SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

[Release No. IC-27255; File No. S7-06-06; File No. 4-512]

RIN 3235-AJ51

Mutual Fund Redemption Fees

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission ("Commission" or "SEC") is proposing amendments to the redemption fee rule we recently adopted. The rule, among other things, requires most open-end investment companies ("funds") to enter into agreements with intermediaries, such as broker-dealers, that hold shares on behalf of other investors in so called "omnibus accounts." These agreements must provide funds access to information about transactions in these accounts to enable the funds to enforce restrictions on market timing and similar abusive transactions. The Commission is proposing to amend the rule to clarify the operation of the rule and reduce the number of intermediaries with which funds must negotiate information-sharing agreements. The amendments are designed to address issues that came to our attention after we had adopted the rule, and are designed to reduce the costs to funds (and fund shareholders) while still achieving the goals of the rulemaking.

DATES: Comments must be received on or before April 10, 2006.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or

- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-06-06 on the subject line; or
- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303.

All submissions should refer to File Number S7-06-06. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/proposed.shtml). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Thoreau Bartmann, Staff Attorney, or C. Hunter Jones, Assistant Director, Office of Regulatory Policy, (202) 551-6792, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5041.

SUPPLEMENTARY INFORMATION: The Commission today is proposing amendments to rule 22c-2[1] under the Investment Company Act of 1940[2] (the "Investment Company Act" or the "Act").[3]

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[1] 17 CFR 270.22c-2.

[2] 15 U.S.C. 80a.

[3] Unless otherwise noted, all references to statutory sections are to the Investment Company Act, and all references to "rule 22c-2" or any paragraph of the rule will be to 17 CFR 270.22c-2.

I. BACKGROUND

On March 11, 2005, the Commission adopted rule 22c-2 under the Investment Company Act.[4] We adopted the rule to help address abuses associated with short-term trading of fund shares. Rule 22c-2 provides that if a fund redeems its shares within seven days[5], its board must consider whether to impose a fee of up to two percent of the value of shares redeemed shortly after their purchase ("redemption fee").[6] The rule also requires such a fund to enter into agreements with its intermediaries that provide fund management the ability to identify investors whose trading violates fund restrictions on short-term trading.[7]

When we adopted rule 22c-2 last March, we asked for additional comment on (i) whether the rule should include uniform standards for redemption fees,[8] and (ii) any problems with the

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4 See Mutual Fund Redemption Fees, Investment Company Act Release No. 26782 (Mar. 11, 2005) [70 FR 13328 (Mar. 18, 2005)] ("Adopting Release").

5 Because the large majority of funds redeem shares within seven days of purchase, the practical effect of rule 22c-2, and these proposed amendments, would be to require most funds to comply with the rule's requirements. Therefore, throughout this Release we may describe funds as being "required to comply" with a provision of the rule, when the actual requirement only applies if a fund redeems its shares within seven days. A fund that does not redeem its shares within seven days would not be required to comply with those provisions of rule 22c-2.

6 Rule 22c-2(a)(1). Under the rule, the board of directors must either (i) approve a fee of up to 2% of the value of shares redeemed, or (ii) determine that the imposition of a fee is not necessary or appropriate. Id.

7 Under the rule, the fund (or its principal underwriter) must enter into a written agreement with each of its financial intermediaries under which the intermediary agrees to (i) provide, at the fund's request, identity and transaction information about shareholders who hold their shares through an account with the intermediary, and (ii) execute instructions from the fund to restrict or prohibit future purchases or exchanges. The fund must keep a copy of each written agreement for six years. Rule 22c-2(a)(2),(3).

8 See Adopting Release, supra note 4, at Section II.C. As we noted when we adopted the rule, "[a]lthough we received comment on these [uniform standards] issues during the initial comment period, those comments were offered in the context of a mandatory redemption fee" rather than in the context of the voluntary approach that we adopted. See id.

rule that might arise during the course of implementation.[9] We received over 100 comment letters in response to the request for comment.[10] Commenters expressed various views on the need for uniform standards, but a number of commenters also raised concerns with the basic requirements of the rule.

In their letters in response to the rule's adoption, commenters representing fund managers and other market participants stated that implementing the rule would be more costly than we had anticipated, and requested that we address certain interpretive issues that arose in connection with the implementation of the rule.[11] The amendments we are proposing today address concerns and questions regarding rule 22c-2 that commenters have brought to our attention. These amendments are designed to reduce the costs of complying with the rule and clarify its application in certain circumstances.[12]

We also received comments on whether we should provide for a uniform redemption fee

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[9] See id.

[10] Comment letters on the 2004 proposal and the 2005 adoption are available in File No. S7-11-04, which is accessible at http://www.sec.gov/rules/proposed/s71104.shtml. References to comment letters are to letters in that file.

[11] For example, a number of commenters in their 2005 letters objected to the definition of "financial intermediary" and to the requirement that funds enter into agreements with these intermediaries to receive transaction information upon request. See, e.g., Comment Letters of OppenheimerFunds, Inc. (May 9, 2005), T. Rowe Price Associates, Inc. (May 24, 2005), and the Vanguard Group (June 1, 2005).

[12] We received a number of comments from insurance companies and other market participants that sell variable insurance products. Many of these commenters were concerned that rule 22c-2 could expose insurance companies to increased liability. These commenters stated that variable insurance product contracts typically include clauses that specify the maximum charges and fees that an insurance company can assess against an annuity holder. We do not believe that redemption fees charged pursuant to rule 22c-2 should be interpreted to cause insurance companies to breach their contracts with annuity holders. Redemption fees are not fees that the insurance companies are themselves imposing pursuant to the contract between the insurance company and its customer. Instead, the funds underlying the separate accounts will impose any redemption fees that are charged. See Miller v. Nationwide Life Ins. Co., 2003 WL 22466236 (E.D. La.) (Oct. 29, 2003), aff'd on other grounds, 391 F.3d 698 (5th Cir. 2004).

applicable to those funds whose directors determined to impose a redemption fee. While most commenters asserted that funds and intermediaries would likely achieve certain benefits or cost savings if the Commission mandated uniform redemption fee standards,[13] others disagreed, asserting that the best way to serve funds, intermediaries, and investors was by allowing each fund to adopt redemption fee policies that best fit its particular circumstances.[14] Among the commenters who argued that uniform standards would benefit market participants, no consensus emerged as to what those uniforms standards should be, if they were adopted. We are taking the commenters' views under advisement, but are not proposing uniform redemption fee standards at this time.

II. DISCUSSION

The amendments to rule 22c-2 we are proposing today (i) limit the types of intermediaries with which funds must negotiate information-sharing agreements, (ii) address the rule's application when there are chains of intermediaries, and (iii) clarify the effect of a fund's failure to obtain an agreement with any of its intermediaries.

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13 Comment Letter of Flexible Plan Investments Ltd., at 2 (May 9, 2005) ("[O]ne of the most complicating factors caused by redemption fees is the lack of uniformity in their calculation and imposition .… When intermediaries and advisors are dealing with many platforms and fund families, sorting out the requirements of each is a tremendous burden on the industry, adding costs that are simply passed on to investors."); Comment Letter of Horton, Lantz & Low at 1 (May 24, 2005) ("[T]he lack of uniformity may result in increased costs associated with our retirement plan. Such higher costs could arise through higher plan administration costs … or higher mutual fund expenses.").

14 See Comment Letter of the Vanguard Group at 6 (June 1, 2005) ("[M]andatory redemption fee standards are not appropriate or necessary in the context of a voluntary fee. We believe that standardization under these circumstances would create significant disincentives to the adoption of redemption fees that might otherwise benefit a fund.").

A. Small Intermediaries

Rule 22c-2 prohibits a fund from redeeming shares within seven days unless, among other things, the fund enters into written agreements with its financial intermediaries (such as broker-dealers and retirement plan administrators)[15] that hold shares on behalf of other investors.[16] Under those agreements, the intermediaries must agree to provide, at the fund's request, the shareholder identity (i.e., taxpayer identification number) and transaction

[15] "Financial intermediary" is defined in rule 22c-2(c)(1) as: (i) any broker, dealer, bank, or other entity that holds securities of record issued by the fund, in nominee name; (ii) a unit investment trust or fund that invests in the fund in reliance on section 12(d)(1)(E) of the Act (15 U.S.C. 80a-12(d)(1)(E)); and (iii) in the case of a participant-directed employee benefit plan that owns the securities issued by the fund, a retirement plan's administrator under section 3(16)(A) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002(16)(A)) or any entity that maintains the plan's participant records.

[16] Rule 22c-2(a)(2). Some commenters expressed concern about the ability of financial intermediaries to provide information to funds, in light of applicable privacy laws. See, e.g., 15 U.S.C. 6801-09, 6821-27 (privacy provisions of Gramm-Leach-Bliley Act); Regulation S-P, 17 CFR Part 248 (Commission rules implementing privacy provisions for funds, broker-dealers, and registered investment advisers). Under those laws, financial institutions such as funds, broker-dealers, and banks must provide a notice describing the institution's privacy policies and an opportunity for consumers to opt out of the sharing of information with nonaffiliated third parties. These privacy laws also contain important exceptions to the notice and opt-out requirements. Under the Commission's privacy rules, for example, these requirements do not apply to the disclosure of information that is "necessary to effect, administer, or enforce a transaction that a consumer requests or authorizes," which includes a disclosure that is "[r]equired, or is a usual, appropriate, or acceptable method … [t]o carry out the transaction or the product or service business of which the transaction is a part …" 17 CFR 248.14(a), (b)(2). See also 17 CFR 248.15(a)(7)(i) (notice and opt-out requirements not applicable to disclosure of information to comply with law). Financial privacy rules that are substantially identical to these rules apply to financial intermediaries other than broker-dealers, and contain comparable exceptions. See, e.g., 12 CFR Part 40 (rules applicable to national banks, adopted by the Comptroller of the Currency).

We believe that the disclosure of information under shareholder information agreements, and the fund's request and receipt of information under those agreements, are covered by these exceptions. We also note that financial institutions often state in their privacy policy notices that the institution makes "disclosures to other nonaffiliated third parties as permitted by law." See 17 CFR 248.6(b). Therefore we believe it will not be necessary for intermediaries such as broker-dealers and banks to provide new privacy notices or opt-out opportunities to their customers, in order to comply with rule 22c-2, both as adopted and as we propose to amend it.

information,[17] and carry out instructions from the fund to restrict or prohibit further purchases or exchanges by a shareholder (as identified by the fund) that has engaged in trading that violates the fund's market timing policies.[18] We designed this provision to enable funds to obtain the information that they need to monitor short-term trading in omnibus accounts and enforce their market timing policies.[19]

Many fund commenters expressed concern that the requirement would necessitate reviewing a large number of their shareholder accounts in order to determine which shareholders meet the definition of "financial intermediary."[20] They noted that because the definition encompasses any entity that holds securities in nominee name for other investors, it would therefore include, for example, a small business retirement plan that holds mutual fund shares on behalf of only a few employees. These commenters emphasized that the task of identifying these intermediaries, as well as negotiating agreements with them, will be costly and burdensome. The effect of the rule with respect to these small intermediaries was an unintended consequence of

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17 One commenter expressed concern that the contract provision of rule 22c-2, requiring that agreements with intermediaries mandate the disclosure of shareholder information at the fund's request, conflicts with Commission rules governing proxy solicitations. See Comment Letter of the American Bankers Association (June 6, 2005). The Commission's proxy solicitation rules are set forth in Regulation 14A under the Exchange Act, 17 CFR 240.14A. The proxy rules govern the disclosure of information in the context of proxy solicitations. They do not prohibit banks, broker-dealers and other intermediaries from complying with agreements entered into pursuant to rule 22c-2.

