May 10, 2004

VIA ELECTRONIC MAIL

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

Re: File No. S7-11-04:

Dear Mr. Katz:

First Trust Corporation ("First Trust") appreciates this opportunity to comment on the Securities and Exchange Commission's proposed rule mandating that mutual funds impose a two-percent short-term redemption fee on all shares sold within five days of purchase (the "Proposed Rule").

First Trust is an FDIC-insured trust company organized pursuant to the banking laws of the state of Colorado, and provides custodial and directed trustee services through its various "business channels" to financial intermediaries such as registered investment advisors ("RIAs"), third-party administrators of qualified retirement plans ("TPAs") and other financial intermediaries. First Trust administers over 326,000 retirement and custodial accounts with assets totaling over $31 billion for financial intermediaries, and processes approximately 2.1 million mutual fund trades annually. First Trust has developed proprietary systems and established relationships with over 4,000 mutual funds from approximately 450 fund families to enable its financial intermediary customers to offer a wide range of investment choices to their individual investor clients. First Trust has been serving the financial intermediary market for over 40 years.

First Trust is sensitive to the Commission's policy goals of preserving the redeemability of mutual fund shares while at the same time reducing or eliminating the ability of short-term traders to profit at the expense of other shareholders. However, First Trust believes that the Proposed Rule does not adequately address the operational complexities of the financial intermediary marketplace, and that its implementation would place onerous burdens on First Trust and other intermediaries through which the great majority of mutual fund trades are facilitated. The costs to intermediaries of overcoming these burdens would ultimately be borne by investors. First Trust does not believe that these costs are justified by the benefits of the Proposed Rule.[1]

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[1] This comment will focus on the expected burdens to intermediaries under the Proposed Rule, and will not discuss the potential disadvantages to investors and others except to the extent that

DISCUSSION

Proposed Rule 22c-2 would require every mutual fund to assess a two-percent short-term redemption fee on all shares sold within five business days after purchase,[2] and would allow each fund to select one of the following three methods for assuring that appropriate redemption fees are assessed: (1) the intermediary would transmit to the fund, at the time of the transaction, the account number used by the intermediary to identify the transaction ("Method One"); (2) the intermediary would enter into an agreement with the fund requiring the intermediary to identify redemptions to which the fee would apply and to transmit to the fund sufficient information to allow the fund to assess the fee ("Method Two"); and (3) the intermediary would enter into an agreement with the fund whereby the intermediary itself would assess the redemption fee and remit the proceeds to the fund ("Method Three"). Regardless of the method chosen by the fund, Paragraph (c) of the Proposed Rule would also require each intermediary to provide to each fund, on at least a weekly basis, the taxpayer identification number, amount, and dates of transactions within an omnibus account for that fund.

The Commission describes the imposition of a two-percent redemption fee as "both mandatory and uniform," and goes on to explain that the goal of requiring uniformity is to "better enable intermediaries that hold shares in omnibus accounts to establish and maintain systems to collect (the redemption fees)." In fact, the rule as proposed would have the opposite effect, requiring each intermediary to develop multiple processes and procedures in an effort to accommodate the various methods of collection proposed, thus substantially increasing costs for the intermediaries themselves. This is true because, <u>under the Proposed Rule, it is the fund, rather than the intermediary, that has the power to choose the method of fee assessment</u>.

The Commission's discussion of potential costs relies on the assumption that each intermediary will be able to choose one method to support. The Proposed Rule, however, contains no language to that effect, and the realities of the intermediary marketplace preclude such an approach. Because under the language of the Proposed Rule the fund, and not the intermediary, would have the power to choose the method of fee assessment, any intermediary processing trades in that fund would have to support the method selected by the fund. Because all intermediaries deal with more than one fund, and

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they relate to the burdens imposed upon intermediaries. Those disadvantages have been addressed at length by other commentators.

