October 13, 2009

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

Dear Chairman Schapiro:

Thank you for your letter of June 23, 2009, responding to the white paper prepared by the Coalition of Mutual Fund Investors ("CMFI")[1] on the problems and risks embedded in hidden mutual fund accounts managed by brokers and other third-party financial intermediaries.

In your response, you noted the importance of evaluating both the costs and the benefits to shareholders of any additional regulatory steps to promote full transparency within these third-party accounts. To help the Commission update its evaluation of this cost/benefit issue, I am attaching a second CMFI white paper on the payments being made by mutual funds to financial intermediaries for shareholder servicing and recordkeeping activities.

CMFI estimates that financial intermediaries are overcharging mutual funds by an average of $48 for each third-party account on an annual basis. If one assumes a total of 200 million investor accounts subject to omnibus recordkeeping, this excess cost may be as much as <u>$9.6 billion each year</u>, or approximately <u>25 basis points</u> across all shareholder accounts. The entire amount of this added expense is being borne by individual shareholders, either: (1) directly through 12b-1 fees (or other payments out of fund assets); or (2) indirectly from fund advisory fees.

As discussed in this CMFI paper, brokers and other intermediaries are currently being paid for suitability analyses and post-sale shareholder servicing activities that are already required of these third-parties by FINRA and/or ERISA rules. And fund directors are being placed in the awkward position of having to authorize 12b-1 plans and other payment arrangements to intermediaries that: (1) increase costs; (2) are the result of non-competitive negotiations between funds and their intermediaries; and (3) require funds to disclose in their prospectus filings that investors in third-party accounts are not going to receive uniform treatment across distribution channels.

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[1] The Coalition of Mutual Fund Investors ("CMFI") is an Internet-based shareholder advocacy organization established to represent the interests of individual investors on mutual fund policy issues. The CMFI website is www.investorscoalition.com.

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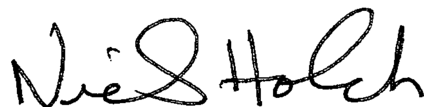
The SEC should consider requiring full disclosure to investors of the amount and nature of these shareholder servicing and recordkeeping payments, as you evaluate Rule 12b-1 and other mutual fund regulations. However, the more significant reform that is needed is to change the regulatory framework for omnibus accounts by eliminating or restricting these excessive payments to intermediaries and developing a system of full transparency within these accounts, so that investors receive the benefits and privileges promised to them in fund prospectuses.

The SEC's upcoming review of Rule 12b-1 is an opportunity to: (1) reduce the costs to shareholders of these excessive third-party shareholder servicing payments; (2) improve the ability of funds to administer their prospectus policies and procedures directly within omnibus accounts; (3) promote uniformity of treatment for all shareholders across distribution channels; and (4) protect minority shareholders from being required to pay for a distribution channel selected by other shareholders.

If one evaluates this omnibus accounts problem in a broader context, the benefits to investors of making these regulatory changes clearly outweigh the costs, once third-party shareholder servicing and recordkeeping payments are also considered. An SEC rule that provides for full disclosure of all shareholder servicing payments and requires full transparency within omnibus accounts will not cost shareholders as much as the $9.6 billion in excessive payments that are currently being used to pay intermediaries for activities they are already required to do under current FINRA and ERISA rules.

Thank you for the opportunity to have a dialogue on this issue and for your earlier pledge to consider these issues as the Commission moves forward on mutual fund reforms.

Sincerely,



Niels Holch
Executive Director
Coalition of Mutual Fund Investors

Attachment

cc: The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes
Andrew J. Donohue
Robert E. Plaze

The Shareholder Costs of Hidden Mutual Fund Accounts

As much as $9.6 billion is being taken from mutual fund shareholders each year to pay for shareholder servicing and recordkeeping activities in hidden accounts that brokers and other third-party financial intermediaries manage for their clients. Transactions in these accounts are shielded from mutual fund compliance personnel. And the account servicing and recordkeeping activities being compensated by funds are already required to be performed by these intermediaries.

