with intermediaries that purchase shares directly from the fund, its principal underwriter or transfer agent, or a registered clearing agency.[4] The proposed amendments refer to these as "first-tier intermediaries."

The shareholder information agreements must grant a fund the right to request, and must require the intermediary to provide promptly, the identification and transaction information for any shareholder accounts held directly with the first-tier intermediary. If a first-tier intermediary were to refuse to honor such a request, the shareholder information agreement must obligate the first-tier intermediary, upon the fund's request, to preclude the indirect intermediary from purchasing additional shares through the first-tier intermediary.

The Effect of Not Having Required Agreements

Some commenters noted that the current version of the Rule could be interpreted to prevent a mutual fund from redeeming the shares of any of its shareholders if it failed to get the requisite agreement from even one of its financial intermediaries. To clarify this potential ambiguity, the final proposed amendment to the Rule would provide that, if a fund fails to obtain an appropriate agreement with a particular financial intermediary, the fund would be precluded from accepting purchase requests from the intermediary, whether the request is for the intermediary itself or on behalf of other persons.

Customer Privacy Implications

Some commenters expressed concerns that the customer privacy provisions of the Gramm Leach Bliley Act ("GLBA") might preclude certain financial intermediaries from providing to mutual funds the shareholder information required by the Rule.[5] Under GLBA, a financial

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4 Currently, the National Securities Clearing Corporation is the only registered clearing agency in existence.

5 The privacy provisions of GLBA are codified at 15 U.S.C. §§ 6801-09, 6821-27. The SEC has promulgated Regulation S-P (17 C.F.R. § 248) implementing these provisions as to funds, broker-dealers, and registered investment advisers. Substantially identical regulations also apply to

intermediary is required to notify certain customers of its privacy and information sharing policies, and give these customers the opportunity to "opt out" of the sharing of the customers' information with non-affiliated third parties of the intermediary. In the release accompanying the proposed amendments, the SEC staff clarified its position that, under regulations implementing GLBA promulgated by various functional regulators, an exception to GLBA exists for information sharing that is necessary to carry out transactions that the customer has requested. Furthermore, the SEC staff notes that another exception exists for disclosures required by law.

other financial institutions, such as banks and thrifts. *See, e.g.,* 12 C.F.R. Part 40 (regulations of the Office of the Comptroller of the Currency pertaining to national banks).

6 17 C.F.R. § 248.14(a), (b)(2).

Conclusion

These amendments, if adopted, will significantly reduce the burden on mutual fund groups to identify and secure agreements with intermediaries, and will clarify several ambiguous provisions of the Rule. However, even under the proposed version of the Rule, mutual fund groups will still be required to consider carefully what level of redemption fee, if any, is appropriate and negotiate shareholder information agreements with relevant financial intermediaries.

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