Capital Research and Management[SM]

May 10, 2004

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

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

Dear Mr. Katz:

Capital Research and Management Company[1] appreciates the opportunity to comment on the Commission's proposal (the "Release")[2] that would require mutual funds, with certain limited exceptions, to impose a two percent redemption fee on the redemption[3] of shares purchased within the previous five days. We believe that a mandatory redemption fee, in conjunction with fair valuation and other efforts, can be a significant tool in combating the undesirable phenomenon of excessive trading. Our specific comments follow below.

A. <u>Minimum Requirement: 2% Fee and 7 Calendar-Day Holding Period</u>

We agree with a two percent fee as a mandated requirement for all mutual funds (with certain limited exceptions).[4] We believe two percent is an amount that can deter excessive trading while being consistent with preserving redeemability of mutual fund shares. Moreover, we suggest that the proposed five business-day holding period be replaced with a seven calendar-day holding period. A holding period of seven calendar days would enhance uniformity across the industry in applying the redemption fee, since the use of calendar days precludes the uncertainty that may arise in determining what

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[1] Capital Research and Management Company is the investment adviser to the American Funds family of mutual funds and other mutual funds. Capital Research and Management Company is responsible for managing more than $500 billion in stocks, bonds and money market instruments and serves over 20 million shareholder accounts of all types.
[2] *See* Mandatory Redemption Fees for Redeemable Fund Securities, Investment Company Act Release No. IC-26375A (Mar. 5, 2004) [hereinafter Release].
[3] In the Release, the Commission clarified that redemptions also include exchanges. *See id*. n.13. Throughout this letter, our discussion of "redemptions" also includes redemptions effected by exchanges.
[4] We agree with the Commission that money market funds, exchange-traded funds, and funds which affirmatively permit short-term trading and that provide such disclosure in their prospectuses, should be excluded from this requirement. *See id.* Section II.E.

days are or are not business days. We strongly agree with the Commission that these minimum requirements should be a mandated standard.[5] Firms should not be allowed to deviate from this standard since deviations would create complexities in several areas. For example, departures from this standard would complicate financial intermediaries' abilities to accommodate and work with all mutual funds, and variations in the holding period and fee percentage from fund to fund may confuse investors.

B. LIFO vs. FIFO

In order for a redemption fee on redemptions within seven calendar days to be an effective deterrent against excessive trading, we strongly believe that the use of the last-in, first-out ("LIFO") method to determine the fee amount is essential. Under a first-in, first-out ("FIFO") method, market timers could "park" funds for a period longer than seven calendar days (or five business days under the current proposal), and then frequently trade on a portion of these funds without incurring a redemption fee. The LIFO method would prevent this from happening. While there are various ways for a timer to exploit the FIFO method, the following hypothetical example illustrates one such way (using five days as the holding period):

Hypothetical Example: 5-Day Holding Period Utilizing FIFO

Day	Buy	Sell	Redemption covered by	Redemption fee assessed?
0	500	-	-	-
1	500	-	-	-
2	500	-	-	-
3	500	-	-	-
4	500	-	-	-
5	500	-	-	-
6	-	500	Day 0	No
7	500	-	-	-
8	-	500	Day 1	No
9	500	-	-	-
10	-	500	Day 2	No
11	500	-	-	-
12	-	500	Day 3	No
13	500	-	-	-
14	-	500	Day 4	No
15	500	-	-	-
16	-	500	Day 5	No
17	500	-	-	-
18	-	500	Day 7	No
19	500	-	-	-
20	-	500	Day 9	No

[5] The Commission has expressed its intent that the redemption fee "be both mandatory and uniform." *See id.* Section II.A.

