

**COMMISSION ADOPTS AMENDMENTS TO RULE 22c-2
(MUTUAL FUND REDEMPTION FEE RULE)**

On September 27, 2006, the Securities and Exchange Commission issued a final rule (the “Release”) that amends Rule 22c-2 under the Investment Company Act of 1940 (“Rule 22c-2”) and extends the compliance date of certain of its provisions.¹ The Commission adopted Rule 22c-2 on March 11, 2005 with an initial implementation date of October 16, 2006, largely in response to the “market-timing” scandal, in which it was revealed that some funds, contrary to their own policies, were allowing favored clients to buy and sell fund shares rapidly, to the detriment of long-term fund shareholders.² The Commission’s purpose for adopting these amendments was to clarify the operation of the rule and reduce the number of intermediaries with which funds must negotiate shareholder information agreements.³

Current Rule 22c-2 under the Investment Company Act

As previously adopted, Rule 22c-2 provides that a board of directors or trustees of a registered open-end fund (other than a money market fund or certain funds that permit short-term trading) must consider whether to impose a fee of up to two percent (2%) of the value of shares redeemed shortly after purchase.⁴ In addition, the rule requires a fund that decides to impose a redemption fee to enter into agreements with its intermediaries that provide the fund’s management the ability to identify investors whose trading violates fund restrictions on short-term trading.⁵

¹ See Investment Company Act Release No. 27504 (Sept. 27, 2006), available at <http://www.sec.gov/rules/final/ic-27504.pdf>.

² See Investment Company Act Release No. 26782 (Mar. 11, 2005), available at <http://www.sec.gov/rules/final/ic-26782.pdf>.

³ See Investment Company Act Release No. 27504 (Sept. 27, 2006) at 1.

⁴ In complying with the requirements set out in the rule, the board must either (i) approve a redemption fee or (ii) determine that the imposition of a redemption fee is either not necessary or not appropriate. The rule requires that each board must at least consider implementing a redemption fee program before the compliance date of October 16, 2006. Any redemption fee implemented must, at a minimum, apply to redemptions within seven days of purchase. See Investment Company Act Release No. 26782 (Mar. 11, 2005).

⁵ A fund (or its principal underwriter) must enter into a written agreement with each financial intermediary under which the intermediary agrees to (i) provide, at the fund’s request, identity and transaction information regarding shareholders who hold their shares through and/or have an account with the intermediary and (ii) execute instructions from the fund to restrict or prohibit future purchases or exchanges. The rule would also require that a fund maintain a copy of each written agreement with a financial intermediary for six years. See Investment Company Act Release No. 26782 (Mar. 11, 2005).

Summary of Amendments

The amendments provide welcome relief. As adopted, the amendments to Rule 22c-2 will:

- limit the types of intermediaries with which a fund must negotiate information-sharing agreements;
- address the rule's application when there are chains of intermediaries; and
- clarify the effect of a fund's failure to obtain an agreement with any of its intermediaries.⁶

Financial Intermediaries

In addressing the financial burdens caused by new Rule 22c-2, the amendments narrowed the definition of a "financial intermediary" to exclude any intermediary that a fund treats as an individual investor for the purposes of the fund's market-timing policies.⁷ In publishing the Release, the Commission set out an example in which a fund applies a redemption fee or exchange limits to transactions by a retirement plan (an intermediary) rather than to purchases and redemptions by the employees in the plan. Under Rule 22c-2, the plan would not be considered a "financial intermediary" and, therefore, the fund would not be required to enter into an agreement with that plan.⁸ To rely on this exclusion from the definition of financial intermediary under Rule 22c-2, the fund must have established market-timing policies.

In responding to industry questions regarding which party a fund would need to enter into a shareholder information agreement with when an agent of an intermediary aggregates and submits purchase and redemption orders on behalf of the intermediary, the Commission made a change to Rule 22c-2.⁹ In addressing this ambiguity, the Commission clarified that funds must enter into agreements with financial intermediaries or their agents even if the intermediaries submit orders through entities that do not qualify as financial intermediaries under the rule.¹⁰

⁶ See Investment Company Act Release No. 27504 (Sept. 27, 2006) at 4.

⁷ A financial intermediary is (i) any broker, dealer, bank, or other person that holds securities issued by the fund, in nominee name; (ii) a unit investment trust or fund that invests in the fund in reliance on section 12(d)(1)(E) of the Investment Company Act; and (iii) in the case of a participant-directed employee benefit plan that owns the securities issued by the fund, a retirement plan's administrator under section 3(16)(A) of the Employee Retirement Income Security Act of 1974 or any person that maintains the plan's participant records. As noted above, a 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. See Rule 22c-2(c)(1).

