May 6, 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:

The Coalition of Mutual Fund Investors ("CMFI")[1] urges you to conduct a review of the issue of hidden shareholder accounts in the mutual fund industry, as your develop your regulatory agenda for 2009.

In your terrific speech to the Society of American Business Editors and Writers on April 27, you made the point that one of the missions of the SEC is to champion the views of investors who otherwise do not have an organized voice. And you noted that mutual fund rules should "operate for the benefit of investors and only investors."[2]

CMFI is in complete agreement with your view and this letter is an attempt to provide you with an opportunity to fix a group of regulatory problems that are creating increased risks for long-term mutual fund investors. These problems are caused by street name or omnibus accounting, where the identities and transactions of shareholders investing through third-party financial intermediaries are hidden from the funds and their compliance personnel. This issue was identified during the mutual fund scandals in 2003 and has still not been resolved properly.

CMFI has written the attached White Paper, outlining some of the risks that these hidden shareholder accounts present to long-term fund shareholders.

The increase in volatility in the capital markets over the last several years is now providing renewed opportunities for arbitrage activity in mutual funds. The SEC rule that was intended to provide transparency within third-party shareholder accounts, Rule 22c-2, is not being used by funds to actively monitor short-term trading account activity at the beneficial owner level. This lack of due diligence, combined with the FIFO accounting

[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.

[2] Speech by SEC Chairman: Address to the Society of American Business Editors and Writers (Apr. 27, 2009), available at http://www.sec.gov/news/speech/2009/spch042709mls.htm.

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convention common within the fund industry, creates a regulatory gap that makes it very easy to engage in market timing activities which dilute the share value of long-term investors.

Mutual fund prospectus disclosures consistently confirm that funds are unable to apply their short-term trading policies and procedures uniformly within these third-party accounts. And the widespread use of street name and omnibus accounting within the financial services industry now means that a substantial majority of fund shares are completely hidden from mutual fund compliance personnel.[3]

To make matters worse, fund companies continue to compensate financial intermediaries for "servicing" shareholder accounts that are already their responsibility to manage as a part of the customer relationship. These fee payments are being made to intermediaries for the purpose of holding fund share positions and, ironically, these payments are doing nothing to ensure uniform compliance with fund prospectus policies and procedures. In fact, the fund shareholders purchasing through intermediary channels face even more disparate treatment as distribution channels grow. Funds now risk losing control over the enforcement of their prospectus policies within the substantial majority of their shareholder accounts.

The lack of transparency in the fund distribution system has also created other problems. Breakpoint discounts for sales load charges are generally not being calculated properly, especially in situations where investors and their family members utilize multiple intermediaries and investment platforms. SEC Fair Fund distributions have been complicated by the lack of transparency in third-party accounts. And money market funds are not able to evaluate accurately their liquidity risks, with so much of their shareholder base shielded from them through street name and omnibus accounting.

The time has come to place investor interests ahead of the needs of the fund distribution system. The simplest and best solution to these regulatory problems is to require full transparency on an ongoing basis within all third-party shareholder accounts. This can be accomplished by the direct registration on a mutual fund's books of all shareholder accounts, regardless of the distribution channel used to transact in these shares. Another alternative is to require same-day disclosure of investor identity and transaction information through Rule 22c-2.

The implementation of a full transparency model for third-party mutual fund accounts will solve a number of regulatory problems:

- Funds will be able to monitor short-term trading activities on a real-time basis;

[3] The Investment Company Institute estimates that more than 80% of fund shares sold through sales forces and as many as 57% of fund shares sold through direct channels are registered in street name. Investment Company Institute, Costs of Eliminating Discretionary Broker Voting on Uncontested Elections of Investment Company Directors (Dec. 18, 2006), available at http://www.sec.gov/comments/sr-nyse-2006-92/nyse200692-100.pdf.

- Funds will be able to enforce all of their prospectus policies and procedures in a uniform manner across all distribution channels;
- Investors will be able to receive properly calculated breakpoint discounts on sales load charges;
- Money market funds will be able to manage liquidity risks by reviewing and monitoring all investor activities on a daily basis; and
- Fair Fund distributions and money market liquidation payments can be made in a more precise and timely manner than under the current process that relies on "best efforts" within omnibus account arrangements.