In our example above, an investor buys 500 shares of Fund A for the first time on Day 0 and holds them. On Days 1 through 5, the investor buys an additional 500 shares each day. Under FIFO, on Day 6 the investor may sell 500 shares without incurring a redemption fee, because the first shares bought (500 shares on Day 0) are outside of the five-day holding period and are sufficient to cover the redemption. On Day 7, the investor purchases an additional 500 shares. On Day 8, the investor may sell 500 shares again without incurring a fee, because these shares are covered by the shares the investor bought on Day 1. As one can see, the investor may continue buying and selling in this manner (executing buys and sells on alternate days) without incurring a fee. By the time the investor sells on Day 16, those shares will be covered by the shares bought on Day 5. When the investor sells on Day 18, those shares will be covered by shares bought on Day 7. And so on. This example shows that, under a FIFO method, an investor who waits five days just once may trade each and every day thereafter without incurring a fee.

Under the LIFO method, an investor cannot trade as frequently. Because the shares which "count" for calculating the fee are those bought last under LIFO, any redemption made within the holding period will, in whole or in part, be subject to a redemption fee. To avoid a fee, the investor must delay the redemption until the holding period has elapsed. This forced delay makes it more difficult for timers to capitalize on movements in the markets by penalizing their attempts to “lock in” profits on short-term trades, thereby making market timing less attractive for rapid traders. Consequently, incidents of market timing should decrease as a result.

We understand that many of today’s market timers do not park assets as described in our example above. Instead, many timers prefer to maximize returns by exchanging substantially all of their account assets in each transaction. Opponents of LIFO would argue that this pervasive behavior of moving substantially all of one’s assets in each transaction renders the LIFO method no more effective than the FIFO method. This is because, opponents would argue, timers who move substantially all of their assets in each transaction during the mandatory holding period would be subject to a redemption fee under either LIFO or FIFO.

However, opponents of LIFO fail to recognize that the strategy of moving substantially all of one’s assets in each transaction makes sense only for rapid traders whose accounts are not currently subject to redemption fees. Once a fee is applicable, such rapid traders will be bound to change their behaviors. They will alter their strategies to circumvent, as much as possible, whatever obstacles the fee presents. If the fee utilizes FIFO, then we believe with almost complete certainty that timers who previously moved substantially all of their assets in each transaction will start behaving more like the investor in our hypothetical example—parking assets, trading rapidly on a portion of those assets, and avoiding redemption fees. By contrast, as noted above, under a LIFO method timers would be unable to escape a fee until the holding period had elapsed.

We also understand that some mutual fund companies already impose redemption fees using the FIFO method. Moreover, we recognize that requiring these companies to accommodate LIFO for purposes of complying with the Commission's proposed rule would entail some cost on these companies. We are sensitive to these considerations, and understand why many of these companies would advocate FIFO over LIFO. However, as discussed in the preceding paragraph, market timers will adapt their strategies in order to circumvent a FIFO methodology, thereby rendering the mandatory redemption fee largely ineffective. Therefore, we strongly believe that LIFO is the only way to deter excessive trading under the Commission's proposed redemption fee. For all the reasons discussed above, we advocate LIFO as being the required methodology to calculate fee amounts under a mandatory two percent redemption fee employing a seven calendar-day holding period.

C. Voluntary Fees for Longer Holding Periods

We believe that funds should be permitted, if they so wish, to impose a holding period longer than seven calendar days. If they choose a longer holding period, funds should be permitted to choose a different fee calculation method (FIFO or LIFO) for that portion of the period that is in excess of seven calendar days. However, the first seven calendar days would still be subject to a two percent fee utilizing LIFO. We believe that this flexibility will allow funds which prefer or have practiced longer holding periods, to do so according to their business needs, while maintaining the uniformity of the two percent/seven calendar-day/LIFO minimum requirement across all mutual funds.

We also suggest, for uniformity purposes, that funds which adopt longer holding periods be permitted to use two percent as the fee percentage for the entire period without regard to the actual costs of redemptions.[6] Funds that impose a two percent fee over longer holding periods would therefore be consonant with the two percent requirement during the seven calendar-day holding period. If funds were to vary the fee percentage on that portion of the holding period in excess of seven calendar days, such variance would add complexity for funds and intermediaries and cause confusion among investors.

