CMFI
Coalition of Mutual Fund Investors

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Dear Ms. Krentzman:

I just finished reading your recent paper, "The Omnibus Revolution," and my purpose for writing is to pass along several substantive comments on the issue of omnibus accounting within the mutual fund industry.

Your paper contained an excellent description and analysis of the many different problems that omnibus accounting is causing for funds and their investors. Thank you for highlighting this issue in such a clear and concise manner, as the omnibus structure needs more public discussion.

Since 2003, the Coalition of Mutual Fund Investors ("CFMI")[1] has been concerned about the investor costs and lack of transparency resulting from the use of omnibus accounts by large broker-dealers. Here are my thoughts about the issues you raised in your paper:

1. **Regulatory Issues**. On page 3, you summarize a number of regulatory "challenges" caused by a lack of transparency within these accounts. Many of these issues have not been adequately addressed by the SEC and remain as significant problems.

A. Market Timing. In my opinion, this problem has not been properly fixed, even though the new regulations promulgated by the SEC were clearly a step in the right direction. The first problem is that Rule 22c-2 provides for investor-level information-sharing only after a formal request by a mutual fund. This places the funds in an awkward position with their distributors and so it is not surprising that this regulatory tool is not being used more robustly to "look through" omnibus accounts.

It doesn't make any sense to me for funds to be paying out additional fees to broker-dealers and receiving back less transparency than what they enjoy with direct

[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. More information about its advocacy activities can be obtained at www.investorscoalition.com.

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shareholders and/or with NSCC Networking accounts. Any type of market timing problem that occurs as a result of a lack of transparency in an omnibus account is not just a liability cost to the third-party recordkeeper, but is also a cost to each fund and its shareholders. The payment of service fees to an omnibus recordkeeper in return for reduced transparency creates an unfortunate dichotomy.

As discussed below, the better approach to this problem is to require that this information-sharing process occur on a daily basis, or as fund orders are placed. This would give funds access to investor identity and transaction data on a more real-time basis, helping them ensure the proper application of redemption fees and other excessive trading policies.

Another problem in combating market timing is the fact that arbitrageurs can successfully maneuver around the imposition of any redemption fee because the fund industry uses the FIFO accounting method instead of the LIFO accounting method. If an arbitrageur limits his or her short-term trading activities to less than 50% of the shares in an account, no redemption fee will ever be assessed because of the application of FIFO on the shares which are held for a longer period. Leaving one-half of the assets in a "sticky" form allows for a circumvention of most redemption fee policies.

B. Breakpoint Discounts. This problem is still around, in my view. The SEC rules adopted after the 2002-2003 investigations of this issue just focused on more disclosure to investors, placing the burden on them to share information with their broker-dealer about other share holdings they and their family members may have in a particular fund. The reality within the marketplace is that investors and their immediate families often have investment accounts with multiple intermediaries. A fund's transfer agent is the only one in possession of information about multiple holdings and is the only one in a position to accurately calculate sales load discounts.

Every few years, FINRA issues a press release announcing sanctions against various broker-dealers for not applying these discounts properly. I believe this compliance problem will continue until we provide full transparency within omnibus accounts to the funds, so that their transfer agents can resume this responsibility. There is really no reason to have such a fragmented approach over what should be a very simple calculation to make by a fund and/or its agent.

Additionally, under pressure from broker-dealers, several fund families have modified their prospectus disclosures to dramatically restrict account relationships that can benefit from breakpoint pricing. Consequently, in order to accommodate omnibus relationships, shareholders have lost privileges in this area.

One reason there are so many problems with breakpoint discounts is the fact that the economic interests of the broker-dealers are not aligned with the interests of a fund's investors. Unfortunately, a broker-dealer benefits when a breakpoint discount calculation is not made correctly because it results in a larger commission than otherwise would be the case. Mutual funds, on the other hand, seek to have as many assets under management as they can and so funds have an economic incentive to avoid overpaying commissions to broker-dealers. This is the same goal as investors and so the economic interests of funds are in alignment with the interests of fund investors on this issue.

C. Fair Fund Distributions. I am not sure if you have reviewed any of the 25 or so SEC Distribution Plans for providing Fair Fund restitution payments to mutual fund investors harmed by market timing and late trading activities. Since 2003, more than $3.5 billion have been collected in penalties from various funds and other parties. These monies are in the process of being distributed to aggrieved investors. As you may know, the issue of omnibus account transparency was a recurring theme in the design of these Distribution Plans. I am not sure how intermediary distributions actually worked in practice, as there is limited information available on the public record about this issue. However, it is clear that these distributions would have been much easier to make with a less fragmented network of intermediary recordkeepers using omnibus accounting.

