Coalition of Mutual Fund Investors

June 14, 2011

The Honorable Bill Lockyer
State Treasurer
State of California
915 Capitol Mall C-15
Sacramento, California 95814

Subject: ScholarShare Investment Board Request for Proposals No. SIB 15-10 (Program/Plan Manager for ScholarShare College Savings Program)

Dear Mr. Lockyer:

On behalf of the Coalition of Mutual Fund Investors ("CMFI"),[1] my purpose in writing is to inform you and your office about a new recordkeeping practice that is being promoted by large broker-dealers to increase the fees that they can charge for services rendered to advisor-sold Section 529 plans. This new recordkeeping practice is being adopted for the Virginia College Savings Plan and it will be an issue in the Request for Proposals ("RFP") that the California ScholarShare Investment Board is currently conducting to select a Program/Plan Manager for the ScholarShare College Savings Program ("ScholarShare Program").

CMFI is concerned that this recordkeeping practice is being implemented without any type of competitive bidding process and for the sole purpose of generating additional fee income for large brokerage firms. While this broker-dealer initiative is being promoted as a more efficient recordkeeping process than current practices, the reality is that this type of account structure will not reduce costs for investors participating in Section 529 plans. Instead, the higher fees generated by broker-dealers using this practice—and the insertion of an additional layer of intermediation between investors and a Section 529 plan—will only increase costs for all participants, without discernable benefits to anyone but the broker-dealers themselves.

The ScholarShare Program, authorized under Section 529 of the Internal Revenue Code, permits investors to purchase mutual fund shares in a tax-favored manner for the purpose of saving for college expenses. Investors in the ScholarShare Program can select and purchase mutual fund shares directly, without the use of a broker-dealer, financial

[1] The Coalition of Mutual Fund Investors ("CMFI") is an Internet-based shareholder advocacy organization established to represent the interests of individual mutual fund investors. CMFI is headquartered in Washington, D.C. Information about CMFI and its advocacy activities can be accessed at www.investorscoalition.com.

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advisor, or other intermediary ("Direct Plan"). Alternatively, investors can select and purchase shares through a financial intermediary ("Advisor Plan").

Investors in the ScholarShare Program—whether purchasing directly or through a financial intermediary—have their Section 529 accounts held directly by the mutual funds selected for this purpose. In administering investor accounts for the ScholarShare Program, the State's Plan Manager—Fidelity Brokerage Services, LLC—knows the identity of each investor and possesses information on all investor-level transactions. Each mutual fund and its compliance personnel are then responsible for administering individual Section 529 accounts in a manner that complies with state and federal laws and the prospectus provided to each investor.

<u>The Proposal by Large Broker-Dealers to Generate Additional Fees from Section 529 Accounts</u>

This direct and transparent recordkeeping system has worked very well over the years for accounts in state-administered Section 529 Plans, including the ScholarShare Program. Unfortunately for the individual investor, several large broker-dealers want to change this recordkeeping system so that they can collect additional fees and payments from mutual funds and their advisers.

This new recordkeeping practice for Section 529 accounts is called omnibus accounting. Under this accounting structure, individual mutual fund share positions are kept on the books and records of the brokerage firm and are not on the books and records of a mutual fund. Orders from individual customers of the brokerage firm to purchase, redeem, or exchange mutual fund shares are consolidated together into one "omnibus" order for each trading day. A mutual fund records only the brokerage firm as the shareholder of record and, in most instances, is not provided with any information about the underlying investors and their transactions involving the fund's shares.

The practice of omnibus accounting is used by broker-dealers to improve the internal operating efficiencies of their brokerage platforms. This practice, however, does not increase efficiencies or reduce costs for 529 plan participants. Instead, this accounting structure only benefits broker-dealers through the payment of new (and more expensive) recordkeeping fees than those which were previously paid to mutual funds.

