CMFI
Coalition of Mutual Fund Investors

May 9, 2005

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549

VIA ELECTRONIC MAIL

Subject: Additional Comments: Mutual Fund Redemption Fees
File No. S7-11-04

Dear Mr. Katz:

The Coalition of Mutual Fund Investors ("CMFI" or "Coalition") is pleased to submit the following comments regarding whether the Commission should establish uniform standards for voluntary mutual fund redemption fees.

CMFI is an Internet-based shareholder advocacy organization representing the interests of individual mutual fund investors. The Coalition is located in Washington, D.C., and has a Web site that can be accessed at www.investorscoalition.com.

1. Redemption Fees Are a Necessary Tool to Combat Short-Term Trading Abuses.

As the Commission has noted on a number of occasions, excessive short-term trading is harmful to the interests of long-term shareholders in a mutual fund. Trading profits taken by market timers increase fund transaction costs and dilute the value of shares owned by other shareholders, a result that transfers wealth from long-term shareholders to short-term shareholders. Abnormal redemption levels in a fund also force fund managers to have larger cash balances in a fund, a situation that limits the ability of a fund to be fully invested at all times.

To address these problems, mutual fund boards have developed policies and procedures to deter short-term trading abuses. The most common of these approaches is the redemption fee. If established at a significant level, a redemption fee can reduce or eliminate the economic incentives of market timing. Redemption fees also provide a mechanism for long-term shareholders to recapture the transaction costs and reverse the dilutive effects of this type of trading activity.

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Redemption fees are used by a substantial majority of the largest mutual funds. A study released by the Coalition on May 5, 2005, found that 70% of the fifty (50) largest mutual fund groups are currently implementing redemption fees on at least one domestic or international equity fund.[1]

Although the Coalition supported a mandatory redemption fee in the most recent rulemaking on this issue,[2] CMFI now agrees with the Commission's determination that a mandatory redemption fee may not in the best interests of the fund industry or its investors.

One of the hallmarks of the mutual fund industry is the differentiation it provides regarding its public offerings. It is clearly in the best interests of individual investors to be able to choose from a wide variety of investment products and services. For this reason, investor choices should not generally be constrained through "one-size fits all" solutions. A better framework for the investor is to have each mutual fund board evaluate the need for a fee, as one of several tools to combat market timing abuses. If it is determined that a redemption fee is desired for a fund, then its board should be free to develop the terms and conditions for such fee in a manner consistent with its fiduciary duty to shareholders.

A problem that the Commission may encounter, however, is the role that competitive pressures in the industry will play on this issue. If redemption fees are truly voluntary, it may erode the willingness of some mutual funds to impose any redemption fees whatsoever, in order to avoid being at a competitive disadvantage with those funds choosing not to impose such fees as a market timing tool. If there is a significant retreat by the industry to impose redemption fees for this purpose, the Commission will need to re-evaluate its position on permitting these fees to be voluntary.

After reviewing the redemption fee final rule, the Coalition also agrees with the Commission's requirement that all third-party financial intermediaries shall negotiate and execute written agreements with funds pertaining to market timing compliance issues. As a first step, the Coalition agrees that these agreements need to contain provisions by which intermediaries will provide shareholder identity and transaction information to the funds, to help the funds monitor: (a) market timing activity at the investor level; and (b) intermediary compliance with fund policies and procedures. Additionally, the Coalition supports the Commission's requirement that intermediaries execute a fund's instructions

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[1] An Evaluation of the Redemption Fee and Market Timing Policies of the Largest Mutual Fund Groups, Coalition of Mutual Fund Investors, May 5, 2005, page 4, available at http://www.investorscoalition.com. (hereinafter cited as "2005 CMFI Study")

[2] Comment Letter of the Coalition of Mutual Fund Investors, May 10, 2004, available at http://www.investorscoalition.com.

to restrict or prohibit further purchases or exchanges by any shareholder identified by the fund as having engaged in trading that violates the fund's market timing policies.

These steps, however, are not going to be sufficient to address the market timing problem because the "upon request" requirement is unworkable and will be very costly for financial intermediaries involved in the marketing and distribution of thousands of different mutual funds. As a result of the same differentiation issues among funds mentioned above, intermediaries are going to be faced with a myriad of different information sharing requests for investor-level identity and transaction information. Some funds will request daily or transactional information from intermediaries. Other funds will request this data on a monthly or quarterly basis. And a third category of funds will request this data sporadically or whenever fund surveillance methods trigger a need for more information at the investor level.

The real regulatory obstacle to uniformly enforcing redemption fees among all shareholders in mutual funds is, as the Commission has noted on numerous occasions, the widespread use of "omnibus accounts" held by financial intermediaries.

2. <u>Redemption Fees Cannot Be Collected in a Uniform Manner Within Third-Party Omnibus Accounts</u>.

Until the last decade, many mutual fund investors would purchase and redeem fund shares directly with a particular fund. This "direct purchase" investor is recorded as a shareholder by the mutual fund or its transfer agent. The fund's compliance personnel are then assigned the task of monitoring this investor's trading activities and enforcing fund policies and procedures.

