Via e-mail

May 10, 2004

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

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

Ladies and Gentlemen:

Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch") appreciates the opportunity to comment on a new rule 22c-2 that the Securities and Exchange Commission (the "SEC" or "Commission") has proposed under the Investment Company Act of 1940 ("Investment Company Act").[1] The Commission proposes to institute a mandatory 2% redemption fee for all fund redemptions within a minimum 5-business day holding period (the "Proposal").

As discussed in more detail below, while we share the Commission's desire to ensure that funds do not bear the costs of short-term or frequent trading strategies, we believe that the Proposal does not adequately address the issues of short-term trading and may result in inequitable treatment of average fund shareholders. We believe that there are more effective and less costly ways to achieve the Commission's objectives, which we submit herein.

I. SUMMARY OF COMMENTS

A summary of our comments regarding the Proposal is as follows:

- The short-term trading issue is actually a number of different, although related, issues, which affect different types of investment companies and products in different ways. To apply to these differing issues a one-size-fits-all remedy, as the Commission proposed

[1] *Mandatory Redemption Fees for Redeemable Fund Securities*, Release No. IC-26375A (March 5, 2004) ("Proposing Release").

with its 2% mandatory redemption fee, would be neither effective in preventing market timing nor equitable to redeeming shareholders.

- Because the 2% mandatory redemption fee would apply to all shareholders, regardless of whether they were frequent traders, the fee would not necessarily have any relationship to actual incremental costs generated by a fund as a result of a shareholder's trading.

- The 2% mandatory redemption fee would not have any relationship to many types of investment products and companies, such as broadly diversified U.S. equity funds that really have little or no short-term trading issues.

- The 2% mandatory redemption fee may also have little relationship to the amount of dilution of shareholder interests that result from inefficiencies in funds' net asset value ("NAV") calculations. The Commission could better address shareholder dilution resulting from inefficiencies in NAV calculation by placing greater emphasis on fair value pricing.

- The 2% mandatory redemption fee would be inequitable to many redeeming shareholders because it would impose a penalty upon them for a one-time redemption that may have no dilutive effect on the fund or its remaining shareholders. In the absence of such dilution, a shareholder should have the right to have a change of heart within five business days of his or her investment without incurring any incremental penalty.

- A better alternative to the Commission's 2% across-the-board redemption fee proposal would be for the Commission to adopt a definitional rule or release that defines the parameters of the differing issues resulting from short-term or frequent trading, as applicable, to different types of funds. The Commission should charge fund boards with appropriately addressing the issues so defined.

- If the Commission, nevertheless, believed an across-the-board redemption fee were desirable, we recommend the following:

    - We recommend that the Commission expand the list of exceptions to exclude from the mandatory redemption fee requirement redemptions at the plan level for participant-directed retirement plans that provide for individual accounts (such as 401(k) plans, 529 Plans), redemptions for *bona fide* trade corrections, and redemptions at the fund level for fund of funds and feeder funds.

    - The Commission should clarify that the Proposed Rule does not apply to participant directed activity conducted within a trust for a retirement plan such as a 401(k) plan.

    - We also recommend that the Commission except from the mandatory redemption fee requirement discretionary advisory accounts that do not have as an objective the realization of gains through short-term trading.

    - We believe that the Commission should not adopt the proposed provision to permit a waiver of the redemption fee for unanticipated financial emergencies, in

part, because such will be very difficult to administer and may be abused by certain shareholders engaging in excessive trading to avoid redemption fees. As an alternative, we believe that the Commission should raise the *de minimis* exception from $2,500 to $10,000.

- We agree with the Proposal's approach with respect to omnibus accounts. We agree with the flexibility allowed by the Proposal for funds and intermediaries to choose among three different methods for assessing the redemption fee to investors.

