CMFI

Coalition of Mutual Fund Investors

December 15, 2008

The Honorable Christopher Cox
Chairman
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Dear Mr. Chairman:

As the credit crisis abates and the capital markets begin to function in a more normal manner, the Coalition of Mutual Fund Investors (CMFI) urges the Commission to take steps to ensure that its regulatory framework is adequately protecting individual investors in mutual funds.[1]

More than 90 million Americans own mutual funds and these investors have seen their fund shares plunge to record lows. For investors who are near or in retirement, this market turmoil presents even more significant and immediate challenges to income levels and accumulated wealth.

While the Securities and Exchange Commission is not responsible for regulating general volatility in the capital markets, it is charged with being "the investors' advocate," a standard articulated so well by former Commission Chairman William O. Douglas during his first press conference in 1937.

Unfortunately, there are existing gaps in the mutual fund regulatory system. It has now been five (5) years since the mutual fund market timing and late trading scandals were uncovered by state regulators and SEC investigators. While the Commission is to be commended for its initial efforts to promulgate new regulations to address these trading abuses, it is still relatively easy to engage in mutual fund arbitrage activities through compliant or unaware financial intermediaries. And the distribution system for the mutual fund industry makes it difficult or impossible for funds to enforce their prospectus policies and procedures in a uniform manner among all shareholder classes. An additional problem is the fact that there is inadequate disclosure to investors of the compensation payments which are being made to third-party intermediaries.

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[1] The Coalition of Mutual Fund Investors (CMFI) is an Internet-based shareholder advocacy organization which represents the interests of individual investors on mutual fund policy issues. CMFI's website can be accessed at www.investorscoalition.com.

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These issues deserve immediate attention by the Commission, in order to restore investor trust and confidence in mutual funds as an important investment vehicle.

The Problems Created By the Use of Omnibus Accounting in Mutual Fund Transactions

As the Commission is well aware, the use of omnibus accounting permits the financial services industry to have a very efficient order processing system. At the end of each trading day, financial intermediaries aggregate all purchase and redemption requests from their customers into one consolidated order for each mutual fund. A fund handles this consolidated order as a single transaction, treating the financial intermediary as the shareholder of record for an "omnibus account."

Each omnibus account may represent the transactions of thousands of customers of a particular financial intermediary. However, no information is generally disclosed to the compliance personnel at a mutual fund about the individual trading activities of these underlying investors. Likewise, the identities of these investors are normally not disclosed to the fund.

While this distribution and accounting system has helped the financial services industry to market mutual funds to more than 90 million investors, it has created a regulatory nightmare for the fund industry and the investors it serves. The perpetuation of omnibus accounts, the use of the First In-First Out (FIFO) accounting convention, and the once-a-day pricing of fund shares, all have combined together into a system that makes it very easy for sophisticated arbitrageurs to succeed in executing a variety of short-term trading strategies. While the industry states publicly that market timing problems have been resolved, the reality is otherwise and the **interests of long-term shareholders continue to be at risk**.

Omnibus accounts prevent funds from uniformly applying any of their short-term trading policies and procedures. And other important fund policies, such as the proper calculation of breakpoint discounts for sales loads and Contingent Deferred Sales Charges (CDSCs), are also not being handled in a consistent and equitable manner.

Under the current system, the treatment an investor receives depends on the distribution channel that he or she selects when purchasing a mutual fund. An investor who purchases fund shares directly from a fund will be subject to all of the policies and procedures that are outlined in the prospectus. However, an investor transacting in fund shares through a broker or other third-party intermediary is very likely to receive differing treatment than other investors. Rights and privileges promised in the prospectus may or may not be provided; and, according to fund prospectus filings, investors in omnibus accounts will likely be subject to fewer protections against short-term trading, to the possible detriment of fully disclosed investors in an affected fund.

The Commission's New Regulatory Tools to Combat Market Timing Are Not Being Used by Mutual Funds

Since short-term trading abuses were uncovered by regulators, the Commission has promulgated two very important regulations to address these problems directly. The first rule requires funds to disclose with some specificity the policies and procedures they are using to discourage or prevent frequent trading activities.[2] The second regulation, Rule 22c-2, requires that funds have written agreements with all of their financial intermediaries, in order to facilitate information sharing at the individual investor level.[3] Rule 22c-2 requires an intermediary to provide shareholder identification and transaction information for any or all of its customers at the request of a fund.

Unfortunately, this new regulatory tool is not being used by funds. Funds continue to rely on intermediaries to enforce prospectus policies and procedures, causing a substantial lack of uniformity in the application of these policies and procedures across intermediary distribution channels.