As the distribution and marketing of mutual funds to the public has evolved over the years, funds are now more and more reliant on financial intermediaries, such as broker-dealers, retirement plans, and financial advisors. Investors transacting in mutual funds through a third-party usually do not deal directly with a fund. Instead, shareholder statements, servicing, and recordkeeping are usually handled by each intermediary, as well as all aspects of the business relationship with the investor.

The use of financial intermediaries has helped to bring the mutual fund investment vehicle to more than 90 million Americans. Many individual investors prefer to transact in mutual funds through a third-party for the convenience and the additional services which are provided.

Unfortunately, the use of financial intermediaries has created a regulatory nightmare for the fund industry in trying to prevent short-term trading abuses, as well as the enforcement of fund policies and procedures in a uniform manner among all shareholders.

A. The Omnibus Account Problem.

The reason for this problem is the accounting method used by intermediaries when transacting in mutual funds. At the end of each market trading day, financial intermediaries that utilize omnibus accounting bundle up all the trading requests from their customers and send one consolidated purchase and redemption order to each mutual fund. A mutual fund handles this consolidated order as a single transaction, recording each third-party intermediary on its books as one shareholder or "omnibus account." An omnibus account order may represent the transactions of hundreds of thousands or customers of a particular third-party financial institution. However, in most of the cases, no information is disclosed to the compliance personnel at a mutual fund about the individual activities of these omnibus account investors, nor are the actual identities of the investors known to anyone but the financial intermediary.

This regulatory problem is an even greater concern to individual investors because of the fact that a number of the short-term trading abuses uncovered by state and federal regulators over the past two years occurred in omnibus accounts, as investors were (and still are) able to conceal their identities and trading activities.

B. The CMFI Omnibus Account Study.

As noted above, a CMFI study released last week found that 70% of the largest fifty (50) mutual fund groups have implemented some type of redemption fee policy to deter excessive short-term trading.[3] This is good news for individual investors.

Unfortunately, the study also found that the ***overwhelming majority of these large fund groups—a stunning 97%—have excluded, waived, or limited the enforcement of redemption fees in omnibus accounts*** held by third-party financial intermediaries, where the outside financial institution maintains the underlying shareholder account.[4]

Remarkably, only 1 fund group out of 35 groups—the GMO Fund complex—imposes a redemption fee policy without any exclusions, waivers, or limitations regarding third-party omnibus accounts.[5]

[3] 2005 CMFI Study, May 5, 2005, page 4, available at http://www.investorscoalition.com.
[4] Id.
[5] Id.

This data represents a *9 percent* increase from an earlier CMFI study in August of 2004, where 88% of fund groups (28 of 32 groups) disclosed exclusions, waivers, or limitations on the enforcement of redemption fees in omnibus accounts.[6]

Excerpts from the most current prospectus material filed with the Commission from some of the mutual fund groups with redemption fee policies include the following statements:

- "Fund Management's ability to monitor trades that are placed by individual shareholders of omnibus accounts, which are accounts maintained by financial intermediaries on behalf of multiple beneficial shareholders, is *severely limited* because Fund Management does not have access to the underlying shareholder account information."[7]

- "The Fund typically is not able to identify trading by a particular beneficial owner through an omnibus account, which may make it *difficult or impossible* to determine if a particular account is engaged in frequent trading."[8]

- "…the ability of a Fund to assess a redemption fee on the underlying shareholders of an omnibus account maintained by a financial intermediary is *limited* due to the fact that individual shareholder information is maintained by the intermediary and not by the Fund."[9]

- "By their nature, omnibus accounts … *conceal the identity* of the individual investors from the Fund. This makes it more difficult to identify short-term transactions in the Funds, and makes assessment of the Redemption Fee on transactions effectuated through such accounts *impractical* without the assistance of the financial intermediary. Due to these limitations on the assessment of the Redemption Fee, the Funds' use of Redemption Fees *may not successfully eliminate successive short-term trading* in shares of the Funds."[10]

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[6] Analysis of Mutual Fund Redemption Fee Policies: Largest Fifty (50) Mutual Fund Groups (Ranked by Long-Term Assets), Coalition of Mutual Fund Investors, August 3, 2004, available at http://www.investorscoalition.com.
[7] Wells Fargo Advantage International Stock Funds Prospectus, April 11, 2005 (emphasis added).
[8] Columbia Acorn Fund Supplement to Prospectus, November 18, 2004 (emphasis added).
[9] Evergreen Global and International Funds Prospectus, March 1, 2005 (emphasis added).
[10] Allianz/PIMCO Domestic Stock Funds Prospectus, as revised April 1, 2005 (emphasis added).

- "There is *no assurance* that these policies and procedures will be effective in limiting short-term and excessive trading in all cases. For example, the adviser *may not be able to effectively monitor, detect or limit short-term or excessive tradin*g by underlying shareholders that occurs through omnibus accounts maintained by broker-dealers or other financial intermediaries."[11]

More than one-third of fund groups with redemption fee policies—34%—disclosed that operational deficiencies in intermediary record-keeping systems are a significant factor in the funds' inability to ensure enforcement of a fee.[12] More than one-quarter of these fund groups—29%—also disclosed that a lack of information about the underlying shareholders in these third party accounts is a major factor.[13]

The CMFI study also found 15 fund groups (30%) using other methods to discourage market timing abuses, but with no policy to impose a redemption fee. Among these fund groups, CMFI found that more than 50% disclosed concerns about the ability or practicality of enforcing their market timing policies within omnibus accounts.