II. BACKGROUND

A. Merrill Lynch

Merrill Lynch is registered as a broker-dealer under Section 15 of the Securities Exchange Act of 1934, as amended (the "1934 Act"), and as an investment adviser under Section 203 of the Investment Advisers Act of 1940, as amended (the "Advisers Act"). In addition to offering Merrill Lynch proprietary funds, Merrill Lynch supports approximately 140 fund companies and currently offers approximately 11,700 individual mutual fund share classes on behalf of its customers. Merrill Lynch has approximately 11.1 million customer positions in retail brokerage accounts that are invested in mutual funds and serves approximately 5.4 million additional retirement plan participants who have mutual fund investments. In 2002, Merrill Lynch executed over 130 million fund transactions (excluding money market transactions) for these customers. Currently, Merrill Lynch supports the transactions of over $300 billion in mutual fund assets.

Merrill Lynch is a wholly owned subsidiary of Merrill Lynch & Co., Inc. ("ML&Co."), one of the world's largest financial services firms. Its affiliates include Financial Data Services, Inc. ("FDS"), a registered transfer agent that serves as the transfer agent for Merrill Lynch's proprietary mutual funds, and Merrill Lynch Investment Managers, the investment management unit of ML&Co.

B. Proposed Rule 22c-2

Proposed rule 22c-2 would require mutual funds to impose a redemption fee of 2% on fund shares redeemed within 5 business days of their purchase. The rule would not permit funds to impose a higher or lower fee than 2%. Each fund, unless excepted, would have to impose the fee.

III. DISCUSSION

We fully support the Commission's efforts to prevent the dilution of shareholder interests caused by frequent and excessive trading. Indeed, we commend the Commission's recent adoption of amendments that will require mutual funds to disclose the risks to shareholders of frequent purchases and redemptions, as well as the fund's policies and procedures with respect to

such excessive trading practices.[2] The Market Timing Disclosure Release requires funds to address the issue of market timing, but wisely avoids mandating funds to adopt uniform one-size-fits-all policies and procedures. Instead, the Commission permitted fund boards to adopt policies and procedures tailored to the needs of each fund. The Commission's approach in the Market Timing Disclosure Release is consistent with its ongoing efforts to enhance the role of independent directors in fund governance. However, we believe that the Proposal, in requiring funds to impose an across-the-board mandatory redemption fee, is a step in a different and inconsistent direction. The Proposal is not only at odds with the Commission's prior positions on the impact of redemption fees, but the Proposal fails to recognize that the short-term trading issue addressed by the Proposal is in reality a number of different, although related, issues, which impact different types of investment companies in different ways. Moreover, the Proposal unfairly restricts the ability of the average shareholder to freely redeem his or her fund shares.

A. <u>The Commission's Prior Position on Redemption Fees</u>

The Commission historically expressed serious concerns when considering the imposition of redemption fees on the sale of fund shares. During the legislative hearings on the Investment Company Act, the Commission characterized the right of mutual fund shareholders to receive the net asset value of their shares upon redemption as "the most important single attribute which induces purchases of the securities of open-end companies."[3] The Commission's characterization was reflected in Section 5(a) of the Investment Company Act, which requires that the securities of an open-end investment company be "redeemable." In addition, Section 2(a)(32) of the Investment Company Act requires that fund shareholders receive approximately their proportionate share of the issuer's current net assets, or its equivalent in cash, upon redemption. The effect of these requirements, as the Commission recognized, is that:

> The imposition of any charge or fee upon the redemption of fund shares raises serious questions . . . . A fee payable upon redemption may take the securities issued by the fund outside the definition of a "redeemable security."

Indeed, the Commission has warned that, "it may well be materially misleading to market a product as 'liquid' or 'easy to redeem,' if redemption is then 'penalized' by high redemption charges."[4] Consistent with the Commission's position, the staff, in 1979, informally took the position that a fund may impose a redemption fee of ***up to*** 2%.[5]

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[2] *Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings*, SEC Release Nos. 33-8408, IC-26418 [69 FR 22300] (Apr. 19, 2004) ("Market Timing Disclosure Release").

[3] *See* Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. On Banking and Currency, 76th Cong., 3d Sess. at 985 (1940) (memorandum introduced by David Schenker, Chief Counsel, SEC Investment Trust Study).

