

# ALSTON + BIRD<sub>LLP</sub>

## *Securities Law Advisory*

March 8, 2006

### SEC Proposes Amendments to Mutual Fund Redemption Fee Rule

On February 28, 2006, the Securities and Exchange Commission (the “SEC” or “Commission”) proposed amendments (the “Amendments”) to its recently adopted Rule 22c-2 under the Investment Company Act of 1940, as amended (the “Act”).<sup>1</sup> Rule 22c-2 requires most registered open-end investment companies (“funds”) to, among other things, either approve a redemption fee of up to two percent or determine that such fee is not necessary or appropriate for the fund. The Amendments would (1) limit the types of intermediaries with which funds must negotiate shareholder information agreements, (2) address the application of Rule 22c-2 to “chains of intermediaries” situations, and (3) clarify the consequences that would result from a fund’s failure to enter into the required agreement with an intermediary. The proposing release to the Amendments also addresses an interpretive issue related to the interaction of Rule 22c-2 with federal privacy laws. The Amendments are intended to address comments the SEC received in response to the adoption of Rule 22c-2 in March 2005.

This advisory provides a summary of the Amendments. Although the Commission may revise the compliance date when it adopts the Amendments, **the compliance date for Rule 22c-2 remains October 16, 2006**. Comments to the Amendments must be received by April 10, 2006.

#### Mutual Fund Redemption Fee Rule

##### *What does Rule 22c-2 Require?*

Rule 22c-2 prohibits funds from redeeming shares within seven calendar days after the share purchase, unless the fund meets the following two conditions:

- First, the board must either: (i) approve a redemption fee that, in its judgment, is necessary or appropriate to recoup costs the fund may incur as a result of redemptions or to otherwise eliminate or reduce dilution of the fund’s outstanding securities, or (ii) determine that a redemption fee is not necessary or appropriate; and
- Second, the fund (or its principal underwriter) must enter into a written agreement with each financial intermediary pursuant to which the intermediary agrees to: (i) provide, promptly at the fund’s request, identity and transaction information about shareholders who hold their shares through an account with

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<sup>1</sup> See Proposed Rule: Mutual Fund Redemption Fees, Investment Company Act Release No. IC-27255, available at <http://www.sec.gov/rules/proposed/ic-27255.pdf> (Feb. 28, 2006) [hereinafter Proposed Rule].

the intermediary, and (ii) execute instructions from the fund to restrict or prohibit future purchases or exchanges (such agreement, the “shareholder information agreement”).

Rule 22c-2 applies to all funds except money market funds, exchange-traded funds, and funds that affirmatively permit market timing of fund shares. Regardless of whether they adopt a redemption fee, all funds (unless excepted) must enter into shareholder information agreements with financial intermediaries.

## **Proposed Amendments**

### ***What Changes do the Amendments Make to the Redemption Fee Rule?***

#### **Definition of “Financial Intermediary”**

The Amendments propose three changes to Rule 22c-2. First, the Amendments would revise the definition of “financial intermediary” contained in Rule 22c-2 to exclude from it any person that the fund treats as an individual investor for purposes of its market-timing policies.<sup>2</sup> As originally adopted, Rule 22c-2 defines “financial intermediary” to include any entity that holds securities in nominee name for other investors, including small business retirement plans holding fund shares on behalf of only a few employees. Fund companies expressed concern that identifying these intermediaries and negotiating shareholder information agreements with them would be costly and overly burdensome. The revised definition of “financial intermediary” attempts to limit the potential pool of financial intermediaries with which funds must enter into shareholder information agreements by carving out these small intermediaries from the definition and relieving funds of the burden of entering into agreements with them. Funds should note, however, that if their market-timing policies do not treat these smaller intermediaries as individual investors, they will be required to treat them as financial intermediaries for purposes of Rule 22c-2.

#### **Intermediary Chains**

The Amendments also would address Rule 22c-2’s application to so-called “chain of intermediaries” arrangements. In these situations, a broker-dealer or other financial intermediary may hold fund shares on behalf of other second-tier intermediaries, such as retirement plans and other broker-dealers. Funds commented that they were uncertain as to how to apply Rule 22c-2 to such arrangements and expressed concern regarding the practical difficulty involved in obtaining shareholder information through multiple layers of intermediaries.

To address this concern, the Amendments would revise Rule 22c-2 to require funds to enter into shareholder information agreements only with those financial intermediaries that submit orders to purchase or redeem shares directly to the fund, its principal underwriter, its transfer agent, or a registered clearing agency.<sup>3</sup> The Amendments would permit the fund’s principal underwriter, transfer agent, or a registered clearing agency to enter into shareholder information agreements with first-tier financial intermediaries on behalf of the fund. In addition, the Amendments would require the shareholder information agreement to obligate the first-tier

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<sup>2</sup> See Proposed Rule 22c-2(c)(1)(iv).

<sup>3</sup> See Proposed Rule 22c-2(a)(2).

intermediary to:

- Upon the fund’s request, use its best efforts to promptly identify its accountholders that are themselves financial intermediaries (“indirect intermediaries”); and
- Upon the fund’s request, obtain and forward, or have forwarded, identification and transaction information for those shareholders that hold accounts with the indirect intermediary; or
- Upon the fund’s request, restrict or prohibit indirect intermediaries that refuse to provide requested shareholder information from purchasing additional fund share purchases through the first-tier intermediary.

