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SEC Gets Final Input on Redemption Fees

By Chris Frankie

With the SEC close to putting the finishing touches on its redemption fee rule, a number of groups have offered their suggestions for last-minute tweaks and improvements.

The SEC adopted its existing policy on redemption fees in early March. It requires fund boards to assess whether redemption fees are needed. But upon adopting the rule, the regulator sought additional industry comment on the need for developing standards for the fees.

The follow-up comment period closed earlier this week, and now it is up to the regulator to decide if it needs to establish standards for redemption fees.

In a comment letter sent to the SEC on Monday, the **Coalition of Mutual Fund Investors,** or CMFI, says the SEC should require intermediaries to provide funds with shareholder identity and omnibus account transaction information. CMFI is proposing that the information could be relayed at the time of the transaction or on a daily basis.

Without that level of disclosure, not all shareholders are treated equally, according to CMFI. Meanwhile, in regulatory filings, a good number of the largest funds in the industry have decribed challenges in policing market timers in omnibus accounts.

When an investor buys fund shares through an intermediary, his trades are often consolidated into one omnibus account, which is sent to the fund complex. Such bulk trades make it easier to administer thousands of individual trades, but also make it difficult to identify individual shareholders' account activity.

Bulk trading also makes it extremely hard to stop market timing. According to CMFI, 80 million omnibus accounts are currently avoiding redemption fee policies.

CMFI argues that the costs of requiring such information would be "minimal" for both funds and intermediaries if the SEC encourages firms to rely on the National Securities Clearing Corp. NSCC currently provides services to more than 80% of the largest fund shops and intermediaries, according to CMFI.

The new rule is expected to cost funds and intermediaries $630 million over the next three years. First-year costs are expected to be as high as $100,000 per fund and $150,000 for each intermediary.

CMFI also urges the SEC to consider requiring firms to use an accounting method known as LIFO, or "Last in, first out" as opposed to what is currently the industry standard of FIFO, or "First in, first out."

"LIFO is the only method that actually matches market-timing transactions correctly, and the widespread use by the industry of FIFO is only perpetuating opportunities for market timers," the comment letter states.

The **NDCC/Spark Institute** (Society of Professional Administrators and Record Keepers), which was recently created and is the product of a merger between the two groups, also has its own suggestions. The NDCC stands for the National Defined Contribution Council.

The combined group is urging the commission to adopt uniform standards for assessing redemption fees

against employee retirement plan investments. The commission should also adopt uniform standards for collecting and reporting fee information in the investments.

If industry standards are not formed, the group says it is concerned that there will be an unfair assessment of redemption fees in the industry. It could also mean administrative complexity and participant confusion, as well as increased administrative costs for retirement plans. It will also result in limited investment choices because plan service providers might limit the availability of certain funds due to cost concerns.

However, despite all the suggestions, some think the rule is not likely to undergo any major changes stemming from this comment period.

Derek Meisner, an attorney with **Kirkpatrick & Lockhart Nicholson Graham,** says he doesn't expect to see too many tweaks to the rule going forward. He notes that the rule doesn't prevent firms from taking further steps to weed out timers.

"I would expect the rule [to be] adopted substantially as proposed," he says. "Each fund needs to determine whether the fee is necessary or appropriate to recoup the costs that short-term trading poses."

But Sam Campbell, a research analyst at **Financial Research Corp.**, says he suspects the SEC will need to refine a number of areas.

He says a lot of the across-the-board mandates could be pared back to require brokers to supply investor information on an "as needed" basis. For instance, if a firm believes there is a timing issue coming from a specific omnibus account, it could require that information be supplied, as opposed to having a regular flow of shareholder account information.

Campbell says most firms are able to get a sense of the activity going on in such omnibus accounts, even if they are not provided with underlying account information.

He also says firms need to have a better idea of the consequences of non-compliance.

"There probably needs to be more clarity so firms can get a better idea of the penalties that are going to be assessed if they can't get the information from intermediaries," he says.

Industry consultant Burton Greenwald says he expects the SEC to allow firms some flexibility when interpreting the new voluntary redemption fee rule, but that it will require much more disclosure and clarity in the prospectus as to exactly what the fund is doing.

However, Greenwald says there are some in the industry still rooting for an across-the-board redemption fee mandate. "There are a lot of people in the industry who would like to have a hard and fast redemption fee because it would be easier to administer," he says.