



April 10, 2006

Ms. Nancy M. Morris  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, D.C. 20549

VIA ELECTRONIC MAIL

Subject: Mutual Fund Redemption Fees/Proposed Rule  
File No. S7-06-06

Dear Ms. Morris:

The Coalition of Mutual Fund Investors ("CMFI" or "Coalition") is pleased to submit the following comments regarding proposed amendments to the Commission's recently adopted redemption fee rule.

CMFI is an Internet-based shareholder advocacy organization representing the interests of individual mutual fund investors. The Coalition is located in Washington, D.C., with a Web site that can be accessed at [www.investorscoalition.com](http://www.investorscoalition.com).

1. An Exemption for Small Intermediaries Should Not Become a Loophole.

A primary focus of the Commission's redemption fee rule is the requirement that mutual funds enter into written agreements with financial intermediaries that submit orders to purchase or redeem fund shares. These agreements are now called "shareholder information agreements."

At a minimum, these agreements must require each intermediary to: (a) provide investor-level identity and transaction information upon the request of a fund; and (b) execute any instructions from a fund to restrict or prohibit future purchases or exchanges of fund shares by a shareholder who has been identified by the fund as having engaged in transactions that violate policies designed to eliminate or reduce any dilution of the value of fund shares.

A number of companies in the financial services industry have expressed concern regarding the definition of "financial intermediary" in the final rule. In response to comments about the cost and practicality of a broad definition, the Commission is now proposing that the definition be amended to exclude any financial intermediary that a

mutual fund treats as an individual investor for the purpose of applying a fund's policies to short-term trading or other activities that dilute the value of fund shares.

The Commission's rationale for this proposal is that a mutual fund is unlikely to need information about the trading activities of individual shareholders if a fund applies its policies (and imposes restrictions) on transactions at the intermediary level only. According to the Commission, this proposal was suggested by the Securities Industry Association ("SIA") in a comment letter filed with the SEC on May 9, 2005.<sup>1</sup>

The Commission notes that this change to the redemption fee rule will significantly reduce the number of financial intermediaries that need to enter into information agreements with funds. While CMFI does not advocate an information sharing requirement that is overly expensive or cumbersome to implement, the Coalition is concerned that this amendment, as drafted, will create a potential loophole regarding the information sharing requirement. For example, it leaves open the possibility that a fund may decide to enforce all of its anti-market timing policies at the intermediary level, thereby bypassing any scrutiny of trading activity at the shareholder level. If even a few fund complexes adopt this approach, the Commission's efforts to "look through" to the shareholder level within an omnibus account will be significantly circumvented.

CMFI believes that the Commission needs to add clarifying language to ensure that only omnibus accounts with little or no trading or dilution risk are excluded from the definition of financial intermediary. One method of addressing this issue could be to adopt the recommendation of the Securities Industry Association to implement a rebuttable presumption that an underlying account is an individual one, absent information to the contrary.<sup>2</sup> If information is received that such an account is not an individual one, the presumption would be "rebutted" by this new information and the account would be subject to transparency at the individual shareholder level.

A second method for addressing this issue could be to permit a fund to treat an omnibus account as an individual investor as long as no evidence exists of trading activities that violate fund policies at the investor level within an omnibus account.

For example, the following language could be added to the Commission's proposed exemption to the financial intermediary definition contained in § 270.22c-2(c) (1) (iv):

Financial intermediary does not include any person that the fund treats as an individual investor with respect to the fund's policies established for the purpose of eliminating or reducing any dilution of the value of the outstanding securities issued by the fund. The foregoing shall not apply to

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<sup>1</sup> Comment Letter of the Securities Industry Association, May 9, 2005. *available at* <http://www.sec.gov/rules/proposed/s71104/sia050905.pdf> (SEC should apply a presumption that an underlying account is an individual one, absent information to the contrary).