18 See proposed rule 22c-2(c)(5) (defining "shareholder information agreement," which is discussed further below in Section II.B).

19 As we noted when we adopted rule 22c-2 in 2005, a fund that receives shareholder information for a purpose permitted by the privacy rules under the exceptions to consumer notice and opt out requirements may not disclose that information for other purposes, such as marketing. See Adopting Release, supra note 4, at n.47 ("Our privacy rule prevents a fund that receives this [shareholder] information from using the information for its own marketing purposes, unless permitted under the intermediary's privacy policies. See 17 CFR 248.11(a) and 248.15(a)(7).").

20 See, e.g., Comment Letter of OppenheimerFunds, Inc. (May 9, 2005). At the suggestion of several commenters, we broadened the definition of "financial intermediary" in the final rule.

the rule, which we did not foresee when we modified the definition of 'financial intermediary' in response to the concerns that commenters raised with us.

We propose to revise rule 22c-2 to exclude from the definition of "financial intermediary" any intermediary that the fund treats as an individual investor for purposes of the fund's policies intended to eliminate or reduce dilution of the value of fund shares.[21] These types of policies include restrictions on frequent purchases and redemptions, as well as a fund's redemption fee program.[22] As a result, if a fund, for example, applies a redemption fee or exchange limits to transactions by a retirement plan (an intermediary) rather than to the purchases and redemptions of the employees in the plan, then the plan would not be considered a "financial intermediary" under the rule, and the fund would not be required to enter into an agreement with that plan.[23]

Our proposed approach, which was suggested by several commenters,[24] has advantages over the rule as initially adopted, while still achieving the goals of the initial rulemaking. First, when a fund places restrictions on transactions at the intermediary level (rather than the individual shareholder level), the fund is unlikely to need data about frequent trading by individual shareholders, because abusive short-term trading by the shareholders holding through the omnibus account would ordinarily trigger application of those policies to the intermediary's

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[21] Proposed rule 22c-2(c)(1)(iv).

[22] The rule excepts a fund from the requirement to enter into written agreements if, among other things, the fund "affirmatively permits short-term trading of its securities." See rule 22c-2(b)(3).

[23] Proposed rule 22c-2(c)(1)(iv) would exclude from the definition of "financial intermediary" any person the fund treats as an individual for purposes of the fund's policies on eliminating or reducing dilution in the value of fund shares. If a fund has not established such policies and thus determined which persons it treats as individuals, this exclusion would not apply, and the fund would need to identify those shareholder accounts that are "financial intermediaries."

[24] See, e.g., Comment Letter of the Securities Industry Association (May 9, 2005).

trades.[25] Therefore, transparency regarding underlying shareholder transactions executed through these accounts is unnecessary to achieve the goals of the rule. Second, our proposed approach would substantially eliminate the need for funds to devote resources to identifying intermediaries, because the funds will have already identified the relevant intermediaries in the course of administering their policies on short-term trading.

We request comment on this proposed amendment to the definition of financial intermediary.

- Should additional entities be excluded or included as financial intermediaries? Should funds be required to enter into agreements with any other types of entities? Should the definition of financial intermediary be revised in any other way to further the purposes of the rule or to reduce the cost of its implementation in a manner consistent with these purposes?[26] Should the rule contain additional (or different) exclusions?

- Is the proposed approach of allowing funds to determine which entities are financial intermediaries practical? Will this result in funds being more (or less)

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25 Individual transactions (e.g., by plan beneficiaries) in omnibus accounts (e.g., self-directed defined contribution plans) trigger corresponding transactions by the omnibus accounts with funds in which the plan invests on behalf of plan beneficiaries. In other words, when a plan participant allocates an investment to Fund A, the plan must buy an equivalent number of shares of Fund A. If the plan has not identified itself to the fund as an intermediary (so that a fund will not apply its redemption fee or market timing policies to plan transactions) even harmless transactions by a number of participants (as well as market timing transactions) will cause the plan to effect transactions with the fund that will trigger application of a fund's redemption fee or market timing policies to the plan. Plans that do not identify themselves as intermediaries will likely either have very few participants and/or restrict their transactions so that transactions by participants do not trigger application of a redemption fee or violate fund market timing policies.

26 See, e.g., rule 17Ad-20 under the Securities Exchange Act of 1934 [17 CFR 240.17Ad-20] (defining "securities intermediary" as a registered "clearing agency … or a person, including a bank, broker, or dealer, that in the ordinary course of its business maintains securities accounts

(footnote continued)

likely to impose redemption fees and restrictions on inappropriate short-term trading? Would the revised definition of financial intermediary create an incentive for funds to modify their market timing or redemption fee policies to treat more shareholders as individual investors?

- What are the costs to funds and financial intermediaries of the requirement to enter into agreements? How many new agreements will funds need to enter into with their intermediaries after the proposed revisions? How much will it cost to enter into a new agreement or modify an existing agreement to accommodate the requirement of rule 22c-2? Are there any other costs related to the agreement requirement?
- Should the definition of "shareholder" be revised?[27] For example, the definition excludes funds that rely on section 12(d)(1)(G) of the Act in order to invest in other funds in the same fund complex.[28] The Commission has proposed new rule 12d1-2 which, if adopted as proposed, would expand the ability of funds to rely on section 12(d)(1)(G). In light of this proposal, should the definition include these types of funds as shareholders (i.e., should the exclusion be deleted)?[29] Should the definition provide for different circumstances in which these types of funds will not be considered shareholders? For example, should the definition be revised to limit the exclusion to funds that rely on section 12(d)(1)(G), but that do

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for others in its capacity as such.").

27 See rule 22c-2(c)(4).

28 See Adopting Release, supra note 4, at n.55.

29 See Fund of Funds Investments, Investment Company Act Release No. 26198 (Oct. 1, 2003) [68 FR 58226 (Oct. 8, 2003)] (proposing rule 12d1-2).

not rely on rule 12d1-2 (if adopted)?

B. Intermediary Chains

In some cases, a brokerage firm may hold its shares of a mutual fund not only on behalf of individual investors, but also on behalf of other intermediaries, such as pension plans or other broker-dealers.[30] Fund commenters said that they were uncertain how rule 22c-2 applied to these arrangements, and expressed concern how, as a practical matter, a fund could obtain shareholder information through multiple layers of intermediaries.[31] They pointed out that the rule did not specify, in such a "chain of intermediaries," how the written agreement requirement would apply to any second tier (or additional tiers) of financial intermediaries. Two of these commenters recommended that the Commission revise the rule to limit the written agreement requirement to those entities that trade directly with the fund.[32] Two other commenters recommended that the rule mandate that a fund's contract with its intermediaries require them to provide information to the fund, and also require that those intermediaries contract with other intermediaries to agree to

[30] One commenter questioned whether, in the context of insurance company separate accounts, a holder of a variable annuity contract is a "shareholder" of a mutual fund in which the insurance company separate account invests. See Comment Letter of American General Life Insurance Co. at 12 (May 9, 2005) (submitted on behalf of the company and certain affiliated companies). The term "shareholder" does encompass these investors. See rule 22c-2(c)(4) (defining "shareholder" to include, among others, "a holder of interests in a fund or unit investment trust that has invested in the fund in reliance on section 12(d)(1)(E) of the Act"). We also noted, when we adopted rule 22c-2, that the term "shareholder" includes, among others, "a holder of interests in … an insurance company separate account organized as a unit investment trust." Adopting Release, supra note 4, at n.55. Insurance company separate accounts are susceptible to many of the same short-term trading abuses as mutual funds, and the investor protection goals of rule 22c-2 apply equally to them as well. See In the Matter of Millennium Partners, L.P., Investment Advisers Act Release No. 2453, Administrative Proceeding File No. 3-12116 (Dec. 1, 2005) (ordering fees and penalties of $180 million and finding that Millennium Partners had, among other things, engaged in market timing trading through variable annuity contracts, employing a number of deceptive practices to avoid detection as a market timer).

[31] See, e.g., Comment Letter of T. Rowe Price Associates, Inc. (May 24, 2005).

[32] See id.; Comment Letter of the ICI (May 9, 2005).

provide information to the fund, through chains of agreements.[33]

In light of these comments, we propose to revise the rule to provide that a fund must enter into a written agreement only with those financial intermediaries that submit orders to purchase or redeem shares directly to the fund, its principal underwriter or transfer agent, or a registered clearing agency[34] ("first-tier intermediaries").[35] We are proposing to define this written agreement as a "shareholder information agreement."[36] The proposed rule would include transfer agents and registered clearing agencies among the entities that may enter into shareholder information agreements with financial intermediaries on behalf of funds.[37] In practice, it is often the transfer agent that may have preexisting agreements with a fund's financial intermediaries, and to avoid potentially duplicative agreements or inefficiencies in the process, we propose to permit transfer agents to enter into agreements on behalf of the funds that they serve.[38]

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33 See Comment Letter of American Society of Pension Professionals & Actuaries (May 9, 2005); Comment Letter of Charles Schwab & Co., Inc. (May 9, 2005).

34 Currently, the National Securities Clearing Corporation ("NSCC") is the only registered clearing agency for funds. A "clearing agency" is a person that acts as an intermediary in making payments or deliveries (or both) in connection with transactions in securities, or that provides facilities for comparing data with respect to the terms of securities transactions to reduce the number of settlements or the allocation of securities settlement responsibilities. See 15 U.S.C. 78c(a)(23)(A). A clearing agency is a self-regulatory organization, and its rules of operation are subject to approval by the appropriate federal regulatory agency. See 15 U.S.C. 78c(a)(26), 78s(b).

35 Proposed amendment to rule 22c-2(a)(2). We understand that retirement plan administrators and other persons that maintain the plan's participant records typically submit transactions in fund shares to the fund or to its transfer agent, principal underwriter, or to a registered clearing agency. The rule we adopted last spring specifically includes these administrators and recordkeepers within the definition of a "financial intermediary." See rule 22c-2(c)(1)(iii).

36 Proposed rule 22c-2(c)(5). The agreement may be part of another contract or agreement, such as a distribution agreement.

37 If a transfer agent or clearing agency enters into an agreement on behalf of the fund, the agreement must require the financial intermediary to provide the requested information to the fund upon the fund's request, as provided in the definition of shareholder information agreement.