A review by CMFI of recent prospectus filings of the largest mutual fund complexes confirms that investor-level data within omnibus accounts is not being requested on a periodic or regular basis, resulting in a significant lack of oversight by the funds regarding transactions at the investor level within hundreds of intermediaries which are marketing fund shares. Reliance on fund intermediaries to enforce anti-market timing rules is exactly where the industry found itself prior to the adoption of Rule 22c-2. And, based on the foregoing prospectus review, reliance on intermediaries is essentially where the industry is today, notwithstanding the adoption of the Rule. If Rule 22c-2 was worthy of adoption, then why is it not worthy of enforcement?

It is believed that more than fifty percent (50%) of all fund shares are transacted through omnibus accounts, which means that many funds are <u>not able to apply prospectus policies and procedures to a majority of their individual shareholders</u>. This is a situation which should not be left unaddressed.

CMFI's prospectus filings review found that all of the largest fund complexes freely acknowledge their <u>inability to apply prospectus policies and procedures in a uniform manner</u>. Excerpts from the prospectus filings of three well-regarded fund complexes—Fidelity, Franklin Templeton, and Vanguard—illustrate their inability to ensure uniform treatment of investors in third-party omnibus accounts:

- "Excessive trading in omnibus accounts is likely to go undetected by the fund and may increase costs to the fund and disrupt its portfolio management. Under

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[2] Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, 69 Fed. Reg. 22, 300 (Apr. 23, 2004), *available at* http://www.investorscoalition.com/disclremarkettimingfinalrule.pdf.
[3] Mutual Fund Redemption Fees, 70 Fed. Reg. 13, 328 (Mar. 18, 2005); Mutual Fund Redemption Fees, 71 Fed. Reg. 11,351 (Mar. 7, 2006); and Mutual Fund Redemption Fees, 71 Fed. Reg. 58, 257 (Oct. 3, 2006) (codified at 17 C.F.R. § 270.22c-2).

policies adopted by the Board of Trustees, intermediaries will be permitted to apply the fund's excessive trading policy (described above), or their own excessive trading policy if approved by FMR. In these cases, the fund will typically not request or receive individual account data but will rely on the intermediary to monitor trading activity in good faith in accordance with its or the fund's policies. Reliance on intermediaries increases the risk that excessive trading may go undetected. For other intermediaries, the fund will generally monitor trading activity at the omnibus account level to attempt to identify disruptive trades, focusing on transactions in excess of $250,000. The fund may request transaction information, as frequently as daily, from any intermediary at any time, and may apply the fund's policy to such transactions exceeding $5,000. The fund may prohibit purchases of fund shares by an intermediary or by some or all of an intermediary's clients. FMR will apply these policies through a phased implementation. <u>There is no assurance that FMR will request data with sufficient frequency to detect or deter excessive trading in omnibus accounts effectively.</u>" *Fidelity Aggressive Growth Fund Prospectus*, January 29, 2008, pages 11-12 (emphasis added).

- "While the Fund will encourage financial intermediaries to apply the Fund's Market Timing Trading Policy to their customers who invest indirectly in the Fund, <u>the Fund is limited in its ability to monitor the trading activity or enforce the Fund's Market Timing Trading Policy with respect to customers of financial intermediaries</u>. For example, should it occur, the Fund may not be able to detect market timing that may be facilitated by financial intermediaries or made difficult to identify in the Omnibus Accounts used by those intermediaries for aggregated purchases, exchanges and redemptions on behalf of all their customers. More specifically, unless the financial intermediaries have the ability to apply the Fund's Market Timing Trading Policy to their customers (for example, participants in a 401(k) retirement plan) through such methods as implementing short-term trading limitations or restrictions, imposing the Fund's redemption fee and monitoring trading activity for what might be market timing, the Fund may not be able to determine whether trading by customers of financial intermediaries is contrary to the Fund's Market Timing Trading Policy. " *Templeton Global Opportunities Trust Prospectus*, May 1, 2008, pages 49-50 (emphasis added).

- "When intermediaries establish accounts in Vanguard funds for their clients, we cannot always monitor the trading activity of individual clients. However, we review trading activity at the omnibus level, and if we detect suspicious activity, we will investigate and take appropriate action. If necessary, Vanguard may prohibit additional purchases of fund shares by an intermediary or by certain of the intermediary's clients. Intermediaries may also monitor their clients' trading activities in the Vanguard funds. For those Vanguard funds that charge purchase or redemption fees, intermediaries will be asked to assess purchase and redemption fees on shareholder and participant accounts and remit these fees to the funds. <u>The application of purchase and redemption fees and frequent-trading</u>

> policies may vary among intermediaries. There are no assurances that Vanguard will successfully identify all intermediaries or that intermediaries will properly assess purchase and redemption fees or administer frequent trading policies." *Vanguard International Growth Fund Prospectus*, April 29, 2008, pages 35-36 (emphasis added).

