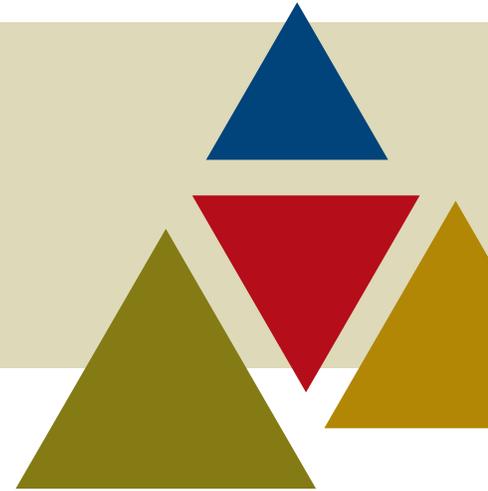


# Short-Term Redemption Fees

*Compliance Challenges and Opportunities*



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# Short-Term Redemption Fees: The Call to Action

The SEC recently issued a proposed ruling 22c-2 on mandatory short-term redemption fees as part of its attack on abusive market timing—the rapid buying and selling of fund shares that can drive up costs and lower performance for long-term investors. Short-term redemption fees are paid back into the fund to cover the trader’s transaction costs.

Although the SEC proposal has recommended a minimum two-percent penalty on the proceeds from shares traded within five days of purchase, additional fees and varying holding periods are being instituted by fund companies to address these concerns. A rapidly unfolding landscape of fees, schedules and rules around the early redemption of shares is creating challenges for organizations that trade and manage mutual funds.

## The “Hodgepodge” of Fees and Conditions

During an open meeting of the SEC on February 25, 2004, SEC Chairman William H. Donaldson described these emerging challenges: “Today, the vast majority of mutual fund shares are held through financial intermediaries such as broker-dealers, banks, insurance companies, and retirement savings plans,” Chairman Donaldson said. “Thus, funds that impose redemption fees must turn to the intermediaries for assistance in implementing them. These intermediaries may be reluctant to undertake this burden on behalf of the funds, particularly when confronted with a hodgepodge of fees and conditions that differ from fund to fund and complex to complex...”

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While the stated purpose of the proposed SEC rule is to simplify the implementation of short-term redemption fees, in reality some complex issues are emerging. Mutual fund companies are moving to send their own messages to intermediaries in the form of varying fee amounts, holding periods, and implementation dates. Some mutual fund companies already have imposed short-term redemption fees, while others are scheduling and re-scheduling effective dates.

An array of varying fund-directed redemption fees now exists. Holding periods range from a few days to more than a year; fee rates vary from 0.5% to 2% or more. Tiered fees, where mutual funds impose a 2% rate for a short holding period and a lower percent for redemptions held longer, are also emerging. Making the landscape more complex, these rules may be assessed differently to funds within the same mutual fund family and sometimes differ depending upon the type of redemption transaction. While some funds impose redemption fees only on participant-directed exchanges and transfers, others impose them on all participant transactions, even on transactions that can’t be used for market timing purposes.

The following table presents a sample of the mutual fund companies that have published their mandatory short-term redemption fee schedules.

Company	Effective Date	Redemption Fee	Minimum Holding Period
American Century	3/1/04	2%	180 days
	3/1/04	2%	60 days
	3/1/04	2%	60 days
Black Rock	1/28/04	2%	90 days
	3/3/04	2%	90 days
	12/5/01	2%	None
Loomis Sayles	4/1/04	2%	60 days
Federated	5/15/04	2%	90 days
Fidelity	Delayed	1%	60 days
	from 1/05	1.5%	90 days
		13 different combinations	
T-Rowe Price	6/1/04	0.5% - 2%	90 days to 1 year

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**Sample Exceptions to Redemption Fees**

- Total or partial redemptions made within 30 days following the death or disability of the purchaser
- Total or partial redemptions made due to a previously approved automated non-discretionary automatic rebalancing program or a systematic withdrawal plan set up in the funds
- Redemptions initiated by the fund
- Accounts held by financial institutions not able to track the fees (alternate methods for fee accounting is required)

## Who Will Meet the Challenge?

Many financial intermediaries have taken a “wait and see” approach to the short-term redemption fee issue, assuming that record keeping system vendors will solve the problem for them. Others have suggested that they will simply avoid trading those funds that impose short-term redemption fees for the near term, buying time to see how the industry as a whole handles the issue. Still others assume the funds will do the calculations for them.

There are long-term benefits for financial service organizations that choose to move quickly to ensure compliance with the myriad of rules, fee agreements and holding periods now being set by fund companies. Financial intermediaries that implement the processes and technology necessary to ensure compliance with short-term redemption fees now rather than later stand to realize significant control, efficiency and revenue gains. Intermediaries that implement open-ended tracking technology will be positioned to offer a wider variety of mutual fund products to their client base. In addition, they will enhance processing control and efficiency.

Taking a “wait-and-see” position, on the other hand, is risky business.

## Emerging Responses

Financial service organizations operating in an omnibus account environment have options for how to address short-term redemption fees. They should weigh the responsibilities and potential returns associated with approaches for compliance carefully and engage the appropriate approach for their business.

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## Fund Driven Approach

Under the fund driven approach, all positions at the fund must be held in fully disclosed accounts. The fund assumes all responsibility for tracking and aging share lots based on all the transaction activity hitting the account. The fund is also responsible for assessing and collecting the fees related to transactions that are subject to short-term redemption fees.