These intermediary payments add an average of $48 to the expense of maintaining each mutual fund investor account. This increases the cost structure for the average shareholder by approximately 25 basis points each year.

What Is A Hidden Mutual Fund Account?

Many investors purchase mutual fund shares through third-party financial intermediaries, such as a broker, financial adviser, retirement plan provider, bank, or insurance company. At the end of each trading day, these intermediaries aggregate all purchase, redemption, and exchange requests from their customers into one consolidated order for each individual mutual fund. A fund handles this order as a single transaction, treating the financial intermediary—instead of the underlying investors—as the account holder and as the shareholder of record.

Each consolidated or "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 specific trading activities of these underlying investors. Likewise, the identities of these investors are normally not disclosed to the fund for compliance purposes.

Payments to Financial Intermediaries for Shareholder Servicing Activities

Many financial intermediaries charge mutual funds for shareholder servicing and recordkeeping activities. This compensation, which can be a form of revenue-sharing, is often paid for each underlying shareholder position in a particular fund. Some intermediaries also receive an asset-based fee of as much as 25 basis points through a 12b-1 fee program or another funding source. Frequently, mutual funds are paying their intermediaries a higher per account fee than the per account fee paid by the funds to their transfer agent for the same services.[1]

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[1] The most likely reason for these excess payments is the fact that a mutual fund's relationship with its third-party intermediaries is not typically an arm's length relationship subject to normal market forces. Competitive bidding for sales and distribution services is a rare occurrence; and fees and commissions are paid based on compensation levels that are either established in a prospectus or are generally known to be the expected amounts to be paid to acquire these services. A further complication is the fact that trustees of a mutual fund are not able to compare pricing for shareholder servicing and recordkeeping activities when approving these arrangements because of a lack of competitive bidding or arm's length bargaining.

The following is a description from Smith Barney regarding how it charges fund families for these "back office" services:

> Morgan Stanley Smith Barney or its agents receive compensation from funds or their affiliated service providers for providing certain recordkeeping and related services to the funds. These charges typically are based upon the number or aggregate value of client positions and the levels of service provided. Our clearing broker processes transactions with certain fund families on an omnibus basis, which means we consolidate our clients' trades into one daily trade with the fund, and therefore maintain all pertinent individual shareholder information for the fund. Trading in this manner requires that we maintain the transaction history necessary to track and process sales charges, annual service fees, and applicable redemption fees and deferred sales charges for each position, as well as other transaction details required for ongoing position maintenance purposes. We charge those funds administrative service fees of up to $21 per year per client position. Because omnibus trading offers economies for us and the funds that are greatest when daily trade volumes are high, we have sought to establish omnibus trading arrangements with the fund families that clients trade the most.[2]

The Estimated Number of Third-Party Hidden Accounts

As of the end of 2008, the Investment Company Institute ("ICI") reported a total of 264,499,000 mutual fund shareholder accounts, reflecting a mix of individual and omnibus accounts.[3] However, this ICI data does not include the individual accounts of certain 401(k) and other retirement plans.

A 2008 industry study by KDS Partners estimates total mutual fund accounts at 400 million, including all retirement accounts that are held through financial intermediaries.[4] KDS Partners also estimates that 50% of these accounts, or as many as 200 million accounts, use the omnibus recordkeeping process described above.[5]

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[2] Smith Barney, Mutual Funds Revenue Sharing: Expense Reimbursements and Administrative Service Fees, available at https://www.smithbarney.com/products_services/mutual_funds/investor_information/revenueshare.html (last visited June 2, 2009).

[3] Investment Company Institute, 2009 Investment Company Fact Book, April 2009, p. 110, available at http://www.ici.org/home/12009_factbook.pdf.