Excerpts from the prospectus filings of the remaining fund complexes evaluated by CMFI can be reviewed through the following link to the Home page of the CMFI website: http://www.investorscoalition.com.

The Problems with Current Rule 12b-1 Practices

The problems with omnibus accounts are exacerbated when you factor in the 12b-1 fee system. As the Commission is well aware, many funds use 12b-1 fees in part to compensate brokers and other third-party intermediaries for providing account maintenance and record keeping services to their own customers, who are also shareholders of the underlying funds. For investors with more than one mutual fund, these fees result in **multiple payments to intermediaries** for holding the security position(s) of their customers, as these payments are made on a fund-by-fund basis.[4]

Currently, there are pending lawsuits against several investment advisers and their distributors, alleging that 12b-1 fees for the funds they manage are excessive and only a disguise for revenue-sharing payments to brokers. A complaint in one of these cases alleges that sub-transfer agency fees paid to intermediaries were often higher than the account maintenance fees paid to service direct accounts. Here is what is stated in the complaint:

> "Inflated sub-transfer agency fees paid by the Funds and their investors were really used to pay for revenue sharing arrangements. For example, instead of charging $5 per account for the year, the broker would charge $25 per account per year. The inflated amount would be used to settle revenue sharing agreements."[5]

This complaint also cites a 2005 lawsuit against the same management company

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[4] These payments can be substantial for a broker or financial advisor whose customers are invested in a diversified portfolio of numerous mutual funds. Under current practices which compensate these intermediaries on a per fund basis, revenue streams are received from each fund where a security position is held, causing an intermediary to be compensated in a manner which greatly exceeds what is reasonable for normal and routine shareholder servicing activities. In reality, a broker or other third-party intermediary is being compensated in multiple ways for simply holding customer security positions, a practice that does not occur for investments in equity securities. This discrepancy may adversely influence a broker's decision whether to recommend to its customer an investment in a mutual fund versus one in an equity security; and, according to industry sources, brokers are not disclosing to their customers the existence or amount of this discrepancy.

[5] Fourth Amended Complaint at 50-51, *In Re American Mutual Funds Fee Litigation*, No. 04-5593 (C.D. Cal. filed May 16, 2008).

filed by the California Attorney General, which alleged that sub-transfer agency fees were paid "ostensibly for the cost of record-keeping but were, in part, actually a disguised additional form of Shelf-Space Payments from fund assets."[6] Similar allegations about the use of 12b-1 fees for shareholder servicing payments also have been made in other pending federal cases filed earlier this year.[7]

If these allegations are true, brokers and other intermediaries are receiving inflated fees from multiple fund sources for holding the security positions of their customers and performing routine shareholder servicing functions which also may be compensated by commissions or sales loads. <u>And these fees and arrangements are not being disclosed to the investor, either at the point-of-purchase or on an ongoing basis</u>.

Higher fees and charges by intermediaries are not resulting in more protection or services for individual investors. To the contrary, the language in fund prospectus documents demonstrates that <u>higher</u> shareholder servicing fees are actually resulting in funds being <u>unable to enforce their prospectus policies and procedures within these omnibus accounts</u>. It is clear, based on these prospectus disclosures about omnibus accounts, that almost every fund that employs omnibus accounting is receiving <u>fewer and fewer</u> services from these third parties, despite these payments. And as omnibus accounts grow, funds risk <u>losing control</u> over almost every transaction occurring in these third-party accounts.

SEC regulations provide that fund directors may approve a 12b-1 plan "only if the directors who vote to approve such implementation or continuation conclude, in the exercise of reasonable business judgment and in light of their fiduciary duties under state law and under sections 36(a) and (b) [15 U.S.C. 80a-35(a) and (b)] of the Act, that there is a reasonable likelihood that the plan will benefit the [mutual fund] and its shareholders."[8]

In CMFI's view, fund directors have a duty of oversight that is more robust than simply relying on assurances by third-party intermediaries that they are enforcing similar requirements. In fact, if you look at the reality of how funds are marketed and distributed, brokers and other financial intermediaries with commission-based compensation systems have economic interests that are in <u>direct conflict</u> with a fund's desire to enforce its policies and procedures in a uniform manner for all shareholders. A mutual fund will never be able to protect its shareholders by relying on intermediaries with such divergent economic interests. This is simply a case of the distribution system being favored over the interests of long-term shareholders.