[2] The Proposed Rule does include certain exceptions, but none impacts the discussion here.

because not all funds are likely to choose the same method, every intermediary will be forced to support all three methods. First Trust, for example, maintains relationships with approximately 450 fund families, and would be required to support all three methods across all of its business channels.

Because the estimates included in the Commission's discussion do not reflect the reality that virtually all intermediaries would be forced to support all three methods of fee assessment, those estimates fall short of accurately addressing the economic and operational impact of the Proposed Rule on intermediaries. As discussed in more detail below, the cost of initial investments in processes and technology (or "start-up costs") and well as ongoing operational and maintenance efforts is likely to be more than double that estimated by the Commission.

I. Start-up costs to all intermediaries are likely to exceed those estimated by the Commission.

The estimated start-up costs relied upon by the Commission do not take into account the fact that, under the Proposed Rule, each intermediary will be forced to support all three methods of fee assessment. They also do not include the start-up cost of certain efforts that are not identified by the Commission in its discussion, as further set forth below.

A. Estimated Start-up costs related to Method One

In First Trust's RIA business channel, First Trust's RIA customers send fund trades to First Trust on behalf of their investor clients, and First Trust processes those trades through omnibus accounts at the funds, allocating the appropriate number of shares to each investor. While First Trust does maintain individual account-level records in this business channel, it does not currently have processes or technology in place to transmit underlying investor data with each transaction as would be required under Method One. First Trust would therefore be required to develop processes and technology to transmit information to the funds and to maintain records of the information sent. First Trust agrees with the Commission's estimates that the cost to develop these capabilities would be approximately $100,000 for its RIA business channel.

First Trust's TPA business channel provides services to qualified retirement plan recordkeepers, who in turn maintain account records for underlying investors (the "Participants"). Participants submit their trades to the TPA, which aggregates the trades and sends them to First Trust, which in turn processes the trades through omnibus accounts at the funds. First Trust does not currently receive or maintain Participant records in its TPA business channel. While it might be able to adopt the processes and technology developed for the RIA business channel for transmitting this data to the funds, First Trust would be required to develop additional processes and technology to receive Participant account data with each transaction from its TPA customers in the first place and to maintain appropriate records of this information. First Trust estimates that it would incur an additional cost of $100,000 to develop these additional capabilities.[3]

The Commission has estimated that the one-time start-up cost for an intermediary to support Method One would be $100,000. First Trust expects the total start-up cost required to support Method One for its RIA and TPA business channels to be $200,000. This estimate is $100,000 higher than that set forth by the Commission.

B. Estimated start-up costs related to Method Two

To support funds selecting Method Two, First Trust's RIA channel would be required to identify transactions in each account that would be subject to a redemption fee, and to transmit that information to the funds. First Trust's RIA business channel does not currently have processes or technology in place to accomplish these tasks. While the RIA business channel could adopt the transmission and data storage methods that it develops in support of Method One, it would still be required to develop additional processes and technology to evaluate transactional data and to compare purchases and redemptions in client accounts. First Trust estimates that development of these additional processes and technology would cost $80,000.

To support Method Two in its TPA business channel First Trust would be forced to depend on each TPA to evaluate transactional data and to compare purchases and redemptions at the Participant level. First Trust would be able to use the same processes and technology to receive that data from the TPAs as in Method One, and would be able to transmit that information to the funds using similar processes and technology as for its RIA business channel. First Trust therefore estimates that the additional cost to develop this capability would be negligible.

The Commission has estimated that the one-time start-up cost for an intermediary to support Method Two would be $10,000. First Trust expects the total start-up cost to

[3] First Trust has taken a very conservative approach in all of its estimates for start-up and ongoing operation and maintenance costs. The numbers used in this comment represent the low end of the range that First Trust would expect to incur for these efforts.

support Method Two for its RIA and TPA business channels to be $80,000. This estimate is $70,000 more than that set forth by the Commission.