Excerpts from the prospectus material filed with the Commission by some of these fund groups without redemption fees include the following statements:

- "…the Funds *may not be able to detect* excessive or short-term trading in Fund shares attributable to a particular investor who effects purchase and/or exchange activity in Fund shares through omnibus accounts. Also, multiple tiers of these entities may exist, each utilizing an omnibus account arrangement, which may further *compound the difficulty of detecting excessive or short duration trading activity* in Fund shares."[14]

- "…the ability of the Funds to monitor and detect excessive share trading activity through omnibus accounts is *very limited*, and there is *no guarantee* that the Funds will be able to identify shareholders who may be engaging in excessive trading activity through omnibus accounts or to curtail such trading."[15]

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[11] Scudder Core Global/International Funds II Prospectus, February 25, 2005 (emphasis added).
[12] 2005 CMFI Study, May 5, 2005, page 5, available at http://www.investorscoalition.com.
[13] Id.
[14] AllianceBernstein Growth Funds Prospectus, November 1, 2004 (emphasis added).
[15] Dodge & Cox International Stock Fund Prospectus, May 1, 2004, as supplemented August 30, 2004 and March 10, 2005 (emphasis added).

- "Because the funds receive these [omnibus account] orders on an aggregated basis and because these omnibus accounts may trade with numerous fund families with differing market timing policies, the funds are *substantially limite*d in their ability to identify or deter Excessive Traders or other abusive traders."[16]

The findings of these CMFI studies present very troubling news for individual mutual fund investors. While it is convenient for many investors to have access to mutual funds through a third party, it is fundamentally unfair to treat omnibus account shareholders differently from direct purchase shareholders.

The Investment Company Act requires that investment companies be operated in "the interest of *all classes* of such companies' security holders."[17] It is also the fiduciary duty of a mutual fund board to treat all shareholders evenly and fairly.

Unfortunately, it is impossible for fund boards to ensure fair and uniform treatment of all shareholders under a sales and distribution system where there are really two shareholder classes: (1) the "direct purchase" shareholders; and (2) the "omnibus account" shareholders.

3. <u>Financial Intermediaries Need to Provide Full Transparency to Mutual Funds to Ensure the Uniform Application of Redemption Fees</u>.

The fact that an overwhelming majority of the largest mutual fund groups cannot enforce redemption fees or market timing restrictions within omnibus accounts demonstrates the need for full transparency in these accounts, in order to ensure that individual investors are protected from abusive short-term trading activities and their harmful effects.

Many mutual funds rely on contractual commitments with fund intermediaries to enforce the rules of a particular fund. However, this approach is unworkable, as demonstrated by the results of the CMFI studies in 2004 and 2005.

A. <u>The Different Economic Interests of Funds and Intermediaries</u>.

An additional point is that the mutual fund and its intermediaries differ in their respective economic interests, despite the fact that it is the legal obligation of both parties to properly impose a redemption fee or enforce other fund market timing policies.

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[16] <u>The Hartford Mutual Funds Prospectus</u>, March 1, 2005 (emphasis added).
[17] 15 U.S.C. § 80a-1(b)(2) (emphasis added).

It is in the mutual fund's economic interest to correctly calculate the redemption fee because these monies are the property of the fund and its shareholders, to help compensate for the results of abusive, short-term trading. On the other hand, a fund intermediary does not receive any benefit from the accurate calculation of a redemption fee and, in fact, is often being compensated for increased trading activity in a mutual fund account. Thus, an intermediary is a direct beneficiary of any system that does not calculate redemption fees properly.

Likewise, intermediaries are receiving fees from mutual funds for shareholder servicing and recordkeeping activities, providing more reasons why the omnibus account system is benefiting financial intermediaries at the expense of shareholders.

In a related regulatory problem—the accurate calculation of volume or "breakpoint" discounts to shareholders who are charged a sales load for the purchase of mutual fund shares—the divergence of economic interests between a fund and its intermediaries can also be easily illustrated. In this situation, a mutual fund wants to correctly calculate a breakpoint discount in order to avoid losing unnecessary investment monies to third party brokerage commissions. On the other side of the transaction, a fund intermediary is the direct beneficiary of an overcharge of sales commissions because it receives these amounts as additional commissions.

B. The Need for Omnibus Account Transparency on a Same-Day Basis.

For several years, CMFI has advocated that the best solution to this problem is a requirement that financial intermediaries disclose shareholder identity and transaction information to mutual funds on a *same-day* basis. With this information provided on a daily or transactional basis, funds can actively monitor shareholder activity at the individual investor level and be in a position to ensure the uniform application of their policies and procedures.