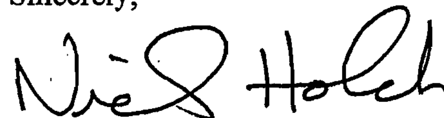
A full transparency model also can be implemented in a cost-effective manner using the existing fund order and intermediary account processing systems established by the National Securities Clearing Corporation. These systems have been in place for more than a decade and the costs of exchanging account information electronically have been reduced over the years as a result of significant economies of scale.

The most important benefit of a full transparency approach to these regulatory problems is that the interests of individual investors will be placed ahead of the needs of fund advisers and distributors, a result that properly implements the policy goals of the Investment Company Act, when it was enacted in 1940.

CMFI urges the Commission to add this important issue to its regulatory agenda for 2009.

Many thanks for your consideration of these views.

Sincerely,



Niels Holch
Executive Director
Coalition of Mutual Fund Investors

Attachment

cc: The Honorable Kathleen Casey
The Honorable Elisse Walter
The Honorable Luis Aguilar

The Honorable Troy Paredes
Andrew Donohue
Robert Plaze

# CMFI WHITE PAPER:

# WHO IS WATCHING OUT FOR MUTUAL FUND SHAREHOLDERS?

## Hidden Shareholder Accounts in the Mutual Fund Industry Place Long-term Shareholders at Risk

### Introduction

In the aftermath of the largest financial crisis since the Great Depression, federal regulatory agencies and the U.S. Congress are working to close regulatory loopholes that permitted trillions of dollars of financial derivatives to be accounted for outside of the balance sheets of many financial institutions. Washington policymakers are also aggressively focused on fraudulent activity in certain brokerage and hedge fund accounts—activity which was hidden from regulators and investors for many years.

After these regulatory gaps are fixed, federal regulators should turn their attention to hidden mutual fund accounts that have served as a haven for improper arbitrage activities and other abusive short-term trading, through the use of "off-balance sheet" record keeping that continues to dilute the share holdings of long-term individual investors. These accounts also have created unnecessary barriers to the uniform enforcement of mutual fund policies and procedures among all shareholders.

### The Structure and Operations of Mutual Funds

Under the federal Investment Company Act of 1940, a mutual fund is an independent entity, organized under state laws as a business trust or a corporation. A mutual fund is overseen by a board of directors that, in most cases, consists of a majority of independent directors. Mutual funds are also regulated by the U.S. Securities and Exchange Commission ("SEC"), under the Investment Company Act.

Mutual funds in the United States are externally managed, with professional services provided by outside service providers operating separately from a fund.[1] The corporate sponsor of a fund (or an affiliate of the sponsor) generally serves as both the investment adviser and the distributor.[2]

A good description of how a mutual fund operates in practice can be found in a U.S. Senate Report which was issued in connection with 1970 amendments to the Investment Company Act:

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[1] See Fund Director's Guidebook, Second Edition, Federal Regulation of Securities Committee, American Bar Association, pp. 4-5 (2003).
[2] Id. at 5.

> Mutual funds, with rare exception, are not operated by their own employees. Most funds are formed, sold, and managed by external organizations that are separately owned and operated. These separate organizations are usually called investment advisers. The advisers select the funds' investments and operate their businesses. For these services they receive management or advisory fees. These fees are usually calculated at a percentage of the funds' net assets and fluctuate with the value of the funds' portfolio.
>
> Because of the unique structure of this industry the relationship between mutual funds and their investment adviser is not the same as that usually existing between buyers and sellers or in conventional corporate relationships. Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm's length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy.[3]

The substantial majority of mutual fund shares are marketed by brokers and other third-party financial intermediaries. These financial intermediaries place mutual fund shares in their own customer accounts, which remain hidden from the mutual fund. The existence of these hidden accounts also creates a lack of uniformity in the ability of a mutual fund to apply and enforce the policies and procedures outlined in its prospectus.