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[6] *Id.* at 51, citing Complaint at 9, <u>*State v. American Funds Distributors, Inc.*</u>, No. BC330774 (Cal. Super. Ct. filed Mar. 24, 2005).
[7] Complaint, *Korland v. Capital Research and Management Company*, No. 08-04020 (C.D. Cal. filed June 18, 2008); Complaint, *Turner v. Selected Advisers, L.P.*, No. 08-421 (D. Ariz. filed July 28, 2008).
[8] 17 C.F.R. § 270.12b-1(e).

CMFI believes that fund directors are not fulfilling their fiduciary duties when they approve plans to pay higher fees that result in **even more non-uniform treatment of shareholders**. And the payment of higher fees that do not benefit all shareholders is inconsistent with the intention of Rule 12b-1 and the Investment Company Act, especially when these higher payments are only benefiting the third-party distributors of the funds and not all shareholders in an equitable and uniform manner.[9]

The SEC Needs to Mandate the Full Use of Rule 22c-2

Mutual fund policies and procedures cannot be enforced uniformly within omnibus accounts because of the hundreds of record keepers and institutions handling fund transactions in a manner that is independent of an underlying mutual fund.

The mutual fund industry is highly competitive and needs certain regulatory rules to be standardized and mandated. In order to protect investor interests, the SEC needs to amend Rule 22c-2 to mandate the provision and use of information sharing within omnibus accounts on a regular basis. The relationship between a mutual fund management company and its distributors is a delicate one, and it is clear that, given the superior economic leverage of the distributors, funds are not going to use this new regulatory tool unless its use is required.

Mandated regulatory solutions can be very beneficial to an industry that is competitive and diverse. A good presentation on the benefits of mandated rules for this industry can be found in a recent letter to the SEC, written by the well-respected Mutual Fund Directors Forum, a nonprofit organization dedicated to helping independent mutual fund investors:

> "... the fact that specific board action is mandated often imposes a beneficial discipline on fund management and others involved in daily fund operations. A specific requirement of board oversight often necessitates the adoption of practices and procedures and the preparation of reports that enable oversight. Regulatory provisions that require directors to address specific issues thus ensure that the management company's attention is directed at issues that Congress and the Commission have previously determined present a risk for fund shareholders. This, by itself, may serve to reduce those risks."[10]

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[9] Section 1 of the Investment Company Act specifically states that "... the national public interest and the interests of investors are adversely affected ... (2) when investment companies are organized, operated, [and] managed ... in the interest of underwriters, brokers, or dealers ... rather than in the interest of all classes of such companies' security holders; (3) when investment companies issue securities containing inequitable or discriminatory provisions, or fail to protect the preferences and privileges of the holders of their outstanding securities ... (5) when investment companies, in keeping their accounts ... employ unsound or misleading methods, or are not subject to adequate independent scrutiny ..." 15 U.S.C. § 80a-1.

[10] Letter to Andrew Donohue, Director, Division of Investment Management, from David B. Smith, Executive Vice President, Mutual Fund Directors Forum, May 2, 2008, *available at* http://www.mfdf.com/documents/DirectorDutiesMFDFLetterMay22008.pdf.

Short-term trading activity within mutual fund accounts should not be permitted to continue because of an inability of funds to have timely information about the identities and transactions of shareholders who are also customers of third-party intermediaries. The lack of transparency that exists within omnibus accounts should be addressed immediately to ensure that all fund policies and procedures—from redemption fees to sales load breakpoint discounts—are applied uniformly to all shareholders and across all distribution channels.

Rule 22c-2 begins to address this issue by permitting funds to receive investor-level identity and transaction information "upon request." As a result of the implementation of this Rule, the infrastructure is now in place to exchange this information on a regular basis. Since mutual funds are traded and priced on a daily basis, the best solution to these problems is to have investor-level information also shared as orders are placed or on a "same day" basis. A mandated requirement that this information be exchanged daily would ensure that funds receive this information in a manner that can assure appropriate and timely oversight of transactions within all intermediary accounts.