[4] Separate Accounts Funding Flexible Premium Variable Life Insurance Contracts, SEC Release No. IC-15651 [52 FR 11187] (Mar. 30, 1987).

[5] *Id.* (citing *John P. Reily & Associates*, SEC No-Action Letter (July 12, 1979)).

Because of the importance placed on the redeemability of mutual fund shares, the Commission and staff have recognized certain principles, including that: (1) a redemption fee must be paid directly to the fund, and (2) a redemption fee may recoup or offset only limited types of brokerage and administrative expenses caused by shareholders' frequent redemptions.[6] Thus, a redemption fee must be reasonably intended to compensate the fund for "expenses directly related to the redemption of fund shares."[7] Moreover, although the Commission has reluctantly permitted funds to charge a redemption fee to cover administrative expenses associated with frequent redemption, it has never endorsed the imposition of redemption fees.

In light of the Commission's past concerns regarding the impact of redemption fees on the redeemability of fund shares, we are concerned with the Commission's Proposal to impose a blanket mandatory redemption fee.

B. The Short-Term Trading Issue Is More Complex than Redemption Fees

We believe that the Proposal does not recognize that the dilution of shareholder interests resulting from short-term redemptions is actually a number of different, although related, issues, which affect different types of investment companies in different ways. To apply to these differing issues a one-size-fits-all remedy, as proposed by the Commission's mandatory 2% redemption fee, would be neither effective in preventing market timing nor equitable to redeeming shareholders.

The 2% mandatory redemption fee was originally developed to discourage certain short-term traders who sought to realize gains from anticipating short-term market swings with respect to particular industry sectors or particular issuers.[8] This type of short-term trading mostly affected sector funds and certain non-diversified funds with relatively concentrated portfolio holdings. The issue arises from traders affecting a series of frequent in and out trades from one sector to another over time. Such excessive trading may disrupt the management of the fund's portfolio and raise a fund's transaction costs. The resulting administrative and brokerage costs may dilute the value of the other fund shareholders' shares. Some funds have sought to deter such excessive trading. As noted in the Proposing Release, some funds restricted exchange privileges, including delaying both the redemption and purchase sides of the exchange, and limited the number of trades within a specified period.[9] The maximum 2% redemption fee was developed to allow these types of funds to recoup such brokerage and administrative costs caused by frequent purchases and sales of fund shares, and thereby to mitigate the dilution of interests of long-term shareholders.

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[6] *See* Rule 11a-3(a)(7). 17 CFR § 270.11a-3(a)(7).

[7] *Id*.

[8] *See Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth Before the House Comm. On Interstate and Foreign Commerce*, H.R. Rep. No. 89-2337, at 58, n. 156 (1966) (stating that "[r]edemption fees serve two purposes: (1) they tend to deter speculation in the fund's shares; and (2) they cover the fund's administrative costs in connection with the redemption").

[9] Proposing Release at 11763, n. 7.

The imposition of the Commission's proposed across-the-board 2% redemption fee to all types of funds, however, would likely be largely ineffective and inequitable to many redeeming shareholders because it would apply to every shareholder redemption within 5 business days, not just to frequent in and out trades. For example, the proposed redemption fee would apply to funds that invest exclusively in frequently-traded exchange listed securities of large capitalization U.S. issuers, which the Commission conceded in its Market Timing Disclosure Release, may have little or no issues with abusive short-term trading.[10]

The application of the 2% mandatory redemption fee as a tool to combat market timers would be equally inequitable and would not go to the root causes of market timing. Unlike the speculative short-term traders described above, market timers try to take advantage of mispricing of a fund's NAV. Such market timing activities may affect different types of funds. For example, fund mispricing may be the result of unreliable market quotes at the time of market closing. Such mispricing typically affects certain foreign funds, certain high-yield bond funds, and other funds that invest primarily in thinly traded securities. Other market-timers may try to take advantage of changes in economic or market conditions abroad after a foreign market closes, but while the U.S. market is still open. This type of market timing, or time-zone arbitrage, affects mostly single country funds or particular region funds. Still other market timers may try to arbitrage a fund based on changes in U.S. economic or market conditions occurring after foreign markets are closed, which could impact those U.S. funds that invest primarily in foreign markets that are closely integrated with the U.S. markets.