38 We have also included registered clearing agencies as an entity that may enter into agreements on

(footnote continued)

The shareholder information agreement must obligate the first-tier intermediary to provide, promptly upon the fund's request, identification and transaction information for any shareholder accounts held directly with the first-tier intermediary.[39] If the first-tier intermediary maintains a shareholder account for another financial intermediary, the shareholder information agreement must obligate the first-tier intermediary to use its best efforts to identify, upon request by the fund, those accountholders who are themselves intermediaries, and obtain and forward (or have forwarded) the underlying shareholder identity and transaction information from those intermediaries farther down the chain (i.e., second- or third-tier intermediaries, or "indirect intermediaries"). If an intermediary that holds an account with a first-tier intermediary refuses to honor the request, the agreement must obligate the first-tier intermediary to prohibit, upon the fund's request, an indirect intermediary from purchasing additional shares of the fund through the first-tier intermediary.

These proposed rule amendments are designed to enable funds to request the information they need to enforce their market timing and redemption fee policies, while reducing the costs of complying with the rule.[40] The rule therefore relies upon the initiative of the fund to determine

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behalf of funds. This amendment could allow funds and intermediaries to utilize the registered clearing agency as a central agreement repository, if such an arrangement is feasible.

39 As discussed further below, if a fund does not enter into a shareholder information agreement with an intermediary, it must restrict future purchases of fund shares by the intermediary. See infra Section II.C.

40 A number of intermediaries have already developed or are developing systems that will allow for transmission of this information. For example, Charles Schwab & Co. has developed a system that allows fund companies to view and download information regarding the identity and transaction history of accountholders that trade through Schwab. Julie Segal, Schwab Makes Omnibus Data Available to Fund Companies, Fund Action (Dec. 2, 2005). See also Tom Leswing, SunGard Creating Redemption Fee Rule Service, Ignites (Sept. 30, 2005) (discussing SunGard's development of a similar system allowing funds to impose redemption fees and access underlying shareholder identity and transaction information through omnibus accounts). We also understand that the NSCC is developing enhancements to its Fund/SERV order processing and

(footnote continued)

whether to request that first-tier intermediaries identify and collect information from specific indirect intermediaries, and to request that an indirect intermediary be restricted from further trading in fund shares due to its failure to provide requested information on shareholder transactions. We believe that this targeted approach would allow a fund to collect and analyze the most relevant information from intermediaries and enable it to efficiently and effectively enforce its short-term trading policies. This approach is also designed to permit a fund to look through multiple levels of intermediaries to reach relevant information about trading by ultimate shareholders.[41] These proposed amendments do not require first-tier intermediaries to enter into formalized information-sharing agreements with indirect intermediaries, although they would not prohibit any such agreements.

We request comment on how we propose to address chains of intermediaries.

- Would the proposed amendments result in funds receiving enough information from intermediaries to effectively address inappropriate short-term trading? Should the shareholder information agreement include any other requirements?
- Should the rule require that the agreement between the fund and each first-tier intermediary include a provision requiring first-tier intermediaries to enter into explicit agreements with all of their indirect intermediaries, or will the arrangements envisioned by the proposed rule be sufficient? Should the rule require funds to collect information from indirect intermediaries instead of having

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clearing systems that should allow members to request and transmit shareholder identity and transaction information.

41 We anticipate that intermediaries may use a variety of arrangements with indirect intermediaries to ensure that the requested information is provided to the fund, ranging from formalized contracts to informal communications in response to a specific fund inquiry.

the shareholder information agreement require first-tier intermediaries to assume this role? Do the proposed amendments strike the proper balance of duties and costs between funds and intermediaries?

- Is there another approach that we should take in addressing the chains of intermediaries issue? For example, should the rule require that first-tier intermediaries collect information only from second-tier intermediaries, without addressing the need for further information from more distant intermediaries? Would this approach allow investors to mask short-term trading activity by acting though multiple layers of intermediaries?
- What steps are funds and intermediaries already taking to share information? Are there systems in place (or in development) that could be used to reduce the costs of collecting and sharing this information?
- What are the costs of collecting shareholder information from intermediaries? How often do funds anticipate requesting shareholder information from intermediaries? How much would it cost to establish and maintain systems to collect and transmit the shareholder information between funds and intermediaries? What would it cost for first-tier intermediaries to ensure that funds receive the shareholder information from indirect intermediaries and restrict indirect intermediaries' trading upon the fund's request?
- Under the proposed amendments, a fund could enter into a shareholder information agreement through its principal underwriter, transfer agent, or registered clearing agency. Should the rule include any other types of entities?

C. Effect of Lacking an Agreement

Some commenters questioned the effect under the rule of a fund's failure (or inability) to obtain agreements with all of its intermediaries.[42] The rule could be interpreted to mean that in such a circumstance, the fund would be precluded from redeeming the shares of any of its shareholders within seven days of purchase.[43] In order to prevent a fund's lack of agreements with certain intermediaries from affecting the redeemability of shares that investors own through other intermediaries, we propose to revise the rule to provide that, if a fund does not have an agreement with a particular intermediary, the fund must thereafter prohibit the intermediary from purchasing, on behalf of itself or other persons, securities issued by the fund.[44] We intend this change to focus the remedy (prohibition of future purchases) on the particular intermediary that fails to execute an agreement with the fund.

We request comment on the proposed amendment clarifying the effect of a fund's lacking a shareholder information agreement with a financial intermediary.

- Instead of restricting any further purchases by a financial intermediary that does not have an agreement with a fund, would precluding an intermediary without an agreement from redeeming purchased shares within seven days serve the purposes of the rulemaking? Would this alternative preclusion on redemption within seven days effectively encourage intermediaries to enter into agreements with funds? Would this alternative of precluding redemption within seven days by intermediaries without agreements impose hardships on shareholders in financial

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42 See, e.g., Comment Letter of T. Rowe Price Associates, Inc. (May 24, 2005).

43 Comment Letter of OppenheimerFunds, Inc. (May 9, 2005).

44 Proposed rule 22c-2(a)(2)(ii).

emergencies, or implicate other shareholder redemption issues?

- Is there another approach available to us that would further the goals of this rulemaking?

III. COMPLIANCE DATE

When the Commission adopted rule 22c-2 in March 2005, we established a compliance date of October 16, 2006. Commenters pointed out that they would need significant time to revise agreements with intermediaries and change their systems to accommodate the transmission and receipt of trading information. That compliance date remains in effect, although we may revise or extend that compliance date if and when we adopt the amendments we are proposing today. We request comment on whether additional time would be needed to comply with the amendments.

IV. CURRENT INDUSTRY EFFORTS REGARDING SHAREHOLDER INFORMATION

We understand that representatives of mutual funds, transfer agents, and broker-dealers are currently engaged in an effort, in order to implement the information-sharing provisions of rule 22c-2, to develop standardized contractual terms and information exchange protocols.[45] We support the work of the representatives in developing these standards, and urge others involved with the distribution of mutual fund shares to become involved in this effort. We direct our staff to provide appropriate assistance.

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[45] See Comment Letter of the Securities Industry Association (May 9, 2005) (noting that the SIA has been "exploring with ICI the possible development of prototype contractual terms and approved methodologies for transmission of fund transactions data between intermediaries and funds").

V. ONGOING MONITORING

As discussed above, this release addresses only certain technical issues that have arisen to date. We intend, however, to monitor implementation of the rule, and accordingly we are interested in hearing on an ongoing basis from funds with experience complying with the rule, and other interested parties, about any further implementation issues or developments. In this regard, we encourage fund shareholders, funds and other interested parties to submit feedback as they develop experience with the rule. For example, we understand that the industry is developing a number of initiatives to streamline the flow of shareholder data between funds and intermediaries. If those initiatives are implemented, we would be interested in knowing whether they have assisted funds in complying with the rule. We also would be interested in hearing feedback with respect to issues such as the following:

- How have the required board findings with respect to the necessity and propriety of a redemption fee worked in practice?
- How has the rule affected the use of redemption fees by funds?
- How has the rule affected the level of redemption fees and the percentage of funds imposing redemption fees?
- How has the rule affected the length of redemption periods?
- Has the rule resulted in any unexpected benefits or adverse consequences for fund shareholders?

Feedback may be provided to the Commission by any of the following methods:

Electronic Submissions:

- Use the Commission's Internet submission form at www.sec.gov/rules/proposed.shtml; or
- Send an e-mail to rule-comment@sec.gov. Please include File Number 4-512 on the subject line.

Paper Submissions:

- Send paper submissions in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303.

All submissions should refer to File Number 4-512. This file number should be included on the subject line if e-mail is used. To help us process and review your submissions more efficiently, please use only one method. The Commission will post all submissions on the Commission's Internet Web site (http://www.sec.gov/rules/proposed.shtml). Submissions are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549. All submissions received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

VI. COST-BENEFIT ANALYSIS

The Commission is sensitive to the costs and benefits imposed by its rules. As discussed above, the amendments we are proposing today would (i) limit the types of persons with which funds must negotiate agreements, (ii) address the rule's application to chains of intermediaries, and (iii) clarify the effect of a fund's failure to obtain an agreement with any of its intermediaries. These proposed amendments are designed to respond to concerns that commenters identified during the course of implementing rule 22c-2. We believe that the changes would result in substantial cost savings to funds, financial intermediaries, and investors, and provide clarification of the rule's requirements.

A. Benefits

We anticipate that funds, financial intermediaries, and investors will benefit from the proposed amendments to rule 22c-2. As discussed more fully in the Adopting Release we issued in 2005, rule 22c-2 is designed to allow a fund to deter, and to provide the fund and its shareholders reimbursement for the costs of, short-term trading in fund shares.[46] The general benefits of rule 22c-2 therefore include the deterrence of short-term trading, in which short-term traders cause the fund to incur expenses that are ultimately borne by the long-term shareholders in a fund. Short-term trading can disrupt funds' stated portfolio management strategies, increase funds' transaction costs, require the maintenance of elevated cash positions (thereby reducing funds' returns), and dilute the value of fund shares held by long-term shareholders. One benefit of discouraging short-term trading is to increase the confidence of long-term investors in the capital markets as a whole, and in funds in particular. Rule 22c-2 is also designed to foster greater cooperation between funds and their intermediaries, and may result in improved communication and transparency of information between them.

Rule 22c-2 explicitly allows funds to adopt redemption fees of up to two percent as a means of recouping costs associated with short-term trading in fund shares. If a fund's board adopts a redemption fee, the resulting revenues will be returned to the fund and its investors. The revenue that funds and investors receive from redemption fees reimburses long-term shareholders for some, if not all, of the costs caused by short-term traders. Many of the costs

[46] See Adopting Release, supra note 4, at Section IV.A.

associated with rule 22c-2 discussed below are incidental to this purpose of better enabling funds to collect redemption fees from short-term traders in order to reimburse investors for any dilution of the fund. In many cases, the revenue received from redemption fee proceeds may be enough to allow funds to recoup both the direct and indirect costs associated with short-term trading. For example, based on conversations with fund representatives, we understand that one large fund complex collected approximately $34 million in redemption fee revenue in 2004. Funds that choose not to adopt redemption fees would not collect these fees, but would continue to realize the other benefits discussed below.