[4] KDS Partners, Discussion of Omnibus Recordkeeping, January 2008, p. 4, available at http://omnibusrecordkeeping.com/Publications_files/White%20Paper%20for%20First%20Five%20Pages%2012-06-07%20v18.pdf.

[5] Id. See also, KDS Partners, Consulting on Omnibus Accounting: Allocation of US Mutual Funds by Recordkeeping Method and Change in Number of Accounts (2005-2008), March 16, 2009, available at http://omnibusrecordkeeping.com/Case_Studies/Entries/2009/3/16_Consulting__on_Omnibus_Accounting.html.

The Estimated Shareholder Costs of Third-Party Servicing Payments

According to public sources, financial intermediaries are being paid by mutual funds and their shareholders an average of between $19 and $25 for each shareholder position held in a fund:

- Morgan Stanley has disclosed that it receives up to $19 per fund per account.[6]
- Smith Barney (see above) has disclosed that it receives up to $21 a year for each client position in a fund.[7]
- Wachovia Securities has disclosed that it receives up to $22 per fund per account.[8]
- An independent pension fiduciary has estimated in Congressional testimony an average of $22 per year for each participant account in a 401(k) or similar retirement plan.[9]
- A pending lawsuit against the American Funds family alleges that it may be paying as much as $25 per account per year.[10]

These payments are made to brokers and other intermediaries for every mutual fund position in each investor account held by the broker or intermediary. This process is explained in the Smith Barney disclosure above.[11] This process is also described in a lawsuit filed against the Davis Funds, alleging an excessive use of 12b-1 fees for shareholder servicing payments.[12] The following is a description of how these multiple payments occur, from the Amended Complaint in this case:

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[6] "Record-keeping Payola Could Be Substantial On Wall Street," On Wall Street, April 1, 2004.
[7] Smith Barney, supra note 2. Smith Barney is now in a joint venture with Morgan Stanley, as of June 1, 2009.
[8] "Record-keeping Payola Could Be Substantial On Wall Street," On Wall Street, April 1, 2004.
[9] Matthew D. Hutcheson, Independent Pension Fiduciary, Testimony before the U.S. House Committee on Education and Labor, March 6, 2007, p. 14, available at http://edworkforce.house.gov/testimony/030607MatthewHutchesontestimony.pdf.
[10] Fourth Amended Complaint at 50-51, In Re American Mutual Funds Fee Litigation, No. 04-5593 (C.D. Cal. filed May 16, 2008) ("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."), available at http://www.investorscoalition.com/InReAmericanFundsComplaint508.pdf.
[11] Smith Barney, supra note 2 (""We charge those funds administrative service fees of up to $21 per year per client position.").
[12] Shareholder's Amended Complaint, Turner v. Davis Selected Advisers, L.P., No. 08-421 (D. Ariz. filed April 23, 2009), available at http://www.investorscoalition.com/DavisFundsAmendedComplaint4-23-09.pdf.

> Many shareholders of the Fund own shares of more than one Davis Fund, including the [Davis New York Venture] Fund, in either one account or in multiple accounts at the same broker-dealer.
>
> If one Fund shareholder owns three mutual funds within the Davis Funds family (including the Fund), and those funds are in one account at a given broker-dealer, the shareholder is charged three times by defendants for account maintenance and operations activities and suitability analyses, even though the broker-dealer prepares and sends to that shareholder only one monthly account statement (not three), and the broker conducts only one suitability analysis for the whole account.[13]

In 2008, the ICI estimated that each investor portfolio holds a median number of four (4) different mutual funds.[14] If one assumes a $22 average payment for each fund position in a third-party account, mutual funds are paying as much as $88 per account for shareholder servicing and recordkeeping to intermediaries. With 200 million shareholder accounts eligible for these payments, the cost of these sub-transfer agency payments is estimated to be as much as $17.6 billion per year.