<sup>2</sup> Id.

a person (or to an account or shareholder of such person) who has been identified by the fund as having engaged in transactions in fund shares (directly or indirectly through an intermediary's account) that violate policies established by the fund for the purpose of eliminating or reducing any dilution of the value of the outstanding securities issued by the fund.  
(Note: new proposed language is underlined)

This CMFI proposed language is derived from the requirement in a shareholder information agreement that an intermediary agree to execute any instructions from a fund to restrict or prohibit further purchases or exchanges of fund shares by any shareholder who has been identified as violating fund policies.<sup>3</sup> Once such a shareholder or account is identified as violating fund policies, the exemption from the definition of financial intermediary should no longer apply and the Commission's information sharing requirement should be followed for that account and shareholder.

The Commission's proposal to exempt any financial intermediary or omnibus account that is treated as an individual investor by a fund needs further clarifying language to ensure complete transparency once there is evidence that an intermediary or account is not an individual investor, or when there is evidence of transactions at the individual investor level that are in violation of fund policies.

## 2. The Proposed Rule on Intermediary Chains Will Need Ongoing Monitoring.

In the case of multiple layers of financial intermediaries, the Commission proposes to impose the requirement of a shareholder information agreement only on those intermediaries which trade directly with a fund. The Commission calls these entities "first tier intermediaries." The Commission's proposal also permits transfer agents and registered clearing agencies to enter into these information sharing agreements with intermediaries on behalf of the funds they represent.<sup>4</sup>

Under the Commission's proposal, an indirect intermediary is still responsible for providing investor-level identity and transaction information to a fund when requested. However, a direct or first tier intermediary is only required to use "best efforts" to determine whether any person who holds shares through the intermediary is itself a financial intermediary. Further, the direct or first tier intermediary is required, upon request of a fund, to provide or (arrange to have provided) the investor-level identity and transaction information for all shareholders who hold an account with such indirect intermediary.

Absent specific evidence that indirect intermediaries or intermediary chains are being widely used as havens for abusive short-term trading, it appears that the Commission is striking the correct balance between transparency at the investor-level and

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<sup>3</sup> See 17 C.F.R. § 270.22c-2(c)(5)(ii), 71 Fed. Reg. 11365 (March 7, 2006).

<sup>4</sup> The Commission's final rule on redemption fees only permitted the fund or its principal underwriter to enter into these agreements. 17 C.F.R. § 270.22c-2(a)(2), 70 Fed. Reg. 13341 (March 18, 2005).

the practical effects of a more rigid rule regarding these indirect intermediaries. However, CMFI recommends that the Commission continue to monitor compliance with this new rule.

3. Current Efforts Regarding Shareholder Information Sharing Should Be Expanded to Address the Frequency of Such Disclosure.

Section IV of the Commission's proposed rule discusses efforts within the financial services industry to implement the information sharing provisions of the final redemption fee rule. These efforts, discussed in a comment letter of the Securities Industry Association, note that the SIA and the Investment Company Institute are working to develop standardized contractual terms for shareholder information agreements and "approved methodologies for transmission of fund transactions data between intermediaries and funds."<sup>5</sup>

The information-sharing requirement of the rule is an essential component to ensure full transparency within omnibus accounts. Efforts to standardize the protocols and systems for sharing investor-level identity and transaction information will be very helpful in reducing the industry cost of implementing this requirement.

CMFI supports these industry activities, but reiterates its concerns that the frequency of when this information is to be shared also needs to be standardized, preferably through Commission regulation. With thousands of mutual funds and hundreds of large financial intermediaries, CMFI continues to believe that an "upon request" information-sharing requirement is not the most effective method for achieving the objectives of the redemption fee rule.

As a result of the natural differentiation of policies and practices within the financial services industry, intermediaries are going to be faced with a myriad of different information sharing requests for investor-level data from funds. Some funds will request data on a daily basis, or when orders are placed. Others will request the information on a weekly, monthly, or quarterly timetable. And a third category of funds will request this data when a fund's anti-market timing surveillance methods trigger a need for more information at the investor level within an omnibus account. (Anecdotal reports suggest that many fund complexes are contemplating an infrequent reporting request structure.)