The amendments to rule 22c-2 that we are proposing today will likely result in additional benefits to funds, financial intermediaries, and investors. As discussed in the previous sections of this Release, some commenters argued that the rule's definition of "financial intermediary" was too broad because it would have required funds to identify and enter into agreements with a number of intermediaries that may not pose a significant short-term trading risk to funds, and may have imposed unnecessary costs to market participants.[47] For example, one large fund complex asserted that, under the rule as adopted, identifying their "financial intermediaries" could cost that fund complex $8.5 million or more.[48] As discussed above, our proposed amendments would modify the definition of financial intermediary to exclude entities that a fund

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[47] Comment Letter of the ICI at 3 (May 9, 2005). The ICI stated in its comment letter that, under the rule as adopted last March, three large fund complexes alone would have to evaluate 6.5 million accounts that are "not in the name of a natural person and thus could be held as an intermediary for purposes of the rule" and might have to enter into agreements with a significant portion of those accounts that are held in nominee name. Id. at 3. The ICI noted that many of these accounts are likely associated with small retirement plans, small businesses, trusts, bank nominees and other entities that are unlike typical financial intermediaries such as broker-dealers. It added that funds typically do not have agreements with such small entities, other than agreements incidental to the opening of an account.

[48] This estimate is based on telephone conversations with representatives of that fund complex.

treats as an individual investor for purposes of the fund's policies on market timing or frequent trading. We believe that these amendments would reduce the burden on funds of identifying those entities that might have qualified as financial intermediaries under the rule as adopted, because a fund should already know which entities it treats as intermediaries for purposes of its policies on market timing or frequent trading. As further discussed in Section VIII below, for purposes of the Paperwork Reduction Act we have estimated that, if these amendments are adopted, identifying the intermediaries with which a fund complex must enter into agreements may take the average fund complex a total of 250 hours of a service representative's time, at a cost of $40 per hour,[49] for a total burden to all funds of 225,000 hours, at a total cost of $9 million. These amendments would likely provide a significant benefit because they should reduce the costs associated with the intermediary identification process.

By enabling funds to forego the cost of entering into agreements with omnibus accountholders that they treat as individual investors, we anticipate that the large majority of small omnibus accountholders would now fall outside the shareholder information agreement provisions of the rule. This would likely result in significant cost and time savings to funds and financial intermediaries through reduction of the expenses associated with these agreements. The reduction of these costs also may benefit fund investors and fund advisers, to the extent that these costs would have been passed on to them. We estimate that this would significantly reduce the burden on many entities that would otherwise qualify as intermediaries under the rule, since the excluded entities would no longer need to enter into shareholder information-sharing agreements, or develop and maintain systems to provide the relevant information to funds.

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[49] See infra note 69.

Commenters were also concerned that the rule as adopted might have required funds to enter into agreements with intermediaries that hold fund shares in the name of other intermediaries (a "chain of intermediaries"), potentially resulting in a fund having to enter into agreements with intermediaries with which it may not have a direct relationship (i.e., indirect intermediaries).[50] The proposed amendments would further clarify and define the operation of the rule with respect to intermediaries that invest through other intermediaries. As proposed, the amendments to rule 22c-2 would define the term "shareholder information agreement," and provide that funds need only enter into shareholder information agreements with intermediaries that directly submit orders to the fund, its principal underwriter, transfer agent, or to a registered clearing agency. Accordingly, funds would not need to enter into agreements with indirect intermediaries and may incur lower systems development costs related to the collection of underlying shareholder information, thereby reducing the costs of compliance.

Under the proposed amendments, a first-tier intermediary, in its agreement with the fund, must agree, upon further request by the fund, to: (i) provide the fund with the underlying shareholder identification and transaction information of any other intermediary that trades through the first-tier intermediary (i.e., indirect intermediary); or (ii) prohibit the indirect intermediary from purchasing, on behalf of itself or others, securities issued by the fund. This approach is designed to preserve the investor protection goals of the rule by ensuring that funds have the ability to identify short-term traders that may attempt to evade the reach of the rule by trading through chains of financial intermediaries. We considered not requiring the collection of shareholder information from indirect intermediaries at all, but are concerned that providing such

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50 See Comment Letter of T. Rowe Price Associates, Inc. at 2 (May 24, 2005); Comment Letter of OppenheimerFunds, Inc. at 3 (May 9, 2005).

an exemption might encourage abusive short-term traders to conduct their activities through another intermediary in order to avoid detection by the fund.

By defining minimum standards for what must be included in these shareholder information agreements, we have attempted to balance the need for funds to acquire shareholder information from indirect intermediaries who trade in fund shares, with practical concerns regarding the difficulty that funds might face in identifying these intermediaries and entering into agreements with them. Because the intermediary that trades directly with the fund already has a relationship with second-tier intermediaries (and is likely to have a closer relationship than the fund to any intermediary that is farther down the "chain") the first-tier intermediary appears to be in the best position to arrange for the provision of information to the fund regarding the transactions of shareholders trading through its indirect intermediaries. By providing a definition of the term "shareholder information agreement," the amended rule would more clearly explain the balance of duties and obligations between funds and financial intermediaries. Because first-tier intermediaries may already have access to the shareholder transaction and identification information of their indirect intermediaries, they will likely be able to provide this information to funds at a minimal cost, especially compared to the significant costs that funds would incur if they were required to collect the same information from indirect intermediaries themselves. Although first-tier intermediaries may incur some costs in collecting and gathering this information from indirect intermediaries, there is a benefit in having the entity that has the easiest access to the relevant information have the responsibility for arranging for its delivery to funds.

As discussed in the previous sections, these proposed amendments clarify the result if a fund lacks an agreement with a particular intermediary. In such a situation, the fund may continue to redeem securities within seven calendar days, but it must prohibit that financial intermediary from purchasing fund shares, on behalf of itself or any other person. Some commenters had stated that the rule, as adopted in 2005, could be interpreted to require a different approach to these situations.[51] The proposed amendments would provide the benefit of certainty regarding the duties of funds and financial intermediaries under the rule, and clarity concerning the intent of the Commission, without imposing additional costs.

B. Costs

Many commenters expressed concerns about the costs of rule 22c-2 as we adopted it in 2005. As discussed above, we anticipate that the proposed amendments would allow funds, financial intermediaries, and investors to incur significantly reduced costs under the rule as we propose to amend it, compared to the rule as it was originally adopted. Although these proposed amendments would reduce many of the costs of the rule, they should nonetheless maintain the investor protections afforded by the rule.

The primary result of these proposed amendments would be to reduce the number of financial intermediaries with which funds must enter into shareholder information agreements. This should reduce costs to all participants by allowing funds to enter into shareholder information agreements only with those intermediaries that hold omnibus accounts that are most likely to trade fund shares frequently. The rule's investor protections will be maintained because funds will continue to monitor the short-term trading activity of the rest of the fund's omnibus accounts as if they were individual investors in the fund, according to the fund's policies on short-term trading.

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[51] See Comment Letter of the ICI at 4 (May 9, 2005).

A number of costs are associated with the shareholder information agreement provision of the rule, both as adopted and as we propose to revise it. These costs are incurred by both funds and financial intermediaries, and include: (i) identifying those accounts that qualify as financial intermediaries; (ii) modifying existing agreements with intermediaries to cover the shareholder collection requirements of the rule or, if no agreement exists, entering into a new agreement; (iii) developing systems that assemble and transmit shareholder information between funds and intermediaries; and (iv) maintaining and monitoring the systems and the shareholder information collected on an ongoing basis. The specific costs incurred by each fund and financial intermediary may vary widely. Among other factors, these costs will vary based upon the size of each entity, the number of accounts handled, the number of shareholder agreements that must be modified or entered into, the size and complexity of the systems developed to handle the information, whether or not a fund determines that it needs a redemption fee, whether the fund has policies on the intermediaries it treats as individual investors, and the specific policies on short-term trading that a fund has adopted.

The proposed amendments would reduce the number of entities that would be considered financial intermediaries under the rule. Commenters raised concerns about the costs of identifying which accountholders are financial intermediaries, but did not identify specific costs related to this review.[52] In any event, the costs related to this review would be greatly reduced under the rule as we propose to revise it, because we expect that a fund will generally already

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[52] As discussed above, the ICI noted that, between just three large fund complexes, 6.5 million accounts may need to be reviewed, and estimated that the total number of accounts which would be evaluated by all funds could be in the "tens of millions." Comment Letter of the ICI at 3 (May 9, 2005). OppenheimerFunds noted that, although it has more than 7.5 million shareholder accounts in its records, 137,000 or fewer of those accounts may qualify as financial intermediaries under the rule as adopted last spring. See Comment Letter of OppenheimerFunds,

(footnote continued)

have identified those accountholders that it does not treat as an individual investor for purposes of its restrictions on short-term trading. As discussed above in the benefits section, for purposes of the Paperwork Reduction Act, we have estimated that completion of this identification process will cost all funds a total of approximately $9 million.

We received a few comments regarding the number of accounts maintained by funds that qualify as financial intermediaries.[53] Commenters indicated that revising the rule in the manner that we are proposing today would significantly reduce the costs of entering into or modifying these agreements, as well as the costs of developing, maintaining and monitoring the systems that will collect the shareholder information related to these agreements for funds.[54] Omnibus accountholders that previously would have qualified as financial intermediaries are also likely to realize substantial savings under the amended rule. When an omnibus accountholder is treated as an individual investor (or does not trade directly with the fund), such an omnibus account will no longer be treated as a financial intermediary and will not incur the costs of entering into or modifying agreements with that fund. There will also no longer be the start-up and ongoing costs of developing and maintaining shareholder information-sharing systems for those accountholders.

We received a few comments regarding the costs of modifying or entering into

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Inc. at 8 (May 9, 2005). Neither commenter estimated the costs of performing this review.

[53] OppenheimerFunds estimated that it has 137,000 omnibus accounts that might qualify as financial intermediaries, USAA Investment Management Company stated that it has "thousands" of these accounts, and T. Rowe Price estimated 1.3 million accounts that are not registered as natural persons. See Comment Letter of OppenheimerFunds, Inc. at 8 (May 9, 2005); Comment Letter of USAA Investment Management Company at 2 (May 9, 2005); Comment Letter of T. Rowe Price Associates, Inc. at 2 (May 24, 2005).

[54] See Comment Letter of USAA Investment Management Company at 2 (May 9, 2005); Comment Letter of the ICI at 3 (May 9, 2005).

shareholder information agreements. The only commenter that gave specific numbers indicated that it would take approximately four hours to modify and/or enter into, follow-up on, and maintain an agreement on its systems for each account identified as a financial intermediary.[55] The same commenter indicated that it may have as many as 137,000 accounts that might qualify as financial intermediaries under the rule as adopted. We anticipate that if we adopt the proposed revisions, the large majority of the omnibus accountholders that would have qualified as financial intermediaries under the rule as adopted, would instead be treated as individual investors by funds, and therefore no new agreements would be required. Based on conversations with fund representatives, we anticipate that in most cases complying with the amended rule will require a very limited number of new agreements between funds and intermediaries (in many cases virtually no new agreements would be required). We understand that the number of existing agreements that funds have with their intermediaries can vary greatly, from less than 10 agreements for a small direct-sold fund, to more than 3000 for a very large fund sold through various channels. Although funds will still need to modify the existing agreements that they have with their intermediaries (i.e., distribution agreements), we believe that these proposed revisions would greatly reduce or eliminate the need for most funds to identify and negotiate new agreements. Funds are also likely to incur lower costs when modifying existing agreements than when entering into new agreements, and the actual hours required to modify an existing agreement thus may be significantly less than the four hour figure suggested by the commenter.[56] Accordingly, under the cost estimates provided by this commenter, the cost reduction that may

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55 See Comment Letter of OppenheimerFunds, Inc. at 8 (May 9, 2005).