Should the Commission adopt a FIFO method for the mandatory seven calendar-day period, the ability of funds to impose longer holding periods acquires new importance. As we discussed in Section B, we do not believe that FIFO will be effective under a

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[6] We believe two percent is an appropriate level in light of the Commission's objectives. As the Commission states, "The two percent fee is designed to strike a balance between two competing policy goals of the Commission – preserving the redeemability of mutual fund shares, and reducing or eliminating the ability of shareholders who frequently trade their shares to profit at the expense of their fellow shareholders. It reflects the level of redemption fees that many funds today impose, and the maximum level our staff has long viewed as consistent with provisions of the Act that require mutual fund shares to be redeemable." *Id.* Section II.A. We view this statement by the Commission as its acknowledgment that two percent is an appropriate level for purposes of a redemption fee. Therefore, we support a two percent fee as being an allowed uniform standard. By permitting a uniform two percent fee for all holding periods, the Commission would continue to achieve its objectives while minimizing complexity and confusion.

seven calendar-day scheme. Therefore, should FIFO be adopted, we believe that it will be essential for funds to have the flexibility to impose longer holding periods in order to improve the effectiveness of their redemption fees to thwart excessive trading.

D. Exception for Systematic Transactions

To help mitigate the potential imposition of a redemption fee on innocent transactions, we believe there should be mandatory exceptions for systematic transactions. First, transactions involving automatic reinvestment of dividends and capital gains distributions should be excepted. Second, purchases, exchanges and redemptions made pursuant to systematic purchase/withdrawal programs should also be excepted. These exceptions are necessary to protect investors from being penalized for systematic transactions that are unrelated to market timing.

E. *De minimis* Exception

We support the Commission's proposal of a permissive, but not required, *de minimis* exception for redemptions of $2,500 and under. A *de minimis* exception would help protect smaller investors from suffering a fee for redemptions made soon after purchase but which are unrelated to market timing.

The Commission should also clarify that the exception allows up to $2,500 to be redeemed without a redemption fee per account *per day*. This requirement would help ensure that timers are prevented from exploiting the exception by making multiple redemptions of $2,500 from the same account in a single day and avoid any redemption fees.

Moreover, the Commission should make clear that, in keeping with the intent of allowing smaller investors to redeem small amounts without incurring a redemption fee, the *de minimis* exception applies only to redemption transactions of up to $2,500. For redemption transactions that exceed $2,500, the fee would be applied to the whole amount – *i.e.,* the first $2,500 would *not* be made exempt in that case. We believe that redemptions that are greater than $2,500 are no longer insignificant amounts, and therefore the full amount of the redemption should be subject to the redemption fee. To except the first $2,500 of a large redemption would, in our view, contravene the spirit and intent of protecting smaller investors through the *de minimis* exception.

F. Unanticipated Financial Emergency Exception

We believe that the required waiver for unanticipated financial emergencies should be excluded from the final rule. First, we believe that absent a mandatory, automatic exception, funds will make subjective determinations of "emergencies," leading to inconsistencies. Second, there are significant administrative costs entailed with making judgments on the nature of the emergency, including the verification of medical documents and/or financial distress. Third, we believe that seven calendar days is a short enough period so that the vast majority of fund shareholders, in case of financial hardship, would be able to wait before making a redemption and thus avoid the redemption fee. Note that most fund companies place a hold on proceeds from a redemption made within ten days of a purchase to protect against potential insufficient funds. A seven-day holding period to avoid a redemption fee would not impose any greater burden on shareholders than they face today.

G. Account Definition

We request the Commission to clarify the meaning of an "account." We believe that an account should mean a holding in a particular share class of a particular fund. For example, if a retirement plan participant is invested in the class A shares of five different mutual funds, that would count as five different accounts. Moreover, regarding omnibus accounts, the fee should apply to the individual accounts of beneficial owners, so that omnibus accounts are prevented from clouding any market timing activity of the underlying shareholders.

