ReFlow

ReFlow Management Co., LLC
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May 10, 2004

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

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

Dear Mr. Katz:

ReFlow Fund, LLC ("ReFlow) appreciates the opportunity to comment upon the Commission's proposed new rule, Rule 22c-2 (the "Proposed Rule") under the Investment Company Act of 1940 ("1940 Act"), which would require mutual funds to impose a mandatory 2% redemption fee on shares held less than five days.[1] ReFlow is organized as a Delaware limited liability company and is excluded from the definition of "investment company" pursuant to Section 3(c)(7) of the 1940 Act. As described in more detail below, ReFlow is a unique mutual fund service provider, offering funds an alternative liquidity source when they experience net redemptions of their shares. As a general matter, ReFlow favors the concept of a mandatory redemption fee. As drafted, however, the Proposed Rule would have a serious negative effect on ReFlow's operations and may effectively prevent ReFlow from offering this service to mutual funds in its current form. This, in turn, could have the effect of reducing options available to mutual funds in meeting their liquidity needs and increasing certain costs and expenses to funds and, indirectly, their shareholders. ReFlow believes a better approach would be to permit fund boards of directors to adopt non-fundamental policies governing the circumstances under which the mandatory redemption fee will not be imposed, and clearly disclose these limited exceptions in the prospectus.

ReFlow has received a no-action letter from the Commission staff in connection with its operations.[2] In essence, the underlying business premise for ReFlow is based on the fact that open-end investment companies pay a price for liquidity, that is, they bear additional costs due to the statutory obligation imposed on them to stand ready to redeem their shares on a daily basis. This cost of daily liquidity is tangible -- it can be measured for any particular fund depending on the fund's investment policies, composition of its portfolio, and history of daily purchase and redemption activity. For a number of reasons, offering mutual fund shareholders the right to redeem their shares at net asset value on a daily basis produces lower investment returns. Mutual funds may hold a certain amount of cash to be available to meet redemptions, but this money is generally not invested in accordance with the fund's primary investment objectives and, therefore, does not realize the returns that other invested assets may earn. A fund may also borrow to pay redemption proceeds to redeeming shareholders, but this involves the financing costs of borrowing. The fund may, of course, also sell its portfolio securities. This option

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1 Investment Company Act Release No. 26375A (the "Proposing Release").

2 *See* ReFlow Fund, LLC, SEC No-Action Letter (publicly available July 15, 2002).

is likely to involve brokerage and trading costs; it may force the sale of securities at inopportune times; and it may cause the fund to realize capital gains, which may have adverse tax consequences for both redeeming and non-redeeming shareholders.

Through its Auction Program, ReFlow provides mutual funds with an alternative source of liquidity by means of a facility through which ReFlow purchases shares of participating mutual funds, enabling a participating fund to offset in whole or in part its net redemptions. When the fund next experiences positive sales, ReFlow automatically redeems its shares in an amount equal to the lesser of the net number of shares sold by the fund or the number of shares owned by ReFlow.[3] Any fund participating in the Auction Program that is a successful bidder in the auction pays a fee to ReFlow for offering this service. ReFlow offers a valuable service to participating funds, enabling them to potentially reduce costs, achieve better investment results, and ultimately benefit their shareholders.

Because ReFlow holds shares of a participating fund and automatically redeems them when the fund is in a state of net sales, it has limited control over when it will redeem those shares.[4] If a participating fund finds itself in a state of net sales within five days after ReFlow has purchased its shares, ReFlow will be charged the mandatory 2% redemption fee under the Proposed Rule when it redeems those shares. The 2% fee will have a serious negative effect on ReFlow's business, and may threaten the viability of the ReFlow program.

