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PFPC

May 10, 2004

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

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

Dear Mr. Katz:

PFPC Inc. ("PFPC") appreciates the opportunity to comment on the recent Securities and Exchange Commission (the "Commission") proposal to establish a new rule under the Investment Company Act that would require mutual funds to impose a two percent redemption fee on the redemption of shares purchased within the previous five days. This proposed new rule is designed to require short-term shareholders to reimburse the mutual fund for costs incurred when they use the fund to implement short-term trading strategies, such as market timing.

PFPC is a wholly-owned subsidiary of The PNC Financial Services Group, Inc. ("PNC"), Pittsburgh, Pennsylvania, which is one of the largest diversified financial services organizations in the United States. PNC's major businesses include regional community banking, corporate banking, real estate finance, asset-based lending, wealth management, asset management, and global fund processing services. As PNC's primary fund processing services affiliate, PFPC provides a full range of services to investment companies, including transfer agency and shareholder servicing support services. PFPC is the largest full-service mutual fund transfer agent in the United States.

In addition to the proposed redemption fee rule, over the last five months the Commission has engaged in significant rulemaking activities that provide investment companies with tools to discourage market timing activities. For example, the Commission has issued a final rule on compliance programs for investment companies and investment advisors, and has issued a rule proposal on disclosures regarding market timing and selective disclosure of portfolio holdings. These rulemaking initiatives both reinforce fair value pricing requirements for mutual funds and limit the disclosure of mutual fund portfolio holdings to those who may use this information to conduct market timing activities. In PFPC's opinion, these measures will enable mutual funds to effectively deter market timers from employing short-term trading strategies at the expense of long-term shareholders.

In response to the Commission's request for comment, PFPC is in favor of reform to deter market timing, but PFPC has concerns with a number of the provisions contained within the current draft and would like to offer specific suggestions for modification of certain aspects of the proposed rule. Our comments, in the order set forth in the proposing release, address the following: *(1) calendar days versus business days; (2) need for clarity regarding financial hardships; (3) support for the rule's flexibility in connection with financial intermediaries; (4) concerns about inefficiencies resulting from required data exchanges from financial intermediaries; (5) exclusions for multi-tiered fund/account structures; (6) an exclusion for 529 Plans; (7) an exclusion related to pre-arranged transactions; and (8) the implementation period.*

1. Calendar Days versus Business Days

PFPC recommends that the proposed rule be revised to require a minimum seven calendar day holding period instead of a five business day holding period. This change would be easier for shareholders to understand and for any necessary computer programming efforts, since calendar days are more predictable and more easily defined than business days.

2. Need for Clarity Regarding Financial Hardships

The proposed rule provides an exception for a shareholder that has an unanticipated financial hardship, whereby the shareholder can redeem shares without the imposition of a redemption fee. Under the proposed rule, such a shareholder would be required to submit a request in writing to a mutual fund in order to obtain a fee waiver. While the intent of this provision is laudable, the rule as proposed may cause confusion for shareholders and create operational, legal and regulatory risks for financial intermediaries and mutual funds.

If the rule were implemented as proposed, each mutual fund would have to set its own standards as to what constitutes an unanticipated financial emergency, and identify what documentation, if any, would be required to ensure that such an emergency in fact exists. Financial intermediaries would also need to keep track of each mutual fund's policies and documentation requirements. Moreover, each claim of unanticipated financial emergency would have to be evaluated to ensure that it meets each mutual fund's particular policy.

Not only would such an environment likely result in shareholder confusion, as shareholders would have to understand the different policies of each fund, but financial intermediaries and mutual funds may also endure added regulatory and legal risks in administering this exception. For instance, regulatory risk may arise if a financial intermediary or fund erroneously grants a waiver to a shareholder when a bona fide unanticipated financial emergency does not exist. Additional legal risk is also implicated by circumstances where a waiver is not granted when an unanticipated financial emergency claim is rejected and the affected shareholder files a complaint.

In order to avoid the shareholder confusion and additional risks addressed above, PFPC believes that the rule should be modified to specify what would constitute an unanticipated financial emergency, and what supporting documentation, if any, is to be provided by shareholders to validate that such emergency conditions exist. As an alternative measure, we suggest the Commission consider modifying the rule to provide a safe harbor for funds to act on any written claim of unanticipated financial hardship.

