June 4, 2004

Mr. 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:

Fidelity Investments[1] appreciates the opportunity to comment on the Commission's proposal[2] to adopt new rule 22c-2 and amend rule 11a-3 under the Investment Company Act of 1940. The proposal would require funds to impose a 2% redemption fee on short-term trades and require financial intermediaries to cooperate with funds in assuring that fees are collected and other anti-market-timing controls are implemented.

We applaud the Commission's initiative in addressing the problem of short-term trading in the fund industry. Redemption fees are one of the most effective means of protecting funds with high volatility and high transaction costs – such as international funds, small-cap funds, and high-yield funds – against excessive short-term trading, in cases where fair-value pricing and market timing controls are not enough. It is important for fund groups and financial intermediaries to work together for redemption fees to work the way they should to protect long-term fund shareholders.

As Chairman Donaldson remarked at the February 24, 2004 open meeting, "by standardizing the parameters of the redemption fees and requiring financial intermediaries to participate in their implementation the rule would facilitate a new level of cooperation between funds and financial intermediaries that has never been there before."[3] As the largest fund manager and one of the

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[1] Fidelity Investments, as investment adviser to over 290 mutual funds, is the largest complex of mutual funds in the United States and is also a diversified financial services company that includes several registered investment advisers, registered broker-dealers, including a retail broker-dealer and a clearing firm, registered transfer agents, and a retirement plan services administrator.

[2] SEC Release No. IC-26375A (March 11, 2004) ("Proposing Release").

[3] Chairman Donaldson noted the problems facing fund companies as follows in his opening remarks at the meeting:

"Redemption fees can be an effective deterrent to abusive short-term trades that impose unnecessary costs on long-term fund shareholders, such as the market timing trading in the Boilermaker's Union retirement account that led to the first whistleblower complaint about market timing in the Putnam funds. The funds that impose these fees find that there are practical impediments to enforcing them. Today, the vast majority of mutual fund shares are held through financial intermediaries, such as broker-dealers, banks, insurance companies and retirement savings plans. Thus, funds that impose redemption fees must turn to the intermediaries for assistance in implementing. These intermediaries may be

largest fund recordkeepers, we appreciate and agree with the Commission's concerns. Inconsistent application of redemption fees and other short-term trading controls is a significant problem for fund companies. Redemption fees, however, are only one component of a set of deterrents used by funds to deal with excessive trading issues. In many cases market-timing limits, alone or in combination with fair-value pricing, are enough to control the tiny minority of investors who engage in excessive trading or other abuses.

While we support the Commission's goals, therefore, we do not believe that it is necessary for the Commission to require redemption fees on all funds. To summarize:

- The Commission should refrain from adopting a mandatory redemption fee. While we strongly support the Commission's goal of protecting funds against costs and unfairness arising from excessive trading by some investors, we do not believe that it is in the best interests of the larger group of fund shareholders for the Commission to require redemption fees on all funds. We do not believe that lower-volatility funds that invest in more liquid markets – government bond funds, for example or balanced funds – should be required to adopt redemption fees in order to protect shareholders in international funds and a few other fund types from short-term trading. Indeed, a mandatory redemption fee on lower-volatility funds is likely to have the unintended effect of penalizing shareholders who are not engaging in excessive or unfair trading, and whose occasional short-term redemptions do not impose significant costs (certainly not costs that approach 2%) on these funds.

- Instead of imposing a mandatory redemption fee, the Commission should adopt a rule that governs all redemption fees and sets out standards for fund boards and fund sponsors to apply in adopting those fees.[4] This will assist funds that have the greatest need for redemption fees – typically, international funds and other relatively aggressive funds – without subjecting all fund shareholders to a fee that would, in many cases, be punitive. Adopting a rule governing all redemption fees will eliminate an anomaly in the current regulatory framework, where redemption fees are addressed only in the context of exchange privileges.[5] No single rule governing redemption fees currently exists. We believe it would benefit funds if the Commission took this opportunity to gather its various interpretations and concerns regarding redemption fees into a rule specifically regulating their use – not only if the Commission moves

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reluctant to undertake this burden on behalf of the funds, particularly when confronted with a hodgepodge of fees and conditions that differ from fund to fund and complex to complex. The proposal before the commission would resolve this impasse by requiring funds to impose fees in a consistent, standardized way, and financial intermediaries to assist funds in their efforts to collect them. "

[4] As discussed below, the Commission could make it an obligation of fund sponsors and fund boards to consider whether redemption fees are appropriate for funds. Many fund sponsors and boards are already doing so.

[5] Rule 11a-3(a)(7) defines a redemption fee as "any fee (other than a sales load, deferred sales load or administrative fee) that is paid to the fund and is reasonably intended to compensate the fund for expenses directly related to the redemption of fund shares." Rule 11a-3(b)(2) requires that "any redemption fee charged with respect to the exchanged security or any scheduled variation thereof (i) is applied uniformly to all securityholders of the class specified, and (ii) does not exceed the redemption fee applicable to a redemption of the exchanged security in the absence of an exchange," provided that "any scheduled variation of a redemption fee must be reasonably related to the costs to the fund of processing the type of redemptions for which the fee is charged." Redemption fees are also referred to in passing in Section 10(d) of the 1940 Act, as a "discount from net asset value charged upon redemption."

forward with its proposal for mandatory 2%/5 day fees, but for all redemption fees used by funds today and in the future.

- Redemption fees should not be set at 2% or any other single level for all funds. The government should not try to make this decision for all funds at once. A 2%/5-day fee is a poor fit for many funds: a 2% fee rate is unnecessarily high for most bond funds and large-cap stock funds, whose trading costs are unlikely to approach that level; at the same time, a 5-day fee period is too short to deter professional traders from abusive trading in international funds, where transaction costs and potential day-trading profits are much greater. Fund sponsors acting responsibly may well have lower fees (or no fees) for some fund types, and longer-term fees for others. In addition, a single level for redemption fees on all funds conflicts with the longstanding position that the Commission and its staff have taken regarding "redeemable securities" issued by open-end funds. To meet the 1940 Act's requirements, a redeemable security must provide every shareholder the right to receive "approximately his proportionate share" of a fund's current net assets. The "proportionate share" standard has consistently been interpreted to require redemption fees to be related to fund costs. The mandatory redemption fee proposal disregards the cost-based test and would convert a maximum fee of 2% into a standard fee, without any change to governing statutory limits.

- When funds have redemption fees, they should be required to be applied consistently, since the purpose of redemption fees is to recover for a fund the costs imposed upon it through short-term trading, regardless of who is engaged in such trading. The Commission has noted that funds may feel compelled to waive redemption fees for short-term trades in retirement plans or omnibus accounts – whether or not it is fair to do so – because recordkeepers historically have not tracked redemption fees within such accounts.[6] The proposed rule would address this issue by making redemption fees mandatory for all funds in all cases, reasoning that this will force recordkeepers to track the fees.[7] Although we strongly support the Commission's efforts to have intermediaries collect redemption fees, we believe the problem of inappropriate waivers would better be addressed by requiring fees to be applied consistently and by articulating the standards under which fees could be waived. Since any shareholder can avoid the redemption fee merely by holding shares a little longer, based on our experience we believe waivers should be kept to a minimum.