D. Money Market Funds. This is a more recent issue. In 2010, the SEC amended Rule 2a-7 to impose a number of new liquidity requirements on money market funds, including a general liquidity requirement. One of the new rules requires funds to establish internal processes to develop more information about their shareholders and their anticipated redemption needs. This particular rule, referred to as the "know your customer" requirement, is never going to function properly without full transparency within omnibus accounts.

The SEC acknowledges this problem, but money market funds are exempt from Rule 22c-2 and so this tool is not available to the funds. Several commenters, including CMFI, have advocated that Rule 22c-2 should be extended to money market funds and the SEC should consider this in its upcoming rulemaking on these funds.[2] Providing transparency down to the investor level would be a much more practical way to improve the ability of these funds to evaluate their liquidity needs on a more real-time basis, as opposed to more fundamental reforms, such as a floating NAV or through redemption or holdback restrictions.

E. Pay to Play Rules. As you note in your paper, omnibus accounts remain an obstacle to mutual fund adviser compliance with the SEC's pay to play rules. The SEC decided to respond to this problem by issuing a no-action letter to the ICI in

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[2] See Letter from Niels Holch, Executive Director, Coalition of Mutual Fund Investors, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, at 9-11, Sept. 10, 2009, available at http://www.sec.gov/comments/s7-11-09/s71109-135.pdf; and Letter from Phillip Gillespie, Executive Vice President and General Counsel, State Street Global Advisers, to Elizabeth M. Murphy, Securities and Exchange Commission, Sept. 8, 2009, at 9, available at http://www.sec.gov/comments/s7-11-09/s71109-108.pdf; See also Letter from Paul Audet, Vice Chairman, BlackRock, Inc., to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, at 6, Sept. 4, 2009, available at http://www.sec.gov/comments/s7-11-09/s71109-60.pdf; and Letter from George G.W. Gatch, President & CEO, JPMorgan Funds Management, Inc., to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, at 5, Sept. 8, 2009, available at http://www.sec.gov/comments/s7-11-09/s71109-110.pdf.

September 2011.[3] This letter permits advisers to keep an alternative set of records that represents a "do the best you can" approach to collecting information about underlying shareholders in omnibus accounts. This is yet another SEC rule which would benefit from a regulatory framework that provides full transparency, on a standardized basis, down to the investor level.

F. 529 College Savings Accounts. This is also a newer issue. Several large broker-dealers are working to convert into the omnibus structure those accounts in state 529 plans that are sold through investment advisors. This process started with the Virginia 529 Plan and may spread to other state plans. CMFI has been critical of this initiative in correspondence with the Virginia Plan. The response from the Virginia Plan has been that the omnibus conversion did not increase costs for either the 529 Plan or its investors. This assertion is somewhat disingenuous as the cost structure for advisor-sold 529 plans is much more expensive to begin with—involving multiple layers of fees—than the direct-sold plans for state 529 plans.

To document this point, CMFI released a study in January 2012, which compared the fees being paid by investors in 31 different state advisor-sold plans. The study found that these advisor-sold plans are more than twice as expensive as the direct-sold plans in each state's 529 program.[4] CMFI has argued for measures to reduce investor costs in these advisor-sold plans, as well as for steps to ensure continued transparency down to the account level.

2. **Fund Oversight**. One of the biggest problems for investors in omnibus accounts is the lack of uniformity in the application of fund policies and procedures across distribution channels. In my view, investors should expect that what is disclosed to them in the prospectus will be applied uniformly within all intermediary accounts. With some broker-dealers distributing thousands of funds, this is clearly not occurring. And, as you point out in your paper, funds are becoming more and more reliant on their intermediaries to apply their prospectus policies and procedures.

To protect themselves legally, funds describe this problem in summary fashion in their prospectuses, noting that they cannot assure uniform treatment within omnibus accounts.[5] With these accounts quickly becoming the investment vehicle for a majority

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[3] See Investment Advisers Act of 1940 – Rule 240-2(a)(18)(i)(B), Response of the Office of Chief Counsel, Division of Investment Management, Sept. 12, 2011, available at http://www.sec.gov/divisions/investment/noaction/2011/ici091211-204.htm.