An SEC requirement of full transparency within these accounts can occur in a cost-effective manner through National Securities Clearing Corporation (NSCC) systems, which are responsible for processing orders and account information for more than eighty percent (80%) of the mutual funds and their intermediaries.[11]

Through its Fund/SERV, Networking, and Defined Contribution Clearance & Settlement processing platforms, the NSCC is able to permit the exchange of investor-level information between mutual funds and their intermediaries on a daily basis for a cost of 10 cents per 100 records, an expense that keeps coming down each year as new technologies are developed.[12]

As mentioned earlier, this type of transparency will have benefits beyond deterring market timing and other arbitrage activities. Same day disclosure of investor-level data also will ensure the proper calculation of breakpoint discounts for sales loads, the proper calculation of Contingent Deferred Sales Charges (CDSCs), and the uniform application of other mutual fund policies and procedures.

Fund shareholders need to rely on the Commission to be "the investors' advocate" and ensure that the mutual fund distribution system is not given a higher priority than the

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[11] The NSCC is a subsidiary of The Depository Trust & Clearing Corporation (www.dtcc.com).

[12] Press Release, The Depository Trust & Clearing Corporation, "DTCC Announces Major Fee Reductions For Two of Its Core Mutual Fund Services" (Feb. 14, 2008), *available at* http://www.dtcc.com/news/press/releases/2008/funds_fees.php?lpos=wms_lob&lid=funds_fees_cut. In addition to announcing a fee reduction for its services, the DTCC Press Release states: "Networking has become an important compliance tool through which the fund industry can meet the requirements of Rule 22c-2 of the Securities and Exchange Commission and efficiently monitor frequent trading of transactions in omnibus and super-omnibus accounts." The NSCC Networking service has been available for more than a decade, providing full transparency within omnibus accounts at a minimal cost.

needs of its security holders. Investors deserve a system in which there is no difference in how mutual fund policies and procedures are applied between an investor transacting directly with a fund and an investor using a broker or other third-party intermediary. Federal law and common sense tell us that all shareholders should be treated fairly and uniformly.

The SEC Needs To Require Disclosure of All Payments to Third-Party Intermediaries Regardless of the Stated Reason for the Payment

As noted earlier in this letter, it is a common practice within the mutual fund industry for funds, their underwriters, and their advisers to make additional compensation payments to brokers and other third-party financial intermediaries which are selling or distributing their funds. These payments may be in lieu of commissions or may be payments for administrative activities, such as record keeping. Some of these payments are through 12b-1 plans, while others are paid directly by a fund underwriter or adviser.

<u>These payments are not disclosed with specificity to mutual fund investors</u>. The Commission should require the **<u>broadest possible disclosure of these payments</u>**, so that investors are in a position to evaluate both the existence and the indirect costs of these arrangements.

This disclosure should include all payments by (and to) all parties involved in the sale or distribution of mutual fund shares, regardless of the stated purpose of such payments. This disclosure also should include activities that occur both before and after a purchase transaction. A broad disclosure requirement would result in the inclusion of administrative payments and fees for record keeping, shareholder servicing, and other "back office" activities, all of which are direct or indirect costs to an investor. If the parties believe that such payments are not distribution-related, then they should be permitted to characterize the payments, instead of the current system in which they omit disclosure of the payments completely.

Disclosure of this type will help address the problem noted above that the current distribution system for funds is causing an imbalance between omnibus account shareholders and non-omnibus account shareholders. Funds and their advisers are having to pay more to third-party intermediaries for various administrative functions within omnibus accounts than they have to pay to their transfer agents for, in most cases, the same non-distribution related services. However, these same intermediaries are not in a position, nor are the funds, to ensure uniformity in the application of prospectus policies and procedures.

Conclusion

At a time when investor trust in financial institutions has been eroded substantially, CMFI urges the Commission to finish the job it started after the trading scandals five (5) years ago. It is important that the Commission evaluate the regulatory problems that are occurring as a result of omnibus accounting. Rule 22c-2 should be amended to require same-day information sharing, so that there is full transparency within omnibus accounts. Full transparency can be accomplished quickly, inexpensively, and in a manner that resolves a number of other regulatory problems, such as breakpoint discounts and other instances of non-uniform shareholder treatment.

The Commission should also mandate full and complete disclosure of all payments, regardless of cause or purpose, that are being made to third-party intermediaries to service omnibus accounts, so that investors know: (1) what they are paying for when fund shares are purchased through financial intermediaries, and (2) what it costs the fund in lost earnings for investors to maintain their ownership interest through an omnibus account.

Thank you for your consideration of these views.

Sincerely,

Niels Holch

Niels Holch
Executive Director

cc: The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes
Andrew Donohue, Division of Investment Management
Robert Plaze, Division of Investment Management