**New SEC Rules Have Not Eliminated Short-Term Arbitrage Activities in Hidden Fund Accounts**

It has been more than five (5) years since the mutual fund market timing and late trading scandals were uncovered by state and federal regulators. Investigations by these regulators uncovered significant arbitrage activities and other short-term trading transactions that were diluting the share values of long-term investors. And some of these activities were intentional, causing the SEC and state regulators to initiate more than 25 enforcement proceedings and collect more than $3.3 billion in penalties and disgorged profits. In response to this wide-spread scandal, the SEC promulgated new rules to address short-term trading abuses. Unfortunately, these SEC initiatives have not eliminated the risk to individual investors regarding these activities.

In addition to clarifying its position on fair value accounting, the SEC has promulgated at least two new regulations to address short-term trading abuses. The first regulation requires that all funds improve their prospectus disclosures regarding the policies and procedures that are being employed to address frequent trading abuses.[4] The

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[3] Investment Company Amendments Act of 1969, Senate Report No. 91-184, May 21, 1969, p. 5. Almost identical language is contained in the House Report to the same bill. Investment Company Amendments Act of 1970, House Report No. 91-1382, August 7, 1970, p. 7.

[4] Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, 69 Fed. Reg. 22, 300 (Apr. 23, 2004).

second regulation creates a new Rule 22c-2, requiring that mutual funds have written agreements with all of their financial intermediaries, in order to facilitate information sharing at the individual investor level.[5] Rule 22c-2 requires an intermediary to provide shareholder identification and transaction information for any or all of its customers at the request of the fund.

Despite these new rules, it is still relatively easy to engage in mutual fund arbitrage activities through compliant or unaware financial intermediaries. The perpetuation of hidden customer accounts and the use of the First In, First Out ("FIFO") accounting convention are two of the flaws in a system that still creates havens for arbitrageurs.[6]

**The Widespread Use of Hidden Accounts Prevents Mutual Funds from Monitoring Short-term Trading Activities in These Third-Party Accounts**

More than fifty percent (50%) of fund shares are now traded through third-party financial intermediaries, which use an order processing system that keeps trading activities and investor identities hidden from mutual fund compliance personnel. These hidden accounts were used by many of the individuals and entities responsible for market timing and the other short-term trading abuses in the SEC and state enforcement proceedings noted above.[7] And this problem is no different than the efforts by Bernie Madoff to hide his Ponzi scheme from independent oversight by exploiting regulatory loopholes in his broker-dealer operations.[8]

How do these hidden mutual fund accounts work? 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 order as a single transaction, treating the financial intermediary, instead of the underlying beneficial owners, as the shareholder of record.

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[5] Mutual Fund Redemption Fees, 70 Fed. Reg. 13,328 (Mar. 18, 2005); Mutual Fund Redemption Fees, 71 Fed. Reg. 11,351 (Mar. 7, 2006); Mutual Fund Redemption Fees, 71 Fed. Reg. 58,257 (Oct. 3, 2006), codified at 17 C.F.R.§ 270.22c-2.

[6] A third problem involves the need of a money market fund to understand the redemption practices and liquidity needs of its underlying investors trading through third-party financial intermediaries. To reduce fund liquidity risks, the Investment Company Institute has recommended that money market funds improve transparency in third-party accounts by engaging in a robust shareholder due diligence process, including the use of Rule 22c-2, to monitor trading activity at the account level on a periodic or daily level. See Report of the Money Market Working Group, Investment Company Institute, pp. 83-85 and 117-118, available at http://www.ici.org/pdf/ppr_09_mmwg.pdf.

[7] The industry refers to these hidden accounts as "omnibus accounts" because customer purchase, redemption, and exchange orders are consolidated each day and only the intermediary is listed as the shareholder of record on the books and records of the mutual fund. This system hides the underlying transactions and the customer identities of these shareholders from a mutual fund, despite the fact that mutual funds make payments to these intermediaries for providing record keeping and other administrative services.

[8] According to published press reports, the Ponzi scheme created by Bernie Madoff was permitted to operate for many years because his affiliated brokerage firm was the only entity reporting transactions. Madoff could not have conducted this scheme successfully if his hidden accounts were fully disclosed and on the books and records of an independent entity that was SEC-registered.