- Intermediaries should be required to assist funds in identifying abusive trading, whether or not a particular fund has a redemption fee. The proposed rule would require financial intermediaries

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[6] The Proposing Release describes this "serious and growing problem" as follows: "Today many funds choose not to apply redemption fees, or their policies against market timing, to shares held through these omnibus accounts. A number of the market timing abuses identified through our examinations and investigations reveal that certain shareholders were concealing abusive market timing trades through omnibus accounts. As a result, those shareholders have often been beyond the reach of fund directors' efforts to protect the fund and its shareholders from the harmful effects of short-term trading." (Proposing Release, at Notes 39-40)

[7] The Proposing Release states that the two percent redemption fee "is mandatory because it would apply to all fund shares, including shares held by financial intermediaries, which will prevent funds from creating exceptions for certain intermediaries, such as broker-dealers, banks, and retirement plans. [...] absent a mandatory and uniform redemption fee, small funds may feel competitive pressures not to impose redemption fees, which could impose costs on their long-term investors and attract market timers to their funds." (Proposing Release, at Note 17)

to provide funds, at least once a week, with a listing of purchases and redemptions and associated Taxpayer Identification Numbers (TINs). This requirement is at least partly intended to assist funds in identifying individuals trading through third parties who may have engaged in excessive short-term trading, rather than calculating redemption fees.[8] We agree that a requirement to share TIN data will be of crucial help to funds in policing market-timing and abusive short-term trading, but we believe the requirements should be articulated in a separate rule rather than as part of a mandatory redemption fee scheme.

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We have divided the remainder of our comments into three parts. Part I outlines Fidelity's current and historical practices with respect to redemption fees, and describes our experience with their effectiveness. Part II expands on our reasons why we believe redemption fees should not be mandatory, and outlines a possible structure for regulation of non-mandatory redemption fees across the industry. Finally, in Part III, we offer comments on particular provisions of the mandatory redemption fee proposal, even though we strongly urge the Commission to refrain from adopting such a rule.

I. FIDELITY'S EXPERIENCE WITH REDEMPTION FEES

Fidelity has had redemption fees on one or more funds since 1989. We believe we have redemption fees on more funds than any other fund complex, and in all likelihood have equal or greater experience with them than any other fund complex.

The first Fidelity funds to adopt redemption fees were our Select Portfolios, which were introduced in the 1980s and were popular among fund "switchers." We now have redemption fees on over 130 of our funds, including most of our international, sector and small-cap equity funds, and most of our high-yield and municipal bond funds (see Attachment 1 for a listing). We have redemption fees on funds offered directly and through intermediaries, including our Fidelity direct-sold funds, the Fidelity Advisor front-end and back-end load funds and classes, and certain classes of the Fidelity Variable Insurance Products Funds. Our funds currently have redemption fees between 0.25% and 2.00%, mostly for periods of 30, 60 or 90 days[9]; in the past our funds have

[8] "This information is designed to enable the fund to confirm that fund intermediaries are properly assessing the redemption fees. It 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." (Proposing Release, at Note 49) The comments of Paul Roye, Director of the Division of Investment Management at the February 25, 2004 open meeting included a statement that "the rule would require intermediaries to deliver to the funds enough shareholder information so that the funds can oversee the intermediaries' efforts to collect the fee, and then, importantly, fund managers can use this information to better enforce market timing policies, including barring frequent traders from the fund." While this is a worthwhile goal it may be out of place in a rule designed to address redemption fee procedures.

[9] We have generally tried to keep redemption fees to 90 days or less in order to keep quarterly rebalancing outside the scope of the fee (and in light of ERISA's Section 404(c) requirements to allow quarterly changes in investment options). We have found that 30, 60 and 90 day fees are roughly equal in effectiveness.

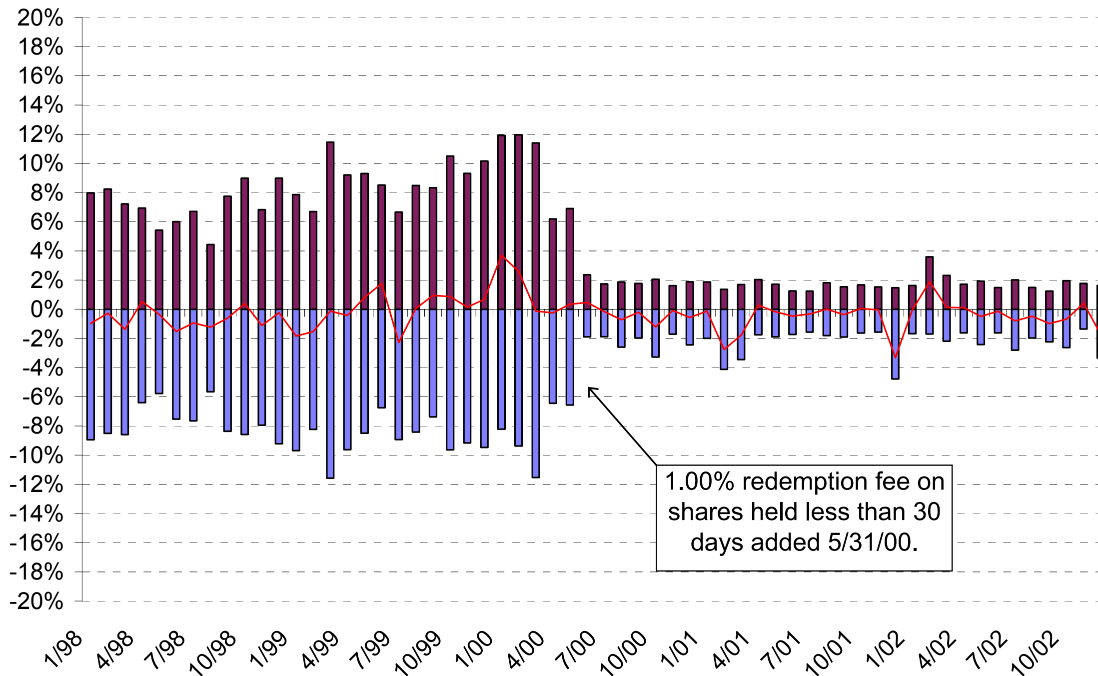
experimented with redemption fees as high as 4% and as long as three years, and with purchase fees as well as redemption fees.

In addition to Fidelity funds, we also recordkeep redemption fees for third-party funds on our FundsNetwork platform, and on our similar recordkeeping platforms for 401(k) and other retirement plans. We have recordkept redemption fees for non-Fidelity funds on FundsNetwork since its inception. For 401(k) and other retirement plans, we have recordkept redemption fees for non-Fidelity funds at the participant level, if the funds so desire, since October 2003.

Like most fund management firms, Fidelity strongly discourages short-term trading by shareholders because such trading by a few gives rise to disproportionate costs that, in the absence of a redemption fee, are unfairly borne by other fund shareholders. This is so regardless of whether such trading involves "market timing" or, for that matter, any other particular trading strategy (or lack thereof). We attempt to control short-term trading through active use of fair-value pricing, by applying limits on exchanges and other market timing controls, and, for some funds, by imposing redemption fees tailored to each fund's needs.

Impact of Redemption Fees on Shareholder Turnover. Although redemption fees potentially limit liquidity for all shareholders, we have found them to be the most effective control on short-term trading, especially for funds that are attractive to market timers. In the late 1990s some of our no-load international funds began experiencing an increased shareholder turnover rate, as investors increasingly bought into the fund and sold out shortly thereafter. At the time, Fidelity was known to be a relatively active user of fair-value pricing to prevent arbitrage activity, and we had various detection and deterrence procedures in place to limit exchanges and other short-term trading. Nevertheless, buy and sell activity continued at a high level, and in early 2000 we decided to implement a redemption fee.

The following graph shows the impact of the redemption fee on the cash flows of one of our larger diversified international stock funds. The bars show the monthly gross purchases (positive) and redemptions (negative) for the fund as a percentage of assets at the end of the prior month, and the line shows monthly net purchase or redemption activity on the same basis. High levels of gross sales and gross redemptions relative to net activity are typically an indicator that a fund is being actively traded by shareholders.



The chart shows that despite our other practices to discourage excessive trading, the fund was consistently experiencing shareholder inflows and outflows of 6% - 12% of assets *per month* before the redemption fee was adopted. The shareholder turnover began to decline in March when we published our intention to add redemption fees; 60 days after that, when the fees took effect on May 31, gross cash flows immediately declined to a monthly range of 2% - 4%, which is typical of funds of this size. The need to pay a fee seems to have discouraged most short-term traders or caused them to modify their behavior. For those who continued to trade on a short-term basis, the 1% fee helped offset the cost that short-term trades imposed on other shareholders.