If a shareholder purchases mutual fund shares directly and is registered in a fund's shareholder file, the cost is estimated to average about $10 per account each year.[15] If one subtracts this "normalized" cost from the number of shareholder accounts, then the added cost of these payments is approximately $48 per account, or $9.6 billion annually, for all 200 million omnibus accounts.[16]

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[13] Id. at 41-42. According to the allegations in this Complaint, the shareholder is being charged multiple times for account maintenance, account operations activities, and suitability analyses, even though the broker maintains only one account for the shareholder (and not multiple accounts).

[14] Investment Company Institute, 2009 Investment Company Fact Book, April 2009, p. 73, available at http://www.ici.org/home/12009_factbook.pdf.

[15] Matthew D. Hutcheson, "Uncovering and Understanding Hidden Fees in Qualified Retirement Plans," Kiplinger's Business Resource Center, March 2007 ("... many funds will pay a third-party administrator $10 per participant per fund."), available at http://www.kiplinger.com/businessresource/summary/archive/2007/hidden_401k_fees.html. See also Coverdell Education Savings Account Application, AARP Funds, ("$10 annual fee (per fund account)"), available at http://74.125.47.132/search?q=cache:8LPj2Dz4MFYJ:www.aarpfinancial.com/content/Files/AARPFunds_Coverdell_App.pdf+Mutual+Fund+Transfer+Agent+%2410+Account&cd=25&hl=en&ct=clnk&gl=us (last visited June 22, 2009); and IRA Application, Oakmark Funds ("$10 Annual fee Per Fund Account up to $20.00"), available at http://www.oakmark.com/forms/pdf/IRAAppl.pdf (last visited June 22, 2009).

[16] Under a system of direct shareholder registration, the cost is estimated to be $10 per position on the mutual fund's shareholder file. If one assumes 4 different mutual fund positions for an average investor, then the cost of $40 (4 positions) is subtracted from the $88 intermediary cost per account, resulting in an excess cost of $48 per intermediary account, or $9.6 billion annually for 200 million accounts. The cost savings under a direct registration model would be even greater if an intermediary account had more than one of these 4 positions invested in the same fund family.

A 2007 study by the U.S. Government Accountability Office estimates that that the median account balance for a 401(k) plan was $19,328 in 2005.[17] An excess cost of $48 per account increases average shareholder expenses by 25 basis points, which is approximately the same amount that is generally allocated for administrative service fees under 12b-1 distribution plans.[18]

Existing Broker Obligations to Maintain and Service Customer Accounts

The Davis Funds litigation described above discusses the type of shareholder services being provided by intermediaries. Specifically, the Amended Complaint in this case asserts that these activities are already required to be performed by broker-dealers under existing regulatory rules:

> The majority of servicing efforts paid by the [Davis New York Venture] Fund and its shareholders are for post-sale shareholder services.
>
> Post-sale 'servicing efforts' include, among other activities, operational and compliance functions with respect to the shareholder's brokerage account, such as providing monthly or quarterly account statements, confirmations of transactions, and suitability analyses of the client's account. Suitability includes the following activities, among others—assisting customers in rebalancing their portfolios; reviewing customer holdings on a regular basis; reassessing customer needs and investment strategies, and helping investors generally understand their investments.
>
> The broker-dealer is legally obligated to provide all customers with the post-sale shareholder services described immediately above pursuant to its operations and compliance obligations.
>
> These obligations exist under the applicable statutes and New York Stock Exchange and NASD/FINRA regulatory regimes.[19]

A review of the NASD/FINRA rules confirms this assertion.[20] NASD Rule 2340 requires a broker-dealer to send quarterly account statements to each of its customers, containing a description of "any securities positions, money balances, or account activity."[21] NASD Rule 2340(d)(1) defines "account activity" to include, but not be

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[17] U.S. Government Accountability Office, "Increased Reliance on 401(k) Plans Calls for Better Information on Fees," GAO-07-530T, March 6, 2007, available at www.gao.gov.

