May 10, 2004

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

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

Dear Mr. Katz:

Morningstar, Inc. ("Morningstar") is pleased to provide comments on the Securities and Exchange Commission's (the "Commission") proposed rule, *Mandatory Redemption Fees for Redeemable Fund Securities* (the "proposal"). This proposal would amend rules under the Investment Company Act of 1940 to require mutual funds (with certain limited exceptions) to impose a two percent redemption fee on the redemption of shares purchased within the previous five days in order to deter short-term trading of mutual funds. The redemption fee in the proposal would be retained by the fund.

Thank you for the opportunity to express our views regarding this important proposal, which we generally support. It should stop short-term traders who don't think their strategy can earn a profit in excess of two percent from using most mutual funds as their trading vehicle. For rapid traders who persist in using mutual funds, the proposal could at least partially reimburse long-term shareholders for the negative impact of this trading. We think the proposed mandatory redemption fee should be disclosed as part of the rule governing the mutual fund confirmation document provided to fund investors, which is proposed in a new point-of-sale disclosure rule.

We think that it is wise for the Commission to exercise its authority under section 22(c) of the Investment Company Act to require funds (with certain exceptions) to impose the two percent redemption fee on shares held for five business days or less. While we generally think transparency regarding fees or the lack thereof allows investors to best decide for themselves how to allocate their capital, recent events have shown that given the opportunity, many mutual fund advisory firms will exploit long-term shareholders by making special arrangements with short-term traders in order to secure profits for themselves, even when this practice violates the terms of a prospectus. In this case, the marketplace has been an inadequate regulator and we now believe that the Commission's proposal to mandate redemption fees is warranted, We believe that redemption fees, when used in tandem with fair-value pricing, should significantly reduce, if not eliminate, stale-price arbitrage opportunities. As such, we think that these practices can go a long-way to protect the interests of long-term shareholders. Since the mandatory redemption fees proposed by the Commission would go to the fund rather than to fund's advisor they would benefit long-term shareholders. They are thus quite distinct from other expenses that go to the advisor.

Our largest concern with proposed rule 22c-2 is that it would not permit funds to impose a redemption fee greater than two percent of assets. Some fund managers have determined that the profits of short-term trading may exceed two percent. That threshold may therefore be insufficient to keep short-term traders at bay. We would prefer a rule that mandated a two percent minimum redemption fee for very short-term trading but would allow funds to impose even higher fees if they so chose. This may encourage some funds to embrace "tiered" redemption fee structures that step down depending on the length of the holding period.

However, we recognize that the primary reasoning behind the uniformity of the two percent fee as proposed was "to simplify the implementation of the rule and better enable intermediaries that hold shares in omnibus accounts to establish and maintain systems to collect these fees." We recognize that omnibus accounts have been important targets for short-term traders because of their limited transparency. We think that proposed rule 22c-2's flexible, tripartite method for identifying the actual account owners within omnibus accounts would give the funds and financial intermediaries the ability to impose appropriate redemption fees. Given the enhanced control over omnibus accounts, we are thus uncertain as to why the Commission maintains the importance of a uniform redemption fee for all funds. Nevertheless, should the Commission's professional staff determine that a uniform redemption fee is imperative for the smooth and effective application of redemption fees to omnibus accounts, this goal should trump our call for allowing mutual funds to impose a higher redemption fee above a two percent minimum. We think that an effort to reduce the profitability of all short-term trading would be a more important deterrent than an effort to completely stamp it out in some places while allowing it to proceed unimpeded in others.

Our opinion regarding the proposed rule's minimum five-day holding period before an investor could redeem shares without triggering the two percent redemption fee is similar to our view that, barring problems associated with omnibus accounts, funds should be able to impose a redemption fee in excess of two percent. That's because we think that one of the most promising deterrents to short-term trading would be a tiered or laddered redemption fee depending on how long a shareholder was invested in a fund. Thus it may be that some funds might come to the conclusion that the most effective way to stem the short-term trading associated with "time-zone arbitrage" would be to impose a redemption fee in excess of two percent for trades made within two days of purchase. These funds may also determine that while the costs associated with trades over longer periods diminish, there are still some negative effects on long-term shareholders when some investors hold shares for only weeks or several months. They may well then want to institute a policy by which redemption fees slide downward over time. We are thus pleased that the Commission's proposal does not preclude funds from imposing a redemption fee for periods in excess of five days.

In principle, we see no reason why redemptions less than $2,500 should be exempt from the short-term redemption fees. Morningstar prides itself on representing the interests of smaller investors. While the proposal to allow or require funds to exempt redemptions below $2,500 is made in the name of smaller investors, we believe that smaller investors' interests are best served by taking a long-term view of their investments. The redemption fee could simply encourage smaller investors to take a similar long-term view.

That said, we understand that in practical terms the costs associated with collecting the redemption fee for small amounts may not be worth the benefits to long-term shareholders. We think the proposal takes a logical stand by allowing fund firms to make this cost-benefit analysis. We also understand that it may make sense to require funds to make the $2,500 *de minimis* exemption, as the uniformity of the requirement may help intermediaries. Consequently, we would not oppose either a voluntary or a mandatory *de minimis* exemption, but we don't think that exemption should exceed the proposed $2,500. A mandatory *de minimis* exemption at one level (e.g. $2,500) and a voluntary exemption at another level (e.g. $10,000) sends the wrong message. It wouldn't provide the uniformity that presumably would help administrators of omnibus accounts and it seems to open the gates a bit for rapid trading.

Despite our belief that in principle even smaller investors shouldn't be exempt from the redemption fee, we completely support the proposal's waiver of redemption fees in the case of an unanticipated financial emergency, upon written request of the shareholder. We also support the proposal's requirement that the fund would be required to waive the fee on redemptions of $10,000 or less and permit funds to waive the redemptions in excess of $10,000 in emergency situations. Shareholders should plainly disclose and certify the cause for their appeal for emergency exemption.

Although in an ideal world, fund company discretion in determining what constitutes an emergency would be best, in practice we think the expenses associated with making wide-ranging decisions could be high. Therefore, we think the rule should provide guidelines to the fund companies on what would constitute an unanticipated financial emergency. We think that death, disability, or other specific personal emergencies and personal economic hardship or unanticipated changes in personal circumstances should qualify. It may be beneficial if the exceptions for this rule were aligned with Internal Revenue

Service (IRS) guidelines regarding financial hardship, where the focus is on "unforeseeable emergencies." We think the rule should offer quite specific guidelines and examples to fund administrators because this would relieve a great deal of the administrative burden and thus reduce costs that could be borne by fund shareholders.

Finally, we support the Commission's proposed fund exceptions for money market funds, ETFs, and fund that are explicitly designed (and so state in their prospecti) to permit short-term traders and that explain to shareholders that this policy can impose additional costs on long-term shareholders.

We also think that the Commission should consider making an exception for ultra-short duration bond funds. Though these funds are not designed to help investors manage cash (as are money market funds), they in fact are used in this way by many. Since we don't see how short-term traders could exploit these very short-duration funds, we think that providing investors liquidity without the burden of redemption fees has merit.

Overall, we are pleased that the Commission has proposed a meaningful step in the direction of deterring the short-term trading of mutual funds. We think that a mandatory minimum redemption fee of two percent for shares purchased in the previous five days will certainly reduce the profitability of short-term trading strategies and will offset the cost of theses trades for long-term investors. Morningstar has a longstanding public record of encouraging investors to take a long-term view of their investments. Long-term investors would be well served by this proposed rule. We thank the Commission for its work on this rule and for giving us the opportunity to comment on it.

Sincerely,

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