We believe that our redemption fees have been successful because they require short-term traders to pay the costs of their activity, and because they are applied without exceptions. Before implementing redemption fees on our Select Portfolios in 1989, we tried a number of different exchange fees and exchange limits, with limited success. We believe that those fees and limits fell short, in part, because they were complex and had a number of exceptions that allowed dedicated short-term traders to find ways to circumvent the limits. Redemption fees succeeded where exchange limits failed, in our view, because they are simple, consistently applied, have no exceptions or loopholes, and are not so high as to unduly penalize investors or create undue incentives for evasion.

The Commission and its staff have consistently taken the position that redemption fees must not exceed reasonable estimates of amounts needed to compensate funds for costs associated with redemptions. In keeping with these constraints, we have varied redemption fee rates from fund to fund, based on round-trip trading costs associated with each type of security (assuming an involuntary trade compelled by shareholder activity). For example, our Ultra-Short Bond Fund, which invests in highly liquid short-term securities, has a redemption fee of only 0.25%, while our International Small-Cap Fund has a redemption fee of 2%.

We view redemption fees as a mechanism for a fund to recover costs associated with short-term trades. We do not view redemption fees as a tool for penalizing short-term traders. We make no attempt to judge the intentions of the trade: we do not ask ourselves, for instance, is this trade market timing? Instead, redemption fees are simply assessed on all shares held less than the prescribed redemption fee period (using the FIFO method for partial redemptions), regardless of the nature of the transaction or type of account. Similarly, we do not make exceptions to the fee based on the investor's presumed intent: we limit exemptions to a bare minimum, justified on the basis of cost.

Fidelity fund redemption fees have no *de minimis* or hardship exceptions. We do not exempt "rebalancing" transactions, automatic or systematic transactions, or trades placed by registered investment advisors. We treat exchanges and redemptions the same, as required by Rule 11a-3(b)(2)(ii), and do not treat loans or withdrawals from retirement plans any differently than exchanges between options within a plan.[10]

Contrary to concerns expressed by commenters on the proposed rule, we receive relatively few complaints from individual shareholders on our redemption fees. We believe this is because the rules are simple and clear, without exceptions that may appear to be arbitrarily determined, and because the fees are designed to recover costs rather than as a penalty for bad behavior.

We do, however treat reinvested dividends as automatically long-term shares, effectively exempting them from the fee,[11] and we do not charge redemption fees on redemptions in kind, because they do not cause the funds to incur the portfolio transaction costs that are the main reason for redemption fees. In addition, we do not charge redemption fees on transfers of shares between account registrations within the same fund, including rollovers to IRAs or gifts to a minor. We treat these transactions as not involving a redemption, since shares do not leave the fund and no transaction costs are incurred.

While the Fidelity funds do not waive redemption fees for omnibus accounts, historically we have treated each omnibus account as a single account when aging shares for redemption fee purposes. Under the FIFO method this has meant that omnibus accounts have rarely been assessed redemption fees. Since omnibus accounts reflect the aggregate activity of many individual investors, it is common for them to be traded every day. Over time, however, the purchases by long-term "buy and hold" investors accumulate, resulting in substantial inventories of shares held longer than the fund's redemption fee period. As a result, redemption requests from omnibus accounts are nearly always satisfied with long term shares and no redemption fees are incurred.

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[10] Some retirement plan recordkeepers advocate applying redemption fees to exchanges only (not other types of redemptions) or requiring shareholders to hold fund shares for a number of days before allowing them to redeem as preferred alternatives to mandatory redemption fees on all transactions. Regardless of the merits of these proposals within retirement plans, we do not use either of these methods because they would be prohibited by law outside retirement plans, and because we wish to keep our procedures as consistent as possible to prevent inequities among shareholders investing through different types of accounts.

[11] In theory, reinvested dividends and capital gains could take on the holding period of the shares that generated the distributions (for example, 50% short-term and 50% long-term shares, if the account had that mix of shares at the time the dividend was declared). However, we understand that, for simplicity, most funds treat reinvested dividends as 100% long-term, as our funds do.

Unfortunately, this has meant that short-term traders could trade freely in omnibus accounts without having to pay their own way as they would if they traded directly with the fund.

Fidelity believes strongly that intermediaries should account for and collect redemption fees, on the fund's behalf, at the individual investor level. Institutions should not be able to negotiate better terms on redemption fees – for themselves or for their clients or participants – than average investors would be offered if they dealt with the fund directly. From the fund's standpoint, looking through the omnibus account to the end-investor's trading activity ensures equitable treatment of all shareholders.

In late 2003 Fidelity notified broker-dealers, retirement plan recordkeepers and other financial intermediaries and omnibus account holders that they would be required to assess and collect redemption fees at the individual investor level, or cease offering Fidelity funds with redemption fees. While we requested that intermediaries comply with the new omnibus account policy as soon as possible, a final deadline of December 31, 2004 was established by the funds' board of trustees based on feedback from clients. To protect the funds from excessive trading in the meantime, Fidelity, with the approval of the Fidelity funds' board of trustees, has agreed to make payments to the funds of the estimated amounts of redemption fees that would have been collected from omnibus accounts as if the new policy had been fully implemented effective April 1, 2004. Thus, Fidelity is currently paying the Fidelity funds an amount representing an estimate of the redemption fees that would be due if the fees were tracked by recordkeepers at the sub-account level.

In light of recent developments in the fund industry, many recordkeepers have been working diligently to develop redemption fee tracking capabilities. We expect that some major recordkeepers will have at least partial capability to track redemption fees by December 31, 2004; however, hundreds of other recordkeepers and omnibus account holders have advised us that they will not complete development of redemption fee procedures until the fate of the proposed mandatory SEC fee is known. In fact, many recordkeepers have expressed unwillingness even to begin programming for redemption fees without further guidance from the Commission. Therefore, we believe it is urgent that the Commission make public its intentions with respect to the proposed rule promptly, to allow recordkeepers to make reasonable plans for needed systems enhancements.

II. ALTERNATIVES TO A MANDATORY REDEMPTION FEE

The Commission should not require the same redemption fees for all funds. Although Fidelity strongly supports the Commission's goals underlying the proposal, we believe that a rule imposing a uniform fee on all redemptions is an overly broad measure that conflicts with the 1940 Act as the Commission and its staff have long construed that statute. The analysis of the statutory limits placed on redemption fees is set forth in the no-action letter issued to Fidelity by the staff of the Division of Investment Management in 2001 in connection with the conversion of the Fidelity Advisor Korea Fund from a closed-end fund to an open-end fund. [12]

We quote from the Korea Fund no-action letter (omitting footnotes):

[12] *See* Fidelity Advisor Korea Fund, Inc. (pub. avail. March 7, 2001)

> “During the legislative hearings on the [1940] 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.’ The Commission further stated that ‘the importance of the redemption feature of open-end securities appears to the Commission beyond question.’
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> “Congress incorporated the Commission’s views into the Act by requiring that the securities of an open-end investment company be ‘redeemable,’ which in turn 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 has recognized, is that:
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>> “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.'
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> "Because the imposition of a redemption fee by an open-end fund raises serious questions about the redeemability of the fund's shares, the Commission has adopted rules that permit funds to impose only limited redemption fees, and the staff has taken no-action positions consistent with those rules. The Commission and staff positions recognize certain principles, including that: [...]
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> "● A redemption fee may recoup or offset only limited types of administrative expenses caused by shareholder redemptions, *i.e.,* the following expenses that are ‘directly related to’ processing shareholder redemption requests: (a) brokerage expenses incurred in connection with the liquidation of portfolio securities necessitated by the redemption; (b) processing or other transaction costs incident to the redemption and not covered by any administrative fee; (c) odd-lot premiums; (d) transfer taxes; (e) administration fees; (f) custodian fees; and (g) registrar and transfer-agent fees (collectively, ‘Administrative Costs’)
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> "● A fund may not impose a redemption fee greater than the lesser of: (a) an amount approximating, or ‘reasonably related to,’ the anticipated, specific Administrative Costs identified above; or (b) 2% of the net asset value of the redeemed shares, even if the fund’s approximate, anticipated Administrative Costs exceed 2%."

