

May 11, 2004

Mr. Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
450 5<sup>th</sup> St., N.W.  
Washington, D.C. 20549-0609

**Re: File No. S7-11-04**  
**Mandatory Redemption Fees for Redeemable Fund Securities**

Dear Secretary Katz:

We are writing on behalf of Consumer Federation of America<sup>1</sup> and Fund Democracy, Inc.<sup>2</sup> in support of the proposed rule to require most mutual funds to impose a two percent redemption fee on the redemption of shares purchased within the previous five days. Our organizations believe that a properly structured redemption fee will benefit long-term mutual fund shareholders by helping to deter excessive trading that can skim off profits that would otherwise have gone to them. Furthermore, we generally believe the SEC proposal does a good job of balancing two conflicting goals – discouraging excessive trading and preserving the redeemability of mutual fund shares.

■ **We believe a properly structured redemption fee will benefit long-term mutual fund shareholders.**

The most substantial losses suffered by mutual fund shareholders as a result of the recent trading scandals were caused when certain investors took advantage of stale or inaccurate prices to trade rapidly in and out of the fund.<sup>3</sup> Some academics who have studied this issue have

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<sup>1</sup> Consumer Federation of America is a non-profit association of approximately 300 national, state, and local pro-consumer organizations founded in 1968 to represent the consumer interest through advocacy and education.

<sup>2</sup> Fund Democracy is an advocacy group for mutual fund shareholders that was founded in 2000.

<sup>3</sup> By trading scandals, we mean excessive trading and late trading. We do not include sales abuse scandals in this category.

estimated that this practice costs long-term fund shareholders billions of dollars each year. While we believe initiatives to promote more accurate pricing should be the primary means used to combat excessive trading, we also recognize that pricing is not a perfect science. As a result, even the best intentioned funds may still use slightly inaccurate prices from time to time that sophisticated traders can identify and exploit.

We share the Commission's view that these opportunities could be significantly reduced by the imposition of a small redemption fee on all sales of fund shares occurring within a short time period after the purchase. Last November, our organizations – along with Consumers Union, Consumer Action, and U.S. Public Interest Research Group – released a position paper on mutual fund reform in which we advocated mandating a two percent redemption fee for sales within 30 days of purchase and permitting redemption fees of up to five percent for sales within five days of the purchase.<sup>4</sup> That said, we are not privy to the data necessary to determine the most appropriate level for the redemption fee, which depends on the degree of error margin necessary to protect shareholders against inevitable mispricing of fund shares. The Commission is, in view of its recent fair value pricing inspections, in a better position to determine this margin of error and ensure that the mandatory redemption fee is tailored accordingly. We assume that the Commission will take action against funds whose mispricing is not the result of the inevitably subjective nature of fair value pricing, but of a conscious disregard of their legal obligation to ensure that their prices are accurate, as discussed further below.

Wherever it sets the fee level, we urge the Commission to impose an outside time limit on the redemption fees. Failure to impose an outside time limit could allow some funds that are anxious to retain assets to set a lengthy redemption fee period that is not justified by the goal of deterring short-term trading of fund shares. Setting an outside time limit would have the added benefit of promoting uniformity in the application of the rule, which should help to reduce compliance costs. Furthermore, if the Commission determines that a redemption fee of greater than two percent is needed to remove the profits from short-term trading, we strongly recommend limiting this higher fee to a very short time period, such as five days, in keeping with the Commission's stated goal of preserving the redeemability of fund shares.

■ **The mandate is essential to the rule's effectiveness.**

The proposing release asks whether the rule should permit, rather than require, the redemption fees. We would not support such an approach. Funds are free to impose modest short-term redemption fees today. Those that are serious about discouraging short-term trading have already done so. Eliminating the mandate would thus reduce this rule proposal to a meaningless exercise that essentially reaffirms the status quo. Furthermore, we urge the Commission to make clear that waivers of the fee will not be permitted except under those conditions specifically allowed for under the rule. It is our understanding that fund companies

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<sup>4</sup> "A Pro-Investor Blueprint for Mutual Fund Reform," prepared by Mercer Bullard, Founder and President of Fund Democracy, Inc., and Barbara Roper, Director of Investor Protection for Consumer Federation of America, and released by Fund Democracy, CFA, Consumers Union, Consumer Action, and U.S. Public Interest Research Group.

waive certain fees for some investors – e.g., employees of the fund manager. Given the employees at some fund companies have been directly implicated in the trading scandals, the Commission should make clear that this mandate applies to all fund investors and cannot be waived except in accordance with the rule proposal.

■ **We support allowing small redemptions and redemptions in financial emergencies without triggering the redemption fee.**

When our organizations released our position paper in support of a mandatory redemption fee, we conditioned that support on proper structuring of such a fee. In particular, we specified that proceeds from the fee should go to the fund itself, rather than to the fund manager, to ensure that shareholders are the beneficiaries. We also specified that provisions should be included to allow redemptions without payment of the fee in genuine financial emergencies. The Commission proposal – with its provisions for small redemptions and emergency redemptions without payment of a redemption fee – generally seems to satisfy these requirements.