The mutual fund industry is operated and managed on a daily basis, with fund shares being priced once a day, usually on or after the close of the major U.S. stock exchanges at 4:00 P.M., Eastern Standard Time. Purchases, redemptions, and exchanges are made on a transactional basis; certain events, such as the pricing of fund shares and the application of "breakpoint" sales load discounts, occur at the end of each trading day.

C. The Problems with "Upon Request" Intermediary Disclosure.

CMFI believes that it will impose unnecessary financial and accounting burdens on funds and their intermediaries to require investor-level information

sharing "upon request" within an industry processing system that is now functioning on a daily basis.

An "upon request" rule will require intermediaries to establish compliance systems that can function on a daily, weekly, monthly, quarterly, or sporadic basis, depending on the policies of each fund with which a business relationship exists. Given the diversity within the industry on these matters, it is not unreasonable to conclude that fund boards will impose differing rules and policies on intermediaries, making a difficult situation even more complex.

An additional problem to these systems processing issues is the fact that a non-daily compliance process is going to result in the imposition of *retroactive redemption fees*, something that should not be permitted to occur.

To illustrate this point, consider the interrelationship among three time variables: (1) the industry's transaction settlement timetable of trade date + 1 day ("T+1"); (2) the seven-day minimum holding period in the Commission's final rule; and (3) intermediary disclosure of omnibus account data on a weekly, monthly, or quarterly basis. In a significant number of transactions, a mutual fund is not going to be able to ensure the timely imposition of a redemption fee once a compliance problem is discovered. For example, a market timer can purchase shares on a Monday and redeem those same shares on Wednesday of the same week, with settlement of his or her redemption occurring one day later, on Thursday. In a situation in which an intermediary is providing omnibus account data on a weekly basis, it will not be until the *following week* that a fund is in a position to know that an intermediary has failed to impose the redemption fee, after the weekly disclosure of an omnibus account shareholder's TIN and transaction information.

This problem will be exacerbated by a monthly or quarterly disclosure requirement. In all of these cases, a fund will be forced to impose a redemption fee *retroactively*, once it learns that an intermediary has failed to do so. This is not a very investor-friendly action for either the fund or any of its intermediaries. Equally difficult is the fact that funds will be forced to impose retroactive fees on those institutions selected to distribute its funds. Finally, and most disturbing, is the strong possibility that the market timer has closed out the account altogether, leaving the fund with no ability to impose the redemption fee at all unless an intermediary agrees to indemnify the funds for this purpose.

This process of weekly, monthly, quarterly, or sporadic disclosure will result in too many after-the-fact redemption fees, and it forces funds and their intermediaries to integrate an "upon request" compliance and reconciliation process into technology systems which operate on a daily basis. The better approach, as noted earlier, is to have omnibus account disclosure information being processed at the same time, and on the same basis, as the underlying transactions themselves.

As stated earlier, CMFI believes that the Commission should require all intermediaries to provide disclosure of investor-level identity and transaction information on a same-day basis. At a minimum, this rule should uniformly apply to all funds that decide to impose a redemption fee; however, the Commission should consider extending this requirement to all funds and all intermediaries, so that other market timing restrictions and breakpoint discounts can be properly administered in a consistent manner across all shareholders and independent of their choice of investment vehicle.

An additional benefit of this solution is that mutual funds also will be able to use this information to validate the accuracy of breakpoint discounts, other fund fees and charges, and dividend reinvestments.

D. The Need to Expand Intermediary Disclosure to Include Name and Address.

The Commission's intermediary information-sharing proposal requires only the disclosure of an account holder's Taxpayer Identification Number (TIN), along with transaction information, permitting a fund to match transactions with the same TIN.

To ensure that market timers do not use multiple accounts to circumvent redemption fees, the Commission should consider expanding the information sharing requirement to include the disclosure of the name and address of each omnibus account holder. A husband and a wife living together with separate accounts, for example, would find it more difficult to avoid a redemption fee by executing a purchase in one account and a redemption in a second account. Intermediary disclosure of the names and addresses of all omnibus account holders would provide funds with an additional tool to deter the use of multiple accounts for market timing purposes.[18] A further benefit to this type of disclosure would be the calculation of breakpoint sales load discounts, where house holding information permits a fund to more accurately calculate the discount in a situation where its policies permit consolidation of family purchases.

What this proposed information disclosure requirement should *not* do is provide mutual funds with access to the customers of third-party intermediaries. Non-public personal information shared with a fund by its intermediaries is protected by privacy

[18] See Report of the Omnibus Account Task Force, National Association of Securities Dealers, January 30, 2004, page 5, available at http://www.nasd.com/pdf_text/omnibus_report.pdf.

policies and current SEC regulations, ensuring that this information will be used for compliance activities only and not for any mutual fund marketing purpose.[19]

4. Same-Day Information Sharing is the Most Cost Effective Solution to this Regulatory Problem.

Remarkably, same-day intermediary disclosure appears to be more cost-effective than an "upon request" requirement because of the technology that is already being used by the substantial majority of large mutual funds and intermediaries.