In August of 2010, CMFI released a White Paper that analyzes the fee practices used in the omnibus accounting structure. CMFI's analysis concluded that large broker-dealers using this accounting method are imposing unnecessary costs on individual investors each year of as much as $1 billion in account maintenance charges and more than $7 billion in shareholder servicing payments. A copy of the CMFI White Paper is attached to this letter.

As noted earlier, the primary motivation behind omnibus accounting is the opportunity to extract additional fees for overseeing mutual fund accounts that are converted onto a brokerage account platform and are placed under the complete control of the broker-dealer. Mutual funds are very reliant on broker-dealers—and especially the largest brokerage firms—to sell and distribute their shares to individual investors. As a result of the market power of these large firms, the fees paid by mutual funds and their investment advisers for services provided are typically set without any competitive bidding process and are often fees that are higher than those set by normal market forces.

These fees are also being paid despite the fact that securities issuers do not normally pay broker-dealers to hold positions in individual accounts for other types of investments. For example, broker-dealers are not paid to hold municipal or corporate bonds, equity securities, or exchange-traded funds ("ETFs") in a brokerage account. These positions are tracked by broker-dealers in their accounting systems as a part of their required services to customers, typically at no charge to the account holder.

Aside from the payment of unnecessary fees, the largest problem created by the use of omnibus accounting is a lack of transparency at the investor account level. Each omnibus account can involve thousands of investors in a particular mutual fund and, in most circumstances, the identity of the underlying investors and their specific transactions are not disclosed outside of the broker-dealer accounting platform. For Section 529 accounts, this lack of transparency will create oversight and compliance challenges for the ScholarShare Program, if permitted to be implemented.

<u>The Use of Omnibus Accounting Will Cause Significant Problems in Ensuring Compliance with Current IRS Recordkeeping Rules</u>

The proposed conversion to an omnibus accounting structure by large broker-dealers is inconsistent with current guidance from the Internal Revenue Service ("IRS"), regarding the recordkeeping requirements of Section 529 qualified tuition programs.

Section 529(b)(3) of the Internal Revenue Code states that "[a] [state] program shall not be treated as a qualified tuition program unless it provides separate accounting for each designated beneficiary."[2] Proposed Treasury Regulation § 1.529-2(f) requires each 529 program to maintain records for each beneficiary account showing the total investment in the account, any earnings and distributions, and the total account balance:

> (f) *Separate accounting*. A program shall not be treated as a [Qualified State Tuition Program] unless it provides separate accounting for each designated beneficiary. Separate accounting requires that contributions for the benefit of a designated beneficiary and any earnings attributable thereto must be allocated to the appropriate account. If a program does not ordinarily provide each account owner an annual account statement showing the total account balance, the investment in the account, earnings, and

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[2] 26 U.S.C. § 529(b)(3).

> distributions from the account, the program must give this information to the account owner or designated beneficiary upon request.[3]

Current guidance also requires state programs to file a Form 1099-G with the IRS, for each account owner and beneficiary who receives a taxable distribution.[4] A state program must include account-level information in any Form 1099-G filed, including: (1) the name, address, and taxpayer identification number of the distributee; and (2) the amount of earnings distributed to the distributee in the calendar year.[5]

Additionally, current IRS guidance requires that all accounts maintained by a state 529 program for the benefit of a designated beneficiary are to be aggregated and treated as a single account for the purpose of calculating the earnings portion of any distribution.[6]

All of these IRS recordkeeping rules require that state agencies maintain oversight of individual Section 529 accounts and track all contributions, earnings, distributions, and other transactions. The use of omnibus accounting for Section 529 accounts will make it difficult for the ScholarShare Program to fulfill its tax compliance responsibilities, by permitting the conversion of a very transparent recordkeeping system into one with multiple recordkeepers and an unnecessary layer of intermediaries in between the ScholarShare Program and the investor accounts it is responsible for overseeing.

