Legal Update:

If you have questions or would like additional information on the material presented herein, please contact:

Jay S. Neuman  
412.288.7496  
jneuman@reedsmith.com  

or  
Frederick C. Leech  
412.288.4178  
fleech@reedsmith.com

SEC Amends Rule 22c-2 and Extends Compliance Dates


Dates: The "effective date" of the amendments will be 60 days after the Release is published in the Federal Register (publication likely during the week of Oct. 2, 2006). The SEC extended the "compliance dates" for the shareholder information agreement provisions of rule 22c-2 as follows. Affected funds have until April 16, 2007 to enter into "shareholder information agreements" with their "intermediaries." The SEC also extended, until Oct. 16, 2007, the date by which funds must be able to request and promptly receive shareholder identity and transaction information pursuant to shareholder information agreements.

Note: The SEC did not propose an extension of the compliance date for the provision of the rule that requires a fund's board to consider the adoption of a redemption fee policy [section 22c-2(a)(1)]. The compliance date for that provision remains Oct. 16, 2006.

Background

On March 11, 2005, the SEC adopted rule 22c-2 under the Investment Company Act "to help address abuses associated with short-term trading of fund shares." The rule generally provides that if a fund redeems its shares within seven days, its board must consider whether to impose a fee of up to 2 percent of the value of shares redeemed shortly after their purchase ("redemption fee"). The rule also requires such a fund to either enter into agreements with its "financial intermediaries" (such as broker-dealers or retirement plan administrators) that hold shares on behalf of other investors ("shareholder information agreements"), or else prohibit the intermediary from purchasing fund shares. Under those agreements, the intermediaries must agree to provide, at the fund's request, shareholder identity and transaction information, and carry out instructions from the fund to
restrict or prohibit further purchases or exchanges by a shareholder (as identified by the fund) who has engaged—directly or indirectly through the intermediary’s account—in trading that violates the fund’s frequent trading policies. The agreement must be in writing, but may be part of another contract or agreement (such as a distribution agreement).

In response to widespread concern about the operation of the information-sharing provisions of the rule as originally adopted, the SEC earlier this year proposed amendments that were intended to reduce the costs of compliance and clarify the rule’s application in certain circumstances. The SEC has now adopted those amendments substantially as proposed, with some changes that reflect comments received on the proposed revisions. The Release discusses these revisions and provides additional clarification on operation of the rule.

Changes to Shareholder Information Agreement Provisions

The new amendments to rule 22c-2 limit the types of intermediaries with which funds must enter into shareholder information agreements; address the rule’s application when there are "chains of intermediaries"; and clarify the effect of a fund’s failure to obtain an agreement with any of its intermediaries.

Definition of "Financial Intermediary." The SEC has amended the rule’s definition of "financial intermediary" to exclude from that definition any entity 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 (i.e., frequent trading and redemption fee policies). Thus, for example, if a fund 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 a shareholder information agreement with that plan.

Note, however, that the SEC did not (as recommended by some commenters) revise the rule to specify the circumstances under which a fund may treat an intermediary as an individual investor (rather than an intermediary) for purposes of its frequent trading policies. In this regard, the Release notes the SEC's continued belief that "funds are in the best position to determine the treatment of an account as an individual investor under their frequent trading policies."

In a change from the proposal, this provision, as adopted, provides that funds must enter into agreements with "each financial intermediary that submits orders, itself or through its agent, to purchase or redeem shares directly to the fund ..." (changes in italics). The SEC made this revision in response to commenters who sought clarification about cases where purchase and redemption...
orders are aggregated and submitted by agents of intermediaries on behalf of the intermediaries. This revision is intended to make clear that funds must enter into agreements with financial intermediaries or their agents, even if the intermediaries submit orders through entities that would not themselves meet the rule's definition of "financial intermediary."

**Intermediary Chains.** In some cases, an intermediary such as a broker-dealer may hold shares of a mutual fund not only on behalf of individual investors, but also on behalf of other financial intermediaries, such as pension plans or other broker-dealers ("indirect intermediaries") through one or more layers (or "chains") of intermediaries. In order to clarify the operation of the rule as it applies to "chains of intermediaries," the revised rule requires that a fund (or, on the fund's behalf, its principal underwriter or transfer agent) enter into a shareholder information agreement only with those financial intermediaries, or their agents, that submit purchase or redemption orders directly to the fund, its principal underwriter or transfer agent, or a registered clearing agency ("first-tier intermediaries"). The rule does not require first-tier intermediaries to enter into shareholder information agreements with any indirect intermediaries.