These types of market timing activities occur because of inefficiencies in a fund's NAV calculations. The 2% redemption fee would appear to be unrelated to the principal cost in terms of shareholder dilution resulting from these types of market timing activities. The principal source of dilution to shareholders from market timing results from inefficiencies in NAV calculation, which may in turn generate excess brokerage and administrative costs of the type the maximum 2% redemption fee was historically designed to reimburse. Such a redemption fee would be a highly inefficient technique to try to compensate long-term shareholders for failures in other controls to eliminate the arbitrage opportunities flowing from pricing process inaccuracies.

Many funds, with the encouragement of the Commission, have moved to fair value pricing to discourage market timing.[11] Indeed, the Market Timing Disclosure Release clarifies that funds must explain in their prospectuses both the circumstances under which they will use fair value pricing and the effects of using fair value pricing.[12] The Commission could better address shareholder dilution resulting from inefficiencies in NAV calculation by placing greater emphasis on fair value pricing. The Commission also might consider, in some special situations, such as funds investing exclusively in a particular region, requiring such funds to modify their

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[10] Market Timing Disclosure Release at 22305.

[11] *See* Ken Hoover, *Why Mutual Funds Discourage Timers; Two forms of practice; They increase expenses, can disrupt portfolios and rob other investors*, Investor's Business Daily, Sept. 17, 2003, at A09.

[12] Market Timing Disclosure Release at 22304-22305.

pricing process and order entry within the U.S. to coincide with the underlying fund investments' opening and closing market times.

Just as the Commission has been reluctant to set rates for fund management fee structures, we believe that the Commission should not be setting shareholder fees related to distribution of redemption proceeds. Given the range of different types of potentially abusive market timing practices and types of mutual funds involved, we believe that each fund's board must have the flexibility to determine whether to adopt redemption fees, as well as the amount of any such fees, that best fits the circumstances of the fund, subject to fiduciary and competitive considerations.

It is no answer to the foregoing to say that the Commission's proposal would allow funds the flexibility to fashion their own remedies for their particular circumstances, in addition to the mandatory 2% redemption fee. The imposition of an across-the-board 2% redemption fee on all fund shareholders would be arbitrary and inequitable to redeeming shareholders.

The Proposal would ensnare even those shareholders that have no intention to, or interest in, engaging in market timing activities. The 2% mandatory redemption fee would apply to any shareholder redeeming within 5 business days who may simply have had a change of heart. Shareholders should have the right to have a change of heart without incurring a penalty. The proposed 2% mandatory redemption fee would be a penalty because it is not related to any incremental costs to the fund of the one-time redemption or to any unfair dilution of remaining shareholders. The fee would be charged regardless of any pattern of frequent purchases and sales of fund shares over time or whether the redemption actually results in disruption to fund portfolio management or in actual incremental costs to the fund.

Moreover, the minimum 5-business day holding period is arbitrary and not supported by any evidence that one-time redemptions within 5 business days of purchase result in greater dilution than redemptions within 6 or 10 business days of purchase. The apparent justification for the proposed 5-business day holding period is that "the vast majority of investors hold shares of their funds for more than five days."[13] However, the Investment Company Institute report to which the Commission cites in support of its 5-business day holding period, clarifies that the "vast majority of equity fund investors did not make a single redemption during the 12-month period ending January 1999."[14] Shareholders who redeem within 5 business days are in a no different position than shareholders who redeem within 10 business days, and it is unfair to treat them differently.