C. Estimated Start-up costs related to Method Three

Under Method Three each intermediary would be required to determine which transactions are subject to a short-term redemption fee, and to actually assess the redemption fee and remit proceeds to the funds. While the Commission's discussion indicates that this method would impose no burdens on intermediaries, it would in fact be impossible for an intermediary to assess the fee without first identifying which transactions the fee would apply to by evaluating transactional data comparing purchases and redemptions in client accounts – exactly the same burden imposed under Method Two. Each intermediary would also be required to develop additional processes and technology to actually assess the fees and remit them to the funds, as well to maintain appropriate records.

First Trust estimates that the cost to develop the capability to assess redemption fees in the RIA business channel and to remit payment to the funds and keep appropriate records would be $35,000. First Trust would be required to develop similar capability to assess and remit fees to the funds and to maintain appropriate records for its TPA business channel. Because of the similarities, First Trust estimates that the additional cost to develop these capabilities in the TPA business channel would be negligible.

The Commission has estimated that there would be no start-up costs to intermediaries relating to Method Three, stating that there would be "no collection of information requirements on intermediaries." As set forth above, First Trust would be required to assess the fee, to remit payment to the funds, and to maintain appropriate records, and estimates that the total start-up cost to accomplish these tasks would be $35,000.

D. Estimated start-up costs related to the requirements of Paragraph (c)

With respect to the provision of periodic information pursuant to Paragraph (c) of the Proposed Rule, including the TIN of each shareholder, on at least a weekly basis, the Commission has estimated a one-time capital cost of $150,000 per intermediary. First Trust agrees with the Commission's estimate.

E. Estimated cost of contract modifications

The Commission recognizes that most funds would have to modify their contracts with intermediaries regardless of the approach selected, and estimates a one-time burden to each fund of 4.5 hours. The Commission does not, however, include any estimate of cost to the intermediary for contract modification. Because these contracts are between the fund and the intermediary, the intermediary would by necessity be involved in the negotiation and review of these contract modifications, and could be expected to incur burdens substantially similar to those borne by the funds. Using the Commission's numbers, First Trust could be expected to incur a burden of 2,025 hours to modify its fund contracts at an approximate cost of \$81,000.[4] In addition, First Trust currently has approximately 76 TPA customers. First Trust would be required to modify its contract with each TPA to clarify the roles of each with respect to the transmission of information and the assessment of redemption fees. First Trust would expect to incur an average of five labor hours to modify each of these contracts, for a one-time cost of approximately \$15,200.[5] First Trust estimates its total one-time contract modification cost to be \$96,200.[6]

F. Aggregate estimated start-up costs

The Commission's aggregate estimated start-up cost to all intermediaries, based on each intermediary being required to support only one method and assuming a 15%-35%-50% distribution among the three methods, is \$1,145,800,000.[7] However, as discussed above, virtually all intermediaries would be required to support all three methods. Assuming that First Trust is an "average" intermediary, the estimated aggregate of start-up costs to all intermediaries grows to an astonishing \$3,816,160,000.[8]

In an effort to reach a more conservative estimate, First Trust employed the following assumptions: (1) Most intermediaries (First Trust assumed 98% for purposes of this

[4] 4.5 hours x 450 contracts x \$40 average hourly cost

[5] 5 hours x 76 TPAs x \$40 average hourly cost.

[6] \$81,000 + \$15,200.

[7] This includes \$100,000 x 1,020 intermediaries supporting Method One, \$10,000 x 2,380 intermediaries supporting Method Two, no cost for intermediaries supporting Method Three, \$150,000 x 6,800 intermediaries (the Commission's estimate of the total number of intermediaries) related to the TIN requirements of paragraph (c), and no contract modification cost.