[4] See Coalition of Mutual Fund Investors, Comparison of Investor Fees and Costs in Section 529 College Savings Plans, January 30, 2012, available at http://www.investorscoalition.com/sites/default/files/Comparison%20of%20Investor%20Fees%20and%20Costs%20in%20Section%20529%20College%20Savings%20Plans%201-30-2012.pdf. See also Mark Jewell, "Investors can rein in college savings plan fees," Associated Press, April 26, 2012, available at http://www.investorscoalition.com/sites/default/files/Associated%20Press%20Column%20re%20529%20Fees%204-26-2012.pdf.

[5] CMFI has tracked this trend for some time and publishes a document each year that highlights the disclaimers that are used to describe the transparency problems in omnibus accounts, derived from the

of the shares issued by mutual funds, the fund industry is losing its ability to ensure uniform treatment of prospectus policies and procedures by the intermediaries distributing fund shares.

3. **Fund and Investor Costs**. Omnibus accounts are also an expensive relationship for both funds and their investors, as the real goal of large broker-dealers is to extract more fee income for distributing fund shares to their customers.

CMFI conducted a study on the costs of omnibus accounting in August 2010 and found that large broker-dealers were imposing unnecessary costs of more than $7 billion dollars a year.[6] These fees are being paid despite the fact that securities issuers do not pay broker-dealers to hold positions in individual accounts for other types of investments. For example, broker-dealers are not paid by issuers to hold municipal or corporate bonds, equity securities, or 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. Other charges, such as transaction commissions or advisory fees, are paid directly by the investor.

Even recordkeeping fees are inflated by these larger broker-dealers. CMFI's study found that broker-dealers are typically charging between $19 and $25 for each shareholder account holding fund shares, or an average of about $22 per account each year.[7] 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.[8] The difference between the two averages—$9 per account—is an unnecessary cost for funds and their investors. Remember that the broker-dealers are also receiving 12b-1 fees and revenue-sharing payments as a part of their distribution and shareholder servicing activities.

Another point to consider here is the impact of omnibus accounting on the cost of servicing the remaining accounts that are held directly by the fund and/or its transfer agent. Funds have certain fixed costs that must be incurred to provide basic services to its shareholders. These costs are spread across the shareholder base and have the advantage of scale, as a fund grows. However, the benefits of scale are lost as more and more shareholder accounts are handled by a decentralized group of third-parties. Funds are left with a higher fee structure in compensating third-parties for servicing these accounts. And, ironically, the benefits of scale actually start to work in reverse, as a fund

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prospectus filings of the 50 largest fund complexes. See Coalition of Mutual Fund Investors, Excerpts from SEC Prospectus Filings Regarding Enforcement of Mutual Fund Market Timing and Other Short-Term Trading Policies within Third-Party Hidden Accounts, May 1, 2011, available at http://www.investorscoalition.com/sites/default/files/Analysis%20of%20Omnibus%20Surveillance%20Procedures%206-10-11.pdf.

[6] See Coalition of Mutual Fund Investors, CMFI White Paper: The Costs of Providing Shareholder Services to Hidden Mutual Fund Accounts, August 18, 2010, available at http://www.investorscoalition.com/sites/default/files/CMFIWhitePaperAug18.pdf.

[7] Id. at 6-7. Within the industry, these accounts are also referred to as "positions."

[8] See Id. at footnote #21.

and its transfer agent have to spread costs over a declining shareholder base, thereby increasing the unit costs incurred for servicing direct shareholders.

Funds also have increased surveillance and oversight costs for accounts under an omnibus structure. These costs are borne by all shareholders, even those who are in direct accounts or are held in an account structure with full transparency, such as accounts processed through the NSCC Networking system.

4. **Brand Management**. Another issue you raise in your paper is the reputational impact on funds if they are negatively impacted by a compliance failure or other problem involving the shareholder accounts managed by an intermediary. This could be a very significant "brand" problem for funds if non-transparent omnibus accounts are permitted to expand. I keep waiting for a fund board or an adviser to demand certain conditions from their intermediaries, such as competitive bidding on shareholder servicing fees and full transparency into the underlying shareholder accounts. However, very few fund boards and their investment advisers are contemplating these steps, or considering the establishment of shareholder servicing standards that are measured by a third-party.