[18] This amount is derived by dividing $48 by $19,328, for a total of 0.25% or 25 basis points.

[19] Shareholder's Amended Complaint, Turner v. Davis Selected Advisers, L.P., No. 08-421 (D. Ariz. filed April 23, 2009), pp. 26-27, available at http://www.investorscoalition.com/DavisFundsAmendedComplaint4-23-09.pdf.

[20] NASD refers to the National Association of Securities Dealers, which, in 2007, consolidated its responsibilities with the regulatory, enforcement, and arbitration functions of the New York Stock Exchange to become FINRA, the Financial Industry Regulatory Authority (www.finra.org).

[21] NASD Rule 2340: Customer Account Statements, available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3647. See also,

limited to, purchases, sales, interest credits or debits, charges or credits, dividend payments, transfer activity, securities receipts or deliveries, and/or journal entries relating to securities or funds in the possession or control of the broker-dealer.[22]

A second Rule, NASD Rule 2310, requires broker-dealers to conduct suitability analyses prior to the execution of a recommended purchase, sale, or exchange transaction:

> (a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.
>
> (b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:
>
> (1) the customer's financial status;
> (2) the customer's tax status;
> (3) the customer's investment objectives; and
> (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.[23]

Taken together, NASD Rules require brokers to perform recordkeeping and shareholder servicing activities as part of their current obligations to customers.

Broker Compensation for Servicing Activities Already Required to be Performed

The Davis Funds that are the subject of the fee litigation mentioned above disclose in prospectus materials that payments are being made to brokers and other third-party intermediaries for both suitability analyses and account recordkeeping activities, both of which are already required to be performed for these customers.[24] The section of the most recent prospectus filing for the Davis Funds had the following to say about payments for broker suitability analyses:

> For Class A, B, or C shares, up to 0.25% of distribution expenses may be used to pay service fees to qualified dealers providing certain shareholder

Customer Account Statements, NASD Notice to Members 01-08, January 2001, pp. 33-34, available at http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=2571.

[22] Id.

[23] NASD Rule 2310: Recommendations to Customers (Suitability), available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3638.

[24] See Davis New York Venture Fund, Prospectus, December 1, 2008, pp. 15-18, available at http://www.davisfunds.com/pdf/DNYVpro.pdf.

services. These services may include, but are not limited to, assessing a client's investment needs and recommending suitable investments on an ongoing basis.[25]

Likewise, the section of the Davis Funds prospectus disclosing recordkeeping payments to intermediaries states the following:

> Recordkeeping services typically include: (i) establishing and maintaining shareholder accounts and records; (ii) recording shareholder account balances and changes thereto; (iii) arranging for the wiring of funds; (iv) providing statements to shareholders; (v) furnishing proxy materials, periodic Davis Funds reports, prospectuses and other communications to shareholders as required; (vi) transmitting shareholder transaction information; and (vii) providing information in order to assist Davis Funds in their compliance with state securities laws. Each Davis Fund typically would be paying these shareholder servicing fees directly if a Qualifying dealer did not hold all customer accounts in a single omnibus account with each Davis Fund.[26]

Other funds disclose similar arrangements, although with fewer details.[27] At least two other fund families—BlackRock and MFS—disclose the purpose of these arrangements with more specificity and note that intermediary administrative payments can come from 12b-1 fees, other fund assets, and/or through revenue-sharing from the investment adviser. BlackRock's latest prospectus filing states the following:

> In return for the shareholder servicing fee, financial intermediaries (including BlackRock) may provide one or more of the following services to their customers who own Investor A, Investor B and Investor C Shares:
>
> - Responding to customer questions on the services performed by the financial intermediary and investments in Investor A, Investor B and Investor C shares;

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[25] Id. at 15.

[26] Id. at 18.