⁸ See Investment Company Act Release No. 27504 (Sept. 27, 2006) at 7.

⁹ *Id.* at 8.

¹⁰ See Rule 22c-2(a)(2). See also Investment Company Act Release No. 27504 (Sept. 27, 2006) at 8.

Intermediary Chains

Under Rule 22c-2, a fund would be required to enter into a written agreement only with those financial intermediaries that submit orders to purchase or redeem shares directly to the fund, its principal underwriter or transfer agent, or a registered clearing agency (“first-tier intermediaries”).¹¹ Rule 22c-2 allows transfer agents and registered clearing agencies, among other entities, to enter into shareholder information agreements with financial intermediaries on behalf of a fund. These agreements must require the financial intermediary to provide, promptly upon a fund’s request, identification and transaction information for any shareholder accounts held directly with the first-tier intermediary.¹²

In its application to a chain of intermediaries (*i.e.*, when one intermediary has a relationship with another intermediary for the sale of fund shares), Rule 22c-2 requires a fund to enter into an agreement obligating the first-tier intermediary to use its best efforts to identify, upon request by the fund, those accountholders who are themselves intermediaries (“lower-tier” or “indirect intermediaries”), and obtain and forward (or have forwarded) the underlying shareholder identity and transaction information from those intermediaries further down the chain. If a lower-tier financial intermediary holding an account with the first-tier intermediary refuses to honor the request, then the agreement must obligate the first-tier intermediary to prohibit, upon a fund’s request, such lower-tier intermediary from purchasing additional shares of the fund through the first-tier intermediary.¹³

In response to industry concerns regarding a blanket request by a fund to identify all indirect intermediaries, the Commission revised the rule to clarify that a fund, after receiving initial transaction information from a first-tier intermediary, must make a specific further request to the first-tier intermediary for information on certain shareholders.¹⁴ The Commission noted that under Rule 22c-2, a shareholder information agreement need not obligate a first-tier intermediary to perform a complete review of its books and records to identify all indirect intermediaries.¹⁵

Lack of a Shareholder Information Agreement

In responding to industry concerns regarding some ambiguity as to the rule’s effect on a fund’s failure (or inability) to obtain agreements with all its intermediaries and whether it would preclude the fund from redeeming its shares of any of its shareholders within seven days of

¹¹ *Id.* at 9.

¹² *See* Investment Company Act Release No. 27255 (Feb. 28, 2006) at 14.

¹³ *See* Rule 22c-2(c)(5)(iii)(B). *See also* Investment Company Act Release No. 27504 (Sept. 27, 2006) at 11.

¹⁴ *See* Rule 22c-2(c)(5)(iii).

¹⁵ *See* Investment Company Act Release No. 27504 (Sept. 27, 2006) at 10.

purchase, the SEC articulated the view that the lack of an agreement would not preclude a fund from redeeming its shares.¹⁶ The Commission stated that if a fund does not have a shareholder information agreement with a particular intermediary, the fund must thereafter prohibit that intermediary from purchasing securities issued by the fund.¹⁷ The Commission specifically stated that the prohibition applies only to the intermediary with which the fund does not have an agreement and purchases from other intermediaries will not be affected.¹⁸

In responding to industry comments, Rule 22c-2 will not prohibit further purchases by an intermediary that does not enter into a shareholder information agreement if the purchases are fully disclosed to the fund.¹⁹ In addition, the Commission revised this provision of the rule so that it does not apply to the intermediary's purchase of fund shares on its own behalf.

Compliance Deadlines

The Commission did not extend the October 16, 2006 deadline for the Board determination; however, it did extend the compliance deadline until April 16, 2007 for funds to enter into shareholder information agreements with their intermediaries. In addition, the Commission extended the compliance deadline until October 16, 2007 for funds to be able to request and promptly receive shareholder identity and transaction information.

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¹⁶ *Id.* at 11.

¹⁷ *See* Rule 22c-2(a)(2)(ii).

¹⁸ *See* Investment Company Act Release No. 27504 (Sept. 27, 2006) at 11.

¹⁹ *Id.* at 12. A similar revision has been made to the same type of provision concerning chains of intermediaries. *See* Rule 22c-2(c)(5)(iii)(B).

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