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SEC's Redemption Fee Rule Goes Live

Unexpected charges could spark concerns

BY CAROL E. CURTIS

The Securities and Exchange Commission's Rule 22c-2, or the redemption-fee rule, became effective last week, after two extensions of last year's Oct. 16 deadline—but the consequences for mutual funds and their intermediaries are far from certain.

One in a series of reforms prompted by the market-timing and late-trading scandals that in 2003 shook the industry, Rule 22c-2 requires mutual fund boards to determine whether short-term redemption fees are necessary to prevent market-timing abuses in their funds. They must also enter into formal agreements with intermediaries such as broker-dealers and retirement plan administrators to gain access to trading and shareholder information.

The reason for the delay, experts say, is that the redemption-fee policy is one of the most daunting compliance issues the mutual fund sector has faced, and for broker-dealer intermediaries and their customers, there may be some unintended consequences.

The rule's ramifications "are still not well understood," says Jeff Levering, VP of corporate development at Andover, Mass.-based New River, which provides technology designed to help with the investor-disclosure aspect of the regulation. Levering says that difficult times are ahead "because the rubber is hitting the road, and these complex policies will be applied to an unsuspecting adviser population."

The SEC, in its efforts to curb abusive trading practices, is asking mutual funds to bring greater transparency to shareholder trading patterns. However, because funds cannot identify customers who own mutual funds via omnibus accounts such as 401k plans, and thus cannot say who is trading



Jeff Levering

or how often, the SEC is requiring that intermediaries provide funds with shareholder identity and trading records on request.

"This will permit funds to identify shareholders who violate the funds' market-timing policies, and oversee the intermediaries' assessment of any redemption fees," the SEC said in the March 2005 release that announced the adoption of the rule.

The one-year extension has made it easier for broker-dealers to comply. "While there are additional hoops for [brokers] to jump through, our members have had plenty of time to get systems in place that bring them into full compliance with the rule," says Mike Udoff, managing director and associate general counsel of the Securities Industry & Financial Markets Association.

Brokers' Burden

Still, the rule will require a great deal of back-office effort from intermediaries as they collect massive amounts of data, some of it confidential, and transmit it in a secure fashion. "The mechanics of the technology are far from simple," says New River's Levering, who explains that Depository Trust & Clearing Corp. has provided a hub for the transfer of information from

intermediaries to mutual funds.

New River's products include FundPoint Desktop, a Web-based tool that allows intermediaries to draw disclosure data directly from filings in the SEC's Edgar database. Other vendors with redemption rule solutions for broker-dealers include AccessData Corp. in Lindon, Utah, SunGard Data Systems of Wayne, Pa. and Columbus, Ga.-based Delta Data Software.

While mutual fund companies set their own redemption-fee policies, the broker selling the fund is obligated to communicate the policies to the customer through the fund prospectus, which investors do not routinely familiarize themselves with. "Retail investors do not read the prospectus, and they do not understand how these things work," says David Wray, president of the Profit Sharing/401k Council of America, a Chicago-based nonprofit group.

Wray says that the automatic rebalancing function of 401k plans—which occurs monthly in some cases—could result in redemption fees being charged to ordinary investors who have no intention of engaging in abusive trading. "No 401k plan participants are sophisticated enough to understand how this is going to apply to them," he says. "This is a potential problem down the road."

One solution, Wray says, is for mutual funds to grant a blanket waiver to 401k plans so that investors will not face such fees. Until then, the millions of small investors holding mutual funds in their brokerage and retirement accounts may be hit with fees that could engender resentment toward the seller. "This could cause investor confusion and reputational risk" to the broker-dealer selling the fund, notes Levering. ■