As noted in previous comment letters by CMFI, the Fund/SERV, Networking, and Defined Contribution Clearance & Settlement processing platforms operated by the National Securities Clearing Corporation ("NSCC") permit transaction data to be provided in a standardized, same-day basis between mutual funds and their intermediaries. According to industry experts, these processing platforms are currently being used by more than 80% of the largest mutual fund groups and the largest financial intermediaries. Clearly, this technology provides the most cost-effective mechanism for funds to monitor intermediary compliance with redemption fees and other market timing restrictions, as well as other fund policies and procedures.

NSCC is a central counterparty, providing clearance, settlement and information services for "virtually all broker-to-broker equity, corporate bond and municipal bond, exchange-traded funds and unit investment trust (UIT) trades in the U.S."[20] The NSCC is registered with the Commission as a clearing agency, and is a wholly-owned subsidiary of The Depositary Trust & Clearing Corporation (DTCC).[21]

At present, NSCC is the only registered clearing agency providing services to the mutual fund industry.[22] Owned and managed by the financial services industry, NSCC serves as "the leading processor of mutual fund transactions between mutual funds and [its] distribution channels, which include brokers, banks and financial planners. NSCC's entry into this area began in the mid-1980's, when the mutual fund industry was

[19] See 69 Fed. Reg. 11,762, 11,766 (March 11, 2004), citing 17 C.F.R. § 248.11(a) and 17 C.F.R. § 248.15(a)(7)(i).
[20] Welcome to the National Securities Clearing Corporation, National Securities Clearing Corporation, available at http://www.nscc.com.
[21] 2004 Financial Statements, National Securities Clearing Corporation, February 18, 2005, available at http://www.dtcc.com/AboutUs/2004annual/NSCC_2004_Financials.pdf.
[22] See Statement Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Ann E. Bergin, Managing Director, National Securities Clearing Corporation, March 2, 2004, available at http://www.banking.senate.gov/_files/bergin.pdf.

searching for a way to centralize, standardize and reduce the costs of linking to distributors."[23]

A. The NSCC Fund/SERV Order Processing System.

NSCC's best known processing platform is called Fund/SERV. In operation since 1986, Fund/SERV provides an automated and standardized system to process mutual fund transactions between funds and their intermediaries. In 2003, NSCC Fund/SERV processed more than 86 million transactions with a total value of $1.5 trillion.[24] A Web site review of the membership of both the Investment Company Institute and the NSCC indicates that more than 50% of the Institute's fund members are participants in Fund/SERV.[25]

According to material presented on the NSCC Web site, the Fund/SERV service works as follows:

> With Fund/SERV, NSCC acts as a communications hub, receiving and distributing transaction and account registration information through computers, rather than on paper. Firms send their orders directly to NSCC either through CPU-to-CPU links or personal computer hookups. NSCC reviews the order requests, then electronically forwards them to the appropriate mutual fund distributors for processing. Both parties are given the opportunity to make corrections over the system, making additional paperwork unnecessary.
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> Once the fund distributor sends an electronic message to NSCC confirming acceptance of the order, NSCC relays that confirmation to the financial institution and proceeds to settle the accounts of both parties. The entire process can be completed on the same day, next day, or in whatever cycle is appropriate for the fund.
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> Since Fund/SERV began operating in 1986, manual processing of mutual fund transactions has been greatly reduced. Today, nearly 90 percent of

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[23] Distribution Services Overview, National Securities Clearing Corporation, available at http://www.nscc.com/distservices.html.
[24] 2003 Annual Review, Depository Trust & Clearing Corporation, available at http://www.dtcc.com/AboutUs/2003annual/mutual.html.
[25] See http://www.ici.org/funds/mem/list-open-end.html (updated March 2004) and http://www.nscc.com/directory/fundserv.pdf (updated April 2, 2004).

> all electronic and wire orders received by participating mutual fund companies are transmitted via the Fund/SERV system.[26]

B. The NSCC Networking Service for Shareholder Account Information.

Since 1988, NSCC also has been offering a centralized record-keeping service called Networking, where mutual funds and their intermediaries can share and reconcile shareholder account information. As of the end of 2003, more than 58 million accounts used the Networking service.[27] In its 2002 Annual Review, NSCC reported that more than 870 financial institutions were participating in the Networking service.[28]

On its Web site, NSCC describes the Networking centralized processing platform as follows:

> Networking is used by banks, brokers, dealers, trust, third-party administrators (TPAs) and other financial services firms seeking a more accurate, timely and flexible means of monitoring their clients' mutual fund assets.
>
> Before Networking, there was no standard, automated method by which financial firms could receive non-trade related information about their clients' mutual fund accounts. Those who wished to monitor these activities to provide better asset management advice to their customers had to create their own sophisticated sub-accounting systems or obtain information from funds in a largely manual, paper-intensive process. These efforts were costly and cumbersome. Sub-accounting activities were duplicated and discrepancies occurred between fund and firm client statements from the use of different sub-accounting methods, often resulting in the distribution to customers of untimely and sometimes inaccurate information.
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> In 1988, with the industry seeking a more efficient and reliable method for monitoring client activity and share [sic] reporting responsibilities, NSCC introduced Networking.