Each consolidated 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.

**The FIFO Accounting Convention Used By the Fund Industry Exacerbates the Hidden Accounts Problem**

Another structural deficiency in combating arbitrage activities within hidden accounts is the widespread use within the mutual fund industry of the First In, First Out ("FIFO") accounting convention.

Market timing in its most basic form involves a "round trip" trade (i.e., a purchase and a redemption or exchange) within a short period of time. The best way to effectively discourage this rapid trading activity is to use an accounting method which directly addresses the underlying market timing transaction.

Of the two choices, the accounting method which best accomplishes this objective is LIFO ("Last In, First Out") because it matches the most recent transactions with each other. Clearly, this is the accounting method which a fund should use to impose its redemption fee or other short-term trading policies, instead of FIFO ("First In, First Out"), the current industry standard.

The FIFO method does trigger a redemption fee when short-term trading activities involve a large portion of an individual account; however, a market timer will be able to circumvent this accounting method by creating a timing "ladder" or "tranche." Under this structure, a market timer can rapidly trade smaller and defined portions of a larger account balance, leaving an equal or greater amount of shares untouched in the fund to avoid triggering a redemption fee.

Ironically, this approach operates in a similar fashion to some of the market timing transactions uncovered by regulators during the recent fund scandals: a significant sum is invested in a fund as a "sticky asset," while other monies are permitted to be used for market timing activities. The use of the FIFO accounting method will still permit market timers to rapidly trade fund shares as long as a "sticky asset" balance of an equal or greater amount is maintained to avoid the short-term trading policies of a fund.

CMFI acknowledges that the use of LIFO is not a perfect solution in all circumstances involving improper short-term trading. However, LIFO is still a better accounting method for funds to use and should be the method required by the SEC to calculate redemption fees or apply other short-term trading policies.

**Recent Industry Studies and Government Statements Indicate that Arbitrage and Market Timing Activities Still Exist in Mutual Funds**

In March 2007, the Investment Company Institute (ICI) invited a noted expert on market timing, Eric Zitzewitz, to present his latest findings on arbitrage and other market timing activities at an industry conference in California. Professor Zitzewitz's study found that arbitrage activity did decline after the scandals in 2003, largely as a result of the industry's use of fair value pricing.[9] However, the data examined by Professor Zitzewitz also shows that dilution of share values as a result of arbitrage activity still remains in international, small cap, and certain bond mutual funds.[10]

Many funds concerned about the risk of arbitrage activity have imposed short-term redemption fees to deter market timing activities. However, a 2007 survey of more than 100 fund directors by a subsidiary of the PNC Financial Services Group found that a substantial majority (69%) of these directors believe that market timers will still time the market, regardless of any short-term redemption fees imposed on them.[11]

In addition to market timing issues, the ICI has recently expressed concern about the ability of a money market fund to manage its redemption and liquidity risks without knowing who its underlying investors are in third-party hidden accounts.[12] In a Report released on March 17, 2009, the ICI recommended new shareholder due diligence procedures to "identify (and perhaps exclude) those shareholders with frequent investment activities in search of yield (sometimes referred to as 'hot money'), or whose actions pose a higher degree of risk to a particular money market fund, based on its structure and operations."[13]

Outside of the financial services industry, the SEC has expressed concern about increased short-term trading activity within funds. In a speech and a media interview in May 2008, the Associate Director of the SEC Office of Compliance Inspections and Examinations, Gene Gohlke, announced that the SEC is increasing its focus on market timing in its fund examinations because of added market volatility.[14] According to

