May 10, 2004

VIA ELECTRONIC MAIL

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549

Subject: Proposed Rule: Mandatory Redemption Fees for Redeemable Fund Securities/File No. S7-11-04

Dear Mr. Katz:

The Coalition of Mutual Fund Investors ("CMFI" or "Coalition") is pleased to submit the following comments regarding a new rule proposed by the Securities and Exchange Commission ("SEC" or "Commission") on March 2, 2004. This proposed rule requires mutual funds to impose a two percent (2%) redemption fee on the redemption of shares purchased within the previous five (5) business days.

CMFI is an Internet-based shareholder advocacy organization representing the interests of individual mutual fund investors. The Coalition is based in Washington, D.C., with a Web site that can be accessed at www.investorscoalition.com.

1. A Mandatory Redemption Fee is a Necessary Tool to Help Mutual Funds Combat Market Timing Abuses.

CMFI strongly supports the use of a mandatory two percent (2%) redemption fee as a mechanism to deter abusive short-term trading activities.

Excessive trading is harmful to the interests of long-term shareholders in a mutual fund. Short-term profits taken by market timers increase fund transaction costs and dilute the value of the shares owned by long-term shareholders. Abnormal redemption levels also force fund managers to have larger cash balances in a fund, a situation which limits the ability of a fund to be fully invested.

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When used by a mutual fund, redemption fees have proven to be a successful tool to discourage short-term trading. If the fee is large enough, it can reduce or eliminate the economic incentives of market timing. Redemption fees also provide a mechanism for long-term shareholders to be compensated for the dilutive effects of this type of trading activity.

Advocated by the Investment Company Institute and other industry opinion leaders, a mandatory fee for redemptions within five (5) business days provides a uniform method for addressing an issue that has evolved into a significant problem for many mutual funds.

Except for those funds which clearly disclose an intent to engage in short- term trading as a fundamental investment strategy, all mutual funds and their long-term shareholders will benefit from the protections provided by a mandatory redemption fee.

2. <u>The SEC Should Authorize Mutual Funds to Have the Option to Impose Redemption Fees Higher Than Two Percent</u>

CMFI believes that mutual funds should be provided with the discretionary authority to establish a redemption fee at a higher level than two percent (2%). In the explanatory materials accompanying the rulemaking proposal, the SEC staff notes that the two percent (2%) fee was an attempt to strike a balance between two competing policy goals of the Commission: (1) "preserving the redeemability of mutual fund shares" and (2) "reducing or eliminating the ability of shareholders who frequently trade their shares to profit at the expense of their fellow shareholders." 69 Fed. Reg. 11,762, 11,764 (March 11, 2004).

The Commission staff acknowledge that a redemption fee higher than two percent (2%) may be more effective at eliminating rapid trading. However, the Commission is concerned that a higher fee would be harmful to those investors who may need to redeem shares to meet a financial emergency.

In CMFI's view, the need to address market timing is a far more important policy goal than the more narrow circumstances of a financial emergency by an individual investor within the proposed five-day holding period. For this reason, CMFI believes that the Commission should authorize funds to have the option to impose a higher redemption fee than the two percent (2%) minimum, if a fund board decides that such a fee structure is in the best interests of the long-term shareholders of the fund.

3. The Required Accounting Method Used for the Redemption Fee Should Be LIFO Instead of FIFO

Under the Commission's proposal, funds would determine the amount of the redemption fee by used the accounting method known as "first in, first out" or FIFO. Apparently, this accounting treatment is the method most often used within the fund industry for this purpose.

Under FIFO, fund shares held the longest time are treated as being redeemed first, and shares held the shortest time are treated as being redeemed last.

While the FIFO method would trigger redemption fees based on short-term activity involving a large portion of an individual account, a market timer could circumvent this accounting method by creating a timing "ladder" or "tranche." Under this structure, a market timer could rapidly trade smaller and defined portions of a larger account balance, leaving an equal amount of shares untouched in the fund to avoid triggering a redemption fee. Ironically, this approach would operate in a similar fashion to some of the market timing transactions uncovered by industry regulators: a significant sum is invested in a fund as a "sticky asset," while other monies are permitted to be used for market timing activities.

The use of FIFO would still permit market timers to rapidly trade fund shares as long as a "sticky asset" balance of a certain amount is maintained to avoid a redemption fee.