3. Support for the Rule's Flexibility in Connection with Financial Intermediaries

The proposed rule provides three alternative methods that would enable mutual funds and financial intermediaries to assure that appropriate redemption fees are imposed. PFPC appreciates the proposed rule's flexibility that would enable funds and financial intermediaries to select a methodology that would best suit their respective operational and business environments. In particular, PFPC believes that the third method (described below) would be critical and recommends that it be preserved in the final rule.

The third method provides for mutual funds to enter into agreements with financial intermediaries requiring the financial intermediary to impose redemption fees and remit the proceeds to the mutual fund. PFPC believes that this option is critically important for financial intermediaries that aggregate individual shareholders' trades for the purpose of placing omnibus trades with a mutual fund, because such financial intermediaries are best positioned to impose the redemption fee from a processing perspective. Moreover, these financial intermediaries are also better positioned to detect market timing strategies that are designed to avoid detection at mutual funds.[1] PFPC therefore recommends that, should the Commission adopt the proposed rule, option three be preserved as one of the approved methods.

4. Concerns about Inefficiencies Resulting from Required Financial Intermediary Data Exchanges

Although PFPC supports the flexibility provided by the three alternative methods of imposing redemption fees, PFPC does not support the proposed rule's requirement that financial intermediaries provide extensive data to funds on at least a weekly basis as it would add unwarranted costs and artificial inefficiencies into the mutual fund industry. The mutual fund industry is multifaceted and, over time, certain financial intermediaries have established omnibus account trading relationships with mutual funds. This practice has prospered as a result of financial intermediaries and mutual funds responding to market opportunities while leveraging each other's expertise and capabilities in an efficient processing environment.

Omnibus accounts bring significant efficiencies to the mutual fund industry. In fact, according to the National Association of Securities Dealers ("NASD") "Report of the

[1] For example, market timing strategies that employ multiple accounts are more likely to be detected by a financial intermediary than a mutual fund, since the financial intermediary is in a better position to evaluate common account names and/or household/address information than the mutual fund that receives transactions from financial intermediaries.

Omnibus Account Task Force[2]," there are currently more than one hundred million shareholders that invest through financial intermediaries that utilize an omnibus processing method. The report also noted that many of these shareholders place numerous small orders through periodic purchase plans. Often, a single such investment is split into multiple investments across several mutual funds. While the report did not provide an estimate of the number of transactions these shareholders place with mutual funds each year, it is reasonable to conclude that more than a billion detailed mutual fund investments are generated from these shareholders on an annual basis.

The proposed rule would require that, on at least a weekly basis, financial intermediaries provide mutual funds the taxpayer identification number, and the amount and dates of all purchases, redemptions, or exchanges for each shareholder within an omnibus account during the previous week. Moreover, the proposed rule appears to contemplate that mutual funds would in some manner post this information to their systems and perform analyses to discern whether redemption fees were appropriately imposed and commission breakpoints accurately calculated. In order to achieve these goals, mutual funds would have to analyze or shadow-post transactions that have already been posted by the financial intermediary. Implicit in these daunting tasks is additional work to reconcile positions and resolve inevitable discrepancies. Consequently, mutual funds would be required to receive, reconcile, analyze or post, and address discrepancies for billions of trades annually. The sole intended benefit of requiring mutual funds to process all of these detailed transactions appears to be that mutual funds could validate that the financial intermediaries are doing their jobs to accurately calculate redemption fees and commission breakpoints.

However, even if mutual funds were to receive and post billions of transactions annually, they would still not be able to fully determine whether or not commission breakpoints were accurately calculated, because the data elements provided for in the proposed rule are insufficient to make such a determination. For instance, the proposed rule does not address the identification of shareholders linked within a household or family relationship. Accordingly, even if financial intermediaries were to transmit these many transactions to mutual funds, and mutual funds were to receive, analyze and/or post these trades, mutual funds would not be able to determine whether the financial intermediaries calculated the breakpoints accurately.

PFPC believes that the enormous inefficiencies that the required data exchange would impose on the mutual fund industry to perform duplicative work for such an incredible number of transactions far outweighs any benefit that might be achieved.