This third approach of relying on surveillance methods may be the least effective compliance method, despite the fact that a number of mutual fund groups note in their prospectus material that fund compliance personnel often rely on aggregate trading data at the intermediary level as a primary tool to monitor market timing activities. This is a flawed approach to detecting abusive short-term trading in omnibus accounts. The Canary case and other similar regulatory investigations highlighted the fact that

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<sup>5</sup> Footnote 45, 71 Fed. Reg. 11355 (March 7, 2006) (citing Comment Letter of the Securities Industry Association of May 9, 2005).

considerable trading activity can be successfully hidden in large omnibus accounts. In such a circumstance, it is difficult, if not impossible, to detect market timing abuses by only looking at aggregate trading data.

The Commission has correctly concluded that the best answer to this problem is through full transparency at the individual shareholder level. It is CMFI's view that mutual funds should not be able to shirk their fiduciary responsibilities to shareholders by primarily relying on periodic reviews of aggregate trading data at the intermediary level.

In furtherance of this point, many mutual fund groups have admitted in prospectus filings that a lack of individual investor information is a significant obstacle to ensuring the uniform application of fund policies and procedures.

In May of 2005, CMFI conducted an evaluation of the redemption fee and market timing policies of the fifty (50) largest mutual fund groups.<sup>6</sup> This CMFI study found that virtually all of the large fund groups (97%) disclosed in SEC regulatory filings that they are *excluding, waiving, or limiting* the enforcement of redemption fees within omnibus accounts. More than one-quarter of these fund groups (29%) noted that a lack of information about the activities of the underlying shareholders in omnibus accounts is a major reason for this problem.

Excerpts from the prospectus material evaluated in this 2005 CMFI study include the following statements:

- “Fund Management’s ability to monitor trades that are placed by individual shareholders of omnibus accounts, which are accounts maintained by financial intermediaries on behalf of multiple beneficial shareholders, is *severely limited* because Fund Management does not have access to the underlying shareholder account information.” Wells Fargo Advantage International Stock Funds Prospectus, April 11, 2005 (emphasis added).
- “The Fund typically is not able to identify trading by a particular beneficial owner through an omnibus account, which may make it *difficult or impossible* to determine if a particular account is engaged in frequent trading.” Columbia Acorn Fund Supplement to Prospectus, November 18, 2004 (emphasis added).
- “...the ability of a Fund to assess a redemption fee on the underlying shareholders of an omnibus account maintained by a financial intermediary is *limited* due to the fact that individual shareholder information is maintained by the intermediary and not

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<sup>6</sup> An Evaluation of the Redemption Fee and Market Timing Policies of the Largest Mutual Fund Groups, Coalition of Mutual Fund Investors. May 5, 2005, available at <http://www.investorscoalition.com>.

by the Fund.” Evergreen Global and International Funds Prospectus, March 1, 2005 (emphasis added).

- “By their nature, omnibus accounts ... *conceal the identity* of the individual investors from the Fund. This makes it more difficult to identify short-term transactions in the Funds, and makes assessment of the Redemption Fee on transactions effectuated through such accounts *impractical* without the assistance of the financial intermediary. Due to these limitations on the assessment of the Redemption Fee, the Funds’ use of Redemption Fees *may not successfully eliminate successive short-term trading* in shares of the Funds.” Allianz/PIMCO Domestic Stock Funds Prospectus, as revised April 1, 2005 (emphasis added).
- “There is *no assurance* that these policies and procedures will be effective in limiting short-term and excessive trading in all cases. For example, the adviser *may not be able to effectively monitor, detect or limit short-term or excessive trading* by underlying shareholders that occurs through omnibus accounts maintained by broker-dealers or other financial intermediaries.” Scudder Core Global/International Funds II Prospectus, February 25, 2005 (emphasis added).

What is the answer to this problem? The mutual fund industry is operated and managed on a daily basis. Fund purchases, redemptions and exchanges are made on a transactional basis; other events, such as the pricing of fund shares and the application of breakpoint discounts, occur at the end of each trading day.

As a threshold matter, mutual funds should not be permitted to use prospectus filings to exclude omnibus accounts from their policies and procedures once the final redemption fee rule is implemented in October of this year.

