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MEMORANDUM

To: Files

From: Hester Peirce HP

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

Date: August 3, 2004

On June 15, 2004, Jerry Wagner and Peter Mauthe of the Society of Asset Allocators and Fund Timers, Inc. (SAAFTI) and Bob Knott and Keith Hartwell of Edelman met with Commissioner Atkins and Hester Peirce, counsel to the Commissioner, to discuss the Commission's mandatory redemption fee proposal. The SAAFTI representatives discussed the views contained in the SAAFTI and Fidelity Investments comment letters (both available in File No. S7-11-04). The handouts they distributed are attached.

Mandatory Redemption Fees or User Fees Would Harm Individual Investors

1. Most 401k participants participate in payroll deduction plans so they will be "trading" every two weeks in the mutual funds that are offered in their employer plan. Under S. 2059 that individual will be hit with a redemption fee if he/she makes any changes in the five days subsequent to their payroll date. That change could be for two reasons, both of which occur frequently: (1) they feel the market is going to move lower and they want to move from stock funds to bond funds or money market funds to protect their principal; (2) they want to rebalance their account based on whatever asset allocation model they are using.

   During 25 weeks of the year (the week immediately after payroll) the provision as written takes away the investor's ability to make any decisions about his/her own savings without incurring a large penalty. That is a large price to pay for individuals who are not the target of this fee. With millions of investors it is inevitable that they will lose track of this timing and get hit with the fee inadvertently.

2. The provision as written allows fees in excess of 2 percent to be based on an undefined period of time and subjective determination of what is "unfair" to the shareholders. Mutual fund companies will try to make the time period as long as possible and the definition of "unfair" as broad as possible because it is in their best interest to deter anyone from leaving the fund. Royce Select Fund for instance has now imposed a redemption fee of 2% for as long as three years. The ability for mutual funds to "skim" using redemption fees will not be addressed adequately enough without mandating that funds justify a redemption fee by specifically ascertaining the costs incurred.

3. Redemption fees are a blunt instrument that will not accommodate individual emergencies. Individual investors may need to take their money out of mutual funds for countless reasons and they will not always be able to time those reasons.

4. A 2% user fee will cause investors to hesitate in responding to sharply lower market moves, resulting in greater losses. Over the past 10 years, there have been 404 occurrences where an investor waiting five days to avoid a 2% redemption penalty would have experienced a greater than 2% loss. Five of these instances would have resulted in a loss of greater than 10%, while 46 occurrences would have resulted in losses from 5 to 10%. Individual investors should have the right to exit the fund when they believe it is under performing or have concerns about the direction of markets. Arbitrarily inhibiting the liquidity of open ended mutual funds, i.e. applying redemption fees to transactions that are punitive rather than simply recovering extra costs that may result from such transactions, seems (1) to inappropriately mandate

an investing philosophy on private investors and (2) to fly in the face of the SEC's position relative to the importance of liquidity as stated in Fidelity Korea Fund No-Action Letter in 2001.

SAAFTI is the premier organization for investment advisers who believe in utilizing active investment strategies designed to protect clients against market downturns and capitalize on up trends in the market. SAAFTI regular members are registered investment advisers, actively managing assets for clients using dynamic asset allocation, sector rotation and other active management strategies. Collectively, they manage an estimated $14 billion in client assets.

*For more information on SAAFTI, visit the association's home page at **http:\\www.saafti.com**.*

How Redemption Fees or User Fees Would Harm Everyday Investors

End Of Year	$4000/Year Contribution	Annual Return	% of Rebalances Affected by Red. Fee	Redemption * Fee Cost	Year End Balance
	$ 4,000	6.00%	25%		
0	Average mutual fund investor today has				$75,000
1	$4,000	$4,500	25%	$406	$83,094
2	$4,000	$4,986	25%	$448	$91,631
3	$4,000	$5,498	25%	$492	$100,637
4	$4,000	$6,038	25%	$538	$110,137
5	$4,000	$6,608	25%	$587	$120,158
6	$4,000	$7,210	25%	$639	$130,729
7	$4,000	$7,844	25%	$693	$141,880
8	$4,000	$8,513	25%	$751	$153,642
9	$4,000	$9,219	25%	$811	$166,049
10	$4,000	$9,963	25%	$875	$179,137
11	$4,000	$10,748	25%	$943	$192,942
12	$4,000	$11,577	25%	$1,014	$207,505
13	$4,000	$12,450	25%	$1,089	$222,867
14	$4,000	$13,372	25%	$1,168	$239,071
15	$4,000	$14,344	25%	$1,251	$256,164
16	$4,000	$15,370	25%	$1,339	$274,195
17	$4,000	$16,452	25%	$1,432	$293,214
18	$4,000	$17,593	25%	$1,530	$313,277
19	$4,000	$18,797	25%	$1,633	$334,441
20	$4,000	$20,066	25%	$1,742	$356,765

