CMFI
Coalition of Mutual Fund Investors

December 12, 2003

The Honorable William H. Donaldson
Chairman
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549

Subject: Omnibus Accounts and the Need for Uniform Treatment of Mutual Fund Shareholders

Dear Mr. Chairman:

On behalf of the Coalition of Mutual Fund Investors, I am writing to recommend a regulatory solution to the problematic practice of omnibus accounting by broker/dealers and other financial intermediaries that trade mutual fund shares for their customers.

The Coalition of Mutual Fund Investors ("Coalition") 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.

In your testimony before the Senate Banking Committee on November 18, 2003, you stated that the staff at the Commission have been directed to develop a regulatory solution to the trading problems occurring in omnibus accounts. The Coalition is offering its views as a part of this staff evaluation process.

As you know, many financial intermediaries, including broker/dealers, use omnibus accounting to transact in 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.

Many of the recent sales load discount abuses, and at least some of the market timing and late trading abuses, that have been made public through state, federal, and industry investigations of the mutual fund industry are alleged to have occurred in

400 North Capitol Street, N.W. ■ Suite 585 ■ Washington, D.C. 20001
Telephone 202-783-5300 ■ Fax 202-393-5218 ■ www.investorscoalition.com

omnibus accounts maintained by broker/dealers and other financial intermediaries. And there are other areas which may require additional review for possible transgressions hidden in omnibus accounts, including 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.

While it is important to preserve the primary role that 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.

It is a bedrock principle of the Investment Company Act that mutual funds shall implement their written policies and procedures in a uniform manner. Mutual fund boards have a fiduciary obligation to ensure the equal and fair application of fund policies and procedures across all classes of shareholders. And mutual fund reform legislation moving through Congress will likely raise the current fiduciary standards for fund boards to an even higher level.

However, it is hard to imagine how a mutual fund board will be able to ensure the uniform application of its fund policies and procedures without knowing both the identity of all of its shareholders as well as what individual shareholders are doing in omnibus accounts.

By obscuring the identities of individual shareholders, the industry practice of relying on contractual relationships with financial intermediaries to implement fund policies and procedures in omnibus accounts clearly isn't protecting the interests of long-term fund shareholders. To the contrary, the current financial arrangements between mutual funds and 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.

A good example of this problem is the policy of many fund groups to provide volume or "breakpoint" discounts to shareholders who are charged a sales load for their purchases of mutual fund shares. The National Association of Securities Dealers has 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.

Omnibus accounting plays a major role in the lack of recognition of breakpoint discounts, and the problem is exacerbated by the fact that mutual funds have different policies for the application of these volume discounts. Individual investors can qualify for these sales load discounts by agreeing to buy a specified number of shares over a defined period of time. Many funds also permit investors to aggregate purchases among related parties, such as certain family members, for the purpose of qualifying for discounts as a group. Each fund group establishes its own policies for the dollar breakpoint thresholds (e.g., $25,000), 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 funds to have different 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, individual shareholders may use different broker/dealers for transactions within the same mutual fund group and this is even more likely for related party investors who may qualify for breakpoint discounts as a group.

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 3rd 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 a position to administer a fund's breakpoint discount policy because of the potential for the use of multiple broker/dealers among shareholders who qualify for the discounts.

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/or transfer agent function is under the direct jurisdiction of the mutual fund board and

does not have 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.

A second example of this problem involves the market timing of mutual fund shares. You issued a statement on October 9, 2003, outlining your regulatory agenda for the market timing and late trading issues. In that statement, you noted that the Commission staff is going to consider new rules requiring enhanced disclosure in fund offering documents of market timing policies and procedures. It is also the Coalition's understanding that the Commission staff is considering a mandatory two percent (2%) fee for redemption transactions that occur within a specified time period. This mandatory fee would be used as a "tool" for those mutual funds seeking to discourage market timing activities by short-term investors.

While the Coalition is supportive of these regulatory initiatives, more will need to be done to solve the structural problem of uneven treatment of mutual fund investors.

Today, many mutual funds already have written policies that discourage market timing and a significant number of funds already use redemption fees to create a disincentive for short-term trading. However, the use of omnibus accounts by intermediaries has made it impossible for a fund to implement its market timing policies and impose its redemption fees in a uniform manner. This problem is going to become more of a challenge when mutual funds develop more rigorous market timing rules, particularly if redemption fees are used on a more widespread basis and at higher levels.

It is the view of the Coalition that individual, long-term shareholders will not be guaranteed equal and fair application of fund policies, procedures, fees and charges, unless and until each mutual fund is provided information from its intermediaries about the identity of all shareholders in omnibus accounts and the individual transactions engaged in by those shareholders. More disclosure to investors of fund policies and after-the-fact compliance audits are not going to be sufficient steps to rebuild investor trust and confidence.

As a specific solution to this problem, the Coalition recommends that each fund intermediary, including broker/dealers, be required to disclose basic investor identity information to each mutual fund, including, at a minimum, the name, address, and Taxpayer Identification Number (TIN) 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.

If this shareholder identity and transaction information from omnibus accounts is disclosed to a mutual fund, the fund will be in a stronger position to ensure uniform application of its policies, procedures, fees, and charges for all of its shareholders. The fund record keeping and/or transfer agent function will be directly accountable to the fund board of directors and this particular conflict of interest among fund intermediaries will be eliminated.

This proposed framework is preferable to the current bifurcated structure in which a fund applies its rules to its "direct purchase" shareholders, while relying on fund intermediaries to apply certain of its rules to "omnibus account" shareholders. Under the present system, shareholders in these omnibus accounts are not shareholders of record in a mutual fund in that their ownership interests in the shares of such mutual fund are not set forth in the mutual fund's master shareholder database.

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

The widespread failure to favor shareholder interests over institutional interests regarding breakpoint discounts, market timing and late trading requires a fundamental change to the status quo in the use of omnibus accounts by fund intermediaries. In order to protect long-term shareholders, a mutual fund needs to be placed in a position where it can ensure the uniform and proper enforcement of its policies and procedures, especially those rules regulating market timing and the proper calculation of fees and charges.

Individual investors rely on the fact that the stated policies and procedures of a mutual fund will be applied evenly and fairly. The current structure of omnibus accounts will not permit this to occur unless, at a minimum, the identity and transactions of these "omnibus" shareholders are disclosed to funds.

The Coalition of Mutual Fund Investors offers these views to assist the Commission in developing an appropriate regulatory response to this issue of importance to the interests of individual investors.

Thank you for considering the Coalition's proposal.

Sincerely,

Niels Holch
Executive Director

cc: The Honorable Paul S. Atkins, Commissioner
The Honorable Roel C. Campos, Commissioner
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Harvey J. Goldschmid, Commissioner
Paul Roye, Director, Office of Investment Management