H. Accounts Held by Intermediaries

In the case of accounts held by intermediaries[7], we strongly support the Commission's proposal to allow funds the flexibility to choose any of the three proposed methods of assuring that the appropriate redemption fees are imposed.[8]

In addition, we have the following specific comments on the three proposed methods:

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[7] We understand this to mean the situation where (i) an omnibus account is held on the fund's books, and (ii) the individual shareholder accounts (which comprise the omnibus account) are held on the intermediary's books.

[8] According to the Release, "[e]ach fund would be able to select the method(s) to use." *See* Release, *supra* note 2, Section II.D. Our understanding is that this would allow a fund to choose, with respect to each intermediary, any one or more of the three methods proposed.

Under the first method, the financial intermediary would transmit to the fund (or its transfer agent), at the time of the transaction, the account number used by the intermediary to identify the transaction. This information would permit the fund to match the current transaction with previous transactions by the same account and assess the redemption fee when it is applicable.

Under the second method, the financial 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, and transmit holdings and transaction information to the fund (or its transfer agent) sufficient to allow the fund to assess the amount of the redemption fee. Under this approach, the intermediary would be required to submit substantially less data along with each transaction than under the first method.

Under the third method, the fund would enter into an agreement with a financial intermediary requiring the intermediary to impose the redemption fees and remit the proceeds to the fund. This approach would require the intermediary to determine which transactions are subject to the fee, and assess the fee. This method would alleviate the burden on intermediaries to transmit shareholder account and transactional information to the funds on a transaction-by-transaction basis. *Id.*

Method 1. The Commission should mandate that, if a fund and intermediary choose the first method, then the intermediary must utilize the NSCC's Networking Level 3. Networking Level 3 already provides a workable systematic solution that achieves what the first method seeks to accomplish.

Method 2. The Commission should mandate that, if a fund and intermediary choose the second method, then the intermediary must be required to provide the fund with two separate redemptions – one redemption to represent the amount on which the redemption fee is chargeable, and the other redemption to represent the amount on which the fee is non-chargeable.

Method 3. We have concerns about the proposed third method as currently described in the Release. If intermediaries were to impose redemption fees and remit the proceeds to the funds, then under current practices, intermediaries would remit these fees once per month, thereby delaying the funds' ability to timely invest the redemption fee proceeds. This delay would ultimately disadvantage the funds' shareholders. Even if the intermediaries were to wire the redemption fee proceeds to the funds daily, the proceeds would be accompanied without any data that could be used to reconcile accounts.

As discussed above, we strongly support the notion that funds should be given the flexibility to choose among any of the three proposed methods. In our view, the second method is most favorable because it allows for ongoing record keeping by intermediaries, while permitting funds to collect fees in a timely manner.

I. <u>Information Regarding Accounts Held by Intermediaries</u>

We disagree that financial intermediaries should be required to provide funds with the TIN and the amounts and dates of all purchases, redemptions and exchanges for each shareholder within an omnibus account during the previous week.[9] We propose that such a requirement be removed from the rule for the following reasons:

First, it will be onerous and costly for funds to receive and store this information. For example, we estimate that the American Funds would be required to increase their total number of shareholder records by 19 million in order to accommodate this information. We estimate that the additional cost resulting from these new records will amount to approximately $67 million annually, which represents an additional expense to fund shareholders of 1.25 basis points per year. This amount is a significant increase, both in

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[9] Regardless of which of the three methods described in the Release are used to collect the redemption fee, the rule "would require that, on at least a weekly basis, the financial intermediary provide to the fund the Taxpayer Identification Number ("TIN"), and the amount and dates of all purchases, redemptions, or exchanges for each shareholder within an omnibus account during the previous week." *Id.*

absolute terms and relative to the funds' current transfer agency expenses, which currently average approximately 8.5 basis points annually.