21	$4,000	$21,406	25%	$1,857	$380,313
22	$4,000	$22,819	25%	$1,979	$405,153
23	$4,000	$24,309	25%	$2,107	$431,356
24	$4,000	$25,881	25%	$2,241	$458,996
25	$4,000	$27,540	25%	$2,384	$488,152
26	$4,000	$29,289	25%	$2,534	$518,907
27	$4,000	$31,134	25%	$2,692	$551,349
28	$4,000	$33,081	25%	$2,859	$585,570
29	$4,000	$35,134	25%	$3,036	$621,669
30	$4,000	$37,300.1	25%	$3,222	$659,747
			Total Redemption Fees Paid	$44,293	

* Redemption fee = (Prev year end bal + contribution + (0.5 * annual return)) * 2% red fee * % of rebalances

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What's Been Written About How Redemption Fees or User Fees Would Harm Everyday Investors

No one knows how much short term trades really cost a fund, and by saddling new fees on investors who want the flexibility to reclaim their own money, funds are penalizing people for practicing risk management with their life savings.

> "Meanwhile, back at the SEC, the regulatory blunderbuss was firing at full bore. The commission generated about 10 proposals for a myriad of new rules aimed at everything from disclosure to corporate governance. Most of these rules will hurt investors without adding anything to the party.
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> "Take the rule to impose a 2% redemption fee on investors who redeem their shares within five days of purchase. This rule is meant to stop trading on stale prices. But academic studies have shown that it will, at best, only discourage such trading, not end it, since stale-price trading would still be profitable after big market moves even after netting out the penalty fee. Worse, this fee would whammy innocent investors who have unexpected liquidity needs or even experience a change of mind.
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> "The really grating aspect of the SEC's extravaganza of rule-making is that there is a simple, non-harmful remedy for stale-price trading – fair-value pricing.
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> "The problem is that, after the headlines have faded, these regulations will raise costs, limit choices and diminish liquidity for the 95 million investors who invest in mutual funds."
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> -- *"Headline Risk at the SEC," The Wall Street Journal, May 10, 2004.*

> "One of the loudest voices in opposition has been that of the Society of Asset Allocators and Fund Timers Inc., an association of financial advisers who practice market timing and other legal strategies of moving money among different types of securities in order to boost return and reduce risk. 'The proposed redemption fee would penalize individual investors for responding to significant market events,' the group has said."
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> --*Karen Damato and Judith Burns, The Wall Street Journal, April 5, 2004.*

"Securities regulators remain divided over plans to require mutual funds to impose a 2% penalty on investors who sell fund shares within five days of buying them...Controversy is apparent, even within the SEC. Commissioner Paul Atkins called the fee a tax on fund investors and voted not to seek comment on it. Other commissioners expressed reservations but agreed to get public reaction to the plan."

--Judith Burns, Dow Jones Newswires, April 14, 2004.

"This mandatory fee will not fully prevent, or protect investors from, the recent market timing abuses that have come to light. Further, potentially subjecting investors to an unnecessary, mandatory fee is not serving as their advocate. It is a fund 'tax' that will hit the unwary..."

--SEC Commissioner Paul S. Atkins at an open meeting of the SEC, February 25, 2004.

"A redemption fee 'is a very coarse weapon – it affects everyone, not just the ones who are the target. The longer the holding period and the higher the fee, the more we deter short-term trading, but the more we affect the long-term investors, too.'"

--Professor K. Geert Rouwenhorst, Yale School of Management in The New York Times, November 21, 2003.

"Many scholars who have studied the problem say that high redemption fees could wind up hurting the very people Congress is trying to protect – the long term, middle-income investors in mutual funds – by making it riskier for them to invest money they might need for emergencies."

--The New York Times, November 21, 2003 (Diana B. Henriques).

"It comes down to the difference between treating a symptom and curing the disease. 'If mutual fund shares were priced correctly, there would be no opportunities for market timers and thus redemption fees would be unnecessary.'"

--Professor John M. R. Chalmers, Lundquist College of Business, University of Oregon in the New York Times, November 21, 2003.

"The beautiful thing about mutual funds was that they gave you infinite liquidity. You can imagine a situation where, hell, you just invested and you suddenly need the money. After all, stuff happens."

--Professor Robert F. Whitelaw, Stern School of Business, New York University, in The New York Times, November 21, 2003.

"Information and disclosure requirements should be designed to provide investors with real value rather than serve mainly to increase costs and decrease returns."

--Federal Reserve Board Chairman Alan Greenspan and Treasury Secretary John W. Snow in a letter to the Honorable Richard Shelby, Chairman of the Senate Committee on Banking, Housing, and Urban Affairs and the Honorable Michael Oxley, Chairman of the House Committee on Financial Services, November 18, 2003.