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[26] NSCC Mutual Funds Brochure, National Securities Clearing Corporation, available at http://www.dtcc.com/Publications/mutual/index.html.
[27] 2003 Annual Review, Depository Trust & Clearing Corporation, available at http://www.dtcc.com/AboutUs/2003annual/index.html.
[28] 2002 Annual Review, Depository Trust & Clearing Corporation, available at http://dtcc.com/AboutUs/2002annual/index.html.

> Networking allows identical account records to appear at both the mutual fund and the firm. The fund maintains the individual account information, giving the firm access to this information directly from the fund's record-keeping system.
>
> Once in Networking, funds and firms can exchange account updates. Firms can update information such as address and dividend option changes, and receive confirmations of these transactions from the funds.[29]

Through this service, NSCC Networking provides a standardized and automated process to report and reconcile shareholder account information between a fund and its intermediaries, using the existing record-keeping systems of its individual mutual fund participants.

At least one senior NSCC executive appears to agree that the company's Networking service does provide a mechanism to promote uniformity in imposing redemption fees:

> Tracking redemption fees on short-term trades is easier in a networked environment, where funds and firms use Networking…With omnibus reporting, however, the distributor holds the details of customers' accounts and fund companies can't see inside the accounts. So the distributor needs to send the information to the fund companies so they can track who should be paying redemption fees.[30]

NSCC Networking also permits 5 levels of reporting (Levels 0, 1, 2, 3 and 4), providing mutual funds and its intermediaries with several options for allocating shareholder account responsibilities, such as trade confirmations, distribution of account statements, and tax reporting.[31] An intermediary can continue to control its accounts and manage customer relationships, within a standardized environment which utilizes a mutual fund's own record-keeping system.

A number of mutual fund industry experts have examined the issue of omnibus accounts and a consensus appears to be forming that the NSCC Networking system provides a simplified alternative to omnibus account processing. On January 30, 2004, a

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[29] NSCC Mutual Funds Brochure, National Securities Clearing Corporation, available at http://www.dtcc.com/Publications/mutual/index.html.
[30] DTCC's Involvement Grows, as Industry Weighs in on Omnibus Reporting, Remarks of Ann Bergin, NSCC Managing Director, Mutual Funds News, Depository Trust & Clearing Corporation, April/May 2004, available at http://www.dtcc.com/Publications/mfn/04may/omnibus.htm.
[31] Id.

working group of technology experts convened by the National Association of Securities Dealers (NASD) issued a report and recommendations to the Commission regarding the imposition of a mandatory redemption fee in omnibus accounts managed by fund intermediaries.

In this report, several of the experts acknowledged that the NSCC Networking platform provides a cost-effective mechanism for intermediary disclosure of TINs and transaction information in omnibus accounts:

> Some large fund transfer agents have software (currently used to enhance breakpoint discounts by identifying account linkage opportunities) that might be modified to facilitate matching of purchases and redemptions. Broker-dealers using National Securities Clearing Corporation (NSCC) Networking Level 4 (one of the most widely used Networking Levels), as a general matter, already transmit TINs to fund transfer agents. It also appears that broker-dealers using other Networking Levels could transmit TINs to fund transfer agents without incurring significant costs. One Task Force member already includes TINs for all orders transmitted through Networking, on a transaction-by-transaction basis, including Networking Level 3.[32]

The NSCC processing systems also service intermediaries that manage defined contribution retirement plans, including 401(k) and 403(b) plans. Through its Defined Contribution Clearance and Settlement service, NSCC offers order processing, settlement, and account reporting and reconciliation for defined contribution retirement plans.[33] This platform provides the same processing services for retirement plans as the NSCC Fund/SERV and Networking programs described above. More than 26 million transactions were processed by this defined contribution service in 2003.[34]

C. <u>The Low Cost of Disclosure Through the NSCC Clearinghouse</u>.

CMFI believes that the NSCC technology platforms and services provide a very practical solution to disclosing omnibus shareholder information to mutual funds, in a timely and accurate manner, for the purpose of ensuring compliance with the imposition of redemption fees. The vast majority of mutual funds, broker-dealers, and retirement

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[32] <u>Report of the Omnibus Account Task Force</u>, National Association of Securities Dealers, January 30, 2004, page 7, n.6, <u>available at</u> http://www.nasd.com/pdf_text/omnibus_report.pdf.
[33] <u>NSCC Mutual Funds Brochure</u>, National Securities Clearing Corporation, <u>available at</u> http://www.dtcc.com/publications/mutual/index.html.
[34] <u>DTCC Settles $923 Trillion in 2003 on Record Volumes</u>, Depository Trust & Clearing Corporation, <u>available at</u> http://www.dtcc.com/Publications/dtcc/mar04/recordvolumes.html.

plan intermediaries already utilize some or all of these NSCC services and it obviously can be very cost-effective to use this technology for intermediary disclosure purposes. ***In fact, the use of these NSCC centralized systems may provide the industry and the SEC with the lowest cost alternative in mandating intermediary disclosure of omnibus account information.***

As an example of this point, CMFI reviewed the fee schedule for NSCC institutional clients. Mutual funds and intermediaries using the Networking service pay between 1 and 2 cents a month for each side of a transaction (i.e., mutual fund and intermediary).[35] Assuming an average of 1.5 cents per side each month, the cost of using this service is 36 cents per account each year ($0.015 x 2 x 12). If industry reports are accurate that there are approximately 80 million omnibus accounts, then the cost of using the NSCC Networking service is about $28,800,000 per year (80,000,000 x $0.36).