<u>Other Regulatory Problems Caused By Omnibus Accounting</u>

As a separate concern, the lack of transparency within omnibus accounts has created a number of regulatory problems for mutual funds. As you may know, omnibus accounts were implicated in the 2003-2004 market timing and late trading scandals within the mutual fund industry. In response, the U.S. Securities and Exchange Commission promulgated a regulation that requires a minimum level of transparency for these otherwise non-transparent accounts.[7] However, this information-sharing tool is not being used regularly by mutual funds; and the lack of transparency within these accounts continues to raise regulatory concerns.[8] For example:

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[3] U.S. Department of the Treasury, Qualified State Tuition Programs, Proposed Rule, 63 Fed. Reg. 45,019 (Aug. 24, 1998).

[4] Prop. Treas. Reg. § 1.529-4. 63 Fed. Reg. 45,019, at 45,030-45,031 (Aug. 24, 1998).

[5] Prop. Treas. Reg. § 1.529-4(b)(3). 63 Fed. Reg. 45,019, at 45,030-45,031 (Aug, 24, 1998). <u>See</u> Section 529 Programs, Notice 2001-81, Internal Revenue Bulletin No. 2001-52, at 618 (Dec. 26, 2001) ("Prop. Treas. Reg. § 1.529-4 requires a State tuition program to report on Form 1099-G, Certain Government Payments, the earnings portion of any distributions made during the year, together with other information such as the name, address and TIN of the distributee.").

[6] Prop. Treas. Reg. § 1.529-4(c). 63 Fed. Reg. 45,019, at 45,031 (Aug. 24, 1998).

[7] <u>See</u> 17 C.F.R. § 270.22c-2(c)(5).

[8] <u>See</u> Coalition of Mutual Fund Investors, <u>Excerpts from SEC Prospectus Filings Regarding Enforcement of Mutual Fund Market Timing and Other Short-Term Trading Policies within Third-Party Hidden</u>

- Mutual funds are not able to monitor, on a real-time basis, excessive short term trading activities at the investor account level;

- Investors being charged sales loads by broker-dealers are not receiving the proper volume or "breakpoint" discounts, as outlined in mutual fund prospectus filings;

- Money market funds are not able to evaluate accurately the liquidity needs of both retail and institutional investors, by being unable to "look through" the omnibus accounting structure to the investor account level; and

- Restitution payments and other distributions from SEC enforcement proceedings and private class action cases are not being made in as precise and timely a manner because of difficulties in obtaining investor-level information.

The problems of omnibus accounting have become so widespread that almost all mutual funds—including Fidelity—now add language to their prospectuses disclosing the transparency problems within these accounts and the impact of non-uniform application of a fund's prospectus policies.[9] Here is what Fidelity says in almost all of its mutual fund prospectus filings, including for those funds offered within the ScholarShare Program:

> Omnibus accounts, in which shares are held in the name of an intermediary on behalf of multiple investors, are a common form of holding shares among retirement plans and financial intermediaries such as brokers, advisers, and third-party administrators. Individual trades in omnibus accounts are often not disclosed to a fund, making it difficult to determine whether a particular shareholder is engaging in excessive trading. Excessive trading in omnibus accounts is likely to go undetected by a fund and may increase costs to the fund and disrupt its portfolio management.[10]

The mutual fund regulatory problems caused by omnibus accounting should serve as a warning to all state agencies responsible for Section 529 programs. The lack of transparency within these accounts will create similar obstacles to complying with current and future IRS recordkeeping requirements at the investor account level.

Accounts, updated as of May 1, 2011, available at http://www.investorscoalition.com/Analysis_of_Omnibus_Surveillance_Procedures_6-10-11.pdf. .

[9] See Id.

[10] Fidelity Freedom Funds, Prospectus, May 29, 2010, available at http://fundresearch.fidelity.com/mutual-funds/performance-and-risk/315792663.

