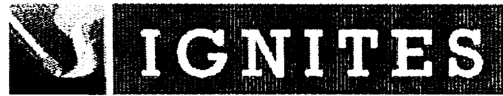

All that's hot in the mutual fund industry

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Redemption Fee Rule Widely Opposed

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By Alison Sahoo

As the comment period on the SEC's 2% redemption fee proposal closed yesterday, many made their opposition to the proposal clear.

Top reasons for the opposition include penalization of investors, the need for funds to police sales through intermediaries and the ability of fair-value pricing to eliminate arbitrage opportunities.

The rule would require mutual funds to impose a 2% redemption fee on sales of fund shares that were bought within five days of being purchased. The fee would be retained by the fund. All mutual funds, except for money market funds, exchange-traded funds and portfolios designed for short-term trading, would be subject to the rule.

It's an attempt by the SEC to make short-term traders reimburse the fund for the costs incurred when they use it to implement trading strategies like market timing.

Dr. Gary Harloff, founder of investment firm **Harloff, Inc.**, doesn't like the idea of a five-day blackout period. Anything could happen during that time, he notes. Plus, he likes the flexibility of being able to liquidate a position quickly if circumstances warrant.

Harloff says he isn't a very rapid trader. He typically places a few trades each month. But he says he doesn't want to be forced into using a market-timing-friendly fund family like **Rydex** or **Profunds**.

"I'd rather be in another fund family," he says. "Rydex and Profunds don't encompass the entire universe of funds. Their international funds are very limited."

Sheldon Stein, general counsel of **Ariel Capital Management**, says the new rule is not good for fund firms, either.

"The major problem with the fee is that 70% to 80% of all fund transactions are through intermediaries," he says. "Either we, the fund or the transfer agent will be responsible for double-checking that the intermediaries are imposing the fee correctly. It's a ridiculous burden. And if we fail, we'll have the SEC in on us or have some litigants ready to sue us."

Stein says the cost of such an undertaking could be steep. And it would be borne by the fund, not the manager.

Bin Zhou, president of **Fair Value Research**, says there's no reason for the fee when market-timing solutions are available.

"The intention of the rule is to curb market timing," he says. "And the reason for timing is price differentials between different markets. The only way to solve the market-timing problem is by fair-value pricing to eliminate those discrepancies."

Fair Value Research has developed a tool that aims to totally eliminate such arbitrage opportunities. Several companies are now testing it, says Zhou, but the product is not yet ready for commercial use.

When it is, it will compete with fair-value tools from **FT Interactive** and **Investment Technology Group**. Over the past 24 months, those companies have built a large following of fund clients seeking to reduce the extent to which their funds will be attractive to market timers.

Zhou says the SEC should issue further guidance on fair-value pricing so funds will understand the extent of their responsibilities.

The last time the regulator issued such direction was about three years ago, when Division of Investment Management chief counsel Doug Scheidt sent a letter to the Investment Company Institute on the topic.

That letter created a flurry of interest in the subject. But it also raised more questions about the circumstances under

which funds should fair-value their holdings.

Rooney Barker, a senior vice president with **M Financial Services**, says the proposal is just being used as a scapegoat to hide the performance of some fund managers.

"Some managers whose funds have underperformed their benchmarks are trying to blame that on market *timers,*" *he* says. "This is their way of getting together to get rid of them. But what are they going to use next time their fund underperforms?"

Barker also notes that day traders can buy and sell stock as often as they please with no restrictions. So a fee imposed on fund trades is unfair in comparison.

Bob Millen, a principal with **Jensen Investment Management**, says his firm doesn't have a position on the proposal one way or another.

"Our fund is not subject to trading and market timing," he says. "We have a very-low-turnover fund made up of high-quality securities that are very liquid. It wouldn't have a significant impact on us."

Millen does think, though, that the industry shouldn't be painted with a broad brush. That means letting individual boards decide whether or not to impose redemption fees.

A few folks favor the proposal.

Niels Holch, founder of The Coalition of Mutual Fund Investors, says he supports the 2% fee.

"It's a great tool to combat market timing," he says. "I think you need more than one tool to deal with this problem. Many funds now use redemption fees successfully."

Holch also notes that the proposal provides for exceptions for investors with particular problems. For example, it allows for free redemptions within the five-day window for those with financial hardship. And it doesn't apply to amounts of $2,500 or less.

The ICI would like to see the fee be even higher.

In its comment letter, the industry association suggested that the fee start at 2% and go as high as 4%. The ICI also wants to extend the fee period to seven days and eliminate the exceptions for financial emergencies and amounts under $2,500. That could allow market timers to game the system, it argued.

One industry observer says he thinks that despite the dissent, the rule will be passed.

"I think the SEC will adopt something whether we like it or not," he says. "The SEC doesn't like omnibus accounts. This may be a way to force third parties to give information to funds."

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