[9] Eric Zitzewitz, Are Funds Arbitrage Proof? (March 26, 2007) (unpublished presentation to the Investment Company Institute Conference).
[10] Id.
[11] "Mutual Fund Directors/Executives Expect Rule 22c-2 to Identify and Deter, But Not Prevent, Market Timing, PFPC Study Reveals," PFPC Press Release, October 3, 2007, available at: http://www.pncgis.com/pncgis/news/pdfs/2007_archives/100307_PR_PFPC_MutualFundDirectors_22c-2.pdf. .
[12] See Report of the Money Market Working Group, Investment Company Institute, March 17, 2009, available at http://www.ici.org/pdf/ppr_09_mmwg.pdf.
[13] Id. at 83. The Report goes on to recommend that "[i]n particular, funds should consider the various risk levels of shareholders that are omnibus accounts, external direct clients, or internal accounts or cash sweeps from other lines of business of the fund sponsor. Funds also should look closely at the shareholders' use of portals (especially those portals that do not provide funds with the identities of the underlying users) or other third-party distribution methods, because the intentions of the shareholders using the portal may be unclear." Id. at 84.
[14] "SEC Stepping Up Market Timing Vigilance," Ignites, May 1, 2008, available at: http://www.investorscoalition.com/SECSteppingUpMarketTimingVigilance.pdf.

Director Gohlke, the SEC will be spending "more time understanding exactly what a fund is doing to monitor shareholder flows and understand a little better how they follow up on situations."[15]

The problem with monitoring shareholder flows is the fact that hidden accounts from financial intermediaries are not disclosed to funds, leaving fund personnel only able to evaluate aggregated data that is of limited usefulness in uncovering abusive short-term trading activities.

**Industry Redemption and Exchange Data Indicate a Level of Volatility Similar to the 1999-2003 Scandal Period**

The increasing risk of arbitrage activity in mutual fund accounts can also be identified through industry redemption and exchange data provided by the Investment Company Institute ("ICI"), the fund industry's trade association.

Attached to this White Paper is a spreadsheet prepared by CMFI that evaluates monthly redemption and exchange information from the ICI, dating back to 1999.[16] During the period leading up to the public announcement of the first market timing investigation in September of 2003, the rolling average of mutual fund redemptions and exchanges as a percentage of average net assets was between 34.80% and 45.60%. This data implies that the average investor had a holding period of between 2.2 and 3 years during the period from February 1999 to September 2003.

After the market timing investigations became public in 2003, the level of redemption and exchange activity dropped significantly, into a rolling average range of between 23.20% and 28.80%, from January 2004 to June 2007. This data implies that the holding period for the average investor increased to between 3.5 and 4.3 years.

Starting in mid-2007 and continuing until February of 2009, the redemption and exchange rolling average increased to a range of between 24.90% and 35.96%. This implies a decreased average holding period of between 2.8 and 4.0 years. The data shows a steady increase in transaction activity—from less than 25% to more than 35%—and the higher rolling average experienced in 2008 and the beginning of 2009 is at the lower end of the range that occurred in the pre-market timing scandal period.

Certainly, some of this redemption and exchange activity reflects the increased volatility experienced by investors in 2008. However, an evaluation of other ICI data, demonstrates that a small minority of investors are responsible for a large percentage of this redemption and exchange activity.

In February and March of 2008, the ICI and the trade association representing the broker-dealer industry, SIFMA, conducted a survey of 1,600 investors. This study found

[15] Id.
[16] Trends in Mutual Fund Investing, Investment Company Institute, available at: http://www.ici.org/stats/mf/arctrends.

that 57% of the investors surveyed did not conduct any mutual fund transaction within the past 12 months. This data indicates that all of the redemption and exchange activity reported by the ICI is coming from the other 43% of investors who conducted at least one transaction over a given period.

If one assumes that one-half of the other 43% have a long-term time horizon and only have minimal transaction activity over the defined period, then the bulk of the timing activity is coming from a small group that makes up about 21% of all investors. Using the redemption and exchange ratio of 35.36% for December 2008, these investors have an average holding period of only 222 days, which implies an average redemption and exchange rate of 164% and indicates significant short-term trading activity.[17]

The ICI's own data indicate that a significant risk of market timing activity still exists in mutual fund accounts, despite improvements that have been made over the years to address these activities that are so harmful to long-term shareholders.