56 See Section VIII below for a discussion, in the context of the Paperwork Reduction Act, of some of the estimated costs of the shareholder information agreement and information-sharing system

(footnote continued)

result if the proposed amendments were adopted for a fund complex in a similar position as the commenter could be 536,000 hours.[57]

Based on further information that our staff has obtained, for purposes of the Paperwork Reduction Act as discussed below, we have estimated that it will cost all funds and financial intermediaries a total of approximately $53,550,000 to enter into and/or modify the agreements required under the amended rule.[58] This represents a significant cost reduction from the most recent estimates provided to us in response to the rule's adoption.[59]

There will also be some costs related to the amendments we are proposing to make in the context of chains of intermediaries. By clearly defining the duties that a fund's agreement must

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development and operations aspects of the rule as we propose to amend it.

[57] See Comment Letter of OppenheimerFunds, Inc. (May 9, 2005). This estimate is based on the following calculations: 137,000 potential accounts times 4 hours per account equals 548,000 potential hours. However, the proposed amendments might eliminate the burden of reviewing and modifying those 137,000 potential accounts, and could limit the burden to a far reduced number, perhaps 3000 agreements for a very large fund. (3000 agreements to be modified times 4 hours equals 12,000 hours.) Instead of potentially incurring 548,000 hours complying with the agreement portion of the rule, a similar fund might incur 12,000 hours in modifying its existing agreements, for a savings of 536,000 hours. (548,000 potential hours minus 12,000 hours equals 536,000 hours saved).

[58] See infra Section VIII.

[59] However, this revised estimate is an increase over the amount we estimated in the Adopting Release ($3,353,279) for funds and intermediaries to enter into information-sharing agreements. See Adopting Release, supra note 4, at n.108. In response to our request for comment on any aspect of the rule's implementation, we received new information and updated estimates that noted that the cost of entering into agreements for funds and intermediaries would be significantly higher than the estimate included in the Adopting Release. After reviewing the comments we received in response to the Adopting Release, as well as other information received from fund representatives, we now estimate that on average, a fund complex might incur $250,000 or more in expenses related to entering into or modifying the agreements required under the rule as adopted. With approximately 900 fund complexes currently operating, we now estimate that the agreement portion of the rule as adopted could potentially cost all funds a total of approximately $225,000,000. Despite the increase in estimated costs for entering into agreements that we have included here over the cost estimates included in the Adopting Release, we anticipate that the proposed amendments would reduce the costs of the agreement portion of the rule as adopted by approximately $171,450,000 ($225,000,000 (updated cost estimate) minus $53,550,000 (cost

(footnote continued)

impose on intermediaries in the “chain of intermediaries” context, the proposed rule amendments may result in first-tier intermediaries incurring some costs that might otherwise have been borne by funds. These may include costs related to negotiating agreements (if necessary) with indirect intermediaries, processing requests from funds to investigate accounts, costs related to collecting and providing the underlying shareholder information to funds from the indirect intermediaries and restricting further trading by indirect intermediaries if the fund requests it. We believe that first-tier intermediaries are in a better position than funds to fulfill these obligations. Unlike funds, first-tier intermediaries have a direct relationship with second-tier intermediaries (and may be in a better position than funds to collect information from other indirect intermediaries), and will thus be able to identify, communicate with, and collect information from these indirect intermediaries at a lower cost than if funds were to conduct such activities. First-tier intermediaries are also in a better position than funds to identify and gather shareholder information from more distant indirect intermediaries because of their relationships with second-tier intermediaries.

As further discussed in connection with the Paperwork Reduction Act, we have estimated that the costs of entering into arrangements between first-tier and more indirect intermediaries would be approximately $63 million.[60] We anticipate that intermediaries will generally use the same systems that they use to provide the required underlying shareholder identity and transaction information directly to funds to process the information that first-tier intermediaries will forward (or have forwarded) to funds from indirect intermediaries, thus resulting in significant cost efficiencies.

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estimate after proposed amendments) equals $171,450,000 (total potential cost reduction)).

Funds and intermediaries may also incur some costs related to drafting or revising terms for the agreements required by rule 22c-2. We have been informed that industry representatives are working together to develop a uniform set of model terms, and anticipate that such model terms may significantly reduce the costs related to developing individualized agreement terms for each fund and intermediary. As further discussed in Section VIII, for purposes of the Paperwork Reduction Act, we estimate that a typical fund complex will incur a total of 5 hours of legal time at $300 per hour in drafting these agreement terms, for a total of 4500 hours for all 900 fund complexes at a total cost of $1,350,000.

We understand that several service providers are developing systems to accommodate the transmission and receipt of transaction information between funds and intermediaries pursuant to contracts negotiated to comply with rule 22c-2.[61] At least one of these organizations is revising the infrastructure that it already has in place, in order to facilitate the communication of fund trades and other "back office" information between funds and financial intermediaries, including the information required under the rule. Based on information from industry representatives, we understand that, with the exception of some smaller to mid-sized funds and intermediaries, the large majority of funds and intermediaries currently use the organization's existing infrastructure to process fund trades. In addition, some funds and intermediaries may develop their own competing or complementary information-sharing systems.

As further described in connection with the Paperwork Reduction Act, we estimate that all funds will incur a total of approximately $47,500,000 in one-time capital costs to develop or upgrade their software and other technological systems to collect, store, and receive the required

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60 See infra Section VIII.

identity and transaction information from intermediaries, and a total of $21,515,000 each year thereafter in operation costs related to the transmission and receipt of the information.[62] We further estimate that financial intermediaries may incur $227,500,000 in one-time capital costs to develop or upgrade their software and other technological systems to collect, store, and transmit the required identity and transaction information to funds and from other intermediaries, and a total of $140,000,000 each year thereafter in operation costs related to the transmission and receipt of the information.

For the reasons discussed above, we anticipate that the proposed amendments would not create additional costs beyond the rule as adopted. In fact, we anticipate that the amendments may significantly reduce costs to most market participants.[63]

C. Request for Comments

We request comment on the potential costs and benefits of the proposed amendments to rule 22c-2. We encourage commenters to identify, discuss, analyze, and supply relevant data regarding any additional costs and benefits. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,[64] we also request information regarding the potential impact of the proposals on the U.S. economy on an annual basis.

VII. CONSIDERATION OF PROMOTION OF EFFICIENCY, COMPETITION AND CAPITAL FORMATION

Section 2(c) of the Investment Company Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate

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61 See supra note 40.

62 See infra Section VIII.

63 See infra note 105.

64 Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996).

in the public interest, to consider whether the action will promote efficiency, competition, and capital formation. As discussed in the Cost-Benefit Analysis above, the proposed amendments to rule 22c-2 are designed to reduce the burdens of the rule as adopted, while maintaining its investor protections. Funds would no longer be required to incur the expense of modifying or entering into agreements with omnibus accounts that they already effectively monitor by treating as individual investors, and would not need to enter into agreements with intermediaries that do not trade directly with the fund. The proposed amendments would promote efficiency in the capital markets by enabling funds to focus their short-term trading deterrence efforts on those omnibus accounts that could be used to disguise this type of trading. The amendments would also promote efficiency by reducing the number of omnibus accountholders that would otherwise incur the expenses of entering into agreements, and of establishing and maintaining systems for collecting and sharing shareholder information.

We do not anticipate that the proposed amendments would harm competition. They would apply to all market participants and, as discussed in the Cost-Benefit Analysis above, serve to reduce cost burdens for large funds as well as small funds.[65] Some commenters expressed concern that the rule as adopted may disproportionately burden small intermediaries, and thus hinder competition. We anticipate that under the proposed amendments, most omnibus accounts that are treated by the fund as individual investors would be small intermediaries. By excluding these small intermediaries from the rule's requirements, the amendments would serve to alleviate potential anti-competitive effects on small intermediaries.

Even if the proposed amendments are adopted, the competitive pressure of marketing

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[65] See supra Section IV.

funds, especially smaller funds, coupled with the costs of imposing redemption fees in omnibus accounts, may deter some funds from imposing redemption fees. Intermediaries may use their market power to prevent funds from applying the fees, or provide incentives for fund groups to waive fees. However, by reducing the costs of imposing redemption fees for both funds and intermediaries, we believe that any such anti-competitive effects will likely be reduced.

We anticipate that the proposed amendments will indirectly foster capital formation by continuing to bolster investor confidence, because the rule is designed to permit funds to deter, and recoup the costs of, abusive short-term trading. To the extent that the rule enhances investor confidence in funds, investors are more likely to make assets available through intermediaries for investment in the capital markets. The proposed amendments may also foster capital formation by reducing the costs of the rule for funds and intermediaries.

We request comments on whether the proposed rule amendments, if adopted, would promote efficiency, competition, and capital formation. Will the proposed amendments or their resulting costs materially affect the efficiency, competition, and capital formation of funds and other businesses? Comments will be considered by the Commission in satisfying its responsibilities under section 2(c) of the Investment Company Act. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

VIII. PAPERWORK REDUCTION ACT

As discussed in the release in which we adopted rule 22c-2,[66] the rule includes "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.[67] The Commission is submitting the proposed collections of information to the Office of

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[66] See Adopting Release, supra note 4, at Section VI.

Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title for the collection of information requirements associated with the rule is "Rule 22c-2 under the Investment Company Act of 1940, Redemption fees for redeemable securities." An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

The proposed amendments would reduce the burdens associated with the collections of information required by the rule, and would not create new collections of information. The proposed amendments should reduce the number of entities affected by the rule as adopted. We are therefore proposing to revise our previous burden estimates under the Paperwork Reduction Act to reflect (i) new cost and time burden information that we have received from market participants, and (ii) the revised number of entities that would be affected by the amended rule.

This revised Paperwork Reduction Act section contains a number of new cost and hour estimates that are significantly altered from the estimates made in the Adopting Release. Some of these estimates are based on different methods, and different sources, from those in the Adopting Release. Therefore there is not a strict comparability between the estimates here and those made in the Adopting Release. These cost estimates, hourly rate estimates, and the methodology used to make these proposed estimates are based on comments we received in response to the Adopting Release, and on information received from funds, intermediaries, and other market participants during conversations conducted while preparing these proposed amendments. We request comment on any aspect of our staff's estimates regarding the costs of complying with the rule as we propose to amend it.

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[67] 44 U.S.C. 3501-3520.