[27] See Franklin Custodian Funds, Statement of Additional Information, February 1, 2009, p. 31 ("... [Franklin Funds] may also pay servicing fees ... to certain financial institutions (primarily to help offset their costs associated with client account maintenance support, statement preparation and transaction processing ...."), available at http://www.sec.gov/Archives/edgar/data/38721/000003872109000004/fcfbwrap0209.htm; Oppenheimer International Growth Fund, Prospectus, March 27, 2009, p. 39 ("The Distributor uses the service fees to compensate brokers, dealers, banks and other financial intermediaries for maintaining accounts and providing personal services to Class B, Class C or Class N shareholders in the applicable share class."), available at https://www.oppenheimerfunds.com/digitalAssets/International%20Growth%20PSP%20w%20supp%205.15.09-2e814b381cc1c010VgnVCM100000e82311ac____.pdf; and Eaton Vance Emerging Markets Fund, Statement of Additional Information, May 1, 2009, p. 23 ("... the principal underwriter expects to pay a service fee to investment dealers, as compensation for providing personal services and/or the maintenance of shareholder accounts ...."), available at http://www.eatonvance.com/alexandria/EMGIFPSAI.pdf.

- Assisting customers in choosing and changing dividend options, account designations and addresses; and
- Providing other similar shareholder liaison services.[28]

Similarly, the latest filing of a Statement of Additional Information from MFS discloses the following:

> Service fees compensate ... financial intermediaries for shareholder servicing and account maintenance activities, including, but not limited to, shareholder recordkeeping (including assisting in establishing and maintaining customer accounts and records), transaction processing (including assisting with purchase, redemption and exchange requests), shareholder reporting, arranging for bank wires, monitoring dividend payments from the Funds on behalf of customers, forwarding certain shareholder communications from the Funds to customers, corresponding with shareholders and customers regarding the Funds (including receiving and responding to inquiries and answering questions regarding the Funds), and aiding in maintaining the investment of their respective customers in the Funds.[29]

With very few exceptions, brokers are receiving mutual fund payments for services that they are already required to perform for their customers, adding increased costs to all fund shareholders.

Existing Broker Obligations to Disclose Special Compensation Arrangements

NASD Rule 2830(l)(4) requires broker-dealers to disclose cash compensation from a mutual fund in the current prospectus of a fund.[30] If special cash compensation arrangements are made available by a fund to broker-dealers on a non-uniform basis, then the details of the arrangements are also to be disclosed in the prospectus.[31]

In a 1994 Notice to Members, NASD clarified the scope of these disclosure obligations:

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[28] BlackRock Focus Growth Fund, Inc., Prospectus, December 22, 2008, p. 28, available at https://www2.blackrock.com/webcore/litService/search/getDocument.seam?serviceName=PUBLICSERVICEVIEW&ContentID=24790&VenueID=100&venue=PUB_IND.

[29] MFS Emerging Markets Equity Fund, Statement of Additional Information—Part II, October. 1, 2009, p. 11, available at https://www.mfs.com/wps/FileServerServlet?servletCommand=serveUnprotectedFileAsset&fileAssetPath=/files/documents/products/sai/fem_sai.pdf.

[30] NASD Rule 2830: Investment Company Securities ("No member shall accept any cash compensation from an offeror unless such compensation is described in a current prospectus of the investment company."), available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3691.

[31] Id. ("When special cash compensation arrangements are made available by an offeror to a member, which arrangements are not made available on the same terms to all members who distribute the investment company securities of the offeror, a member shall not enter into such arrangements unless the name of the member and the details of the arrangements are disclosed in the prospectus.")