**Mutual Funds Are Relying Improperly on Third-Party Intermediaries to Apply Their Prospectus Policies**

The inability of mutual funds to control short-term trading activities is also evident in a recent review by CMFI of the prospectus filings of the largest mutual fund complexes. These public filings confirm that mutual funds are not able to oversee the hundreds of intermediaries that are marketing their fund shares. And this result is despite the information-sharing provisions of new SEC Rule 22c-2.

CMFI could not find any fund which is requiring the regular disclosure of transaction and customer identity information from these hidden accounts. Instead, funds are relying on fund intermediaries to develop and implement their own short-term trading policies.

This is a significant lack of oversight by the funds, as more than fifty percent (50%) of all fund shares are transacted through intermediaries which control these hidden accounts. This means that many funds are not able to apply prospectus policies and procedures to a majority of their individual shareholders. This is a situation which should not be left unaddressed.

Reliance on fund intermediaries to enforce short-term trading rules is exactly where the industry found itself prior to the adoption of Rule 22c-2. And, based on the

[17] This same analysis was presented to a Congressional committee in 2003 by Vanguard founder John Bogle. Mr. Bogle cited a 1998 ICI survey which found that 82% of equity fund owners have a long-term investment horizon and did not make a single redemption over a defined period. Mr. Bogle then applied the 41% redemption and exchange rate reported by the ICI at the time over the remaining 18% of investors, which resulted in an average holding period of just 160 days. If you further assume that one-half of these investors have a long-term holding period of 10 years, the remaining half would have an average holding period of about 90 days and a redemption rate of 446%. Statement of John C. Bogle, U.S. Senate Governmental Affairs Subcommittee, November 3, 2003, available at: http://www.investorscoalition.com/boglenov3testimony.pdf.

CMFI's prospectus review, reliance on intermediaries is essentially where the industry is today, notwithstanding the adoption of Rule 22c-2.

Even more remarkable is the fact that CMFI's prospectus filings review found that all of the largest fund complexes freely acknowledge their inability to apply prospectus policies and procedures in a uniform manner. 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 these third-party hidden 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 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 any intermediary's clients. FMR will apply these policies through a phased implementation. There is no assurance that FMR will request data with sufficient frequency to detect or deter excessive trading in omnibus accounts effectively." *Fidelity Growth Strategies Fund Prospectus*, March 25, 2009, pp. 13-14 (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, 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. 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, pp. 49-50 (emphasis added).

- "When intermediaries establish accounts in Vanguard funds for the benefit of their clients, we cannot always monitor the trading activity of the 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 an intermediary for the benefit of certain of the intermediary's clients. Intermediaries may also monitor their clients' trading activities with respect to 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. The application of purchase and redemption fees and frequent-trading 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*, December 29, 2008, pp. 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.

**Investment Advisers and Fund Boards Are Compensating Intermediaries for Holding Share Positions in Hidden Accounts**

As noted earlier in this paper, 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.

These payments are not disclosed with specificity to mutual fund investors. Federal regulators should require the broadest possible disclosure of these payments, 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 hidden account shareholders and direct account shareholders. Funds and their advisers have to pay more to third-party intermediaries for various administrative functions within hidden 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.

The problems with hidden 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.[18]

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."[19]

This complaint also cites a 2005 lawsuit against the same management company 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."[20] Similar allegations about

[18] 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.

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

[20] Id. at 51, citing Complaint at 9, State v. American Funds Distributors, Inc., No. BC330774 (Cal. Super. Ct. filed Mar. 24, 2005).

the use of 12b-1 fees for shareholder servicing payments also have been made in other pending federal cases filed earlier this year.[21]

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. And these fees and arrangements are not being disclosed to the investor, either at the point-of-purchase or on an ongoing basis.

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 higher shareholder servicing fees are actually resulting in funds being unable to enforce their prospectus policies and procedures within these hidden accounts. It is clear, based on these prospectus disclosures about hidden accounts, that almost every fund that employs omnibus accounting is receiving fewer and fewer services from these third parties, despite these payments. And as hidden accounts grow, funds risk losing control 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."[22]

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 direct conflict 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.

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,

[21] 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).
[22] 17 C.F.R. § 270.12b-1(e).