The amendments we are proposing to rule 22c-2 include two distinct "collections of information" for purposes of the Paperwork Reduction Act. The first is related to shareholder information agreements, including the costs and time related to identifying the relevant intermediaries, drafting the agreements, negotiating new agreements or modifying existing ones, and maintaining the agreements in an easily accessible place. The second is related to the costs and time related to developing, maintaining, and operating the systems to collect, transmit, and receive the information required under the shareholder information agreements.[68]

Both collections of information are mandatory for funds that choose to redeem shares within seven days of purchase. These funds will use the information collected to ensure that shareholders comply with the fund's policies on abusive short-term trading of fund shares. There is a six year recordkeeping retention requirement for the shareholder information agreements required under the rule.

A. Shareholder Information Agreements

The Commission staff anticipates that most shareholder information agreements will be entered into at the fund complex level, and estimates that there are approximately 900 fund complexes. The Commission staff understands that the number of intermediaries that hold fund shares can vary for each fund complex, from less than 10 for some fund complexes to more than 3000 for others. Based on conversations with fund and financial intermediary representatives, our staff estimates that, on average, under the revised definition of financial intermediary, each fund complex would have approximately 300 financial intermediaries. Industry representatives have informed us that funds would already know and have previously identified the majority of

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68 This second collection of information does not include potential costs or time that funds or intermediaries might choose to incur in analyzing or using the provided information.

their intermediaries. Therefore funds should expend a limited amount of time and costs related to the identification of such intermediaries. Our staff estimates that identifying the intermediaries with which a fund complex must enter into agreements may take the average fund complex 250 hours of a service representative's time at a cost of $40 per hour[69], for a total of 225,000 hours at a cost of $9,000,000.[70] Our staff estimates that for a fund complex to prepare the model agreement, or provisions modifying a preexisting agreement, between the fund and the intermediaries, it will require a total of 5 hours of legal time at $300 per hour, for a total of 4500 hours[71] at a total cost of $1,350,000**.**

The Commission staff estimates that for a fund complex to enter into or modify a shareholder information agreement with each existing intermediary, it would require a total one-time expenditure of approximately 2.5 hours of fund time and 1.5 hours of intermediary time for each agreement, for a total of 4 hours expended per agreement.[72] Therefore, for an average fund complex to enter into shareholder agreements, the fund complex and its intermediaries may expend approximately 1200 hours at a cost of $48,000,[73] and all fund complexes and

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[69] The title and hourly cost of the person performing the intermediary identification and entering into agreements may vary depending on the fund or financial intermediary. This $40 per hour cost is an average estimate for the hourly cost of employing the person doing the relevant work, derived from conversations with industry representatives.

[70] This estimate is based on the following calculations: 250 hours times 900 fund complexes equals 225,000 hours, and 225,000 hours times $40 equals $9,000,000.

[71] This estimate is based on the following calculation: 5 hours times 900 fund complexes equals 4500 hours of legal time.

[72] The 4 hour figure represents time incurred by both the fund and the financial intermediary for each agreement. The Commission staff estimates that this 4 hour figure is comprised of approximately 2.5 hours of a fund service representative's time at $40 per hour and 1.5 hours of an intermediary representative's time at $40 per hour.

[73] This estimate is based on the following calculations: 4 hours times 300 intermediaries equals 1200 hours; and 1200 hours times $40 dollars per hour equals $48,000.

intermediaries may incur a total one-time burden of 1,080,000 hours at a cost of $43,200,000.[74] The Commission staff understands that there are efforts under way (including an industry task force devoted to the project) to produce standardized shareholder information-sharing model agreements and terms. If fruitful, these efforts may reduce the costs associated with the agreement provision of the rule for both funds and intermediaries.[75] Finally, the Commission staff does not anticipate that funds or intermediaries will incur any new costs in maintaining these agreements in an easily accessible place, because such maintenance is already done as a matter of course.

The staff therefore estimates that, for purposes of the Paperwork Reduction Act, the shareholder information agreement provision of the rule as proposed to be revised would require a total of 1,309,500 hours at a total cost of $53,550,000.[76]

B. Information-sharing

Some funds and intermediaries would incur the system development costs discussed in this section, but many would not because they already process all of their trades on a fully disclosed basis, use a third party administrator to handle their back office work,[77] or already have systems in place that allow intermediaries to transmit the shareholder identity and transaction information to funds. Other funds and intermediaries may have special circumstances that could

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[74] This estimate is based on the following calculations: 1200 hours times 900 fund complexes equals 1,080,000 hours; and 1,080,000 hours times $40 per hour equals $43,200,000.

[75] See Tom Leswing, Redemption Rule Fuels Demand For New Standards, Ignites (Oct. 26 2005).

[76] This estimate is based on the following calculation: 4,500 hours of legal drafting time plus 1,080,000 hours of agreement negotiating time plus 225,000 hours of intermediary identification time equals 1,309,500 total hours; and $43,200,000 plus $1,350,000 plus $9,000,000 equals $53,550,000.

[77] Third party administrators maintain accounts for many other intermediaries, and therefore incur the costs to develop a single system.

increase the costs they may face in developing and operating systems to comply with the rule. The estimates below represent the Commission staff's understanding of the average costs that might be encountered by a typical fund complex or intermediary in complying with the information-sharing aspect of the rule as proposed to be amended.

1. Funds

The Commission staff understands that various organizations have developed, or are in the process of developing, enhancements to their systems that will allow funds and intermediaries to share the information required by the rule without developing or maintaining systems of their own.[78] Our staff anticipates that most funds and intermediaries will use these systems, and will generally make minor changes to their back office systems to comply with the rule requirements and to match their systems to those of the service providers. Our staff estimates that most funds could adapt their in-house systems to utilize these service providers' systems at a one-time cost of approximately $10,000 or less.[79] In general, our staff understands that fees averaging 25 cents for every 100 account transactions requested may be charged when funds request information from intermediaries, and in response, intermediaries transmit the information back to funds.

As an example of the cost of using these services, if a fund complex requests information for 100,000 transactions each week, then it would incur costs of $250 each week, or $13,000 a

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[78] These service providers systems include the NSCC's Fund/SERV system, as well as other systems being developed by a number of other providers such as SunGard and Charles Schwab. See supra note 40.

[79] We expect that, in many cases, upgrades to fund transfer agents' as well as fund complex's systems will take place, and the transfer agents' costs will be charged back to the fund complex. These system development and operation costs include our staff's estimates of the potential charges by transfer agents, but do not include potential charges by intermediaries for providing the information.

year.[80] Our staff estimates that approximately 475 fund complexes would use these systems (including substantially all of the largest, and most of the medium-sized, fund families). If all of these complexes use these service providers' systems at the rate described above, they would incur a one-time system development cost of $4,750,000[81] and an annual system use cost of approximately $6,175,000.[82] Those 475 fund complexes may also incur system development costs related to the processing of information under the rule on trades that they receive through other channels than these service providers' systems, which we estimate to cost approximately $50,000 per fund complex, and $20,000 annually, for a total of $23,750,000[83] in system development costs and $9,500,000 annually[84]. Our staff estimates that the total system development cost for these 475 fund complex that are likely to use these existing systems is $28,500,000 with annual operation costs of $15,675,000.[85]

There are approximately 900 fund complexes currently operating, of which approximately 475 may use these existing systems, leaving approximately 425 fund complexes possibly needing to develop specific systems to meet their own particular needs. Our staff

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[80] This estimate is based on the following calculations: 100,000 transaction requests times one quarter of a cent (the charge is 25 cents per 100 transactions requested, or one quarter of a cent per transaction) equals $250; and $250 times 52 weeks equals $13,000.

[81] This estimate is based on the following calculation: 475 fund complexes times $10,000 (one-time system update costs) equals $4,750,000.

[82] This estimate is based on the following calculation: 475 fund complexes times $13,000 (annual costs) equals $6,175,000.

[83] This estimate is based on the following calculation: 475 fund complexes times $50,000 system development cost per fund complex equals $23,750,000.

[84] This estimate is based on the following calculation: 475 fund complexes times $20,000 annual costs per fund complex equals $9,500,000.

[85] This estimate is based on the following calculations: $23,750,000 plus $4,750,000 (one-time system development costs) equals $28,500,000 total start-up costs for fund complexes utilizing existing systems; and $6,175,000 plus $9,500,000 equals $15,675,000 in annual costs.

understands that approximately 75 percent of those fund complexes (or 319 complexes) are small to medium-sized direct-sold funds that have a very limited number of intermediaries. Our staff anticipates that those 319 fund complexes would incur minimal system development costs to comply with the information-sharing provisions of the rule, due to the limited number of intermediaries with which they interact. Our staff estimates that system development costs for handling information under the rule for those 319 fund complexes will be approximately $25,000 each, with annual operation costs of approximately $10,000, for a total system development cost of $7,975,000[86] and an annual operations cost of $3,190,000.[87]

The remaining approximately 106 fund complexes may face additional complexities or special circumstances in developing their systems. Our staff estimates that the start-up costs for those fund complexes will be approximately $100,000 per fund complex and the annual costs for handling the information will be approximately $25,000, for a total start-up cost of $10,600,000 and an annual cost of $2,650,000 for these fund complexes.[88]

For purposes of the Paperwork Reduction Act, our staff therefore estimates that the information-sharing provisions of the rule as proposed to be amended would cost all fund complexes a total of approximately $47,075,000 in one-time capital costs to develop or upgrade their software and other technological systems to collect, store, and receive the required identity and transaction information from intermediaries, and a total of $21,515,000 each year thereafter in operation costs related to the transmission and receipt of the information.[89]

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86 This estimate is based on the following calculations: 319 funds times $25,000 equals $7,975,000.

87 This estimate is based on the following calculations: 319 funds times $10,000 equals $3,190,000.

88 This estimate is based on the following calculations: 106 funds times $100,000 equals $10,600,00; and 106 funds times $25,000 equals $2,650,000.

89 This estimate is based on the following calculations: $28,500,000 (funds' that use service

(footnote continued)

2. Intermediaries

The Commission staff estimates that there are approximately 7000 intermediaries that may provide information pursuant to the information-sharing provisions of rule 22c-2.[90] Of those 7000 intermediaries, our staff anticipates that approximately 350 of these intermediaries are likely to primarily use the existing systems that are in place or under development.[91] The staff understands that these approximately 350 intermediaries include several major "clearing brokers" and third-party administrators that aggregate trades and handle the back-end work for thousands of other smaller broker-dealers and intermediaries, thereby likely providing access to these service providers' information-sharing systems to a significant majority of all intermediaries in the marketplace. Our staff estimates that these approximately 350 intermediaries would provide access to systems that will allow for the transmission of information required by the rule and other processing for the transactions of approximately 80 percent of the 7000 intermediaries (5600 intermediaries) effected by the rule, leaving 1400 intermediaries that do not in some way utilize these systems, and that may need to develop their

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providers start-up costs) plus $7,975,000 (direct-traded funds' start-up costs) plus $10,600,000 (other funds' start-up costs) equals $47,075,000 system development costs; and $15,675,000 (funds' that use service providers start-up costs) plus $3,190,000 (direct-traded funds' annual costs) plus $2,650,000 (other funds' annual costs) equals $21,515,000 annual funds' costs.