The Amendments, as proposed, would not require funds to enter into shareholder information agreements directly with indirect intermediaries. The Amendments also would not require first-tier financial intermediaries to enter into formal written agreements with indirect intermediaries that invest in the fund through them. The Commission did, however, request comment on whether it should impose such a requirement or require funds to obtain the information from indirect intermediaries instead of imposing this obligation on first tier financial intermediaries.

### **Effect of Failing to Enter Into Agreements**

Finally, the Amendments would clarify what consequences would result from failing to enter into a shareholder information agreement with a particular financial intermediary. As adopted, Rule 22c-2 could be interpreted to preclude a fund from redeeming shares held by any shareholder within seven days of purchase if the fund fails to enter into a shareholder information agreement with all financial intermediaries selling the fund’s shares. The Amendments would clarify that, if a fund fails to enter into a shareholder information agreement with a particular financial intermediary, the fund must prohibit only that intermediary from purchasing fund shares on behalf of itself or other investors.<sup>4</sup> Such a failure would not affect the fund’s relationships with other financial intermediaries nor would it affect redemptions by the offending financial intermediary.

### ***Did the SEC Address How the Redemption Fee Rule Interacts with Privacy Laws?***

The SEC also addressed in the proposing release issues raised by financial intermediaries regarding their ability to engage in the information sharing contemplated by Rule 22c-2 under federal privacy laws. Several financial intermediaries expressed concern that they may be prohibited by applicable privacy laws from sharing shareholder information with funds as required by Rule 22c-2. In response to these concerns, the Commission stated that its review of federal privacy laws revealed that the exceptions to those laws permit financial intermediaries to share with funds the information covered by shareholder information agreements. In addition, the SEC stated that, to the extent a financial intermediary’s privacy policy permits it to share information with unaffiliated third-parties where permitted by law, it would not be required to provide its customers with additional privacy notices or opt-out opportunities.

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<sup>4</sup> See Proposed Rule 22c-2(a)(2)(ii).

### ***Do the Amendments Include Uniform Redemption Fee Standards?***

Although many in the industry expected the SEC to adopt uniform redemption fee standards, the Amendments do not include uniform standards. Acknowledging that funds and financial intermediaries could derive benefits and cost savings from them, the SEC elected not to adopt uniform fee standards in connection with the Amendments.<sup>5</sup> However, the SEC stated that it would take all comments related to uniform fee standards under advisement and left open the possibility that would adopt such standards at a later date.

### **Conclusion**

The proposed Amendments attempt to address several interpretive and other issues raised by the version of Rule 22c-2 adopted by the Commission in March 2005, focusing primarily on reducing the number of financial intermediaries with which funds must enter into shareholder information agreements. However, in proposing the Amendments, the Commission acknowledged that additional issues will likely arise as funds and financial intermediaries attempt to implement the requirements of the rule. To that end, the SEC obligated itself to monitor the implementation of Rule 22c-2 on an ongoing basis. As funds and financial intermediaries begin the process of developing redemption fee policies and procedures and revising their agreements with one another, they should take note of all interpretive, operational, and other issues that arise. These issues should be brought to the SEC's attention so that they can be addressed as part of the Amendments or in connection with a later rulemaking.

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<sup>5</sup> See Proposing Release.

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If you have any questions or would like additional information, please contact your Alston & Bird attorney, any member of the Alston & Bird [Securities Practice Group](#) or any of the following attorneys who contributed to this *Securities Law Advisory*:

David Baum  
(202) 756-3346  
[dbaum@alston.com](mailto:dbaum@alston.com)

Sara Burstein  
(202) 756-3364  
[sburstein@alston.com](mailto:sburstein@alston.com)

Mark Costley  
(202) 756-5593  
[mcostley@alston.com](mailto:mcostley@alston.com)

Aaron Gonzales  
(202) 756-3370  
[agonzales@alston.com](mailto:agonzales@alston.com)

Margaret Sheehan  
(202) 756-3305  
[msheehan@alston.com](mailto:msheehan@alston.com)

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[www.alston.com](http://www.alston.com)

**Atlanta:** One Atlantic Center • 1201 West Peachtree Street • Atlanta, Georgia, USA, 30309-3424 • 404-881-7000 • Fax: 404-881-7777

**Charlotte:** Bank of America Plaza • 101 South Tryon Street, Suite 4000 • Charlotte, North Carolina, USA, 28280-4000 • 704-444-1000 • Fax: 704-444-1111

**New York:** 90 Park Avenue • New York, New York, USA, 10016-1387 • 212-210-9400 • Fax: 212-210-9444

**Research Triangle:** 3201 Beechleaf Court, Suite 600 • Raleigh, North Carolina, USA, 27604-1062 • 919-862-2200 • Fax: 919-862-2260

**Washington, D.C.:** 601 Pennsylvania Avenue, N.W. • North Building, 10<sup>th</sup> Floor • Washington, D.C., USA, 20004-2601 • 202-756-3300 • Fax: 202-756-3333