[8] Because all intermediaries would be required to support all methods, each of the 6,800 intermediaries would be required to incur \$200,000 to support Method One, \$80,000 to support Method Two, \$35,000 to support Method Three, \$150,000 to support the TIN requirements of paragraph (c), and \$96,200 in contract modification costs.

calculation) already possess all the investor-level records that they require (i.e. they only have the equivalent of an RIA business channel); (2) Only two percent of intermediaries maintain both an RIA and a TPA-style business channel (for which they would incur additional costs to receive Participant information and to modify TPA contracts); and (3) the average intermediary maintains only a quarter of the fund relationships that First Trust maintains (113 vs. 450). Taking these assumptions into account, First Trust's conservative estimate of aggregate start-up cost to all intermediaries is $2,635,979,200,[9] more than double the Commission's estimate.

II. <u>Ongoing operational and maintenance costs to all intermediaries are likely to exceed those estimated by the Commission.</u>

The estimated ongoing operational and maintenance costs relied upon by the Commission likewise do not take into account the fact that each intermediary will be forced to support all three methods of fee assessment. They also do not include the cost of ongoing operation and maintenance for each of the processes and technology described above. A more complete estimate of ongoing costs is set forth below.

A. Estimated ongoing operational and maintenance costs associated with Method One

The Commission has estimated that the ongoing annual operation and maintenance costs for each intermediary to comply with the transactional information requirements of Method One would be $100,000 per intermediary. First Trust is in general agreement with this estimate insofar as it relates to an intermediary that already receives and maintains account-level records. However, as set forth in detail in the discussion of start-up costs for Method One, First Trust would also be required to operate and maintain processes and technology relating to the receipt of information from TPAs as well. First Trust estimates that this additional ongoing burden would be approximately $20,000 per year.

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[9] Under these assumptions each of the 6,800 intermediaries would be required to incur $385,340 in start-up costs: $100,000 to support Method One, $80,000 to support Method Two, $35,000 to support Method Three, $150,000 to support the TIN requirements of paragraph (c), and $20,340 in contract modification cost. Two percent of the 6,800, or 136 intermediaries, would be required to incur an additional $115,200 each in start-up costs: $100,000 to support Method One for their TPA channels and $15,200 in contract modification cost related to TPA contracts. Because the same processes and technology would be used by both business channels to support Methods Two and Three, the full cost of these would be incurred to support either one channel or two.

B. Estimated ongoing operational and maintenance costs associated with Method Two

The Commission has estimated that the ongoing annual operation and maintenance costs for financial intermediaries to comply with the transactional information requirements set forth in Method Two would be $10,000 per intermediary. First Trust is in general agreement with this estimate insofar as it relates to an intermediary that already receives and maintains account-level records. First Trust would also be required to operate and maintain processes and technology to receive data from TPAs and to transmit that information to the funds. First Trust estimates this additional ongoing burden at $10,000 per year.

C. Estimated ongoing operational and maintenance costs associated with Method Three

The Commission has estimated that there would be no ongoing operation and maintenance costs to comply with the requirements of Method Three. However, as set forth in the discussion of start-up costs for Method Three, First Trust expects to incur costs relating to the maintenance and operation of systems required to assess fees and to remit fees to the funds for both its RIA and TPA business channels, and to maintain records relating to those fees. First Trust estimates this ongoing burden at $7,000 per year.

D. Estimated ongoing operational and maintenance costs associated with the requirements of Paragraph (c)

The Commission has estimated that the ongoing annual cost per intermediary to comply with the requirements of Paragraph (c) would be $100,000. First Trust agrees with this estimate.

E. Aggregate Estimated ongoing operational and maintenance costs

The Commission's estimated aggregate ongoing operational and maintenance cost to all intermediaries, based on each intermediary being required to support only one method and assuming a 15%-35%-50% distribution among the three methods, is $805,800,000 per year.[10] Again, these estimates fall short because all intermediaries would be required to support all three methods. Assuming that First Trust is an "average" intermediary, the estimated ongoing operation and maintenance cost to all intermediaries is likely closer to $1,679,600,000 per year,[11] again more than double that estimated by the Commission. Using the same assumptions made for its conservative estimate of start-up costs above, First Trust's conservative estimate of ongoing operation and maintenance cost to all intermediaries is $1,479,680,000,[12] which is still $673,880,000 per year greater than the costs estimated by the Commission.