The Commission should contrast this cost estimate with the SEC staff estimate of $630,871,200 for the annual ongoing costs of "upon request" information disclosure for all financial intermediaries and mutual funds.[36]

The lower costs for intermediary omnibus account information disclosure will be realized only if the Commission agrees to make this requirement *uniform* across all funds and their intermediaries. It is CMFI's view that the Commission has a unique opportunity to provide a cost-effective solution to the regulatory problems caused by the use of omnibus accounts by encouraging the use of these NSCC services.

Same-day omnibus account disclosure also will permit a fund to ensure intermediary compliance with its other policies and procedures, including sales loads, breakpoint discounts, commissions and fees, contingent deferred sales charges (CDSC), and dividend reinvestments.

Remarkably, the best solution to all of these fund compliance issues is not to have each fund and intermediary decide when "upon request" information should be provided for omnibus account holders. Instead, a more cost-effective solution is to take advantage of the fact that more than 80% of the largest funds and intermediaries are already using a processing system that just requires some modest adjustments in order to solve a number of the regulatory problems associated with omnibus accounts.

If the Commission agrees with CMFI's recommendation that intermediary disclosure of omnibus account information should occur on a same-day basis, then it

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[35] User's Guide to the NSCC Fee Schedule, National Securities Clearing Corporation, January 5, 2005, available at http://www/nscc.com/legal/nsccfeeguide.pdf.
[36] 70 Fed. Reg. 13328, 13339, March 18, 2005.

should also consider amending its breakpoint discount regulations, and any other appropriate rules, to make it clear that funds will be able to receive this shareholder identity and transaction information to ensure uniform compliance with *all* fund policies and procedures.

5. <u>The Commission Should Also Standardize the Accounting Method for Calculating Redemption Fees by Requiring LIFO Instead of FIFO.</u>

The Commission also has requested comment on the accounting method to be used by mutual funds imposing redemption fees to deter excessive short-term trading.

In imposing a redemption fee, a fund typically chooses between two accounting methods: FIFO or LIFO. Under FIFO ("First In, First Out"), fund shares held the longest time are treated as being redeemed first, and shares held the shortest time are treated as redeemed last. Under LIFO ("Last In, First Out"), shares held the shortest time are treated as being redeemed first, and shares held the longest time are treated as being redeemed last.

The method almost universally used within the mutual fund industry is FIFO. The CMFI study referred to above found that 63% of the fund groups (22 of 35 groups) with redemption fee policies disclosed in prospectus filings that they use FIFO to calculate redemption fees.[37] The other 13 fund groups (37%) did not disclose anything about their choice of accounting method in prospectus filings.[38] ***In its study, CMFI could not find any fund group that disclosed the use of the LIFO accounting method***.

A. <u>The Benefits of the LIFO Accounting Method</u>.

Market timing in its most basic form involves a "round-trip" trade (<u>i.e.</u>, a purchase and a redemption) within a short period of time. The only way to effectively discourage rapid trading activity is to use an accounting method that matches the most recent redemptions with the most recent purchases. By matching the last purchase with the most recent redemption, LIFO accomplishes this objective. For that reason, LIFO should be the accounting method that a fund should use to impose its redemption fees.

[37] <u>2005 CMFI Study</u>, May 5, 2005, page 6.
[38] In conducting this study, CMFI only reviewed the most current Prospectus for the 50 largest mutual fund groups. CMFI did not review the Statement of Additional Information for any fund or fund group with respect to this issue.

B. The Problems with the FIFO Accounting Method.

The biggest problem with using FIFO is the fact that market timers can avoid redemption fees without significant difficulty. While the FIFO method can trigger redemption fees based on short-term activity involving a large portion of an individual account, a market timer can easily circumvent the imposition of fees by creating a timing "ladder" or "tranche." Under this structure, a market timer can rapidly trade smaller and defined portions of a larger account balance, leaving an equal number of shares untouched by the fund to avoid triggering a redemption fee.

For example, a market timer could establish an account with a $100,000 account level in a fund with a redemption fee for round-trip trades occurring within 7 days. After the initial 7 days has passed, the timer can actively trade $50,000 of the account balance, leaving the other $50,000 untouched. As each redemption occurs, a fund with a FIFO policy will match it with the $50,000 "purchase" that has been untouched, concluding that *no fee needs to be charged because those funds were invested more than 7 days from a redemption*. Thus, the market timer can trade the other one-half of his or her account balance ($50,000) without triggering any redemption fees whatsoever. Under a LIFO method, the market timer would pay a fee for each redemption which was matched with a purchase within the 7 day period.

Ironically, the FIFO method permits market timers to continue activities that were uncovered by state and federal regulators in their most recent investigations: a significant sum is invested in a fund as a "sticky asset," while other monies are permitted to be used for market timing activities.