As proposed, the 2% mandatory redemption fee will be imposed on ReFlow notwithstanding that ReFlow's activities impose none of the costs on funds that the Proposed Rule is intended to address. Specifically, the Commission notes that the Proposed Rule is designed to require short-term shareholders to reimburse mutual funds for the costs incurred when they use a fund to implement short-term trading strategies, such as market timing. The Commission notes that excessive short-term trading occurs at the expense of long-term investors, diluting the value of their shares, and may also disrupt management of a fund's portfolio and raise a fund's transaction costs because the fund manager must either hold extra cash or sell investments at inopportune times to meet redemptions. The Commission notes that frequent trading may also result in unwanted taxable capital gain distributions to fund shareholders.[5] These negative effects cited by the Commission are precisely the issues that participation in ReFlow by mutual funds is designed to prevent. By standing ready to automatically purchase shares from funds that are in net redemptions, and redeem shares of funds that are in net sales, ReFlow enables fund management to better manage its cash flow, remain more fully invested, and avoid unnecessary transaction costs. Because ReFlow only purchases shares equal to net redemptions, and redeems shares equal to net sales, it imposes no costs upon funds through its transactions. Thus, the regulatory rationale in support of the mandatory 2% redemption fee is inapplicable to ReFlow.

ReFlow recognizes that it is a unique entity and is in a unique position with respect to the Proposed Rule. ReFlow supports the Commission's proposal to require an industry-wide mandatory redemption fee, and the rationale behind the proposal. However, ReFlow believes that funds should be given the flexibility to make exceptions to that fee under appropriate circumstances as determined by the fund's

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[3] Thus, for example, if ReFlow owned 40 shares of a fund and the fund sold 30 shares to investors on a particular day, ReFlow would redeem 30 shares on that day and would retain the other ten. If the fund experienced further net sales of at least ten shares on a later day, ReFlow would then redeem its final ten shares.

[4] While ReFlow has the legal right to redeem shares at any time like any other shareholder, it generally chooses not to do so until a fund is in a state of net sales.

[5] See Proposing Release at notes 3-4 and accompanying text.

board of directors, provided that the exceptions are fully disclosed in the fund's prospectus, are consistent with the best interests of shareholders and are subject to a non-fundamental investment policy changeable only by the fund's board of directors.

The Commission recognized that certain exceptions to the Proposed Rule are necessary where imposition of a mandatory redemption fee would not be equitable or appropriate, such as the proposed exceptions for de minimis redemptions, shareholder emergencies, or funds specifically designed to permit short-term trading activity. Similarly, we believe that their may be other situations that the Commission has not considered, such as participation in ReFlow, where imposition of a mandatory redemption fee is not appropriate, and may be counter to the best interests of shareholders, and that it should be left to the board of directors of a fund to make this determination.[6] This approach is consistent with the Commission's proposed approach for funds designed to permit short-term trading activities. As long as exceptions are adequately disclosed in the prospectus, along with the risks and costs of not imposing a redemption fee, fund boards should have the flexibility to define the situations in which the redemption fee will not be imposed.

We believe it is a mistake for the Commission to mandate the only exceptions to the mandatory redemption fee in the rule itself. Leaving funds the ability to define the limited exceptions in which they will not impose the mandatory redemption fee, consistent with the standards and requirements proposed above, will enable the rule to adapt to changing circumstances.[7] If such flexibility is not built into the Proposed Rule, we believe that the Commission and its staff will be burdened with numerous requests for exemptive and/or no-action relief and that unnecessary costs will be imposed on ReFlow and other industry participants who will be required to request such relief.. We therefore recommend that the Commission replace the specific exemptions in the Proposed Rule with a provision stating that the rule shall not apply to any categories of redemptions set forth in a non-fundamental policy adopted by the fund's board of directors, provided that such exceptions are clearly disclosed in the fund's prospectus, and are based on a finding of the board that such exceptions are in the best interests of shareholders.[8]

We appreciate the opportunity to comment on this proposal.

Sincerely,

J. Alan Reid, Jr.
President

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[6] Another example of a potentially inequitable application of the Proposed Rule is the fund of funds context, in which an investing fund may be required to redeem shares from a fund to which it has recently allocated assets.

[7] For example, using specific dollar amounts in the de minimis and financial hardship exceptions to the rule as is proposed runs the risk that such dollar amounts will be diminished in real terms over time due to inflation. Fund boards should have the flexibility to define these amounts as they deem appropriate.

[8] In other exemptive rules under the 1940 Act, the SEC has deemed it appropriate to give boards discretion in making this determination, *e.g.,* under Rule 17a-8, where a board must make a determination whether an affiliated merger is in the "best interest" of shareholders of the merging company, and under Rule 18f-3 with regard to multiple class funds, where the board must make a determination as to whether a multi-class plan is in the "best interests" of each class of shareholders and all shareholders, as a whole.