5. **Specific Questions**. In your paper, you pose several questions for both fund management and boards regarding the challenges created by omnibus accounts. As someone who has studied these issues for a number of years, here are a few responses for your consideration:

A. How can the funds' service and risk management structure be reshaped to align effectively with the increasing prominence of intermediary subaccounting? In my view, the best and simplest approach is to require that funds have full transparency into shareholder identity and transaction data at the investor level within these accounts. There are too many regulatory imperatives and prospectus policies that are being stymied by the lack of transparency within these accounts, such as short-term-trading rules, breakpoint discounts, money market fund liquidity evaluations, and pay to play compliance.

Many of these regulatory rules can only be implemented as intended through a regular and ongoing "look through" into the omnibus structure. Funds should be in a position of being able to ensure that regulatory rules and prospectus provisions are implemented uniformly across all of their distribution channels. Periodic inspections, annual attestations, and targeted inquiries are not going to solve the problem. A full transparency model that is standardized and imposed as a same-day requirement on all fund intermediaries is the best solution.

B. How can this service and risk management structure manage financial, regulatory, and reputational risks in a cost-effective manner for an expanding enterprise of intermediary relationships? The large broker-dealers argue that the omnibus accounting model is the most efficient structure. The reality, however, is that omnibus accounts only benefit the broker-dealers and no one else. The cost to a fund and its investors is higher in account maintenance fees. A fund also has to spend more in compliance costs to create unique omnibus oversight processes that, in the end, rely on aggregated and incomplete data. One final point is that omnibus accounting raises the per account cost of servicing the remaining shareholders, as a fund's fixed costs are spread over a declining number of direct accounts.

Any objective analysis of omnibus accounts will demonstrate that the only operational efficiencies created are within the broker-dealer platforms. The other parties—funds and their shareholders—are saddled with added costs and growing regulatory problems. If efficiency is a primary goal, then broker-dealers should be given incentives to actually improve their recordkeeping systems, instead of being provided with opportunities to simply increase the incremental fees they receive.

The best solution for funds is to move broker-dealer accounts back to the NSCC Networking system. Broker-dealers can select the level of service that best comports with their individual business models and funds can track accounts and transactions on an ongoing basis, for the purpose of complying with prospectus policies and regulatory rules. The Networking service is much more cost-effective for funds and investors than omnibus accounting.

C. How can sufficient leverage be maintained in conducting intermediary oversight activities and in fee negotiations when the funds may be heavily dependent on these same counterparties for asset growth? On the oversight question, regulators have to keep in mind the fact that the fund industry is highly dependent on broker-dealers for the distribution of fund shares. As a result, it is hard to implement effective oversight programs that require ongoing compliance conversations with entities that funds are also looking to for asset growth. The answer, in my view, is to standardize the information-sharing process by requiring same-day disclosure of investor identity and transaction data within omnibus accounts, as noted above.

On the fee negotiation issue, funds should be considering competitive bidding for all third-party distribution and shareholder servicing arrangements. Fee negotiations with broker-dealers are often "take it or leave it" and are not handled at arm's length. The better model for funds and investors is to develop a more competitive process for fee-setting. Other third-party contracts are negotiated this way and broker-dealer distribution and servicing contracts should not be treated any differently.

It is still very troubling to me that funds are paying so many fees to brokers, when brokers are not paid by issuers to hold other securities, such as equities, bonds, and ETFs. There are no recordkeeping fees, for example, paid by a corporate issuer to a broker-dealer to hold a securities position. Instead, broker-dealers charge account maintenance fees, sales commissions, and/or advisory fees directly to the investor for its services. Why should mutual funds be treated so differently?

6. **Conclusion**. Your paper on omnibus accounting raises many of the key issues facing the fund industry (and its investors). My hope with this letter is to expand the discussion to include several sensible solutions to the mounting problems that this accounting structure is now causing. Mutual funds are the investment vehicle of choice for more than 90 million investors in the United States and it would be very damaging to have the fund industry go through another public embarrassment similar to the market timing and late trading scandal. Investor trust is a fragile commodity and I would like to see the industry get ahead of this problem, instead of waiting for broker-dealer compliance problems to emerge in a more widespread manner.

Thank you for publishing "The Omnibus Revolution" and for considering these views.

Sincerely,

Niels Holch

Niels Holch
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Coalition of Mutual Fund Investors