In light of the Commission’s steadfast interpretation of the 1940 Act’s terms governing “redeemable securities,” it is difficult to articulate the legal basis that would support adoption of a rule that would compel mutual funds not only to impose a redemption fee, but in doing so to disregard the administrative expenses caused by shareholder activity and instead subject all redemptions to a 2% fee. Certainly no such legal basis has been set forth to date.

Although we respect the Commission’s intentions and its goal of deterring short-term trading, we also strongly believe that the Commission should avoid rate-setting. The mandatory redemption fee would send a message to investors that the government thinks mutual funds are not meant for short-term trading, but at the cost of subjecting investors to an arbitrary government fee that is not related to market forces or the cost of processing redemptions. Indeed, we expect that the 2%/5-day

fee is likely to become known as the SEC fee or government fee over time. We believe the Commission has been wise to avoid rate-setting in the past, and that as a general matter the government should avoid setting consumer fees as much as possible. If the Commission believes that market incentives are not properly balanced, so that funds are unwilling to impose fees that would benefit investors, it would be better for the Commission to address the forces that cause the imbalance directly (for example, by requiring financial intermediaries to cooperate in collecting fees and prohibiting funds from waiving them arbitrarily for favored clients) rather than create a new government-imposed user fee.

The reality is that most funds do not need redemption fees either to control market timing or to cover costs. Redemption fees are only one way that funds deal with short-term trading problems. In most cases, mutual funds invest in securities with low enough transaction costs that occasional short-term trades can be allowed without a fee, while excessive trading can be handled differently, by asking the investor to leave. Redemption fees are an effective means of handling short-term trading problems, but they are not required when other techniques can be used to keep short-term trading at a manageable level.

Funds should not charge redemption fees that are in excess of the costs of trading similar investments. Fees that are higher than expected trading costs are a kind of penalty or tax on short-term trades. While we believe it is appropriate to ask short-term traders to bear the costs of their trading, we do not favor penalty fees as a philosophical matter. A 2%/5 day fee is more than is necessary to cover costs for many of our bond funds that have redemption fees, not to mention the many Fidelity funds (such as our Magellan Fund) that have no redemption fees at all and have not needed them in the past. We would prefer not to have to charge a government fee that does not reflect the costs relevant to the securities in which the funds invest.

The Commission need not require all funds to adopt a mandatory fee in order to be confident that funds will consider redemption fees as a possible remedy to short-term trading problems. Indeed, the number of funds that have adopted redemption fees has been increasing rapidly, particularly for especially vulnerable funds such as international and small-cap stock funds. We believe that short-term trading fees are likely to become the norm for these types of funds, even if the Commission takes no further action.

Small investors will be affected by the SEC fee but professional arbitrageurs may not be deterred. We are skeptical that a 2%/5 day government-imposed fee will truly protect shareholders – it will be easy for a dedicated trader to trade successfully within a 5-day window. Indeed, at least one newspaper article has already suggested a method for doing so.[13] Small or less experienced investors may well be deterred by the fee, but professional traders with more expertise and resources may readily be able to adjust their trading strategies to compensate, by hedging or making other tactical changes. For a professional trader seeking to implement a price-arbitrage strategy, a longer holding period increases the risk of holding a hedged position, since it is difficult to perfectly hedge an actively managed fund. In our experience a longer-term fee, such as 30 or 90 days, is necessary to protect funds like international, small-cap and high-yield funds that have the highest profit potential for arbitrageurs and other short-term traders.

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[13] Mark Hulbert, "Why an S.E.C. Hurdle Won't Stop Fund Speculators," *New York Times*, March 7, 2004

The mandatory fee will make existing fees much more complicated. If the mandatory fee is adopted, we will not eliminate our existing redemption fees, because we believe they are appropriate to protect the funds that have them. Instead, we would expect to apply the mandatory SEC fee for the first five days, our redemption fee for short-term trades thereafter, and no fee for periods after that. Especially when coupled with the at-cost standard for redemption fees after the first five days, the proposal is likely to lead to three-tiered fee structures for many funds: for example, 2% for the first five days, 1% for the next 85 days, and zero thereafter. This is more complicated than today's situation, especially when the possibility of different waiver policies for the first 5 days and the next 85 days are taken into account.

We are also concerned that mandatory redemption fees would likely have the unintended effect of signaling, erroneously in many instances, to the average investor that mutual funds are more expensive than competing investments, such as bank accounts, managed separate accounts, individual securities, ETFs and even hedge funds. While some of these other investments have explicit transaction costs associated with them as well, only mutual funds would be forced to impose a fixed, government-imposed 2% fee unrelated to actual transaction costs.

Instead of Mandating Redemption Fees, the Commission should regulate them and set out basic standards. Instead of requiring all funds to have redemption fees, we recommend that the Commission adopt a rule under the 1940 Act that would have two important features. First, the rule should require fund boards to consider whether redemption fees would be appropriate in the interests of the fund's shareholders. Second, the rule should require that any fund that has a redemption fee should distribute its shares and recordkeep ownership of those shares only through transfer agents and financial intermediaries that represent that they can collect redemption fees in accordance with the fund's requirements. The rule should require fund boards to consider redemption fee capabilities of these parties when reviewing recordkeeping, service, or other compensation they may receive from the fund or fund group; the Commission should also consider its authority to adopt rules requiring entities that distribute fund shares or maintain omnibus accounts to collect redemption fees in accordance with the fund's requirements.

If the Commission wishes to encourage funds to adopt redemption fees, we suggest that the Commission require fund sponsors and fund boards to consider, on or before June 30, 2005, whether to adopt a redemption fee, and, if the decision is not to adopt such a fee, that the board state its reason for not adopting the fee in the registration statement. If the Commission wishes to keep this matter before fund boards, the Commission could require the board to review shareholder activity periodically and to consider whether to adopt a redemption fee to control excessive trading by a minority of customers. These options would add to the workload of fund boards, but they would be less burdensome on fund investors than the proposal to require a mandatory fee.

Terms of Rules Regulating Optional Redemption Fees. The Commission should adopt a rule that sets out principles under which redemption fees may be charged by open-end funds. The rule could be created pursuant to authority contained in Section 22(c) and (d) of the 1940 Act. A rule regulating redemption fees should set out the responsibilities of funds with respect to the establishment and collection of redemption fees. It should specify the factors to be considered in adopting a fee, and the responsibilities of fund boards of directors in setting the terms of the fee and of any waivers or variations in the fee. The rule should set standards for disclosure of fees to investors and of any changes in such fees. Finally, the rule should specify the responsibilities of

dealers, underwriters and other financial intermediaries with respect to collecting redemption fees and transmitting them to funds.

We suggest, as a starting point, that a redemption fee rule include the following provisions:

1. Redemption fees should be paid to the fund, and should be reasonably intended to compensate the fund for expenses and other costs directly related to the purchase and redemption of fund shares. This is based on the definition of redemption fees currently contained in Rule 11a-3, which includes the cost-based standard historically recognized as a statutory imperative by the Commission and its staff.

We believe fund groups would benefit if the Commission were to articulate more clearly the application of the cost-based standard. Although the cost-based standard is currently the law for all redemptions as interpreted by the staff, it is not clear that this point of view is universally observed or applied. Adopting a rule regulating redemption fees would provide an opportunity to explain under what conditions a 2% redemption fee is allowed, or whether fees are required to be lower if fund costs associated with redemptions are expected to be lower.