In CMFI’s view, the most effective and least expensive method for implementing the information-sharing requirements of the rule is to take advantage of the fact that the industry’s processing systems currently function on a daily basis. It does not make much sense to impose additional burdens on intermediaries and funds to establish new and discrete compliance systems that will also function on a non-daily basis, in an effort to comply with differing rules and policies of funds and intermediaries. The better approach is to standardize the method and frequency of this required information sharing.

An additional problem of sharing investor information on a non-daily basis is the fact that an “upon request” compliance system is going to result in the imposition of retroactive redemption fees, something that should not be permitted to occur.

The competitive nature of the financial services industry makes it very difficult to develop and impose uniform standards outside of Commission regulation. And it is clear that regulatory policy objectives and cost concerns are both best addressed through a same-day information sharing standard. Given the current state of pricing and technology in the mutual fund industry, there really is no reason why full transparency on a same-day basis can't be achieved.

This standard should apply uniformly to all funds and all intermediaries, so that redemption fees, exchange limitations, other market timing restrictions, and breakpoint discounts all can be administered in a consistent and uniform manner and independent of an investor's choice of investment vehicle.

A same-day information sharing requirement also will be able to take advantage of the fact that more than eighty percent (80%) of the largest financial intermediaries and mutual fund complexes process orders and share investor-level information through the system processing platforms of the National Securities Clearing Corporation (NSCC). This SEC-registered clearing agency provides several services which can provide investor-level identity and transaction information from omnibus accounts to fund compliance personnel on a same-day basis. According to the NSCC Web site, the cost for this information sharing can be as low as 25 cents per 100 records.<sup>7</sup>

The Commission is clearly cognizant of the NSCC's capabilities and the current availability of technology and systems to share this information, noting in section VI of the proposed rule the following:

We understand that several service providers are developing systems to accommodate the transmission and receipt of transaction information between funds and intermediaries pursuant to contracts negotiated to comply with rule 22c-2. At least one of these organizations is revising the infrastructure that it already has in place, in order to facilitate the communication of fund trades and other "back office" information between funds and financial intermediaries, including the information required under the rule. Based on information from industry representatives, we understand that, with the exception of some smaller to mid-sized funds and intermediaries, the large majority of funds and intermediaries currently use the organization's existing infrastructure to process fund trades. In addition, some funds and intermediaries may develop their own competing or complementary information-sharing systems.<sup>8</sup>

The simplest and most cost-effective way to accomplish the information sharing requirements of the redemption fee rule is to have this information provided on a same-

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<sup>7</sup> User's Guide to the NSCC Fee Schedule, National Securities Clearing Corporation, February 27, 2006. available at <http://www.nccc.com/legal/ncccfeeccguide2006.pdf>.

<sup>8</sup> 71 Fed. Reg. 11359 (March 7, 2006).

day basis, i.e., at the same time, and in the same manner, as the underlying mutual fund transaction. For this reason, the Commission should consider proposing a rule to require the frequency of this disclosure to occur on a same-day basis in order to standardize this compliance activity and promote the most effective solution.

For more information on the issue of same-day transparency within omnibus accounts, please feel free to refer to CMFI's Comment Letter of May 9, 2005, available at [www.investorscoalition.com](http://www.investorscoalition.com).

4. Ongoing Monitoring by the Commission of the Implementation of this Rule is Essential.

CMFI strongly supports the Commission's ongoing efforts to monitor the implementation of this rule. The legal and technical issues involved in this rule are quite complex and it will be necessary for refinements to be developed in the future as funds, intermediaries, and regulators gain experience with the rule and its requirements.

CMFI agrees with the Commission that the technical issues in connection with the information sharing requirement will deserve continued attention. In section V of the proposed rule, the Commission noted the following:

For example, we understand that the industry is developing a number of initiatives to streamline the flow of shareholder data between funds and intermediaries. If those initiatives are implemented, we would be interested in knowing whether they have assisted funds in complying with the rule.<sup>9</sup>

The primary reason for the information sharing requirement in the final rule is to provide full transparency regarding shareholders and their trading activities within omnibus accounts held by financial intermediaries. While convenient for individual investors, omnibus accounts have created a regulatory nightmare for the financial services industry in trying to prevent trading abuses and ensuring the uniform application of fund policies among all shareholders.