5. Exclusion for Multi-Tiered Fund/Account Structures
The rule as proposed would require a mutual fund to impose the 2% redemption fee unless the redemption transaction or the particular mutual fund is excepted from the rule. The release notes four exceptions and requests comment on whether other funds should be excepted. If the rule is adopted, we urge the Commission to exclude mutual funds in the top

[2] NASD, January 30, 2004.

tier of a multi-tiered structure such as fund-of-funds, variable annuities and master-feeder funds. However, PFPC believes it would be appropriate to include within the proposed rule's purview the mutual funds in the bottom tier of such structures (e.g., feeder funds) because that is the tier at which market timing activities would occur. In a master-feeder structure, for example, feeder funds aggregate all shareholders' investments and redemptions and, in turn, purchase or redeem shares of a master fund. Due to the impact of aggregation, a particular market timer's transactions would be impossible to police at the top tier. Nonetheless, if shareholders in a particular feeder fund were exclusively long-term shareholders, there would assuredly be cases where due to differing investment and redemption patterns of such shareholders the master fund would be required to impose the redemption fee. In sum, PFPC's concern is that, absent an exclusion for the top tier in these multi-tier structures, redemption fees would need to be collected without relation to market timing activities.

Similarly, PFPC recommends that omnibus trades that represent an aggregation of individual shareholder transactions be excluded from the rule. Financial intermediaries that trade with mutual funds on an aggregate omnibus basis receive trade instructions from their shareholders. These trade instructions would be subject to the mandatory redemption fee as discussed in the proposed rule. However, the proposed rule does not include an explicit exception for trades at the omnibus level, where financial intermediaries aggregate the individual transactions and place a single purchase and/or redemption for the financial intermediary's omnibus account with a mutual fund. Trades that originate from these omnibus accounts typically occur each business day, and therefore may trigger the redemption fee unless excluded by the rule. Since trades at the individual level would be subject to the redemption fee, it would seem inappropriate to also subject the mandatory redemption fee at the aggregate omnibus trade level.

6. Exclusion for 529 Plans

PFPC recommends further that Section 529 college savings plans ("529 Plans"), like the aforementioned multi-tiered structures, be excepted from the proposed rule even though the bottom tier of 529 Plans would be outside of the rule's purview. 529 Plans are simply not attractive market timing vehicles because 529 Plans do not permit frequent exchanges, and any withdrawals for non-qualified purposes are subject to adverse tax penalties. As a result, 529 Plans pose almost no market timing risk. In contrast, the imposition of a redemption fee on 529 Plan transactions would likely harm long-term 529 Plan investors for the same reasons as articulated above for other multi-tiered structures. PFPC respectfully urges the Commission to consider excluding the top tier of multi-tiered structures and 529 Plan investments from the rule's purview.

7. Exclusion Related to Pre-Arranged Transactions

PFPC recommends that the proposed rule be revised to exclude pre-arranged transactions, including those transactions that are established by the shareholder and subsequently executed by the financial intermediary or mutual fund, and those transactions that are a function of the investment product. Financial intermediaries and mutual funds offer a variety of services to shareholders that want to place regularly scheduled purchases or redemptions, such as those made pursuant to automatic investment plans and systematic withdrawal plans. In addition, certain investment products provide for the periodic redistribution of assets among mutual funds. These redistribution transactions are a function of the investment product, rather than individual client instructions. Because transactions generated by the financial intermediary or mutual fund based on shareholder standing instructions or product features are unlikely to be associated with market timing activity, it is appropriate to exclude such transactions from the proposed rule. In doing so, the Commission would help innocent long-term investors from inadvertently triggering redemption fees.

8. Implementation Period

The rule as proposed would require modifications to existing systems and system interfaces at or between financial intermediaries and mutual funds. Also, new operational processes will have to be established to manage the processing of the redemption fee, consideration of unanticipated financial emergency requests, and the process of receiving, reconciling, posting, and analyzing detailed transactions behind omnibus accounts. In addition, revisions need to be implemented to call center scripts, forms, and web sites. PFPC strongly urges that, if the Commission decides to implement this rule, the Commission provide enough time for these systems to be modified and operational practices to be established. Accordingly, PFPC recommends that, if the rule is implemented, compliance be tolled for at least a nine-month period.

PFPC appreciates the opportunity to express its views regarding the proposed rule. Should you have any questions or require additional information, please do not hesitate to contact me.

Sincerely,

Michael DeNofrio
Executive Vice President –Senior Managing Director
Investing Services- Transfer Agency

cc: James S. Keller
Chief Regulatory Counsel
The PNC Financial Services Group