WILLKIE FARR & GALLAGHER LLP

CLIENT MEMORANDUM

COMMISSION ISSUES PROPOSED AMENDMENTS TO ITS VOLUNTARY REDEMPTION FEE RULE

On February 28, 2006, the Securities and Exchange Commission issued a proposed rule (the "Proposal") that, if adopted, would amend Rule 22c-2 under the Investment Company Act of 1940 (the "Proposed Rule").[1] Rule 22c-2 was adopted on March 11, 2005, but registered investment companies are not required to implement until October 16, 2006. The Commission's rationale for proposing these amendments was to address certain questions raised by the industry regarding omnibus accounts and to ease the compliance burden of Rule 22c-2.

Current Rule 22c-2 under the Investment Company Act

As previously adopted, Rule 22c-2 provides that a board 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.[2] In addition, the rule requires such a fund 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.[3]

Summary of Proposed Amendments

Under the Proposal, the Commission would:

- 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

---

[1] *See* Investment Company Act Release No. 27255 (Feb. 28, 2006), available at http://www.sec.gov/rules/proposed/ic-27255.pdf.

[2] 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), available at http://www.sec.gov/rules/final/ic-26782.pdf.

[3] 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* SEC Rel. No. IC-26782 (Mar. 11, 2005).

- clarify the effect of a fund's failure to obtain an agreement with any of its intermediaries.[4]

Financial Intermediaries

To address the financial burdens of Rule 22c-2, the Proposal would narrow 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 policies intended to eliminate or reduce dilution of the value of fund shares (*i.e.*, market-timing policies).[5] In publishing the Proposal, 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 of the employees in the plan. Under the Proposed Rule, the plan would not be considered a "financial intermediary." Therefore, a fund would not be required to enter into an information exchange agreement with the plan. However, a fund must have established policies on eliminating or reducing dilution in the value of its shares for it to rely on this exclusion from the definition of financial intermediary.[6]

In the Proposal, the Commission issued guidance in response to comments on the operation of Rule 22c-2 as it relates to multiple layers of intermediaries ("chain of intermediaries"). Under the Proposal, 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").[7] Proposed Rule 22c-2 would allow transfer agents and registered clearing agencies, among other entities, to enter into shareholder information agreements with financial intermediaries on behalf of a fund. As noted in the release accompanying the Proposal, however, 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.[8] Presumably, most funds would meet this requirement by entering into agreements with their principal underwriter or transfer agent. This solution proposed by the Commission would not, however, have a significant impact on the overall compliance burden of the rule.

---

[4] *See* Investment Company Act Release No. 27255 (Feb. 28, 2006) at 6.

[5] As defined in the Proposal, a financial intermediary means (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 of 1940; 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, as amended, or any person that maintains the plan's participant records. Financial intermediary does not include, however, 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 in the fund.

[6] Investment Company Act Release No. 27255 (Feb. 28, 2006) at n. 23.

[7] *Id.* at 13.

[8] *Id.* at 14.

In its application to a chain of intermediaries (*i.e.*, where one intermediary has a relationship with another intermediary for the sale of fund shares), Proposed Rule 22c-2 would require 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, a lower-tier intermediary from purchasing additional shares of the fund through the first-tier intermediary. The Proposal therefore would shift the responsibility to the first-tier intermediary to enforce compliance by a lower-tier intermediary with the fund's shareholder information request.

Lack of an Agreement

Under the current rule, there is some ambiguity as to the rule's effect on a fund's failure (or inability) to obtain agreements with all its intermediaries. Some in the industry interpret the rule to mean that, unless a fund enters into agreements with all its intermediaries, the fund would be precluded from redeeming the shares of any of its shareholders within seven days of purchase. In responding to this ambiguity, the SEC articulated the view that the lack of an agreement would not preclude a fund from redeeming its shares.[9] The Commission did note, however, that, if a fund does not have a shareholder information agreement with a particular intermediary, the fund must thereafter prohibit the intermediary from purchasing, on behalf of itself and other persons, securities issued by the fund.

Outstanding Issues

The Proposal and the release accompanying it clearly provide greater clarity as to the operation of Rule 22c-2 and should ease some of the burdens of implementing the rule. The Commission did not, though, provide guidance on the frequency with which shareholder information must be obtained or what funds should do with the information received from intermediaries. The Commission also chose not to indicate how the financial intermediaries should deal with differing information-sharing protocols of various fund complexes. Finally, the Commission did not answer an industry concern over the continuing high burden of compliance on intermediaries, particularly smaller intermediaries, to produce and deliver the information requested.

Significant Compliance Steps

Among the steps necessary to implement Rule 22c-2, a fund will need to:

- Decide whether to implement a redemption fee;

---

[9] *Id.* at 17.

- If a redemption fee is implemented:
  - decide the amount of the fee; and
  - define short-term trading (*e.g.*, purchases and sale within seven days);
- Determine who is an intermediary;
- Amend current contracts to address the fund's responsibilities under the rule; and
- Determine whether the fund or an applicable intermediary has available systems that are capable of receiving and evaluating the data from intermediaries.

Compliance Deadlines

The Commission did not extend the October 16, 2006 deadline, but stated that it may revise or extend the compliance date if and when the amendments are adopted.

* * * * * * * * * * * * * * *

If you have any questions concerning this memorandum, please contact Barry P. Barbash (202-303-1201, bbarbash@willkie.com), Rose F. DiMartino (212-728-8215, rdimartino@willkie.com), Maria Gattuso (212-728-8294, mgattuso@willkie.com), Joel H. Goldberg (212-728-8289, jgoldberg@willkie.com), Benjamin J. Haskin (202-303-1124, bhaskin@willkie.com), Burton M. Leibert (212-728-8238, bleibert@willkie.com), Karrie H. McMillan (202-303-1202, kmcmillan@willkie.com), Margery K. Neale (212-728-8297, mneale@willkie.com), Dianne E. O'Donnell (212-728-8558, dodonnell@willkie.com), Daniel Schloendorn (212-728-8265, dschloendorn@willkie.com), Anthony A. Vertuno (202-303-1203, avertuno@willkie.com) or the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, N.Y. 10019-6099 and has an office located at 1875 K Street, NW, Washington, D.C. 20006-1238. Our New York telephone number is 212-728-8000 and our facsimile number is 212-728-8111. Our Washington, D.C. telephone number is 202-303-1000 and our facsimile number is 202-303-2000. Our website is located at www.willkie.com.

March 13, 2006

Copyright © 2006 by Willkie Farr & Gallagher LLP.

All Rights Reserved. This memorandum may not be reproduced or disseminated in any form without the express permission of Willkie Farr & Gallagher LLP. This memorandum is provided for news and information purposes only and does not constitute legal advice or an invitation to an attorney-client relationship. While every effort has been made to ensure the accuracy of the information contained herein, Willkie Farr & Gallagher LLP does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information.