[90] This 7000 number is a rounded estimate, based on the number of intermediaries that may be affected by the rule as we propose to revise it. It consists of the following: 2203 broker-dealers classified as specialists in fund shares, 196 insurance companies sponsoring registered separate accounts organized as unit investment trusts, approximately 2400 banks that sell funds or variable annuities (the number of banks is likely over inclusive as it may include a number of banks that do not sell registered variable annuities or funds and/or banks that do their business through a registered broker-dealer on the same premises), and approximately 2000 retirement plans, third-party administrators, and other intermediaries (this number may be either over or under inclusive, as under the rule as we propose to revise it, the actual number of intermediaries that funds have is dependent on the precise application of varying fund policies on short-term trading).

[91] See supra note 40.

own systems.[92]

Our staff understands that in general, the providers who have developed or are developing these information sharing systems charge the fund, and not the intermediary for providing these systems to transmit shareholder identity and transaction information, or else include access to such systems as a complementary part of their other processing systems, and do not charge additional fees to intermediaries for its utilization. These intermediaries may be required to develop systems to ensure that they are able to transmit the records to these service providers in a standardized format.[93] Our staff estimates that it may cost each of these 350 intermediaries approximately $200,000 to update its systems to record and transmit shareholder identity and transaction records to these service providers, and an additional $100,000 each year to operate their own systems for communicating with the service providers, for a total start-up cost of $70,000,000, and an annual cost of $35,000,000.[94] We understand that these approximately 350 intermediaries may also have to upgrade their systems to handle rule 22c-2 information on trades that do not go through the service providers' systems. Our staff estimates

92 This number is based on the following calculation: 7000 total intermediaries times 20% (the percentage of intermediaries do not use these service providers systems or use the services of the those 350 intermediaries that do) equals 1400 intermediaries that do not use these service providers' systems.

93 Our staff anticipates that in most cases, first-tier intermediaries will use the same or slightly modified systems that they have developed to identify and transmit shareholder identity and transaction information to funds when collecting and transmitting this information from indirect intermediaries. Therefore, we have also included the costs of developing and operating systems to collect information from indirect intermediaries and providing the information to funds in these estimates.

94 This estimate is based on the following calculation: 350 broker-dealer times $200,000 (start-up costs) equals $70,000,000; and 350 broker-dealer times $100,000 (start-up costs and annual costs) equals $35,000,000.

that it will cost each of those 350 intermediaries[95] an additional $250,000[96] to update their systems, and $100,000 annually to process rule 22c-2 information through non service provider networks, for a total cost of $87,500,000 in system development costs and $35,000,000 in annual costs to process data through non service provider networks. Our staff therefore estimates that these approximately 350 intermediaries will incur a total of approximately $157,500,000 in start-up costs and $70,000,000 in annual costs associated with the information-sharing provisions of the rule.[97]

The fund complexes and intermediaries that do not use these service providers' systems to process their trades would have to either develop their own systems to share information under the rule or engage some other third-party administrator to process the information. Our staff estimates that approximately 1400 intermediaries will not utilize these service provider systems to process this information, and estimates that each of these intermediaries will incur $50,000 in system development costs and $50,000 in annual costs in complying with the rule, for a total of $70,000,000 in development costs and $70,000,000 in annual costs for those intermediaries.[98]

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[95] The estimate includes higher costs for these 350 intermediaries in developing systems to handle non service provider information than for remaining intermediaries to handle the same data due to our staff's understanding that, in general, these 350 intermediaries that utilize the service provider's networks represent the largest intermediaries in the marketplace, and will face the highest costs in complying with the rule.

[96] Many of the costs that intermediaries incur in developing and operating systems to handle this information may be recouped from fund complexes through a variety of methods. However, it is unclear what recoupment might take place, and therefore the cost estimates for funds and intermediaries are made here prior to any potential recoupment.

[97] This estimate is based on the following calculations: $70,000,000 (intermediary start-up costs for processing information through service providers) plus $87,500,000 (intermediary start-up costs for handling information through other channels) equals $157,500,000; and $35,000,000 (intermediary annual costs for processing information through service providers) plus $35,000,000 (intermediary annual costs for handling information through other channels) equals $70,000,000.

[98] This estimate is based on the following calculation: 1400 intermediaries times $50,000

(footnote continued)

We understand that there is a task force that is in the process of developing industry standards for transmitting information under the rule between market participants that do not use these service provider systems.[99] This is likely to reduce costs to both funds and intermediaries.

Our staff estimates that the information-sharing provisions of the rule will cost all intermediaries a total of approximately $227,500,000 in one-time capital costs to develop or upgrade their software and other technological systems to collect, store, and transmit the required identity and transaction information to funds and from other intermediaries, and a total of $140,000,000 each year thereafter in operation costs related to the transmission and receipt of the information.[100]

Although the rule does not require first-tier intermediaries to enter into an agreement with their indirect intermediaries to share the indirect intermediaries' underlying shareholder data to funds upon a fund's request, we anticipate that in many cases intermediaries will nonetheless enter into such agreements, or at least enter into informal arrangements and design methods by which to collect the shareholder information. Our staff estimates that each of the 7000 intermediaries potentially affected by the rule will spend approximately 150 hours of service representatives' time at $40 per hour, and 10 hours of legal counsel time at $300 per hour, for a total of 1,050,000 hours of service representatives' time at a cost of $42,000,000, and 70,000 hours of in-house legal time at a cost of $21,000,000 to design and enter into these arrangements

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(development costs) equals $70,000,000; and 1400 intermediaries times $50,000 (annual costs) equals $70,000,000.

99 See Tom Leswing, Redemption Rule Fuels Demand For New Standards, Ignites (Oct. 26 2005).

100 This estimate is based on the following calculations: $157,500,000 (intermediaries that use service providers' start-up costs) plus $70,000,000 (other intermediaries' start-up costs) equals $227,500,000 in total intermediary start-up costs; and $70,000,000 (intermediaries that use service providers annual costs) plus $70,000,000 (other intermediaries' annual costs) equals

(footnote continued)

with other intermediaries.[101] The Commission staff therefore estimates that intermediaries will expend a total of approximately 1,120,000 hours at a cost of $63,000,000 to enter into arrangements to ensure the proper transmittal of information to funds through chains of intermediaries.[102]

C. Total Costs and Hours Incurred

For purposes of the Paperwork Reduction Act, our staff estimates that the amended rule would have a total collection of information cost in the first year to both funds and intermediaries of $274,575,000 in one-time start-up costs, and annual operation costs of $161,515,000.[103] Our staff estimates that the weighted average annual cost of the rule to funds and intermediaries for each of the first three years would be $253,040,000.[104] The total hours expended by both funds and intermediaries in complying with the amended rule would be a one-time expenditure of 2,429,500 hours at a total internal cost of $116,550,000.[105] We anticipate that there will be a total

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$140,000,000 in annual costs.

[101] This estimate is based on the following calculations: 7000 intermediaries times 150 service representative hours at $40 per hour equals 1,050,000 hours at a cost of $42,000,000; and 7000 intermediaries times 10 hours of in-house legal time at $300 per hour equals 70,000 hours at a cost of $21,000,000.

[102] This estimate is based on the following calculations: 1,050,000 service representative hours at $42,000,000 plus 70,000 in-house counsel hours at $21,000,000 equals 1,120,000 hours at $63,000,000.

[103] This estimate is based on the following calculation: $47,075,000 (fund start-up costs) plus $227,500,000 (intermediary start-up costs) equals $274,575,000 in total start-up costs; and $21,515,000 (fund annual costs) plus $140,000,000 (intermediary annual costs) equals $161,515,000 in total annual costs.

[104] This estimate is based on the following calculation: $274,575,000 in total start-up costs plus $484,545,000 (3 years at $161,515,000 in total annual costs) equals $759,120,000 in total costs over a three year period. $759,545,000 divided by three years, equals a weighted average cost of $253,040,000 per year.

[105] This estimate is based on the following calculations: 1,309,500 hours at a cost of $53,550,000 in agreement time plus 1,120,000 hours at a cost of $63,000,000 in chain of intermediary arrangement time equals 2,429,500 hours at a cost of $116,550,000.

(footnote continued)

of approximately 7900[106] respondents, with approximately 3,510,000 total responses in the first year, and 3,240,000 annual responses each year thereafter.[107]

D. Request for Comments

We request comment on whether these estimates are reasonable. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments in order to: (i) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

For purposes of the Paperwork Reduction Act, the Adopting Release included an estimate of the total start up costs to funds and financial intermediaries in complying with the collection of information aspect of the rule of approximately $1,111,500,000. We estimate that if the proposed amendments are adopted, for purposes of the Paperwork Reduction Act, funds and intermediaries would incur the reduced amount of $274,575,000 in start-up costs, for a potential cost reduction of approximately $836,925,000. In the Adopting Release we also estimated that the ongoing annual costs would be $390,556,800. We estimate that if the proposed amendments are adopted, for purposes of the Paperwork Reduction Act, funds and intermediaries would incur the reduced amount of $161,515,000 in total annual costs, for a potential ongoing annual cost reduction of approximately $229,041,800.

106 This estimate is based on the following calculation: 7000 intermediaries plus 900 fund complexes equals 7900 respondents.

107 This estimate is based on the following calculation: 900 fund complexes with an average of 300 intermediaries each, equals 270,000 one time responses for the shareholder information portion of the collection (900 funds times 300 intermediaries equals 270,000). Assuming that each fund requests information from each of its intermediaries once each month, the total number of annual responses would be 3,240,000 (270,000 fund intermediaries times 12 months equals 3,240,000 annual responses). Therefore, in the first year, there would be 3,510,000 total responses (3,240,000 monthly responses plus the 270,000 initial responses required for the agreements) and 3,240,000 annual responses thereafter.

Persons wishing to submit comments on the collection of information requirements of the proposed amendments should direct them to the Office of Management and Budget, Attention Desk Officer of the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 10102, New Executive Office Building, Washington, DC 20503, and should send a copy to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-0609 with reference to File No. S7-06-06. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this Release; therefore a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this Release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No.S7-06-06, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services.

IX. INITIAL REGULATORY FLEXIBILITY ANALYSIS

This Initial Regulatory Flexibility Analysis ("IRFA") has been prepared in accordance with 5 U.S.C. 603. It relates to amendments to rule 22c-2 under the Investment Company Act, which we are proposing in this Release.

A. Reasons for the Proposed Action

Rule 22c-2 allows funds to recover some, if not all, of the direct and indirect (e.g., market impact and opportunity) costs incurred when shareholders engage in short-term trading of the fund's shares, and to deter this short-term trading. As discussed more fully in Sections I and II of this Release, the proposed amendments to rule 22c-2 are necessary to clarify any potentially misleading interpretations of the rule, to enable funds and intermediaries to reduce costs associated with entering into agreements under the rule, and to enable funds to focus their short-term trading deterrence efforts on the entities most likely to violate fund policies. The proposed amendments would also set forth the limitations on transactions between a fund and an intermediary with whom the fund does not have an agreement.

B. Objectives of the Proposed Action

As discussed more fully in Sections I and II of this Release, the objective of the proposed rule amendments is to ensure that the investor protections of rule 22c-2 are fully maintained, while reducing costs to all participants, and addressing certain issues with the rule as adopted.