The use of FIFO would still permit market timers to rapidly trade fund shares as long as a "sticky asset" balance of a certain amount is maintained to avoid a redemption fee.

6. The Commission Should Standardize a *De Minimis* Redemption Fee Exception for Small Investors.

CMFI continues to believe that a redemption fee should have a *de minimis* exception for small accounts, especially if the Commission adopts a uniform rule that requires funds to use the LIFO accounting method.

In its proposed rule for a mandatory redemption fee, the Commission advocated that the redemption fee not be imposed if the amount of the shares redeemed was $2,500 or less.[39] This would result in a redemption fee being waived or excepted if it was $50 or less ($2,500 x 0.02).

At the time, the Commission's rationale for the *de minimis* exception was two-fold: (1) to avoid any adverse impact on small investors; and 2) to avoid having the cost of collecting a redemption fee exceed the actual amount of the fee.

To ensure that this redemption fee does not harm smaller investors—and especially those investors with automatic investment and/or rebalancing plans—CMFI recommends that the Commission consider requiring a uniform *de minimis* threshold at a higher amount. No *de minimis* amount will be a perfect solution for all small investors, but CMFI supports a $10,000 threshold—the same level that the Commission suggested last year in its mandatory redemption fee proposal as the maximum amount for a financial emergency waiver.

In calculating and imposing the redemption fee, CMFI believes that there may be several different scenarios in which gross redemption proceeds will contain mutual fund shares that are not subject to the fee. For this reason, the Commission should consider having the *de minimis* threshold be based on the ***dollar amount of the actual redemption fee to be imposed***, instead of the gross proceeds from a shareholder's redemption. In other words, it may be simpler to permit a fund to waive a redemption fee of $50 or less, instead of waiving fees on all redemption amounts under $2,500. (If the *de minimis* threshold were increased to $10,000, this recommendation would permit a fund to waive a redemption fee that is $200 or less.)

To illustrate this point, consider a systematic investor in a 401(k) retirement plan who chooses to invest $100 into a particular mutual fund on a bi-monthly basis. This same investor also has a periodic rebalancing strategy. The account has a balance of $60,000 and a periodic rebalancing causes a $12,000 redemption within 7 days of one of the investor's regular $100 purchases. Using a LIFO accounting method, the investor has had a purchase of $100, followed by a redemption of $12,000, both within the 7-day holding period. The investor does not appear to meet the *de minimis* threshold, whether it is set at $2,500 or $10,000. After appropriate calculations are made, a redemption fee would be assessed on $100 of the redemption proceeds, resulting in a fee of $2. Obviously a fee of this size should be subject to the *de minimis* rule and waived. ***However, it will be easier to determine if the fee qualifies for a de minimis waiver if the fee becomes the focus of the analysis instead of the gross redemption proceeds***.

Some may argue that a fee-based threshold is more burdensome for any individual investor attempting to calculate the amount of the fee for a specific redemption

[39] 69 Fed. Reg. 11762, 11765 (March 11, 2004).

transaction. It appears to make more sense, however, to calculate the actual redemption fee owed and then apply a *de minimis* threshold, in contrast to calculating the fee and then looking back to determine if the gross proceeds qualify for a redemption fee waiver.

7. Conclusion.

Individual investors deserve a system in which there is no difference in how mutual fund policies and procedures are applied between "direct purchase" and "omnibus account" investors. All shareholders should be treated fairly and uniformly.

While a voluntary redemption fee may be in the best interests of an industry that has extensive differentiation of its products and services, the widespread use of omnibus accounts has made it impossible to achieve uniform shareholder treatment without further SEC action. It now appears that as many as 80 million omnibus accounts are avoiding redemption fee policies, harming the interests of all mutual fund shareholders.

The clear answer to this problem is to require intermediaries to provide mutual funds with shareholder identity and transaction information from omnibus accounts.

The simplest and most cost-effective way to accomplish this goal is to have this information provided at the same time, and on the same basis, as the underlying mutual fund transactions, i.e., using a daily or a transactional method. Interestingly, the cost of this approach will be minimal for the funds and their intermediaries if the Commission encourages all of the parties to rely on the existing systems and services used by the National Securities Clearing Corporation, which provides services for more than 80% of the largest funds and intermediaries today.

The Commission also needs to consider a uniform rule that requires the industry to use the LIFO accounting method instead of the FIFO method for redemption fees. LIFO is the only method that actually matches market timing transactions correctly and the widespread use by the industry of FIFO is only perpetuating opportunities for market timers.

As a final point, the Commission should consider using a fee-based *de minimis* exception for small investors if it agrees that the LIFO accounting method should be applied uniformly to the calculation of redemption fees.

The Coalition of Mutual Fund Investors appreciates the opportunity to submit these comments to the Commission on redemption fee issues. CMFI is prepared to provide further information or clarification regarding the material presented in this comment letter if it would be helpful to the Commission's deliberations.

Sincerely,

Niels Holch
Executive Director
Coalition of Mutual Fund Investors

cc: The Honorable William H. Donaldson
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
Meyer Eisenberg, Division of Investment Management
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