C. <u>Proposed Alternative</u>

We believe a one-size-fits-all approach is inappropriate to an issue that affects different types of funds in different ways. We believe that a better alternative to the Proposal would be for the Commission to adopt a definitional rule or release that defines the parameters of the differing issues which may result from short-term or frequent trading as applicable to different

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[13] Proposing Release at note 28.

[14] Investment Company Institute, *Redemption Activity of Mutual Fund Owners*, Fundamentals, March 2001.

types of funds. The rule or release would charge fund boards with addressing the issues so defined. Each board's approach to these issues would be disclosed to shareholders pursuant to the Commission's recently adopted Market Timing Disclosure Release.[15]

D. Specific Comments on Proposal

If the Commission nevertheless believes an across-the-board mandatory 5-business day redemption fee were desirable, we submit the following comments relating to the Proposed Rule.

1. Exceptions

We generally agree with the Commission's exceptions to the mandatory redemption fee requirement. We agree that the application of the mandatory redemption fee requirement to money market funds, to exchange-traded funds, and to funds that have a disclosed policy of permitting short-term trading would not be appropriate.

We recommend that the Commission expand the list of exceptions to exclude from the mandatory redemption fee requirement certain investments in fund shares made through an investment vehicle such as 401(k) plans, or through two-tier structures, such as funds of funds, master-feeders, and 529 plans. Redemptions in each of these cases involve two separate securities as fund shares are not held directly in the name of the person ultimately making the investment decision – the 401(k) participant, shareholders in a fund of funds or feeder fund, and the holder of a 529 plan account. Instead, the investment vehicle owns fund shares. Accordingly, we recommend that the Commission expand the exceptions to exclude redemptions at the second-tier or investment vehicle level.

Redemptions by such vehicles typically occur in net amounts, reflecting all of the exchanges and redemptions by each investor on a given day. Thus, depending on whether the Commission adopts the "first in, first out" ("FIFO") or the "last in, first out" ("LIFO") method of accounting for the redemption of fund shares, a plan may either always be imposed a redemption fee or the plan may almost never be imposed a redemption fee. For example, if the LIFO method is used, net transaction orders submitted by the investment vehicle to a fund undoubtedly will involve redemptions within a short period of time of purchases in amounts in excess of the *de minimis* limit, even if the individual transactions of the participants would not trigger the imposition of a redemption fee. The opposite would be true if the FIFO method was used. Since all transactions are aggregated, the investment vehicle will almost always be excluded from the imposition of the redemption fee. Accordingly, in order to avoid such unintended results, we recommend that the Commission exclude from the redemption fee requirement redemptions at the plan level for participant-directed investment plans and redemptions at the fund level for fund of funds, master feeder funds, Section 529 plans and similar investment vehicles.

We also believe that the Commission should clarify that the Proposed Rule does not apply to participant directed activity conducted within a trust for a retirement plan such as a 401(k) plan. As mentioned above, such trusts and plans do not act as intermediaries, but rather own the fund shares directly. Participants therefore have no ownership interest in the funds, but

[15] *See supra* note 2.

rather own an interest in the plan itself, which is a separate, albeit exempt, security. As such, it is for the plan and its sponsor to adopt any controls to counter injurious participant short-term trading, not for the funds. The sponsor has a good deal of flexibility in imposing such controls, which may include, in addition to redemption fees, mandatory hold periods, limiting the number of allowable trades, and/or delaying placement of orders. The market has already developed plan-appropriate mechanisms for addressing short-term trading of mutual fund shares, particularly trading restrictions targeted at the abuse and similar means. The United States Department of Labor ("DOL") has issued guidance reconciling those restrictions with its own regulations, and we encourage the Commission to work with the DOL to further educate the plan fiduciaries of the potential detrimental effects of short-term trading to all fund shareholders, including plan participants, so that the fiduciaries are even more willing to work with the mutual funds in implementing appropriate remedies. In the interim, to the extent a fund does not want to engage in trading activities with a plan because of inappropriate behavior, that fund's remedy is to refuse to accept future purchase orders from the specific plan.