C. Legal Basis

As indicated in Section X of this Release, these amendments to rule 22c-2 are proposed pursuant to the authority set forth in sections 6(c), 22(c) and 38(a) of the Investment Company Act.[108]

D. Small Entities Subject to the Proposed Rule and Amendments

A small business or small organization (collectively, "small entity") for purposes of the Regulatory Flexibility Act is a fund that, together with other funds in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year.[109] Of approximately 3,925 funds (2,700 registered open-end investment companies and 825 registered unit investment trusts), approximately 163 are small entities.[110] A broker-dealer is considered a small entity if its total capital is less than $500,000, and it is not affiliated with a

[108] 15 U.S.C. 80a-6(c), 80a-22(c) and 80a-37(a).

[109] 17 CFR 270.0-10.

[110] Some or all of these entities may contain multiple series or portfolios. If a registered investment company is a small entity, the portfolios or series it contains are also small entities.

broker-dealer that has $500,000 or more in total capital.[111] Of approximately 7,000 registered broker-dealers, approximately 880 are small entities.

As discussed above, rule 22c-2 provides funds and their boards with the ability to impose a redemption fee designed to reimburse the fund for the direct and indirect costs incurred as a result of short-term trading strategies, such as market timing. The proposed amendments are designed to maintain these investor protections while reducing costs to market participants and clarifying the Commission's intent as to the proper interpretation of the rule. While we expect that the rule and these proposed amendments would require some funds and intermediaries to develop or upgrade software or other technological systems to enforce certain market timing policies, or make trading information available in omnibus accounts, the amendments we are proposing today are specifically designed to reduce the costs incurred by small entities. In particular, we anticipate that the changes we propose to make to the definition of financial intermediary would significantly reduce the number of small intermediaries that funds must enter into agreements with, and reduce the burden of complying with the rule for small funds and small intermediaries. We request that commenters address the costs of complying with these amendments, including specific data on costs when available and a description of the likely technologies that may be used.

E. Reporting, Recordkeeping, and Other Compliance Requirements

The proposed amendments do not introduce any new mandatory reporting requirements. Rule 22c-2 already contains a mandatory recordkeeping requirement for funds that redeem shares within seven days of purchase. The fund must retain a copy of the written agreement

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[111] 17 CFR 240.0-10.

between the fund and financial intermediary under which the intermediary agrees to provide the required shareholder information in omnibus accounts.[112] The proposed amendments reduce the number of small entities that would otherwise be subject to this recordkeeping requirement.

F. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission has not identified any federal rules that duplicate, overlap, or conflict with the proposed rule amendments.

G. Significant Alternatives

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. Alternatives in this category would include: (i) establishing different compliance or reporting standards that take into account the resources available to small entities; (ii) clarifying, consolidating, or simplifying the compliance requirements under the rule for small entities; (iii) using performance rather than design standards; and (iv) exempting small entities from coverage of the rule, or any part of the rule.

The Commission does not presently believe that these proposed amendments would require the establishment of special compliance requirements or timetables for small entities. These proposed amendments are specifically designed to reduce any unnecessary burdens on all funds (including small funds) and on small intermediaries. To establish special compliance requirements or timetables for small entities may in fact disadvantage small entities by encouraging larger market participants to focus primarily on the needs of larger entities when establishing the information-sharing systems envisioned by the rule and these proposed

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[112] Rule 22c-2(a)(3).

amendments, and possibly ignoring the needs of smaller entities. Nevertheless, we request comment as to whether establishing special timetables or compliance requirements would benefit small entities, while accomplishing the goals of the rulemaking. Would it benefit small entities to have additional time to comply with these amendments? Should we further revise the rule to reduce the compliance requirements for small entities? Are there other compliance requirement alternatives?

With respect to further clarifying, consolidating, or simplifying the compliance requirements of the rule, using performance rather than design standards, and exempting small entities from coverage of these proposed amendments or any part of the rule, we believe additional such changes would be impracticable. These proposed amendments would in effect except a large number of smaller entities from the scope of the rule, by revising the definition of financial intermediary. We have designed these proposed amendments to reduce the cost and compliance burden on small entities to the greatest extent practicable while still maintaining the investor protections of the rule as adopted.

Small entities are as vulnerable to the problems uncovered in recent enforcement actions and settlements as large entities. Therefore, shareholders of small entities are equally in need of protection from short-term traders. We believe that the rule and these proposed amendments will enable funds to more effectively discourage short-term trading of all fund shares, including those held in omnibus accounts. Further excepting small entities from coverage of the rule or any part of the rule could compromise the effectiveness of the rule. We anticipate that the proposed amendments would alleviate much of the burden imposed by the rule on small entities, and result in a more cost effective system for discouraging short-term trading for all entities. Alternatives that we considered but are not proposing included, among others, (i) fully exempting all small entities from complying with the information-sharing aspect of the rule, (ii) not requiring that the information-sharing agreement obligate first-tier intermediaries to assist in providing information from indirect intermediaries to funds, and (iii) extending the compliance date for small entities.

In light of the above discussion, we request comment on whether it is feasible or necessary to make additional or different accommodations for small entities for compliance with the proposed rule amendments. Should the proposed rule amendments be further altered in order to ease the regulatory burden on small entities, without sacrificing its effectiveness? Are there additional alternatives that we have not considered?

H. Solicitation of Comments

The Commission encourages the submission of comments with respect to any aspect of this IRFA. Comment is specifically requested on the number of small entities that would be affected by the proposed rule, and the likely impact of the proposals on small entities. Commenters are asked to describe the nature of any impact and provide empirical data supporting its extent. These comments will be considered in connection with any adoption of the proposed rule and amendments, and will be reflected in the Final Regulatory Flexibility Analysis.

Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-06-06 on the subject line; or
- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the

instructions for submitting comments.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303.

All submissions should refer to File Number S7-06-06. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/proposed.shtml). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549.

X. STATUTORY AUTHORITY

The Commission is proposing amendments to rule 22c-2 pursuant to the authority set forth in sections 6(c), 22(c) and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c), 80a-22(c) and 80a-37(a)].

List of Subjects in 17 CFR Part 270

Investment companies, Reporting and recordkeeping requirements, Securities.

TEXT OF PROPOSED RULE

For reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 270--RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

1. The authority citation for Part 270 continues to read in part as follows:

Authority: 15 U.S.C. 80a-1 et seq., 80a-34(d), 80a-37, and 80a-39, unless otherwise noted.

*   *   *   *   *

2.   Section 270.22c-2 is revised to read as follows:

§ 270.22c-2 Redemption fees for redeemable securities.

(a) Redemption fee. It is unlawful for any fund issuing redeemable securities, its principal underwriter, or any dealer in such securities, to redeem a redeemable security issued by the fund within seven calendar days after the security was purchased, unless it complies with the following requirements:

(1) Board determination. The fund's board of directors, including a majority of directors who are not interested persons of the fund, must either:

(i) Approve a redemption fee, in an amount (but no more than two percent of the value of shares redeemed) and on shares redeemed within a time period (but no less than seven calendar days), that in its judgment is necessary or appropriate to recoup for the fund the costs it may incur as a result of those redemptions or to otherwise eliminate or reduce so far as practicable any dilution of the value of the outstanding securities issued by the fund, the proceeds of which fee will be retained by the fund; or

(ii) Determine that imposition of a redemption fee is either not necessary or not appropriate.

(2) Shareholder information. With respect to each financial intermediary that submits orders to purchase or redeem shares directly to the fund, its principal underwriter or transfer agent, or to a registered clearing agency, the fund, (or on the fund's behalf, the principal underwriter, transfer agent, or registered clearing agency) must either:

(i) Enter into a shareholder information agreement with the financial intermediary; or

(ii) Prohibit the financial intermediary from purchasing, on behalf of itself or other persons, securities issued by the fund.

(3) Recordkeeping. The fund must maintain a copy of the written agreement under paragraph (a)(2)(i) of this section that is in effect, or at any time within the past six years was in effect, in an easily accessible place.

(b) Excepted funds. The requirements of paragraph (a) of this section do not apply to the following funds, unless they elect to impose a redemption fee pursuant to paragraph (a)(1) of this section:

(1) Money market funds;

(2) Any fund that issues securities that are listed on a national securities exchange; and

(3) Any fund that affirmatively permits short-term trading of its securities, if its prospectus clearly and prominently discloses that the fund permits short-term trading of its securities and that such trading may result in additional costs for the fund.

(c) Definitions. For the purposes of this section:

(1) Financial intermediary means:

(i) Any broker, dealer, bank, or other person that holds securities issued by the fund, in nominee name;

(ii) A unit investment trust or fund that invests in the fund in reliance on section 12(d)(1)(E) of the Act (15 U.S.C. 80a-12(d)(1)(E)); and

(iii) In the case of a participant-directed employee benefit plan that owns the securities issued by the fund, a retirement plan's administrator under section 3(16)(A) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002(16)(A)) or any person that maintains the plan's participant records.

(iv) Financial intermediary does not include any person that the fund treats as an individual investor with respect to the fund's policies established for the purpose of eliminating or reducing any dilution of the value of the outstanding securities issued by the fund.

(2) Fund means an open-end management investment company that is registered or required to register under section 8 of the Act (15 U.S.C. 80a-8), and includes a separate series of such an investment company.

(3) Money market fund means an open-end management investment company that is registered under the Act and is regulated as a money market fund under § 270.2a-7.

(4) Shareholder includes a beneficial owner of securities held in nominee name, a participant in a participant-directed employee benefit plan, and a holder of interests in a fund or unit investment trust that has invested in the fund in reliance on section 12(d)(1)(E) of the Act. A shareholder does not include a fund investing pursuant to section 12(d)(1)(G) of the Act (15 U.S.C. 80a-12(d)(1)(G)), a trust established pursuant to section 529 of the Internal Revenue Code (26 U.S.C. 529), or a holder of an interest in such a trust.

(5) Shareholder information agreement means a written agreement under which a financial intermediary agrees to:

(i) Provide, promptly upon request by a fund, the Taxpayer Identification Number of all shareholders who have purchased, redeemed, transferred, or exchanged fund shares held through an account with the financial intermediary, and the amount and dates of such shareholder purchases, redemptions, transfers, and exchanges;

(ii) Execute any instructions from the fund to restrict or prohibit further purchases or exchanges of fund shares by a shareholder who has been identified by the fund as having engaged in transactions of fund shares (directly or indirectly through the intermediary's account) that violate policies established by the fund for the purpose of eliminating or reducing any dilution of the value of the outstanding securities issued by the fund; and

(iii) Use best efforts to determine, promptly upon the request of the fund, whether any other person that holds fund shares through the financial intermediary is itself a financial intermediary ("indirect intermediary") and, upon further request by the fund,

(A) Provide (or arrange to have provided) the identification and transaction information set forth in paragraph (c)(5)(i) of this section regarding shareholders who hold an account with an indirect intermediary; or

(B) Restrict or prohibit the indirect intermediary from purchasing, on behalf of itself or other persons, securities issued by the fund.

By the Commission.

Nancy M. Morris
Secretary

Dated: February 28, 2006