

Amid Uncertainty, Boards Tackle Redemption Fee Rule

Published on Jan 17, 2006

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While still months away, the compliance date for the SEC's new redemption fee rule— Oct. 16 — is actually just around the corner. But the task of complying is proving difficult for boards, with several key questions the industry has about the rule still unresolved.

Many boards are now starting to tackle the most onerous part of that rule: how redemption fees are applied to funds traded through intermediaries in so-called omnibus accounts.

Under the rule, boards must deliberate upon whether their funds should have redemption fees. In addition, the rule requires funds that redeem shares within seven days to enter into agreements with their intermediaries, including those that hold shares through so-called omnibus accounts.

It's this second part of the rule that poses more of a challenge.

Now, some boards are now starting to focus on the process for implementing the provision in the SEC rule that requires funds (or their principal underwriters) to have agreements with intermediaries, says Joan Ohlbaum Swirsky, counsel at **Drinker Biddle & Reath**.

Issues involved include the types of intermediaries and types of arrangements with them, as language may need to be tailored for the particular intermediary.

The **Putnam** board, for example, just formed a special task force to do a major review of redemption fees. In many ways, Putnam is ahead of the game. The firm began putting in place redemption fee policies in 2001, prior to being implicated in the improper-trading scandal.

Post-scandal, in April 2004, the board approved a 2% redemption fee on all Putnam Funds exchanged or sold within five calendar days of purchase, with the exception of money market, variable annuity and closed-end funds. The board has also retained a 1% redemption fee on funds that are exchanged or sold within 90 days.

Still, the process hasn't always been smooth sailing.

"I think 90% of the intermediaries are imposing fees on our account," says John Hill, the board's independent chairman. "A lot of them didn't want to do it. It's a lot of work for them." (Directors do not have to approve the agreements with intermediaries, but many boards are involved in this aspect of complying with the rule.)

Furthermore, in some cases drafting those agreements will be an enormous task for the advisor because the larger fund groups may work with hundreds or even thousands of intermediaries.

Complicating the matter is the fact that the SEC requested comment on certain aspects of the rule when it was finalized last March. There are several areas for possible amendments, says Bob Plaze, associate director of the SEC's division of investment management.

One key area is the definition of what constitutes an intermediary and therefore the definition of with whom the agreements must be made. According to the rule, financial intermediaries include broker-dealers, banks, certain insurance companies, and the plan administrator or plan recordkeeper of employee benefit plans.

The industry has said that this definition is too broad. In a May comment letter, the ICI writes, "To comply with the contract requirement, funds will have to first identify their universe of 'intermediaries.' This is no small task. Two large fund complexes have informed us that they each have over 1.3 million accounts with registrations that are not in the name of a natural person and thus could be held to be an intermediary for purposes of the rule."

Another area the SEC requested additional comment on was whether it should establish a set of uniform standards that would make it easier for intermediaries to assess redemption fees on omnibus accounts.

The agency has yet to issue amendments or clarifications to the rule. Recent high-level personnel changes at the SEC — including a new chairman and commissioner — may have stalled further clarification.

"It's the staff's hope that the commission will consider the issue soon and that there won't

be a need for extension," says the SEC's Plaze. "But we will ask for comment on whether that's going to be an issue." Plaze adds that he expects the staff to recommend amendments to the rule, which will have to be voted on by the commission.

Plaze says the rule is an example of how the agency relies on the industry's comment letters to understand the impact rules may have so that it can then make adjustments. The issues the agency is dealing with now were not brought to its attention when the rule was originally proposed, he says.

Meanwhile, fund firms and boards find themselves caught in a bind — waiting for further clarification yet needing to start complying with the rule in order to meet the October compliance date.

"We are waiting [for clarification from the SEC], but with time getting closer and closer to the compliance date, we are moving ahead with our implementation," Henry Hopkins, **T. Rowe Price's** chief counsel, writes in an e-mail response to questions. "Otherwise, we would not be able to meet the October 16th deadline."

Tackling redemption fee policies for omnibus accounts is one particularly thorny issue facing boards and firms. Omnibus accounting is where individual trade orders processed by third-party providers are lumped together into a single block order. Because these trades are processed together, individual shareholders are difficult to track, so it's hard to impose redemption fees on investors in such accounts.

These accounts gained attention during the scandal because it was discovered that at least one firm had disguised market timing and late trades by mixing those trades in with legitimate ones in omnibus accounts.

Now one fund-shareholder activist says that independent directors should do more to ensure that omnibus accounts are adequately policed for market timing.

Niels Holch, the head of the Coalition of Mutual Fund Investors, sent a letter last December to the independent directors of 33 major fund complexes. In it, he alerts the directors to what he deems "disparate treatment" of shareholders when it comes to redemption fee policies.

According to Holch, the prospectuses of the fund complexes exempt or limit implementation of redemption fees on omnibus accounts. Holch urges the boards to require receipt of shareholder-level data from intermediaries that deal with omnibus accounts on a daily basis. Through receiving this data, fund firms could better monitor for market timing, says Holch.

Thus far Holch has received one response — from Fidelity's board. The independent chair of the independent trustees, Robert Gates, wrote that the funds have a lot of experience with redemption fees, but that the board is not sure what will happen with omnibus accounts because they're waiting for further guidance on the subject from the SEC.