As part of a redemption fee rule, the Commission could provide guidance on factors for boards to consider under an at-cost standard. We understand that some fund groups are uncomfortable with the cost-based standard, perhaps fearing that arbitrageurs could argue, self-interestedly, that their particular trades did not result in high costs; at the other end of the spectrum, some fund groups are comfortable charging 2% fees across the board for all funds under current law.

At Fidelity, we have attempted to adopt redemption fees that are related to fund costs. When setting fee rates, we attempt to cover not only the cost of selling but the cost of the round-trip purchase and sale imposed on the fund by a short-term buy and sell transaction. We also take into account the need to cover costs not only on normal days, when shareholder cash flows may be readily manageable, but also on days when the fund experiences strong net redemptions or net purchases that must be put to work the following days. Thus, we assume a level of transaction costs for involuntary trades forced on the fund by shareholder activity rather than for normal, discretionary trading by the fund manager. At the same time, we also assume that buys and sells from shareholders will normally net off against each other in part. Thus, we have typically set our fees at a level lower than the assumed transaction cost, to reflect the probability that a portion of shareholder transactions will be netted. At times we have also estimated transaction costs across a range of similar funds (sector funds, for example) and adopted equivalent fees for all funds within a given fund type. As detailed in the Attachment, this has resulted in a range of fee rates for our funds that differ by investment discipline, not in 2% fees for all funds. Because costs must be estimated in advance, there is no exact way to relate fees and costs and no single best way to arrive at a fee; rather, there may be a number of appropriate matters for fund sponsors and fund boards to consider within the boundaries of a cost-based fee regime.

A redemption fee rule could give boards greater comfort as to reasonable methods of fee-setting. The Commission could also address standards under which a redemption fee might be allowed to exceed 2%, perhaps requiring the fund's board of directors to determine that a fee in excess of 2% is reasonably necessary viewed solely as a means of compensating the fund for anticipated costs directly related to trading in fund shares, and not as a means of deterring or delaying redemptions.

2. <u>The terms of redemption fees, and any scheduled variations or waivers thereof, should be approved by a majority of a fund's board of directors</u>. Unlike sales loads, which are paid to fund underwriters or other parties, redemption fees are paid to the fund. Thus, they should be specifically approved by fund boards.

3. <u>Any scheduled variations or waivers of redemption fees should be reasonably related to the costs to the fund of such transactions, provided, that the fee may vary depending on the length of time the shares redeemed were held, and the fee may be waived for shares acquired through reinvestment of dividends</u>;

The concept of "scheduled variations" of redemption fees originally comes from Rule 22d-1 under the 1940 Act, which requires consistent application of sales loads. The requirement that scheduled variations of redemption fees be reasonably related to costs is currently contained in Rule 11a-3.

Unlike sales charges, where waivers must be clearly disclosed and consistently applied, the Commission has never articulated a rule for waivers of redemption fees. Some fund groups waive redemption fees for short-term traders in retirement plans, short-term traders in accounts using registered investment advisors, and short-term traders within omnibus accounts. Some fund groups also reserve the right to waive the fee when they feel it is in the fund's best interest. We believe the Commission should set out standards for waivers, and matters for fund boards to consider, particularly in light of the fact that the fees waived would otherwise be assets of the fund.

Rule 11a-3 suggests that all waivers (to the extent they constitute "scheduled variations") must be cost-based, at least for funds that have exchange privileges; however, the Commission has pointed out that fees often are waived in circumstances (for omnibus accounts, for instance) that do not have a clear basis in cost. In addition, commenters on the proposed rule have recommended a great variety of redemption fee waivers, many of which are based on the idea of exempting short-term trades that are not likely to represent market timing. While this may be reasonable it is not clear how to relate the intention of a short-term trade to the trade's cost.

Although the Staff has taken the position that redemption fees, and variations in redemption fees, must be based on cost in order to avoid impairing the redeemability of fund shares, it is not clear that this point of view has been fully articulated or consistently accepted. The industry would benefit if the Commission would formally state whether a waiver of fees for certain types of customers constitutes a scheduled variation in fees that must be justified on the basis of cost to the fund (under Rule 11a-3(b)(2) or some other provision), or is an aspect of redemption fees that may be justified on a more general basis of fairness to shareholders or overall reasonableness.

A new redemption fee rule would provide the Commission with an opportunity to give guidance to funds on the application of the cost-based standard partly applied by Rule 11a-3. Alternatively, the Commission may want to consider a less narrow policy for scheduled variations of redemption fees. Before adoption of Rule 22d-1, which liberalized policies for sales load schedules and waivers, the Commission held sales load variations to a "rational basis" standard[14] in order to

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[14] In 1983, when proposing what eventually became Rule 22d-1, the Commission described the standard then applicable to sales loads as follows: "[T]he Commission has long viewed volume and group discount and other specified types of discounts as consistent with the purposes of section 22(d). It has granted a large number of exemptions by rule and by

prevent unfair preferences in loads from one customer to another. Perhaps such a standard, with costs one of but not the only factor for boards to consider, might be appropriate for redemption fees now.

4. The redemption fee, if charged on an exchange, should not exceed the amount of the redemption fee that would apply in the absence of an exchange. This requirement is currently contained in Rule 11a-3, and prevents funds from charging higher redemption fees on exchange redemptions than on non-exchange redemptions. A number of commentators have recommended that redemption fees be applied only to exchanges in the context of retirement plans, and not to non-exchange redemptions in such plans. If the Commission believes that method of applying redemption fees is appropriate, then this provision should be omitted from this rule and should be eliminated from Rule 11a-3 as well. We note, however, that costs to the fund are not likely to differ between exchanges and other types of redemptions, making it difficult to square such a policy with a strict cost-based standard for fee variations.

5. If the redemption fee varies by class of shares, the fund's board should approve the variation by class, and should approve the allocation of the proceeds of the redemption fee to each class individually or all classes mutually. Some funds, including certain Fidelity funds offered through variable insurance products, have redemption fees that apply to one or more classes of shares and not to others. In such cases fund boards must already consider the variation in redemption fees as part of their considerations under Rule 18f-3; however, including a requirement in a redemption fee rule would give the Commission an opportunity to address the considerations that it is appropriate for Boards to take into account when adopting such a class-specific fee.

6. A fund that imposes a redemption fee (i) should furnish adequate information concerning those fees, and any scheduled variations or waivers thereof, in its registration statement; (ii) should revise its prospectus and statement of additional information in the event of changes to the terms of the fee or to any variations or waivers thereof; (iii) should provide at least 60 days' notice to affected shareholders in advance of any change in redemption fees that would materially increase in the fee payable on redemption of already outstanding shares; and (iv) should advise existing shareholders of any other changes to redemption fee terms within one year after such changes are first applied. These provision are modeled after investor protections contained in Rule 22d-1 applicable to changes in sales load schedules. In adopting disclosure requirements the Commission could take the opportunity to specify how, and whether, notice requirements apply to redemption fees. We believe advance notice should only be required when redemption fees are to be applied to already outstanding shares; for newly purchased shares it should be sufficient to inform the shareholder of the potential for the fee in advance to the purchase.

7. The company, the principal underwriter, dealers in the company's shares, and other financial intermediaries should apply the fee, and any scheduled variation or waiver of such fee, uniformly to all redemptions of the class specified. This parallels a requirement of Rule 22d-1 that requires uniform application of sales loads. Such a provision could be used to address the problem of inconsistent application of redemption fees at the customer level and at the omnibus level. It would also provide an opportunity for the Commission to expand on the definition of the term "financial

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order premised on the theory that discrimination is not unjust, and thus the purpose of the section is not violated, if there is a rational basis for the variation in sales load." (Release IC-13183 (April 22, 1983) at note 8)

intermediary" and specify the extent of their duties.