However, we urge the Commission to remove the \$10,000 limit on mandatory waiver of the redemption fee in the case of financial emergencies. If the emergency is real, the investors should not pay a penalty for removing their funds unexpectedly, no matter the amount of the redemption. On the other hand, we do not believe the exception should apply to market breaks or major political or economic events. The purpose of the exception is not to protect small investors from the risks of the marketplace. Rather it is to ensure that they can redeem their shares without paying a penalty in the case of a legitimate, personal financial emergency that could not have been anticipated when they made their investment.

We also have questions about the effectiveness of the “first in, first out” method of determining the applicability of the redemption fee. Specifically, we wonder whether this wouldn’t allow those who wish to engage in rapid trading to park a certain amount of money in a fund they intend to trade, then, after the five-day redemption period had passed, trade in and out rapidly as the opportunity arose with money added after that time?

As we see it, the redemption fee would raise the stakes for this strategy in several ways. 1) Traders would have to know in advance where they expected to do their rapid trading and could not simply pounce on the opportunity as it arose. 2) They would have to commit a significant amount of money to the fund they plan to trade. 3) As long-term shareholders in the funds in which they are also engaging in rapid trading, the traders would bear a portion of the costs of their short-term trading strategy.

However, in the recent trading scandals, those traders who made advance arrangements with fund managers to permit the rapid trading generally specified in advance in which funds they expected to make their trades. Similarly, the rapid traders would reap 100 percent of the rewards of their strategy, while only bearing a portion of the costs (which would be spread out over all fund shareholders). Given the willingness of rapid traders to provide substantial “sticky” assets in return for permission to engage in rapid trades, the question is whether the

strategy would still be profitable if the “sticky” assets were held in the account being traded.

If, after further analysis, the Commission determines that there is a legitimate concern that the “first in, first out” method for determining applicability of the fee preserves opportunities for excessive trading, we urge you to consider whether a different approach would be more effective in deterring abuses while still preserving the ability of long-term shareholders to engage in legitimate transactions.

- **We strongly support requiring intermediaries to share Taxpayer Identification Numbers and transaction history with funds on at least a weekly basis.**

While some funds knowingly permitted certain favored investors to time their funds, others failed to prevent the rapid trading because they did not insist on receiving adequate information from intermediaries to detect and prevent the trading. This lack of adequate information also contributed to failure of some investors to receive appropriate breakpoints. We believe it is absolutely essential that funds receive the identifying information necessary to ensure that their policies, including policies against rapid trading and policies on breakpoint discounts, are being uniformly and accurately applied. Without this provision, funds would still not be in a position to ensure that redemption fees are being applied in every instance in which they are warranted.

We also urge the Commission to police the effectiveness of the various permissible methods for collecting the redemption fees. If one method should prove to be significantly less reliable than another, the Commission should reexamine whether that method should continue to be permitted. Or, if a particular broker should provide consistently unreliable in collecting redemption fees, the Commission should require that they adopt an alternative approach that gives the fund more control over the collection of redemption fees.

- **We support the exceptions to the mandatory redemption fee provided for in the rule proposal.**

The Commission has in our view done a good job of identifying the instances in which a mandatory redemption fee would not be appropriate. Clearly, a redemption fee would be entirely inconsistent with the nature and purpose of money market funds for example. We also support the exemption for exchange traded funds, which are structured specifically to allow them to trade like listed operating companies on an exchange. Finally, we have no objection to allowing certain funds to specifically permit rapid trading, as long as that fact is prominently disclosed (including in any advertisements for the fund) and brokers are held accountable, under their suitability obligation, for not steering long-term investors into these funds.

- **We applaud the Commission for its continued emphasis on improving the accuracy of share pricing.**

The rule proposal reaffirms the Commission’s belief “that the primary response of funds and fund managers must ... be to more accurately calculate the daily net asset value of the fund

by using fair value pricing methods when closing prices are unreliable.”<sup>5</sup> It also asserts that the Commission is “actively considering ways in which the implementation of fair value pricing could be improved.”<sup>6</sup> We strongly support these efforts. However, because we believe fair value pricing is inherently subjective and will never completely eliminate pricing discrepancies, we also believe a mandatory redemption fee is needed to support these efforts.

## ■ Conclusion

Some have opposed the mandatory redemption fee, arguing that it is simply a “boondoggle” that benefits mutual fund managers at the expense of shareholders. We disagree. Because proceeds of the fee will flow to fund shareholders, the fee will serve primarily to ensure that shareholders recoup the costs that short-term trading would otherwise impose on the fund. Furthermore, the Commission appears to us to be engaged in a legitimate effort to determine the appropriate level to set the fee to accomplish this goal, while preserving the redeemability of fund shares. In addition, the Commission has made appropriate provisions to ensure that small investors are not unduly harmed by the fee, particularly when faced with a financial emergency that requires them to make an unanticipated withdrawal from the fund. The Commission further clearly recognizes that a mandatory redemption is just one part of an overall strategy to prevent excessive trading, and has proposed appropriate safeguards to ensure the accurate imposition of the fees. As a result, we support the proposed rule and urge its adoption.

Respectfully submitted,

Barbara Roper  
Director of Investor Protection  
Consumer Federation of America

Mercer Bullard  
Founder and President  
Fund Democracy, Inc.

cc: Chairman William Donaldson  
Commissioner Paul Atkins  
Commissioner Roel Campos  
Commissioner Cynthia Glassman  
Commissioner Harvey Goldschmid  
Paul Royce, Director, Division of Investment Management

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<sup>5</sup> Proposing Release (II.F.).

<sup>6</sup> Ibid.