



February 11, 2004

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

VIA ELECTRONIC MAIL

Subject: Proposed Rule: Disclosure of Breakpoint Discounts by Mutual Funds/File No. S7-28-03

Dear Mr. Katz:

The Coalition of Mutual Fund Investors (“CMFI” or “Coalition”) is pleased to submit the following comments regarding regulatory proposals issued by the Securities and Exchange Commission (“SEC” or “Commission”) on December 17, 2003, regarding enhanced investor disclosure of breakpoint discounts.

CMFI is an Internet-based shareholder advocacy organization representing the interests of individual mutual fund investors. The Coalition is based in Washington, D.C., with a Web site that can be accessed at [www.investorscoalition.com](http://www.investorscoalition.com).

A. Investors Are Being Denied Hundreds of Millions of Dollars of Breakpoint Discounts

It is common practice for many mutual funds to provide volume or “breakpoint” discounts to shareholders who choose to pay a sales load for their purchases of fund shares. However, as the Commission notes in its explanation of the need for this rulemaking, there is a widespread problem of non-compliance in providing these volume or “breakpoint” discounts to eligible mutual fund shareholders.

In a recent public statement, the National Association of Securities Dealers estimated that more than \$86 million in breakpoint discounts were not correctly applied by broker/dealers in 2001 and 2002, representing investor overcharges in *one out of every five eligible transactions*. And the SEC has disclosed that, in a joint examination sweep of 43 broker-dealers between November 2002 and January 2003, federal and industry regulators discovered that these sales load discounts were not properly applied in as many as *one-third of the transactions eligible for such discounts*.

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The results of these regulatory examinations clearly demonstrate that there is widespread non-compliance among broker-dealers in implementing stated breakpoint discount policies and, as a consequence, many individual shareholders are not receiving these discounts when purchasing mutual fund shares.

While the Coalition is certainly supportive of the SEC's attempt to improve investor disclosure about breakpoint discounts, the Commission needs to evaluate whether these measures will be adequate to protect investor interests.

In CMFI's view, enhanced investor disclosure is helpful, but a more comprehensive and structural solution will be required.

An individual investor should not have to provide his or her investment records, including account statements and all historical cost information, in order to ensure the proper application of a breakpoint discount by an intermediary. This is going to be quite a difficult task for the average investor, especially in those cases where multiple intermediaries and accounts are used by the various investors who, as a group, qualify for these discounts. CMFI actually believes it defies common sense for there to be a regulatory framework in which the individual investor is responsible for locating, collecting, and providing all of the personal and related party information necessary to ensure that the proper breakpoint discount is received.

#### B. The Source of The Problem: Omnibus Accounts

In CMFI's view, the most significant reason behind the failure to recognize breakpoint discounts is the widespread use of omnibus accounts by financial intermediaries.

As the Commission is well aware, many mutual fund intermediaries, including broker/dealers, utilize these consolidated accounts to transact mutual fund shares for their customers. Under this practice, a mutual fund records only one accountholder in its master shareholder file, usually the financial intermediary itself, instead of establishing separate accounts for each shareholder. These omnibus accounts may have hundreds of thousands of shareholders, all recorded as one shareholder in the accounts of the mutual fund.

A further complication to the use of omnibus accounts is the fact that mutual funds have differing policies and formulas in the application of these breakpoint discounts. Individual investors can qualify for sales load discounts by agreeing to buy a specified number of shares over a defined period of time. In addition, many funds permit investors to aggregate purchases among related parties, like family members, for the

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purpose of qualifying for discounts as a group. Each fund family establishes its own policies for the dollar breakpoint thresholds (e.g., \$50,000), the qualifying time periods, and the aggregation (or accumulation) rules for the application of these load discounts. And it is generally viewed as important to individual mutual funds to have differing breakpoint discount policies for competitive reasons.

When a financial intermediary uses an omnibus account structure, the mutual fund and the individual investor have to rely on the intermediary to calculate and apply the correct discount in a manner consistent with fund policies. However, the intermediary often will have insufficient information to calculate the appropriate discount. For example, an individual shareholder may use several different broker/dealers for transactions within the same mutual fund family, or he or she may have separate retirement accounts held by a fiduciary invested in the same fund family. And when a fund permits related party investors to qualify for breakpoint discounts as a group, it is highly likely that this group is transacting in mutual fund shares with different and multiple intermediary accounts.

In contrast, when an investor purchases shares directly from a mutual fund, the fund and/or its transfer agent can (and does) calculate and apply the discount without relying on an intermediary.

Proper application of breakpoint discounts is the legal obligation of both the mutual fund and its intermediaries, although the parties differ in their respective economic interests. It is in a mutual fund's economic interest to correctly calculate breakpoint discounts 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 the broker/dealers and their account executives receive these amounts as additional commissions. And these intermediaries are not in the best position to administer a fund's breakpoint discount policy because of the frequent use of multiple broker/dealers among shareholders who qualify for the discounts.

It is CMFI's view that a mutual fund is the only entity with the ability to correctly calculate and apply breakpoint discounts in accordance with its stated policies. The fund's record keeping and transfer agent function is under the direct jurisdiction of the mutual fund board and it lacks the conflict of interest possessed by a financial intermediary. Yet mutual funds do not currently have access to any shareholder identity or transaction information in omnibus accounts.