The question of how financial intermediaries should deal with redemption fees is at the heart of proposed rule 22c-2. By specifying how mandatory redemption fees should be applied, the Commission would set out at least one way that intermediaries and funds would be required to work together.

Similar provisions could apply in the context of a rule regulating non-mandatory redemption fees. In particular, the definition of financial intermediary in paragraph (f) of the rule and the three alternative methods of communicating with funds about redemption fees in paragraphs (b)(1), (2) and (3) could be retained. However, the terms of paragraph (b) would need to be conditional: intermediaries would be required to collect the fee in accordance with the prospectus if the fund had a fee, and if the fee applied to the types of accounts maintained by the financial intermediary. In addition, a financial intermediary that agrees to assess redemption fees under paragraph (3) should be required, upon the fund's request, to provide data on fund transactions, including account numbers, sufficient to allow the fund to determine whether the fee is properly assessed.[15] For privacy reasons that information should be required to be used only for the purpose of verifying redemption fee collection unless otherwise agreed.

The Commission may be concerned about the possibility that, unless redemption fees are mandatory, investors may seek to evade them, or that intermediaries may use their market power to prevent funds from applying the fees or to provide incentives for fund groups to waive fees for accounts they hold, at the expense of other shareholders. The problem of inappropriate waivers generally should be addressed by requiring fees to be applied uniformly and by requiring board approval of any waiver policies. In addition, the Commission could consider various other means to address these concerns.

> The Commission could put a duty on funds to inquire (though not necessarily audit) whether financial intermediaries maintain accounts that would be subject to redemption fees if held directly with the fund's transfer agent, and if so, require fund boards to consider whether offering shares to that intermediary is in the fund's best interest.
>
> The Commission should consider its authority under the Securities Exchange Act of 1934 to prohibit any broker, dealer, underwriter or transfer agent from offering to purchase, transfer or recordkeep any shares to which a redemption fee applies unless it reasonably believes that it can collect the redemption fee in accordance with its terms. The Commission could also direct the NASD to use its "just and equitable principles of trade" rulemaking authority under Section 15A(b)(12) of the Securities Exchange Act of 1934 to require financial intermediaries, including any broker-dealer engaged in the distribution of a fund's shares or maintaining an omnibus account that holds a fund's shares, to collect redemption fees in accordance with the fund's requirements.
>
> The Commission could address the issue via the practice of paying fees to recordkeepers, by

[15] We recommend that the Commission make it clear that the information required may be provided to the fund by supplying it to the fund's transfer agent or another designee of the fund. It may prove to be efficient for funds to centralize the function of reviewing such data or delegate it to a third party.

requiring fund boards to consider, in reviewing the payment of any recordkeeping, transfer agent, distribution, service, plan service reimbursement or similar fees by the fund or its advisor, transfer agent or distributor, whether the recipient has represented that it is capable of collecting and remitting redemption fees in accordance with the prospectus of the fund.

The Commission could act to forestall improper practices by prohibiting any broker, dealer, transfer agent or principal underwriter for a fund from assisting any person in evading redemption fees, including, without limitation, offering to net purchases and redemptions in the same fund from different beneficial owners in order to avoid such fees.

In any event, we believe that fund groups would benefit from a more direct approach by the Commission to identifying the relative duties of funds, brokers, dealers, underwriters and others in connection with redemption fees. We fear there may be confusion among industry participants as to which entities constitute financial intermediaries for purposes of the rule as proposed, and what their duties may be.

8. The requirement to share TIN-related transaction data should be the subject of a separate rule. The periodic information reporting requirements of paragraph (c) of the proposed rule would require funds to require financial intermediaries to deliver transaction information and customer TIN data to funds at least weekly. This provision includes data in addition to requirements related to redemption fees (for which account-level information rather than TIN-level information is needed), and is expected to assist in policing market-timing and breakpoint policies as well as redemption fees. Because it would require intermediaries to give data on all account transactions to funds, it would greatly change the relationship of funds and omnibus account providers.

The need to impose market timing controls may be greater in a fund that has no redemption fee, since the presence of a fee tends to limit excessive short-term trading and its negative effects. Hence, if redemption fees are made non-mandatory we believe that the TIN-related data sharing requirements should be placed in a separate rule, perhaps applicable to all funds other than those (money funds, ETFs or funds that permit short-term trading) that would be excluded from the mandatory redemption fees as proposed. In connection with such a rule the Commission could expand upon the reasons for sharing transaction data and its views of the relative duties of funds and financial intermediaries with respect to market-timing controls. This is another area where views within the industry are evolving and market participants could benefit from Commission guidance.

A redemption fee regulation would benefit investors more than a mandatory redemption fee. We believe that the Commission does not need to mandate one kind of redemption fee for all funds. Already there are strong market forces pushing funds to standardize fees, at least in terms of the types of transactions to which they apply and sometimes in terms of fee levels and holding periods as well. We believe the Commission should allow these market forces to work, but should set out standards, including board approval of fees and requirements that waivers have a rational basis, to prevent market pressures from defeating investor protection concerns. While a mandatory fee would impose a minimum fee on everyone, it would not address how fees outside the five-day window should be applied. Proper regulation of redemption fees should help assure that fees are applied where appropriate, and establish standards applicable in all cases where the fees are imposed.

III. COMMENTS ON RULE PROPOSAL

As discussed in Part II of our letter, we believe that redemption fees should not be mandatory, and that the Commission should instead adopt rules regulating redemption fees and funds' relationships with financial intermediaries. However, if the Commission wishes to proceed with mandatory fees, we believe that certain changes to the rule are advisable, including modifications to the provisions for fee waivers and the treatment of funds of funds and similar two-tiered structures. These and other suggestions are discussed in the following pages.

De Minimis and Financial Emergency Waivers. We oppose the *de minimis* and financial emergency provisions of the proposed rule, and recommend that they be eliminated or made optional. We would strongly object to being required to waive the funds' existing redemption fees for some of our customers, when we have not had the need to do so for the past fifteen years. Waivers of redemption fees weaken their effectiveness. It seems wrong for the Commission, in the name of improving controls overall, to require funds that have already imposed redemption fees in compliance with the law to weaken their existing standards.

The financial emergency exception has at times been compared to the exceptions available for withdrawals from ERISA plans, and justified on a similar basis. We believe this analogy exaggerates the severity of the redemption fee. Without hardship withdrawal or loan provisions, retirement plan participants would not be able to access their money at all until they separated from service, which could be years or decades away. Without a financial emergency requirement for funds, shareholders would still be able to realize 98% of the value of their investment immediately, and would be able to realize 100% by merely holding shares a few days longer. And since the redemption fee is a constant percentage, a small trade incurs a small redemption fee in dollar terms.

We object to waiving market timing controls for small investors because market timing is not exclusively an activity by the wealthy. Small investors may also be tempted to follow market-timing schemes. In fact, some of our most serious market-timing problems in the past resulted from numerous investors – many of them small – following the same market-timing strategy in domestic equity funds, overwhelming some of our smaller funds and causing us to close them temporarily.[16] Allowing small trades to be executed without fees is an invitation for investors to make small market-timing trades, and for larger investors to break up their trades into smaller pieces. And as the Commission has noted, "the costs imposed on long-term investors in funds by the cumulative effect of many smaller short-term traders may be greater than those imposed by a few large traders."[17]

Finally, redemption fees are designed to cover costs that otherwise would be allocated directly to other shareholders. If the fee is not a penalty or tax, there is little reason to exempt some shareholders and not others from its application, especially when the shareholder could merely hold

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[16] "Fidelity Puts the Padlock on Market Timers," *Money*, December 1990; "Why Are Mutual Funds So Angry with Dick Fabian?," *Business Week*, November 12, 1990

[17] Proposing Release at Note 14.

shares a brief period longer and pay no charge.

Other waivers and exceptions. Comments on the proposed rule have included numerous requests for waivers from application of the redemption fee, many of them relating to retirement plans. Some waiver requests are proposed on the grounds of cost savings, but many are founded on a principle that transactions that are not "market timing" should be exempted from the fee. Our philosophy is different.