> For disclosure of cash and non-cash compensation that does not involve special compensation arrangements, the usual disclosure practices relating to underwriting compensation require the disclosure of the maximum cash compensation and the type of non-cash compensation to be provided to all participating members. As stated in the rule language, any variations from the standard schedule of concessions must be disclosed if concessions are not uniformly paid to all members purchasing the same dollar amounts of securities.[32]

In this 1994 Notice to Members, NASD also made it clear that the "exact details" of any special cash compensation arrangements are to be disclosed:

> While it is anticipated that most special compensation arrangements would be non-cash in nature, the exact details of any special cash compensation arrangements entered into by the underwriter(s) with any member(s) and the identity of the member(s) must also be disclosed.[33]

These rules and interpretations were upheld in 1998.[34] Unfortunately, most funds do not disclose these third-party shareholder servicing and recordkeeping payments with any degree of specificity, even though prospectus filings are clear that these payments are not uniform and vary across brokerage firms.[35]

A number of funds do not disclose any details at all about how these payments are calculated or determined.[36] Other fund families disclose the maximum level of payments to any individual intermediary in its prospectus and then provide a list of the eligible intermediaries in the Statement of Additional Information.[37]

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[32] NASD Clarifies Compensation Disclosure Requirements For Mutual Funds in Article III, Section 26 Of The NASD Rules Of Fair Practice, NASD Notice to Members 94-14, 1994, available at http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=1520. See also, NASD Clarifies Compensation Disclosure Requirements For Mutual Funds, NASD Notice to Members 94-41, 1994, available at http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=1492.

[33] Id.

[34] SEC Approves Rule Change Relating To Non-Cash Compensation For Mutual Funds And Variable Products, NASD Notice to Members 98-75, 1998, available at http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=2011.

[35] See Oppenheimer International Growth Fund, Statement of Additional Information, March 27, 2009, pp. 45-46, available at https://www.oppenheimerfunds.com/digitalAssets/FINAL%20-%20International%20Growth%20SAI%20497%2005.08.09%20with%20financials-7ac13653a8c1c010VgnVCM100000e82311ac____.pdf;sessionid=OCQCCE5WXYO3RLARENVOK5Q; and Federated American Leaders Fund, Inc., Statement of Additional Information, May 31, 2009, pp. 17-18, available at http://www.federatedinvestors.com/daf/pdf/sai/8062808B.pdf.

[36] See Id.

[37] American Funds AMCAP Fund, Prospectus, May 1, 2009, p. 31("The level of payments made to a qualifying firm in any given year will vary and in no case would exceed the sum of (a) .10% of the previous year's American Funds sales by that dealer and (b) .02% of American Funds assets attributable to that dealer."); American Funds AMCAP Fund, Statement of Additional Information, May 1, 2009, pp. 27-28. Both documents are available at https://www.americanfunds.com/funds/prospectuses.htm. See also, Franklin Custodian Funds, Statement of Additional Information, February 1, 2009, pp. 45-46, available at

Both of these approaches to disclosure, however, do not provide enough information to an investor to evaluate conflicts of interest and do not appear to meet the "exact details" standard in the NASD Rules. While it is believed that the brokerage industry's position is that these payments are "reimbursements" instead of compensation, there does not appear to be any accounting or invoicing of actual expenses regarding these services and activities.

Investors Have a Right to Know About All Intermediary Payments

In order to properly evaluate conflicts of interest in the sales and distribution of mutual fund shares, there should be full disclosure to investors of all payments to third-party financial intermediaries. This can be accomplished by requiring the disclosures of 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. In order to distinguish between distribution and servicing activities, an intermediary should be permitted to include in its disclosures a description of the purpose(s) of any of these payments.

Disclosure of these payments will help address the non-competitive nature of the relationship between a fund and the third-party intermediaries responsible for distributing its shares. As noted earlier, payments to intermediaries typically do not involve competitive bidding or arm's length bargaining. Instead, payments are established based on what is generally known within the industry to be the amount which must be paid for these sales and distribution services.[38]

An investor should not be paying excessive fees for shareholder servicing and recordkeeping activities. Instead, each fund shareholder should pay no more than the minimum charges paid by a direct shareholder for these same activities, even though fund shares are purchased through an intermediary distribution channel. Direct shareholders should not be bearing the burden of inflated payments being made on behalf of other shareholders in hidden accounts, especially when they do not obtain any benefits from these broker or intermediary payments.