Second, this requirement would impose an immense burden on intermediaries, as the requirement entails sending voluminous amounts of data each week. This burden could have the unintended consequence of severely straining their resources and jeopardizing many intermediaries' financial health.

Third, providing this data will amount to shadow record keeping, an unnecessary duplication of efforts that will increase costs. Under the methods discussed in Section H, intermediaries will have already provided information or identified redemptions that would trigger a fee. There is therefore little use in again providing to the funds the data used by intermediaries in that process. In addition, although the Release states that "[t]his information is designed to enable the fund to confirm that fund intermediaries are properly assessing the redemption fees,"[10] providing the funds with this data will do little to assist funds because the data is being provided by the very intermediaries who relied on such data to assess the fees in the first place.

Fourth, providing this data will be of limited use to funds with respect to breakpoint discounts.[11] Sales charges are applied at the point of sale, so the funds will receive the data too late for purposes of applying breakpoint discounts.

Fifth, we believe that this requirement will be ineffective for purposes of stopping market timers whom a fund has prohibited from purchasing fund shares and who attempt to enter the fund through a different account.[12] Possession of information about such timers by funds will not stop these timers from acting. Rather, it is the redemption fee itself which deters market timing activity.

Instead of mandating financial intermediaries to provide this large amount of data, we believe that funds and intermediaries can work together to tackle market timing in other ways that are more effective and less expensive. Each individual fund and intermediary is in the best position to decide how best to work with one another. Therefore, they should be allowed this flexibility. In lieu of a mandatory requirement, we propose that intermediaries be allowed to provide this data upon a fund's request.

Moreover, if the intent of the proposed requirement is to create a mechanism by which funds can monitor the intermediary's compliance with the rule, we suggest that this intent can be accomplished through alternative means. We believe the Commission should

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[10] *Id.*

[11] According to the Release, the information "may in some cases be helpful to funds that would be able to use the information to determine whether shareholders received appropriate breakpoint discounts on purchases of fund shares sold with a front-end sales load." *Id.*

[12] The Release states the information "also would permit funds to detect market timers who a fund has prohibited from purchasing fund shares and who attempt to enter the fund through a different account." *Id.*

consider requiring all intermediaries to undergo an annual control audit process, and produce upon a fund's request current SAS 70 control audit reports for the fund's review. This will enable funds to effectively and efficiently monitor intermediaries' activities to ensure compliance with the Commission's rule. We recommend that the Commission set minimum standards for the controls relating to intermediaries' anti-market timing processes. The Commission should require these controls to be covered in the SAS 70 reports.

J. Calculating the Fee on a Gross Basis

We believe that redemption fees should be calculated on a gross basis before loads or other fees are imposed. For simplicity, other fees also should be calculated on a gross basis without regard to the redemption fee.

K. Fee Disclosure

We support the disclosure of the redemption fee in confirmation statements and in fund prospectuses.

L. Implementation Date

Implementing the mandatory redemption fee industry-wide will be a complex undertaking. In order to give mutual funds and intermediaries sufficient time to put the fee in place, we suggest that the final rule specify that the industry implement the redemption fee within approximately 18 months after the rule's adoption. Furthermore, we suggest that the specific compliance date not fall on the last day of a calendar year, so as to minimize conflicts between implementation of the fee and other year-end processes undertaken by mutual funds, intermediaries and the financial services industry in general.

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We appreciate the Commission's consideration of our comments. While the redemption fee is only one tool among several that can be used to combat market timing, we have made our recommendations with the desire of allowing this tool to be as reasonably effective as possible. We believe that our recommendations will enhance the deterring effect of a mandatory redemption fee on excessive trading, and, together with fair valuation and other efforts, render the fee a useful tool in tackling this phenomenon, which has raised funds' transaction costs at the expense of long-term shareholders. If you have any questions or need additional information, please contact the undersigned at (213) 615-0432 or Mr. Kenneth R. Gorvetzian at (213) 486-9253.

Sincerely,

Herbert Y. Poon
Counsel