A better solution to this problem is to use an accounting method known as "last in, first out" or LIFO. Under LIFO, fund shares held the shortest time are treated as being redeemed first, and shares held the longest time are treated as being redeemed last.

Market timing in its most basic form involves a "round-trip" trade (i.e., a purchase and a redemption) within a short period of time. The only way to effectively discourage this rapid trading activity is to use an accounting method which best addresses the underlying market timing transaction. The only accounting method which accomplishes this objective is LIFO because it matches the most recent transactions with each other. Clearly, this is the accounting method which a fund should use to impose its redemption fee.

The Commission notes in Footnote #33 of its explanatory materials that market timers using omnibus accounts may be able to circumvent a redemption fee based on a LIFO accounting method by using multiple accounts. CMFI believes that this issue can be addressed effectively with the Commission's proposal to require regular intermediary disclosure of an account holder's Taxpayer Identification Number (TIN) and transaction information, permitting a fund to match transactions with the same TIN.

Another mechanism for ensuring that multiple accounts are not used to circumvent redemption fees would be to require intermediary disclosure of the name and address of each omnibus account holder. This disclosure would reduce the number of instances in which different accounts are used for market timing purposes. A husband and wife living together with separate accounts, for example, would find it more difficult to avoid a redemption fee by executing a purchase in one account and a redemption in a second account. Intermediary disclosure of the names and addresses of all omnibus account holders would provide funds with an additional tool to deter the use of multiple accounts for market timing purposes. See National Association of Securities Dealers, Report of the Omnibus Account Task Force, at 5, January 30, 2004, available at http://www.nasd.com/pdf_text/omnibus_report.pdf.

4. The De Minimis Threshold for the Redemption Fee Should Be Higher

CMFI agrees with the Commission that any mandatory redemption fee should have a de minimis exception for small accounts. In its rulemaking proposal, the Commission proposed that the redemption fee not be imposed if the amount of the shares redeemed is $2,500 or less. This would result in a redemption fee being waived or excepted if it is $50 or less ($2,500 multiplied by 2%).

The Commission's rationale for the de minimis exception is two-fold: (1) to avoid any adverse impact on small investors; and 2) to avoid having the cost of collecting a redemption fee exceed the actual amount of the fee.

To ensure that this redemption fee does not harm smaller investors--and especially those investors with automatic investment and/or rebalancing plans--CMFI recommends that the Commission consider a higher de minimis threshold. No de minimis amount will be a perfect solution for all small investors, but CMFI will support a $10,000 threshold--the same level that the Commission proposes as the maximum amount for the financial emergency waiver.

In calculating and imposing the redemption fee, CMFI believes that there may be several different scenarios in which gross redemption proceeds will contain mutual fund shares that are not subject to the fee. For this reason, the Commission may want to consider having the de minimis threshold be based on the *dollar amount of the actual redemption fee to be imposed*, instead of the gross proceeds from a shareholder's redemption. In other words, it may be simpler to permit a fund to waive a redemption fee of $50 or less, instead of waiving fees on all redemption amounts under $2,500. (If the de minimis threshold were increased to $10,000, this recommendation would permit a fund to waive a redemption fee that is $200 or less.)

To illustrate this point, consider a systematic investor in a 401(k) retirement plan who chooses to invest $100 into a particular mutual fund on a bi-monthly basis. This same investor also has a periodic rebalancing strategy. The account has a balance of $60,000 and a periodic rebalancing causes a $12,000 redemption within five (5) days of one of the investor's regular $100 purchases. Using a LIFO accounting method, the investor has had a purchase of $100, followed by a redemption of $12,000, both within the five-day holding period. The investor does not appear to meet the de minimis threshold, whether it is set at $2,500 or $10,000. After appropriate calculations are made, a redemption fee would be assessed on $100 of the redemption proceeds, resulting in a fee of $2. Obviously a fee of this size should be subject to the de minimis rule and waived. However, it will be easier to determine if the fee qualifies for a de minimis waiver if the fee becomes the focus of the analysis instead of the gross redemption proceeds.

Some may argue that a fee-based threshold is more burdensome for any individual investor attempting to calculate the amount of the fee for a specific redemption transaction. It appears to make more sense, however, to calculate the actual redemption fee owed and then apply a de minimis threshold, in contrast to calculating the fee and then looking back to determine if the gross proceeds qualify for a redemption fee waiver.

5. The Commission Should Modify the Financial Hardship Waiver

The Commission proposes to require a waiver of the redemption fee in the case of an unanticipated financial or family emergency, upon the request of the shareholder.