Using this approach, financial intermediaries operating in omnibus environments would be required to close those positions, create new accounts at the fund for each of their underlying clients, and then execute transactions to move the shares into the appropriate long title account. If the intermediary has a Sub TA agreement with the fund, then they may also have to give up all—or a large portion of that revenue.

From an operational standpoint, the fund-driven approach requires a considerable amount of work in establishing the new accounts, moving the shares and verifying that shares were accurately moved to each new account. If this process is performed in funds that do daily accruals, then the accrued dividends earned for each account must also be moved and reconciled.

## **Financial Intermediary Driven Approach**

Under this scenario, the financial intermediary takes responsibility for aging share lots, calculating the short term redemption fees and remitting payments along with the supporting detail to the fund. By employing processes and technology that can address the differing aging requirements, methods and rates that are being instituted by the various funds and fund companies, financial intermediaries that decide to internalize this process may be able to seize opportunities by continuing to hold omnibus positions at the fund, enabling them to collect Sub-TA revenue and even renegotiate their agreements with the funds at higher rates.

To realize the full potential of this approach, financial intermediaries can benefit from putting in place technology and processes that enable them to retain their omnibus positions and their Sub-TA revenue stream. By automating fee management processes, financial intermediaries can maintain and control all of their revenue sharing arrangements, electronically matching payment detail against internal calculations. By retaining—potentially even increasing—Sub-TA fees and uncovering lost 12b-1 revenue, this approach offers intermediaries top-line business benefits.

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# Answering the Call

In selecting the appropriate method for complying with the myriad of short-term redemption fee rules, the issue of sub transfer-agent fees (Sub-TA) fees must be considered as it is directly impacted by the method selected. Simply put: If the funds do the work, Sub-TA fees for financial intermediaries are likely to be eliminated. If financial intermediaries perform the work, they may justify an increase in Sub-TA fees that reflects the increased services they are providing.

## Financial Intermediaries Take the Lead

Regardless of the approach selected, it appears clear that compliance with short-term redemption fee mandates will place a substantial burden on financial intermediaries. If financial intermediaries fail to take the lead on short-term redemption fees, leaving the funds to ramp up for and handle the extra burden of processing detailed transaction information at the individual account level, then the funds are justified in reducing the financial institution's Sub-TA fees. Alternatively, adopting the Financial Intermediary-Driven approach opens the door for additional revenue opportunities for financial organizations providing services to funds.

Regardless of whether an organization adopts the Financial Intermediary-Driven approach or decides to let "someone else" tackle the nuances of managing short-term redemption fees, financial intermediaries will be required to send account-level transaction detail to the fund. Because the remittance of collected short-term redemption fees is not currently supported through the NSCC, payments will have to be sent to each fund's transfer agent. There will be no centralized clearing and settlement until the NSCC provides a solution.

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## A Solution for Compliance—and Beyond

Intermediaries require short-term redemption fee solutions that track and age sub-omnibus share lots to identify and calculate redemption fee scenarios. These same solutions must allow them to continue to reap the benefits of trading in omnibus accounts in order to retain Sub-TA revenues. It may also create opportunities to renegotiate with the fund companies for higher fees in exchange for these added services.

For short-term redemption fees, specifically, financial intermediaries require solutions that support and automate share-lot aging, fee calculation, detail tracking and payment remittance. Key ingredients for a comprehensive short-term redemption fee solution include:

- An efficient method for centralizing and maintaining all fee and revenue sharing agreements.
- Support for revenue and commission fee calculations and tracking for omnibus accounts and their underlying sub-accounts, as well as for fully disclosed positions at the fund.
- Automated payment remittance.
- Monitoring and verification of the amounts and frequency of payment.
- The application of business rules down to the CUSIP, account and transaction level to manage the evolving set of rules around short-term redemption fees. Changes in rates and holding periods made at the business-rule level can be automatically replicated across the system.
- Flexibility to track, calculate, optimize and reconcile fees beyond short-term redemption fees for maximum return on investment.
- Precise calculation of all revenue sharing agreements at an account level for compliance and determining profitability.
- Maintenance of a complete history and comprehensive audit trail.

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By implementing robust solutions to meet the demands of varying redemption fee schedules, financial intermediaries have the opportunity to leverage enhanced capabilities to renegotiate revenue sharing agreements. Turning challenge into opportunity, intermediaries can now move ahead of the compliance curve and realize total control and active management of fee arrangements.

For more information on solving the challenges and realizing the opportunities around short-term redemption fees and active fee management, contact Delta Data Software at (800) 451-9188, email us at [info@deltadatasoft.com](mailto:info@deltadatasoft.com), or visit us online at [www.deltadatasoft.com](http://www.deltadatasoft.com).

## About Delta Data Software

With a 19-year legacy of building, implementing, supporting and maintaining sophisticated software systems, Delta Data Software ([www.deltadatasoft.com](http://www.deltadatasoft.com)) is uniquely skilled in the delivery of transaction-based applications specifically tailored to meet the technology needs of the retirement and investment services industry. Delta Data's FUNDLinx is the industry's most advanced and comprehensive mutual fund and securities processing system—driving profitability for our clients with better edits and audit controls, less risk and dramatic cost reductions from straight-through processing.

### Short-Term Redemption Fees:

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