The ScholarShare Investment Board RFP Process Should Establish Minimum Requirements for the Use of Omnibus Accounting in the Advisor Plan

The ScholarShare Investment Board RFP already has raised the issue of omnibus accounting in its requirements for the ScholarShare Advisor Plan. In Section 5.3(g), the RFP states the following:

> (g) Explain your firm's position on National Securities Clearing Corporation enhancements currently in process relating to Omnibus Accounts and/or Levels 3 and 4 processing. How would your firm change your response to 5.3(b) above, if at all, in an Omnibus environment?[11]

This statement refers to the FundSERV and Networking services of the National Securities Clearing Corporation ("NSCC"), a mutual fund order and account processing system that is used by the substantial majority of broker-dealers and mutual funds. The NSCC systems can link up account-level information for both financial intermediaries and the funds, providing full transparency within broker-controlled accounts on a real-time basis, for compliance and other purposes.[12]

These NSCC services were developed more than twenty (20) years ago to standardize, centralize, and automate mutual fund transactions. NSCC processing platforms provide significant operational efficiencies for both funds and their intermediaries. Using an "at cost" business model, NSCC permits investor-level information to be shared between financial institutions on a real-time basis at a cost of only 10 cents for every 100 records processed.

Despite this very successful processing system, large broker-dealers continue to demand that mutual funds pay increasing fees to support their omnibus accounting model, causing more and more mutual fund accounts to be converted onto the accounting platforms of brokerage firms, with a significant loss of transparency within these accounts.

Broker-dealers claim that omnibus accounting is more efficient operationally; however, the only beneficiary of this model is the brokerage industry. The reality is that mutual funds are paying higher fees and charges to these broker-dealers than the cost of using the NSCC platforms described above.

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[11] Scholarshare Investment Board, Request for Proposals No. SIB 15-10 (RFP): Program/Plan Manager for the ScholarShare College Savings Program, Part I – Request for Proposals, at 28, March 23, 2011. Section 5.3(b) of the RFP states: "Describe your firm's procedures to ensure compliance with the requirements of Section 529 of the Code and other applicable laws, including (but not limited to) the MSRB, the SEC, and California laws and regulations. Do you have a procedures manual in place for 529 programs?"

[12] The National Securities Clearing Corporation ("NSCC") is developing a new service, called Omni/SERV, to facilitate information-sharing between mutual funds and broker-dealers holding Section 529 accounts. This new service, however, may not offer the same level of transparency, or provide account-level information on a real-time basis, as the NSCC Networking service does presently.

The CMFI White Paper on shareholder servicing costs referred to above documents these recordkeeping costs, using available and public sources of information. In addition to Rule 12b-1 and adviser revenue-sharing payments, the larger broker-dealers are typically charging between $19 and $25 for each shareholder account holding fund shares, or an average charge of about $22 per account each year.[13] This is in contrast to the typical cost of between $10-16 for each fund account charged by third-party transfer agents within the mutual fund industry, or an average charge of about $13 per account each year.[14] The difference between the two averages—$9 per account—is an unnecessary increased cost to beneficiaries and to the 529 Plan itself. For the California ScholarShare Plan, an extra $9 for each of the Plan's 281,665 accounts (as of December 31, 2010) would add additional costs of $2.5 million each year, assuming that all ScholarShare Plan accounts are converted to an omnibus accounting system.[15]

One of the ironies with omnibus accounting is the fact that this broker-dealer initiative also doesn't improve Section 529 account recordkeeping. The conversion of directly-held investor accounts into an omnibus accounting structure will replace a system using a smaller number of recordkeepers—the group of funds selected for this purpose by the ScholarShare Program—with a system that will utilize multiple broker-dealer recordkeepers. This diffusion of responsibility for account maintenance and recordkeeping will make it much more difficult for the ScholarShare Program to comply with IRS requirements for separate accounting and reporting at the account owner and designated beneficiary levels.

The ScholarShare Board should reject the premise advanced by the broker-dealers that omnibus accounting improves the efficiency of 529 account administration. The rebuttal to this argument is a simple one: If the omnibus accounting platform improves a broker-dealer's operating efficiencies, then why are recordkeeping fees increasing and why are the participants in a 529 plan account not seeing a reduction in their costs?