The Commission's proposal of a five-day holding period should reduce the risk of this type of hardship occurring. It is hard to imagine a situation in which an investor purchases mutual fund shares and then, within a five-day holding period, needs to redeem those same shares for a financial emergency. It would be an unusual case where the

investor could not wait until the sixth day to redeem his or her shares, avoid the redemption fee, and then receive the proceeds through the normal processing timetables of the fund or its intermediary.

CMFI does not believe that this waiver is necessary at all if the Commission imposes a five-day holding period. If, for some reason, the Commission decides to impose a longer minimum holding period, then CMFI supports a financial emergency waiver as long as: (1) it applies to redemption fees of $200 or less, and (2) is discretionary on the part of the fund. The conditions for receiving the waiver should be clearly disclosed in a fund's prospectus.

6. The Commission Should Require Intermediary Disclosure of Omnibus Account Information on a "Same-Day" Basis

As the Commission notes in its explanatory materials, regulatory investigations of market timing activities have uncovered a number of instances in which the individuals and entities involved sought to conceal their transactions from a mutual fund through omnibus accounts used by financial intermediaries. Under this practice, a mutual fund records only one accountholder in its master shareholder file, usually the financial intermediary itself, instead of establishing separate accounts for each shareholder. These omnibus accounts may have hundreds of thousands of shareholders, all recorded as one shareholder in the accounts of the mutual fund.

The Investment Company Act requires that investment companies be operated in the "interest of *all classes* of such companies' security holders." 15 U.S.C. §80a-1(b)(2) (emphasis added). It is also the fund board's fiduciary duty to treat all shareholders evenly and fairly. Unfortunately, it is impossible for fund boards to ensure the equal and fair treatment of all shareholders under a sales and distribution system where there are really two sets of shareholders: (1) the "direct purchase" shareholders; and (2) the "omnibus account" shareholders.

CMFI believes that a mutual fund cannot effectively monitor the activities of omnibus shareholders, or properly enforce its policies and procedures with respect to these shareholders. The current practice of relying on contractual commitments by fund intermediaries to require those same intermediaries to enforce a fund's rules is highly suspect as a solution because it is not in the economic interest of an intermediary to enforce mutual fund rules on its customers.

The use of different intermediaries to sell mutual fund products and the proliferation of fund record keepers also have created an industry accounting structure dominated by the needs of the fund distribution system. After decades of earning a reputation for innovation and trustworthiness, mutual funds are now facing the stark reality that further progress by the industry may be constrained by the economic interests of fund distributors and the antiquated record-keeping systems operated by intermediaries. As mutual fund record-keepers continue to expand and multiply, funds are not able to fully differentiate their products and services, and industry regulators are forced to develop "one size fits all" solutions, to accommodate the least sophisticated accounting systems of broker-dealers and other intermediaries.

To address this bifurcated structure of "omnibus" and "direct" shareholder classes, CMFI has proposed to the Commission that financial intermediaries be required to disclose shareholder identity and transaction information to mutual funds on a daily or transactional basis, so that each fund can monitor shareholder activity and be in a position to ensure the uniform application of its policies and procedures. See Letter from Niels Holch, Executive Director, Coalition of Mutual Fund Investors, to William H. Donaldson, Chairman, U.S. Securities & Exchange Commission, December 12, 2003, available at http://www.investorscoalition.com/regulatory.htm.

This proposal is not an attempt to provide mutual funds with access to the customers of fund intermediaries. To avoid that result, protections will need to be in place to ensure that this information is used for compliance activities only and not for any marketing or customer relationship purpose. In Footnote #47 of its explanatory materials, the Commission notes that non-public personal information shared with a fund by its intermediaries is protected by the intermediary's privacy policies under current Commission regulations. See 69 Fed. Reg. 11, 762, 11, 766 (March 11, 2004), citing 17 C.F.R. § 248.11(a) and 17 C.F.R. § 248.15(a)(7)(i).

The mechanics of implementing the Commission's proposed mandatory redemption fee provide an excellent "case study" of the difficulties presented when a mutual fund does not have adequate information about the underlying shareholders located within an omnibus account umbrella.

Proper application of the mandatory redemption fee is the legal obligation of both the mutual fund and its intermediaries, although the parties differ in their respective economic interests. It is in the mutual fund's economic interest to correctly calculate the