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Some industry officials have suggested that one solution to this problem should be to provide a mutual fund with the right to audit the performance of broker/dealers selling the fund's shares through omnibus accounts. Given the fact that mutual funds have been unable or unwilling to address the structural problems of omnibus accounts for many years now, CMFI believes it is naïve to expect that a mutual fund will "sound the alarm" with respect to broker/dealer procedures for maintaining large omnibus accounts, especially when such accounts represent significant blocs of the outstanding shares of a fund.

While it is certainly important to preserve the primary role that broker/dealers and other financial intermediaries have in facilitating the transactions of their respective customers, the fact that mutual funds do not receive basic information about individual trading activities in omnibus accounts creates an environment in which fund shareholders are not all treated equally and fairly.

The Investment Company Act requires that investment companies be operated in the "interest of *all classes* of such companies' security holders." 15 U.S.C. § 80a-1(b)(2) (emphasis added). It is also the fund board's fiduciary duty to treat all shareholders evenly and fairly. Unfortunately, the sales and distribution system employed by many mutual funds and their intermediaries has created two different classes of shareholders—one "direct" class and one "omnibus" class.

The Coalition believes that a mutual fund cannot guarantee the proper enforcement of its breakpoint policies with respect to omnibus shareholders. By obscuring the identities of these shareholders, the industry practice of relying on contractual relationships with financial intermediaries to implement breakpoint discount and other fund policies and procedures in omnibus accounts clearly isn't adequately protecting the interests of long-term fund shareholders. To the contrary, the current financial arrangements between mutual funds and its intermediaries create financial and structural disincentives toward achieving the goal of fair and equal treatment of the individual investor.

The use of omnibus accounts has created lucrative, revenue-generating activities for financial intermediaries. Mutual funds, on the other hand, have lost their ability to oversee shareholder record keeping and trading activities in a manner which protects investor interests through an adequate system of checks and balances.

The lack of proper recognition of breakpoint discounts is actually just one of the problems caused by the use of omnibus accounts. The ability to engage in abusive market timing activities or late trading transactions is greatly facilitated through the use of these consolidated customer accounts. And there may be additional transgressions

occurring in omnibus accounts, including the proper assessment of contingent deferred sales charges (CDSC), access to and knowledge of fund-offered shareholder privileges, the timing of automatic conversion rights, and the timing and pricing of corporate actions, such as dividend reinvestments.

C. A More Effective Solution: Disclosure of Shareholder Identity and Transaction Information to the Mutual Fund

Given that the root of the problem is that omnibus accounts obscure the identities and activities of certain mutual fund investors, the most effective solution is to implement the Coalition's recent recommendation to the Commission that financial intermediaries be required to disclose basic shareholder identity and transaction information to each mutual fund.

At a minimum, this information should include the name, address, and taxpayer identification number for each shareholder in an omnibus account. The fund intermediary also should be required to disclose the amount and timing of all purchases, redemptions, transfers, and exchanges for each such shareholder. See Letter to SEC Chairman William Donaldson, Coalition of Mutual Fund Investors, December 12, 2003 ([www.investorscoalition.com/regulatory.htm](http://www.investorscoalition.com/regulatory.htm))

Once this shareholder identity and transaction information from omnibus accounts is disclosed to a mutual fund, the fund will be in a position to ensure uniform application of its breakpoint discount policies--as well as other fund policies, procedures, fees, and charges--for all of its shareholders.

This proposed framework is preferable to the current bifurcated structure in which a fund applies its breakpoint discount rules to its "direct purchase" shareholders, while, at the same time, relying on fund intermediaries to apply its breakpoint discount rules to "omnibus account" shareholders.

For this proposed framework to work properly, mutual funds should be permitted to use shareholder information from omnibus accounts only for compliance purposes and not for any marketing or customer relationship activities. It may be necessary to develop specific privacy, confidentiality, and use protections to ensure that the fund intermediary retains its primary role in this area and to prevent any potential misuse of this information by mutual funds.

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The Coalition believes that long-term shareholders need to be guaranteed equal and fair application of all fund policies, procedures, fees and charges. This can only be accomplished, in CMFI's view, with a single record keeper responsible for all shareholder accounts and activity in a given fund. There are too many examples of uneven treatment of shareholders in omnibus accounts for the Commission not to consider a structural solution which changes the status quo for intermediaries.

CMFI's recommendation for disclosure of shareholder identity and transaction information to mutual funds will not be costly to implement with the technology available today. This recommendation also provides an effective solution to other regulatory issues before the Commission involving omnibus accounts, including, but not limited to: (1) the uniform application of mutual fund policies and procedures regarding market timing; (2) the proper application of redemption fees, back-end loads, and other charges; and (3) the proper timing and pricing of corporate actions, such as dividend reinvestments.

As a final point, CMFI does support enhanced disclosure of breakpoint discount policies and procedures. To the extent a fund's breakpoint discount policies are placed in a fund's Statement of Additional Information ("SAI"), CMFI recommends that the Commission require that every fund with an Internet site provide access to the SAI on such site. This step should help to provide additional investor awareness about a fund's breakpoint discount policies, as well as the other information contained in the SAI.

Thank you for providing CMFI with the opportunity to present its views on these issues. If you or any member of the Commission staff have any questions or need additional information from CMFI, please contact me at 202-783-5300.

Sincerely,

Niels Holch  
Executive Director  
Coalition of Mutual Fund Investors