After requesting and receiving initial transaction information from a first-tier intermediary, a fund would have to make a specific further request to the first-tier intermediary for information on certain shareholders. Thus, the revised rule clarifies that a shareholder information agreement need not obligate a first-tier intermediary to perform a complete review of its books and records to identify all indirect intermediaries. Instead, a first-tier intermediary would have to use its best efforts to identify whether or not certain specific accounts identified by the fund are indirect intermediaries.

After the first-tier intermediary informs the fund which shareholders are second-tier intermediaries, the fund could then request that the first-tier intermediary obtain underlying shareholder transaction information from any or all of those second-tier intermediaries. If an indirect intermediary that holds an account with a first-tier intermediary does not provide underlying shareholder information after being requested to do so, the agreement must obligate the first-tier intermediary to prohibit, upon the fund's further specific request, that indirect intermediary from purchasing additional shares of the fund through the first-tier intermediary.

**Effect of Lacking an Agreement.** The rule, as amended, clarifies that, if a fund lacks an agreement with a particular intermediary, the fund may continue to redeem securities within seven calendar days, but it must prohibit that financial intermediary from purchasing fund shares in nominee name, on behalf of any other person. Note that this would not prohibit continued purchases by the intermediary for accounts that are fully disclosed to the fund, nor would it prohibit
the intermediary from purchasing fund shares on its own behalf. The prohibition applies only to the intermediary with which the fund does not have an agreement; purchases from other intermediaries will not be affected.

Clarification on Operation of the Rule

Frequency of Transaction Information Requests. The Release notes that some commenters urged the SEC to impose limits on the frequency of information requests made by funds pursuant to the required agreements. While the SEC declined to impose such limits (because, as it previously noted, "we expect funds that are susceptible to market timing to use the tool regularly"), it did offer suggestions on this topic.

Specifically, the Release notes that a fund, in determining the frequency with which it should seek transaction information from its intermediaries, could consider:

- Unusual trading patterns, such as abnormally large inflows or outflows, that may indicate the existence of frequent trading abuses
- The risks that frequent trading poses to the fund and its shareholders in light of the nature of the fund and its portfolio
- The risks to the fund and its shareholders of frequent trading in light of the amount of assets held by, or the volume of sales and redemptions through, the financial intermediary
- The confidence the fund (and its chief compliance officer) has in the implementation by an intermediary of trading restrictions designed to enforce fund frequent trading policies or similar restrictions designed to protect the fund from abusive trading practices

The Release also noted that, in some cases, fund managers may seek transaction information "only occasionally" to determine whether the intermediary is, in fact, enforcing trading restrictions or imposing redemption fees on behalf of the fund.

Deference to Intermediaries' Policies. The Release notes that some intermediaries have responded to market timing concerns by enforcing their own frequent trading policies, which may be different from policies established by fund boards, and addresses this as follows: "We believe that a fund in appropriate circumstances could reasonably conclude that an intermediary's frequent trading policies sufficiently protect fund shareholders, and could therefore defer to the intermediary's policies, rather than seek to apply the fund's policies on frequent trading to shareholders who invest through that intermediary. In those circumstances, the fund should describe in its prospectus that certain intermediaries through which a shareholder may own fund shares may impose frequent trading restrictions that differ from those of the fund, generally describe the types of
intermediaries (e.g., broker-dealers, insurance company separate accounts, and retirement plan administrators), and direct shareholders to any disclosures provided by the intermediaries with which they have an account to determine what restrictions apply to the shareholder."

Although a fund is required to disclose whether each restriction imposed by the fund to prevent or minimize frequent trading applies to trades that occur through omnibus accounts at intermediaries, and to describe with specificity the circumstances (if any) under which each such restriction will not be imposed, a fund would not be required to describe the frequent trading policies of each intermediary to whose policies the fund defers.

By Jay Neuman. Mr. Neuman is a partner with Reed Smith's Investment Management Group.