We believe that part of the difficulty stems from the perception that the proposed SEC fee is intended not only to recover costs incurred by a fund, but also to penalize and punish market timers and other short-term traders. Since the 2% government fee would often be in excess of what a fund would reasonably expect for trading costs, it could well be seen as a penalty, or tax. A person who made a short-term trade, but did not feel themselves to be a short-term trader by habit, naturally would want an exemption from a penalty or fine. Similarly, the Commission may feel compelled to require an exemption from the mandatory SEC fee for financial emergencies, if the fee is a punishment for bad behavior.

We have always seen the fee differently. We see redemption fees as transaction costs that are very similar to the costs involved in trading a stock or bond. The markets do not vary transaction costs for transactions that are entered into for good or bad reasons – the same bid-offer spread applies if an investor sells a security as part of an active trading strategy, or to pay ongoing medical bills, or to meet a sudden emergency. Likewise, the financial markets do not recognize any *de minimis* exception – to the contrary, the cost in percentage terms of executing a small transaction may well be higher than for larger trades. Since we view redemption fees as equivalent to market transaction costs, we do not waive them based on intent or based on the size of the transaction.

A fund, by setting a redemption fee policy, limits the amount of costs that will be shared relative to the costs that each investor must pay on their own. Short-term trades are charged a fee not because they cost more, but because an investor who holds shares for a short time is causing the fund to bear a level of costs that is disproportionate to the costs borne by that investor. A shareholder who is invested in the fund for 3 days causes the fund to incur as much trading cost as an investor who holds shares for one year – but, since he is only in the fund for three days, the short-term shareholder only bears 1/100th the cost that the one-year shareholder does.

As a general matter, we believe that waivers and exceptions from redemption fees raise more problems than they solve. Waivers are unlikely to be standardized across funds from different complexes, leading to possible investor confusion, additional programming costs for recordkeepers, and an increased risk of transaction errors due to complexity (as the industry and the Commission have recently experienced in the case of load breakpoints). We have also found that exceptions from trading controls, however well-intentioned, are vulnerable to exploitation by dedicated traders bent on short-term profit. In addition, we believe that exceptions and waivers can be just as likely to lead to investor complaints as a no-exceptions policy would be. Once waivers are offered to some investors, it is exceptionally difficult to maintain fairness across all shareholders.[18]

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[18] By our count commenters on the proposed rule have recommended waivers for at least 35 types of transactions, ranging from shares redeemed during a "free look" period to transactions "that do not present the opportunity for abuse." It is hard to see how these exceptions could be applied without either seeming to discriminate against some

Exceptions that should be included in the Rule. At Fidelity, we make as few exceptions as we can. Nevertheless, we believe the following exceptions should be covered by the rule if adopted:

1. Rollovers, transfers and changes of account registration within the same fund – we treat these as not involving a redemption. These transactions involve a change in ownership of fund shares but do not change the number of shares outstanding or require liquidation of portfolio securities.[19]

2. Redemptions in kind – these do not typically generate the same level of portfolio transaction costs (the principal cost to be covered by redemption fees) as cash redemptions; hence, we do not charge redemption fees on them. We recommend that funds be allowed, but not required, to waive the mandatory fees for redemptions in kind.

3. Dividend reinvestments: We consider reinvested dividends to be long-term shares that are exempt from redemption fees. The Commission clearly should allow this practice, which currently is the industry norm; if desired, the Commission could also allow funds to treat reinvested dividends as allocated pro rata across the holding period of shares at the time the dividend is declared, or even as bought on the date the dividend was paid and not exempt from redemption fees at all (which would be required by the rule as drafted).

Funds of Funds and other two-tiered structures. Mutual funds are sometimes used as investments in funds of funds or other, unregistered vehicles that mimic mutual funds such as "strategy funds." These structures can offer valuable benefits to investors, but can also nullify the Commission's proposed mandatory redemption fee, or the fees that funds currently have. The rule should set out conditions under which funds can offer their shares to other funds or similar vehicles, including requirements for the investing fund to share redemption fees it collects with the funds it invests in.

In the case of registered funds (investing funds) that invest in other registered funds (portfolio funds), we believe the rule should require investing funds to pay all redemption fees they receive on transactions in their shares through to the portfolio funds. This would be true in master-feeder arrangements as well. We believe those fees should be paid through to the portfolio funds because that is where portfolio transaction costs are incurred.[20] In cases where the investing fund holds multiple portfolio funds, redemption fees should be allocated based on the relative amount invested in the portfolio funds. If not all portfolio funds have redemption fees, the excess could be retained

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shareholders or weakening the redemption fee significantly.

[19] This policy does have a potential for misuse if taken too broadly: we would not extend this treatment of intra-fund transfers to include unlimited netting of fund buys and sells within omnibus accounts, for example.

[20] Fund-of-funds arrangements may have different goals, however, and different results may be fair. Some fund groups, including Fidelity, have organized registered funds (often money market funds) that are used as subportfolios by other registered funds and advisory clients. Our versions of these funds are referred to as "Central" funds, and they are used principally for investment of relatively short-term positions by the other Fidelity funds. For the Central funds, which are not offered to the general public, we believe the equitable result is for the Central funds to charge no redemption fees and for the investing funds to retain any redemption fees they charge on their shares.

by the investing fund or allocated among the portfolio funds.[21]

A typical unregistered "strategy" fund pools the investments of individual participants in a retirement plan and allocates them among one or more mutual funds and/or other investment options (for example, 60% in one or more stock funds and 40% in one or more bond funds). Under these arrangements the plan would be the record holder of the mutual fund shares and the individual participants of the plan, rather than the strategy fund, would be the beneficial owners. Thus, we believe the rule as proposed would require redemption fees to be assessed to each participant in a strategy fund as if they were invested in the portfolio funds directly. We are concerned that this requirement may be unworkable for recordkeepers of strategy funds, and that a solution similar to that proposed for registered funds of funds may be more equitable.

Business vs. Calendar Days. We recommend that the redemption fee rule refer to calendar days rather than business days. Holidays may differ from fund to fund, and the typical fund's business day calendar (based on the New York Stock Exchange calendar) differs from the business days observed by many other American businesses. In addition, while business days are intuitive over short periods (eg, 5 business days = one week, roughly) they are not readily recognizable over longer periods (19-23 business days= one month; 126 business days = 6 months). This is one reason why current redemption fees, which generally are much longer than one week, are typically stated in terms of calendar days rather than business days.

Payment of redemption fees on behalf of customers. In some cases a financial intermediary may be unwilling to charge a redemption fee to a customer, but may be willing to pay the fee on the customer's behalf. For example, an investment advisor may not wish to have its customers charged for redemption fees incurred as a result of the adviser's trades. To accommodate these situations without creating inappropriate fee waivers, we recommend that funds be allowed to accept payment of redemption fees by a financial intermediary in lieu of payment of such fees by a shareholder, provided that the fund sponsor and the fund board consider whether payment of the fees by a party other than the investor creates inappropriate incentives for active trading.

Fair-value pricing does not remove the need for redemption fees. The Proposing Release asks whether a redemption fee is unnecessary if funds implement fair-value pricing effectively. Redemption fees are not a substitute for fair value pricing – but it is not a case of choosing one or the other; funds should do both. While fair-value pricing addresses the most obvious forms of stale-price arbitrage in foreign markets, fair-value pricing does not address the portfolio transaction costs inherent to many security types, and does not remove the apparent ability to trade "for free" that attracts investors who want to implement rapid-fire trading strategies.