III. Other potential costs

Because of the difficulty in estimating such impacts, the estimates above do not include any opportunity cost incurred by intermediaries due to the re-allocation of resources from other revenue generating (or risk mitigating) activities in order to accomplish the required development, operation, and maintenance called for by the Proposed Rule. These estimates also do not take into account the difficulty created by variables identified in the Proposed Rule and potentially controlled by the funds (such as the ability of funds to impose a longer redemption fee period, to determine whether a *de minimis* exception applies, or to define what an "unanticipated financial emergency" might be.) It is likely, however, that each intermediary will indeed be forced to forego other work in order to comply with the requirements of the Proposed Rule, and will incur additional costs to

[10] See Note 102 of the Commission's discussion.

[11] Each of the 6,800 intermediaries would be required to incur $247,000 each in annual operation and maintenance costs: $120,000 to support Method One, $20,000 to support Method Two, $7,000 to support Method Three, and $100,000 to support the TIN requirements of paragraph (c).

[12] Under these assumptions each of the 6,800 intermediaries would be required to incur $217,000 each in annual operation and maintenance costs: $100,000 to support Method One, $10,000 to support Method Two, $7,000 to support Method Three, and $100,000 to support the TIN requirements of paragraph (c). 136 intermediaries would be required to incur an additional $30,000 annually: $20,000 to support Method One for their TPA channels and $10,000 to support Method Two.

develop methods of dealing with those variables that the Proposed Rule places in the control of the fund companies.

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The Proposed Rule, if adopted, would result in significant costs for both funds and intermediaries. As the Commission recognizes, these costs would ultimately be borne by investors in the form of increased account servicing and administrative fees, causing many potential investors to abandon mutual funds for alternative financial products. By the Commission's own estimates implementation of the Proposed Rule will cost funds and intermediaries approximately $1,053,492,000 per year.[13] Assuming that the Commission's estimate of the annual cost to funds is accurate and using First Trust's conservative estimates of costs to intermediaries, this number more than doubles, growing to $2,278,363,734 per year.[14] In First Trust's opinion these costs are not justified by the benefits of the Proposed Rule.

The Commission, at footnote three of its discussion, cites a study setting forth that short-term trading in international funds resulted in a net wealth-transfer from passive shareholders to active traders in excess of $420 million over a 26 month period. This equates to roughly $194 million on an annual basis. By the Commission's own estimates, each year under the Proposed Rule will cost more than five times this amount. Using First Trust's conservative estimates of costs to intermediaries, each year under the Proposed Rule will cost almost <u>twelve times</u> the annual rate of dilution cited in the study. This is clearly a case in which the cure is worse than the disease.

First Trust appreciates the Commission's willingness to consider its comments to the Proposed Rule and urges the Commission not to adopt an approach that imposes such substantial financial and operating burdens on all intermediaries. Any questions the staff may have regarding our comments should be directed to me at the number below, to Joanne Ratkai, First Trust's General Counsel, at 303-294-5872 or to Cecelia Calaby at Shaw Pittman LLP, 202-663-8984.

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[13] See Note 102 of the Commission's discussion.

[14] By the Commission's estimates, the average per-year cost for funds over the first three years is $413,250,667 (See Note 102 of the Commission's discussion). First Trust estimates an average per-year cost to intermediaries over the first three years to be $1,865,113,067, calculated as follows: $2,635,979,200 for start-up costs plus $1,479,680,000 maintenance cost for year two plus $1,479,680,000 maintenance cost for year three, divided by three.

Sincerely,

/s/ Skip Schweiss

Skip Schweiss
Executive Vice President
First Trust Corporation