"Members of Congress were chagrined to hear testimony that seemingly small amounts skimmed from profits added up to substantial losses over time. For example, Spitzer testified that if the management fees that funds charge their shareholders were cut by as little as a quarter of 1%, the annual savings to shareholders would be $10 billion."

--The Los Angeles Times, November 10, 2003 (Jonathan Peterson).

"There are some glaring ironies involved in the fund timing scandal, but perhaps none bigger than this one: The attack on the general idea of using mutual funds to make market-timing moves comes as many Wall Street pros — and many individual investors — have concluded that 'buy and hold' may not be the best strategy in this decade.

"If the effect of the unfolding scandal is to make it more difficult for all investors to make changes in their portfolios, or to justify changes, it isn't at all clear that the average fund owner's interests would be helped. It might be just the opposite."

--The Los Angeles Times, November 9, 2003 (Tom Petruno).

"...some of the early 'reforms' now being talked about in Congress and the SEC would punish the innocent along with the guilty. Charging fees for quick fund trades, for example, could hurt honest folk who have a sudden need for their cash ... let's hope the political class takes more time and care in thinking about all of this than it did after the accounting scandals of 2002."

-- *The Wall Street Journal, November 5, 2003.*

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THE WALL STREET JOURNAL.

REVIEW & OUTLOOK

Headline Risk at the SEC

How to make the mutual-fund scandal worse.

Generally speaking, the mutual-fund industry is a great model of market capitalism. It is big, diverse and madly competitive. And if our say-so doesn't convince, then the fact that customers are happy to entrust several trillion dollars to mutual funds should suffice. So, why has the Securities and Exchange Commission embarked on a frenzy of rule-making directed at a wide range of industry workings?

The polite answer is that the SEC is overreacting to the scandal that surfaced nine months ago. That's when some funds were caught allowing large investors to engage in two dubious trading ploys: late trading and market timing. Late trading is the clearly illegal practice of placing orders after the day's close at 4 p.m., and market timing is the disruptive (but not illegal) practice of trading quickly in-and-out of a fund.

Both practices take advantage of the fact that funds do not price their securities on a continuous basis, but only once a day. This causes prices to be "stale" and open to gaming. Stale-price trading by some investors disadvantages all other investors.

But once the news of these trading practice was known, the market extracted its own punishment: Investors pulled tens of billions of dollars out of the guilty funds. Dozens of senior executives were fired. And, under existing law, the funds were required to ante-up large fines.

Meanwhile, back at the SEC, the regulatory blunderbuss was firing at full bore. The commission generated about 10 proposals for a myriad of new rules aimed at everything from disclosure to corporate governance. Most of these rules will hurt investors without adding anything to the party.

Take the rule to impose a 2% redemption fee on investors who redeem their shares within five days of purchase. This rule is meant to stop trading on stale prices. But academic studies have shown that it will, at best, only discourage such trading, not end it, since stale-price trading would still be profitable after big market moves even after netting out the penalty fee. Worse, this fee would whammy innocent investors who have unexpected liquidity needs or even experience a change of mind.

Ditto for the proposal to require a hard 4 p.m. close on orders. The current rule allows intermediaries—such as broker-dealers, banks and retirement funds—to aggregate orders from customers across the day and submit them after 4 p.m. The orders are time-stamped so that those received after 4 p.m. are not supposed to trade at that day's price. If these intermediaries now have to submit orders before 4 p.m., investors will have to make decisions early in the day—before the events of a complete trading day can be known.

The really grating aspect of the SEC's extravaganza of rule-making is that there is a simple, non-harmful remedy for stale-price trading—fair-value pricing. This technique requires funds to adjust stale prices to values that they would obtain if trading were continuous.

Even better, the remedy is already in place. The SEC mandated fair-value pricing in 2000 and 2001. Pretty much nobody paid attention and the SEC itself let the matter languish. Then, last December and again in April, two of the SEC rule-making proposals adopted on compliance and disclosure referenced the fair-value pricing requirement, underlining that mandate.

Recently, the SEC has made noises about taking disciplinary action against funds that failed to use fair-value pricing. Although the names of the funds have not been made public, the betting is that the targets come from the commission's survey, done in September, which found nearly a third of 960 funds had not used fair-value pricing in the previous 20 months.

Enforcement of a law already on the books is all that is necessary. It is regulatory overkill for the SEC to dictate the make-up of boards of directors, require a code of ethics or the disclosure of portfolio managers' compensation.

So, back to our question of why the SEC is proposing all these regulations, let us give the less polite answer: It has great headline value. The problem is that, after the headlines have faded, these regulations will raise costs, limit choices and diminish liquidity for the 95 million investors who invest in mutual funds.