We believe certain additional exceptions, including redemptions for *bona fide* trade corrections, are necessary and/or useful to serve the Proposal's purpose of deterring short-term traders from using excessive trading strategies.

2. Proposed Discretionary Account Exception

We recommend that the Commission except from the mandatory redemption fee requirement those discretionary advisory accounts that do have the realization of gain through short-term trading as an objective. Such an exception is necessary because the mandatory redemption fee could unfairly penalize investors in such accounts for routine rebalancings that happen to fall within a 5-business day holding period. For example, an investor might open an account within 5 business days of a general rebalancing across all accounts, or an adviser may have effected a fund order for a particular account within 5 business days of a general rebalancing of all accounts. Such trades within the 5-business day period would be inadvertent and unrelated to any short-term trading abuse.

3. *De Minimis* Redemptions

We believe that the proposed provision in Rule 22c-2 to provide for the waiver of redemption fees in the event of an unanticipated financial emergency would introduce a ready means for short-term traders to evade the mandatory redemption fee. Although we believe that unanticipated financial emergencies do occur, it may be impossible to distinguish legitimate claims from those that are not. The inability to distinguish between legitimate claims and false claims may lead funds to waive the redemption fee for all such claims. Such uncertainties in the application of the waiver provision may unfairly subject funds to the scrutiny of the Commission's enforcement staff for potential violations of the proposed rule. Moreover, the administrative burden could be significant. Accordingly, we recommend that the Commission not adopt a separate exception for unanticipated financial emergencies, but rather raise the *de minimis* exception amount.

The Proposal includes a *de minimis* provision that would permit, but not require, funds to forego the assessment of a redemption fee if the amount of the shares redeemed is $2,500 or less.

We agree that a *de minimis* exception to the Proposal is necessary to allow funds not to charge the fee for smaller redemptions that may not be disruptive to the fund. Moreover, as proposed, a *de minimis* exception permits a fund to perform its own cost-benefit analysis and determine whether the costs of collecting redemption fees in small amounts are worth the benefits. We believe that the Commission should raise the *de minimis* amount to $10,000, thereby obviating the need for a separate exception for financial emergencies and allowing for a more expansive *de minimis* exception.

4. Omnibus Accounts

The Proposal would permit funds and financial intermediaries to select among three methods of assuring that the appropriate redemptions fees are imposed. Under the first method, the fund intermediary would be required to transmit to the fund, at the time of the transaction, the account number used by the intermediary to identify the transaction. Under the second method, the intermediary would enter into an agreement with the fund requiring the intermediary to identify redemptions of account holders that would trigger the application of the redemption fee. The third method would permit a fund to enter into an agreement with an intermediary requiring the intermediary to impose the redemption fee, the proceeds of which would then be remitted to the fund. We agree with the Proposal's approach. We agree with the flexibility allowed by the Proposal for funds and intermediaries to choose among these three different methods for assessing the redemption fee to investors. We also are in favor of intermediaries providing fund companies with client trade activity on a weekly basis or other established frequency such as monthly. However, those smaller trades up to the *de minimis* amount should be excluded from the reporting requirement consistent with the Proposal's *de minimis* trade amount exclusion.

IV. CONCLUSION

As stated above, we commend the Commission's recent efforts to prevent the dilution of shareholder interests caused by frequent and excessive trading. However, we believe that a mandatory redemption fee for all funds does not account for the fact that short-term trading is in reality a number of different issues that affect different types of funds in different ways. Indeed, a 2% mandatory redemption fee would not be related to the types of dilutions that result from current market timing activities. Not only does the Proposal not address the many nuances of short-term trading, the Proposal would result in unnecessary hardships for the average fund shareholder who simply wants to redeem his shares. We recommend that the Commission continue to enhance the role of fund directors by allowing fund boards to adopt policies and procedures that best enables them to protect the interest of fund shareholders in light of all the circumstances before them. The Commission can further assist fund directors by issuing a release that defines the parameters of the differing issues resulting from short-term trading for different types of funds.

Very truly yours,

William A. Bridy
First Vice President