The regulatory investigations of several years ago also uncovered problems with the proper application of breakpoint discounts from sales loads among shareholders within omnibus accounts. It is CMFI's view that the timing and/or pricing of other corporate actions, such as dividend reinvestments, contingent deferred sales charges, and automatic conversion rights, also may be treated differently within omnibus accounts because of a lack of full transparency.

The Commission's rule requiring information sharing of investor-level identity and transaction data will help to address these separate, but related, regulatory problems.

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<sup>9</sup> 71 Fed. Reg. 11355 (March 7, 2006).



Since CMFI believes that the Commission and its staff fully intended to create a regulatory framework of full transparency at the individual investor level, it makes sense for the Commission to propose and promulgate a rule addressing the frequency of these disclosures, so that the redemption fee rule operates as intended and the financial services industry does not drift back into "business as usual." Given the competitiveness and the complexity of the financial services industry, it is inevitable that, at some point, that the Commission will need to step in and take additional steps to standardize the process for this information to be shared, using the same methods and frequency for all funds and intermediaries. At the very least, CMFI requests that the Commission provide guidance regarding: (1) what compliance steps it expects funds and intermediaries to take under the current "upon request" framework; and (2) what circumstances may lead a fund to request transaction data on an other than daily basis.

5. The SEC Has Adequately Addressed Privacy Concerns Regarding its Information Sharing Requirement.

Several commenters from the financial services industry have expressed concern that the information sharing requirement is inconsistent with intermediary privacy rules and policies. In footnote 16 of the proposed rule, the Commission provides its analysis of this issue.<sup>10</sup> The proposed rule notes that current privacy regulations of the Commission and the Comptroller of the Currency, which apply to almost all financial intermediaries, provide for exceptions to: (a) comply with federal or state law; or (b) "effect, administer, or enforce a transaction that a consumer requests or authorizes."

The Commission's position is that these current privacy regulations permit this required sharing of information between intermediaries and funds. Further, the Commission notes that most privacy notices to consumers state that an institution can make "disclosures to other nonaffiliated third parties as permitted by law."<sup>11</sup> Thus, the Commission concludes that intermediaries will not have to provide updated privacy notices to their customers in order to comply with the information sharing required under the rule.

In footnote 19 of the proposed rule, the Commission also notes that current privacy rules ensure that a fund which receives shareholder information from an intermediary under this rule may not reuse or otherwise disclose this information for other purposes, such as marketing.<sup>12</sup>

These two footnotes represent the most comprehensive Commission analysis on this issue to date and CMFI agrees that current privacy rules are not an obstacle to the information sharing requirement of the rule. Further, the current privacy rules also protect against disclosure of this information for any reason other than a compliance purpose.

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<sup>10</sup> 71 Fed. Reg. 11352 (March 7, 2006).

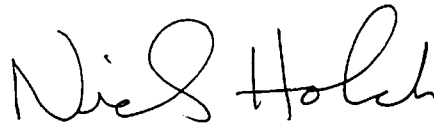
<sup>11</sup> 17 C.F.R. 248.6(b).

<sup>12</sup> 71 Fed. Reg. 11352 (March 7, 2006).

6. Conclusion.

The Coalition of Mutual Fund Investors appreciates the opportunity to submit these comments to the Commission regarding its proposed amendments to the redemption fee rule. CMFI is prepared to provide further information or clarification regarding the material presented in this comment letter if it would be helpful to the Commission's deliberations.

Sincerely,

A handwritten signature in black ink that reads "Niels Holch". The signature is written in a cursive, flowing style.

Niels Holch  
Executive Director  
Coalition of Mutual Fund Investors

cc: The Honorable Christopher Cox  
The Honorable Paul S. Atkins  
The Honorable Roel C. Campos  
The Honorable Cynthia A. Glassman  
The Honorable Annette L. Nazareth  
Susan Ferris Wyderko, Division of Investment Management  
Robert Plaze, Division of Investment Management