The term "market timing," of course, long predates the existence of international funds. Its original meaning related to moving from US stocks – the market – to cash and back again, according to a timing strategy. Excessive trading is a problem in international funds, to be sure, but

[21] Under the rule as proposed, it would seem to be inappropriate for a fund that imposes the 2%/5 day SEC fee to offer its shares to a fund that opts instead to have no fee and affirmatively permit short-term trading. Since the investing fund would be treated as a single account, it would rarely pay a redemption fee to the portfolio fund, even if the investing fund's shareholders engaged in significant short-term trading, thus indirectly exposing the portfolio fund to short-term trading abuses.

also in small-cap funds, aggressive US stock funds, sector funds, high-yield bond funds, and even stock index funds. (Although sometimes overlooked, money market funds are also subject to market timing, because the amortized cost pricing method causes their yields tend to lag current short-term interest rates.[22]) The problem arises not solely because of stale-price problems, but because funds can apparently be traded for free, but actually with costs borne by other shareholders.

Even for international funds it should be recognized that fair-value pricing cannot eliminate potential short-term trading. In our experience fair-value pricing of foreign markets can curtail potential arbitrage profits on days when markets move significantly, but is less reliable in preventing short-term trading profits on less active days: a price move of 25 or 50 basis points, for example. Redemption fees assure that traders are not tempted to try to capture these small potential profits at the expense of other investors.

The need for redemption fees for vulnerable funds is borne out by our experience with our international stock funds as discussed above – even with active fair-value pricing and a program of curtailing market timers, shareholder turnover remained high until the funds adopted their 1%/30-day redemption fees.

* * * * * * *

Fidelity Investments appreciates the opportunity to submit comments on this important rulemaking initiative. Should you have any questions please contact the undersigned.

David B. Jones
Senior Vice President
Fidelity Management & Research Company

Eric D. Roiter
Senior Vice President and General Counsel
Fidelity Management & Research Company

[22] Any fund that values its securities at artificial prices that do not match current market values may be targeted by stale-price arbitrageurs. These include money market funds, which value securities at amortized cost rather than current market price, and stable-value mutual funds, which value securities at book value rather than market value. While money market funds have generally chosen to combat market timing without the use of redemption fees, most stable-value funds have fees designed to apply when book value exceeds market value in order to prevent dilution.

Money market funds can experience pricing-related arbitrage activity when yields fall and money fund yields drop more slowly than market yields. However, this phenomenon is experienced mostly in institutional money market funds, and is usually handled by refusing to accept large purchases that are arbitrage-related rather than by imposing a redemption fee. In the case of stable-value mutual funds, where the divergence between NAV and market value can be much larger than in money market funds, funds have typically adopted redemption fees that are designed to apply if the constant book-value NAV is significantly higher than market prices, presenting a risk of dilution if the fund has redemptions in a rising rate environment. Redemption fees are necessary for such funds because the stale-price problem can become extremely severe, with spiraling effects similar to a run on a bank if not checked.

cc:
Hon. William H. Donaldson, Chairman of the Securities and Exchange Commission
Hon. Paul Atkins, Commissioner
Hon. Roel Campos, Commissioner
Hon. Cynthia A. Glassman, Commissioner
Hon. Harvey Goldschmid, Commissioner

Division of Investment Management:
Paul Roye, Director
Cynthia Fornelli, Deputy Director
Robert Plaze, Associate Director
C. Hunter Jones, Assistant Director
Shaswat K. Das, Senior Counsel

Attachment 1

Fidelity fund redemption fees as of May 1, 2004

Fidelity Funds/Classes with Redemption Fees
As of May 27, 2004

	Fee Rate	Term
Domestic Equity		
Small Cap Stock	2.00%	90 days
Aggressive Growth	1.50%	90 days
Leveraged Company Stock	1.50%	90 days
Low-Priced Stock	1.50%	90 days
Small Cap Independence	1.50%	90 days
Small Cap Retirement	1.50%	90 days
Tax Managed Stock	1.00%	2 years
Advisor Focus Funds (10 funds)	1.00%	60 days
VIP Contrafund Service Class 2 R	1.00%	60 days
VIP Equity-Income Service Class 2 R	1.00%	60 days
VIP Growth Service Class 2 R	1.00%	60 days
VIP Sector Portfolios (7 funds)	1.00%	60 days
Real Estate Investment	0.75%	90 days
Real Estate Income	0.75%	90 days
Export & Multinational	0.75%	30 days
Fidelity Fifty	0.75%	30 days
Focused Stock	0.75%	30 days
Mid-Cap Stock	0.75%	30 days
Select Portfolios (41 funds)	0.75%	30 days
Structured Large Cap Growth	0.75%	30 days
Structured Large Cap Value	0.75%	30 days
Structured Mid Cap Growth	0.75%	30 days
Structured Mid Cap Value	0.75%	30 days
Index		
Spartan International Index	1.00%	90 days
Nasdaq Composite Index	0.75%	90 days
Spartan Extended Market Index	0.75%	90 days
Four-In-One Index	0.50%	90 days
Spartan 500 Index	0.50%	90 days
Spartan Total Market Index	0.50%	90 days
International Equity: Broadly Diversified		
International Small Cap (retail & Advisor classes)	2.00%	90 days

VIP Overseas - Initial Class R, Service Class R & Service Class 2 R	1.00%	60 days
Advisor Diversified International	1.00%	30 days
Advisor Europe Capital Appreciation	1.00%	30 days
Advisor Global Equity	1.00%	30 days
Advisor International Capital Appreciation	1.00%	30 days
Advisor Overseas	1.00%	30 days
Aggressive International	1.00%	30 days
Diversified International	1.00%	30 days
Europe	1.00%	30 days
Europe Capital Appreciation	1.00%	30 days
Global Balanced	1.00%	30 days
International Growth & Income	1.00%	30 days
Overseas	1.00%	30 days
Worldwide	1.00%	30 days
International Equity: Single Country/Regional Emerging Markets		
Advisor Emerging Asia	1.50%	90 days
Advisor Emerging Markets	1.50%	90 days
Advisor Japan	1.50%	90 days
Advisor Korea	1.50%	90 days
Advisor Latin America	1.50%	90 days
Canada	1.50%	90 days
China Region	1.50%	90 days
Emerging Markets	1.50%	90 days
Japan	1.50%	90 days
Japan Smaller Companies	1.50%	90 days
Latin America	1.50%	90 days
Nordic	1.50%	90 days
Pacific Basin	1.50%	90 days
Southeast Asia	1.50%	90 days
High Income		
Advisor High Income	1.00%	90 days
Advisor High Income Advantage	1.00%	90 days
Capital & Income	1.00%	90 days
High Income	1.00%	90 days
Advisor Floating Rate High Income (retail & Advisor classes)	1.00%	60 days
VIP High Income (Initial Class R, Service Class R & Service Class 2 R)	1.00%	60 days
Emerging Market Debt		
Advisor Emerging Markets Income	1.00%	90 days
New Markets Income	1.00%	90 days
Taxable Bond		
Ultra-Short Bond (retail & Advisor classes)	0.25%	60 days
Municipal Bond: State		
Spartan AZ Municipal Income	0.50%	30 days
Spartan CA Municipal Income (retail & Advisor classes)	0.50%	30 days
Spartan CT Municipal Income	0.50%	30 days

Spartan FL Municipal Income	0.50%	30 days
Spartan MA Municipal Income	0.50%	30 days
Spartan MD Municipal Income	0.50%	30 days
Spartan MI Municipal Income	0.50%	30 days
Spartan MN Municipal Income	0.50%	30 days
Spartan NJ Municipal Income	0.50%	30 days
Spartan NY Municipal Income (retail & Advisor classes)	0.50%	30 days
Spartan OH Municipal Income	0.50%	30 days
Spartan PA Municipal Income	0.50%	30 days
Municipal Bond: Federal		
Spartan Intermediate Municipal Income	0.50%	30 days
Spartan Municipal Income	0.50%	30 days
Spartan Short-Intermediate Municipal Income (retail & Advisor classes)	0.50%	30 days
Spartan Tax-Free Bond	0.50%	30 days