



NAGDCA NOTES

"To Fee, Or Not To Fee" That Continues to Be the Question... Latest News on Redemption Fees

In 2004, the Securities and Exchange Commission (SEC) proposed a new Rule 22c-2 under the Investment Company Act of 1940 that would require all mutual funds (with certain limited exceptions) to impose a 2 percent redemption fee on the redemption of shares purchased within the previous five days. The redemption fee would be retained by the fund. The rule was designed to require short-term shareholders to reimburse the mutual fund for costs incurred when they use the fund to implement short-term trading strategies.

Common practice has been that individuals who partake in participant-directed plans direct their account funds among plan investment options that are selected by a plan fiduciary who is responsible for prudently selecting and monitoring the plan investment options. Plan fiduciaries very often select mutual funds as plan investment options and are able to select mutual funds from several different mutual fund complexes under an "open architecture" model. In this regard, plan recordkeepers and administrators that are not affiliated with mutual fund investment managers have developed the capability of providing plans access to a broad, diversified selection of mutual funds and other investment options. As a result, even plan recordkeepers and administrators that are affiliated with large mutual fund complexes often offer their competitors' mutual funds. Many feel that this trend provides important benefits to plans and participants because plan fiduciaries may select from a broad range of mutual funds to obtain the best combination of investment performance and cost for plan participants.

Until recently, many mutual funds have waived redemption fees on shareholder transactions through an "omnibus" account. However, most likely in anticipation of the SEC's final rule respecting this issue, mutual fund complexes are now beginning to request that plan recordkeepers and administrators assist in imposing redemption fees in connection with short-term trading activities by plan participants.

On March 3, 2005, the SEC unanimously voted to adopt a revision of Rule 22c-2, concerning mutual fund redemption fees. The rule will require the boards of mutual funds that redeem shares within 7 days to:

- i. Adopt a redemption fee of no more than 2 percent of the amount of the shares redeemed; or
- ii. determine that a redemption fee is not necessary or appropriate for the fund.

The rule is designed to permit (but not require) funds to impose a redemption fee if they determine that the fee is necessary or appropriate to recoup the costs that short term trading can impose on funds and their long term shareholders. Many funds have adopted redemption fees as a tool to combat market timing and other abusive short term trading in fund shares. The rule will not prevent funds from taking other steps to address such abusive trading.

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The fund itself will retain the proceeds from the redemption fees. Unlike the rule that the SEC proposed in 2004, the rule will not require funds to impose redemption fees, or set the amount of them (other than limiting the fee to 2 percent or less). Many commenters emphasized that short-term trading may not impose the same costs on all types of funds.

The rule will require funds that redeem shares within seven days to enter into agreements with their intermediaries (such as broker-dealers and retirement plan administrators) obligating them to provide funds with shareholder trading information. This information will permit funds to identify shareholders who violate the funds' market timing policies, and oversee the intermediaries' assessment of any redemption fees. However, the difference in the revised proposal from 2004 is that the rule now will permit fund managers to determine how frequently the fund asks for this information, and will include a provision requiring that the agreement obligate the intermediary to respond to directions from the fund to enforce the fund's market timing policies.

The rule will not apply to money market funds and exchange traded funds. It also will not apply to mutual funds that encourage active trading and disclose to investors in the prospectus that such trading will likely impose costs on the fund.

The SEC has also requested additional comment on whether it should revise Rule 22c-2 to require that any redemption fee conform to certain uniform standards. The SEC's adoption of a uniform (but not mandatory) redemption fee might substantially reduce the cost of fee collection and, as a result, enable more intermediaries to participate in redemption fee programs. Without their participation, funds may continue to be unable, as a practical matter, to impose redemption fees in order to protect their shareholders against abusive short term trading. The deadline for comments fell in April of 2005.

The compliance date for the rule is 18 months after Federal Register publication of the release (i.e., late 2006).

For more information on the U.S. Securities and Exchange Commission visit <http://www.sec.gov/> or contact NAGDCA Project Coordinator Robert T. Hansel at rhansel@amrinc.net or 859-514-9161. To view the original proposition of Rule 22c-2 simply visit <http://www.sec.gov/rules/proposed/ic-26375a.htm>.