For all these reasons, CMFI urges the ScholarShare Investment Board to establish at least three (3) requirements for the use of omnibus accounting in its ScholarShare Program:

1. Full Transparency at the Investor Level. The ScholarShare Investment Board should require full transparency within omnibus accounts at the investor level, on a real-time or same-day basis.[16]

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[13] See Coalition of Mutual Fund Investors, CMFI White Paper: The Costs of Providing Shareholder Services to Hidden Mutual Fund Accounts, at 6-7, August 18, 2010, available at http://www.investorscoalition.com/CMFIWhitePaperAug18.pdf (hereinafter "CMFI White Paper"). Within the mutual fund industry, individual accounts are also referred to as "positions."

[14] See Id. at footnote #21.

[15] See California ScholarShare Investment Board, Fast Facts: ScholarShare by the Numbers as of December 31, 2010, available at http://www.treasurer.ca.gov/scholarshare/index.asp (last visited on May 26, 2011).

[16] This can be accomplished through the use of the Level 3 or 4 Networking service offered by the National Securities Clearing Corporation ("NSCC"), as noted in Section 5.3(g) of the ScholarShare Program RFP.

2. Competitive Bidding for Broker-Dealer Recordkeeping Services. California typically requires its state agencies to use competitive bidding processes in public procurements.[17] The ScholarShare Investment Board should mandate that any and all fees paid for recordkeeping services be established through a Request for Proposal ("RFP") process, with the awarding of a contract to the lowest responsible bidder meeting the standards established by the Board.

3. Operational Efficiencies That Reduce Recordkeeping Costs. The ScholarShare Investment Board should require that any operational efficiencies by broker-dealers in the processing of individual accounts result in savings that benefit all participants in the ScholarShare program, through lower recordkeeping fees and expenses.[18]

These proposed ScholarShare program requirements, if implemented, will ensure that individual investors in the program are protected through: (1) full transparency measures in the administration of participant accounts; and (2) competitive bidding processes and pricing practices that result in lower fees and costs for recordkeeping activities.

The ScholarShare Investment Board has worked very hard to ensure that its Advisor Plan is one of the lowest cost programs in the country.[19] The Board should avoid taking a step backwards from this important goal through the improper use of omnibus accounting within its Advisory Plan.

See supra note 11. The terms "real-time" or "same-day" would require full transparency through omnibus accounts at the same time, or within the same day, as mutual fund orders are placed. See CMFI White Paper at 22.

[17] See Cal. Pub. Contract Code §10344(a) ("Contracts subject to the provisions of this article may be awarded under a procedure that makes use of a request for proposal."); and Cal. Pub. Contract Code § 10344(b)(3) ("The contract shall be awarded to the lowest responsible bidder meeting the standards."). California also has developed a separate acquisition authority for information technology contracts with State agencies; these acquisition rules generally require a competitive bidding process for information technology contracts for goods or services. See Cal. Pub. Contract Code § 12100, et seq.

[18] As noted earlier, broker-dealers argue that omnibus accounting improves their own processing efficiencies at the investor level. If this is the case, then the fees for broker-dealer recordkeeping services should be priced at below the level that the ScholarShare program is paying for recordkeeping services today, so that any actual operating efficiencies are passed on to program participants in the form of lower overall costs for recordkeeping.

[19] See Letter from Zeny Marie Agullana, Executive Director, ScholarShare Investment Board, to ScholarShare Program Participants (Annual Report for ScholarShare Advisor Plan), June 30, 2010 ("The ScholarShare Advisor College Savings Plan continues to be one of the most competitively priced advisor-sold programs in the country.").

Thank you for considering these views. Please contact me if CMFI can provide you with any additional information about the issues described in this letter. My address and phone number are on the letterhead and my email is nielsholch@att.net.

Sincerely,

Niels Holch
Executive Director
Coalition of Mutual Fund Investors

Attachment

cc: Zeny M. Agullana, Executive Director, Scholarshare Investment Board
Stanley Zeto, Scholarshare Investment Board