Funds are already providing most of these services to shareholders; the only extra service being provided by brokers to their customers—investor suitability analyses—is already required of them through existing regulatory rules. The costs of a broker's relationship with its customers should be borne by the broker itself, and not by a mutual fund or its shareholders.

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http://www.sec.gov/Archives/edgar/data/38721/000003872109000004/fcfbwrap0209.htm; BlackRock Focus Growth Fund, Inc., Statement of Additional Information, December 22, 2008, p. II-51, available at https://www2.blackrock.com/webcore/litService/search/getDocument.seam?serviceName=PUBLICSERVICEVIEW&ContentID=24791&VenueID=100&venue=PUB_IND; and Columbia Acorn Trust, Statement of Additional Information, May 1, 2009, pp. 82-83, available at http://www.columbiafunds.com/NR/rdonlyres/4B9353DA-E290-47E9-A315-91B80FE4246D/0/SAI_Acorn.pdf.

[38] See supra note 1.

Investors Also Deserve Full Transparency in Hidden Fund Accounts

Another problem to consider is the fact that these excessive fees and charges by intermediaries are not resulting in more protection or services for individual investors. In fact, the opposite is occurring.

Almost all fund complexes defer to their financial intermediaries to enforce each fund's own short-term trading policies. Fund companies then add language to prospectus filings to warn investors that a lack of information about hidden accounts means that each fund cannot guarantee that its policies and procedures will be applied within these accounts.[39] Based on current fund prospectus disclosures about hidden accounts, it is very clear that funds are receiving fewer and fewer services from their financial intermediaries, despite making excessive payments to them. As hidden accounts grow, funds risk losing control over almost every transaction occurring in these third-party accounts.

In addition to improving the transparency to investors of fund payments to financial intermediaries, the problem of hidden accounts should be addressed by requiring full disclosure of the identities and transactions of shareholders purchasing fund shares through a financial intermediary. Full transparency within these accounts can be accomplished by the daily disclosure of shareholder information from intermediaries, or by registering all shareholders directly with a fund.

Only through a full transparency model will a mutual fund be able to ensure that its prospectus policies and procedures are administered in a uniform and efficient manner across all distribution channels. A full transparency model also resolves several other regulatory problems:

- Each fund will be able to monitor short-term trading activities on a real-time basis;
- Investors will be able to receive properly calculated breakpoint discounts on sales load charges;
- A money market fund will be able to manage its liquidity risks more effectively by reviewing and monitoring all investor activities on a daily basis; and
- Distributions from the SEC's Fair Fund program and money market liquidation payments can be made in a more precise and timely manner than under the current processes that rely on "best efforts" in third-party hidden accounts.

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[39] See Coalition of Mutual Fund Investors, Excerpts from SEC Prospectus Filings Regarding Enforcement of Mutual Fund Market Timing and Other Short-Term Trading Policies within Third-Party Hidden Accounts, September 30, 2009, available at http://www.investorscoalition.com/AnalysisofOmnibusSurveillanceProcedures9-30-09.pdf.

Conclusion

Federal regulators and policymakers need to protect investor interests by tackling the excessive fee and transparency problems caused by hidden mutual fund accounts managed by financial intermediaries.

The Investment Company Act intended that a mutual fund be operated and managed for the benefit of its shareholders and not its managers or distributors. This is one reason that a mutual fund is organized as a trust, with fiduciary duties. As a result of this fiduciary relationship, funds need to place the interests of their shareholders above all other interests. In the case of hidden accounts, funds should: (1) require clear disclosures to their shareholders of all payments to third-party intermediaries, regardless of the stated purpose of such payments; (2) avoid conflicts of interest within their sales and distribution system; and (3) ensure that prospectus policies and procedures are applied and enforced in a uniform manner across all distribution channels.

Coalition of Mutual Fund Investors
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