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Fund Shops Wait For Redemption Fee Rule Fix

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By Tom Leswing

Funds firms are lobbying to have the SEC tone down its controversial redemption fee rule[1], and the agency appears to be willing to listen.

The redemption fee rule stipulates that fund firms must forge written agreements with intermediaries such as broker-dealers, retirement plans and other fund distributors to ensure that market-timing restrictions are enforced.

It also stipulates that fund firms must gather sufficient trading information from intermediaries to insure that the distributors are preventing market timing. Fund firms must comply with the rule by October 16, 2006.

The problem, however, is that according to the rule, omnibus accounts are considered intermediaries, points out Forrest Foss, associate legal counsel with **T. Rowe Price**. That includes even small 401(k) plans that may have only four or five participants and submit trades with omnibus accounting. The end result is that many fund firms would have to sign agreements with thousands of small omnibus accounts, he explains. That's causing fund firms to anxiously await the SEC's efforts to fine-tune the rule this summer.

"I thinking everyone is holding their breath," Foss says. "There are some issues and challenges for the industry with complying with all of the regulations."

Omnibus accounting entails batching together individual investors' share purchases and redemptions into net orders. Those orders are then transmitted to fund firms. In many cases, that means fund firms have limited access to information regarding the identity and trading activities of individual shareholders. That means that intermediaries must police market-timing activities and collect short-term trading fees on individual shareholders' trades. Since redemption fees are collected from individual shareholders, the net trades, or omnibus orders, usually aren't subjected to the short-term trading fees.

Yet, smaller omnibus trades, such as those for bank trust departments and small group retirement plans, are an exception, points Robert Plaze, an associate director with the SEC's division of investment management. Rather than collect redemption fees on individual shareholders' trades, the accounts pay fees on net trades, he adds. With that in mind, the SEC is evaluating whether fund firms should be exempt from policing those types of accounts.

"If you treat it as an individual account, it would be subject to redemption fees," he says. "So it wouldn't be subject to the regulation."

While fund firms would favor that approach, not everyone says they support it.

"The problem is that we have a bifurcated system," says Niels Holch, executive director of the Coalition of Mutual Fund Investors, a Washington, D.C.-based investor advocacy group. "If you are a direct investor [not in an omnibus account], there is a very efficient way to apply redemption fees. With omnibus-level accounts you don't have that, so we believe that you need full disclosure."

His organization, in fact, believes that fund firms should be given shareholder-level data on a daily basis to help them battle market timers.

Foss maintains that smaller omnibus accounts that are treated as individual accounts and are therefore subject to redemption fees aren't plagued by market timers. In such cases, plan administrators or other executives police shareholders' activities so that redemption orders don't trigger an order that will be subject to the short-term trading fee.

The idea is that fund firms could instead focus on policing market timing with larger accounts or at intermediaries where trading activity may be a problem. "Do you really need this enormous effort to address problems with just a few accounts?" he asks.

Most small omnibus accounts make periodic purchases through automatic payroll deductions and then occasionally make redemptions for automatic rebalancing of asset allocations, Foss says.

Some other industry executives have other concerns about exempting small omnibus accounts from the redemption fee rule, adds Rheeta Wise, a senior vice president of product development and distribution services for **PFPC**. The main concern is that exempting some, but not all, omnibus accounts from the rule could cause different shareholders to be treated differently.

"I still think it's up for debate," she says. "It could be misconstrued that you are treating certain shareholders one way and others another way."

In the meantime, most fund firms are holding off on developing procedures to comply with the redemption fee rule.

"Fund firms still have to define their processes and add them to their fund prospectuses," Wise says. "Since they have until next year and there is still discussion about the rule, I think they are in a state of flux."

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1. http://www.sec.gov/rules/final/ic-26782.pdf