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.[23]

Fund directors are not fulfilling their fiduciary duties when they approve plans to pay inflated fees that cause even more non-uniform treatment of shareholders. And the payment of higher fees that are not benefiting all shareholders is inconsistent with the intention of Rule 12b-1 and the Investment Company Act.

**Hidden Accounts Prevent the Proper Application of Breakpoint Discounts**

An additional problem with hidden accounts involves mutual fund breakpoint discounts. Many funds provide volume or "breakpoint" discounts to shareholders who are charged a sales load for their share purchases. Individual investors can qualify for these sales load discounts by agreeing to buy a specified number of shares over a defined period of time. Funds also permit investors to aggregate purchases among related parties, such as certain family members, for the purpose of qualifying for volume discounts as a group.

Each fund 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 the sale load discounts.

Hidden accounts prevent funds from properly applying their discount policies and correctly calculating the proper amount of sale load charges for each investor. Brokers and other fund intermediaries often lack sufficient information to calculate the discount, especially when (1) shareholders use multiple platforms or intermediaries to transact in fund shares, and (2) related party investors rely on different brokers and intermediaries to transact shares.

From 2002-2004, the SEC, the New York Stock Exchange and the National Association of Securities Dealers conducted independent investigations on sales load charges. These regulators concluded that nearly one in three mutual fund transactions that appeared eligible for a breakpoint discount did not receive one. The SEC responded with new regulations for breakpoint discounts, but these new rules only required increased disclosure to investors about sales load policies by brokers and other fund intermediaries.[24] Shareholder advocates, such as the Consumer Federation of America,

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[23] 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.

[24] Final Rule: Disclosure of Breakpoint Discounts by Mutual Funds, Release Nos. 33-8427 and 34-49817, 69 Fed. Reg. 33,262 (June 14, 2004).

Fund Democracy and CMFI, all argued in favor of structural solutions to this problem, in addition to enhanced disclosure measures.[25]

In its comment letter on this rulemaking, CMFI argued in favor of a solution to this problem that addressed the conflicting economic interests involved.[26] A fund intermediary is the direct beneficiary of an overcharge in sales commissions and so very little economic incentive exists to properly calculate breakpoint discounts. On the other hand, 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.

Almost five (5) years after these new SEC regulations on breakpoint discounts were finalized, the industry regulator for broker-dealers recently fined twenty-five (25) different firms more than $2.1 million for failures in compliance with mutual fund policies on these sales load discounts.[27] The widespread nature of this compliance failure is further evidence that hidden accounts need to be addressed in a comprehensive and structural manner.

**Investment Advisers, Fund Boards, and Federal Regulators Should Take Additional Steps to Ensure that Mutual Fund Policies and Procedures Are Enforced Uniformly**

The problem of hidden accounts can be solved by getting back to basics. Mutual fund shareholders should be fully disclosed on the books and records of the fund itself, as the fund has a fiduciary duty to all of its shareholders that cannot be fulfilled with hundreds of intermediaries providing record keeping and other administrative services. Instead, mutual funds should register each beneficial owner as a shareholder and provide the uniform application of prospectus policies and procedures across all fund distribution channels. This can be accomplished in a cost-effective manner through the order and account processing systems of the National Securities Clearing Corporation (NSCC).[28] The substantial majority of the financial services industry already uses these NSCC

[25] Letter to Jonathan G. Katz, Consumer Federation of America and Fund Democracy, Feb.12, 2004, p. 4, available at http://www.sec.gov/rules/proposed/s72803/s72803-6.pdf ("If [broker-dealers] cannot show comparable compliance, they should be forced to start providing identifying information when settling mutual fund transactions until they can demonstrate that they have fixed any shortcomings in their system."); Letter to Jonathan G. Katz, Coalition of Mutual Fund Investors, Feb. 11, 2004, p. 4, available at www.investorscoalition.com/regulatory.htm ("By obscuring the identities of [omnibus] 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.").

[26] Id. at 2 ("In CMFI's view, enhanced investor disclosure is helpful, but a more comprehensive and structural solution will be required.").

[27] "FINRA Fines 25 Firms More Than $2.1 Million for Failures in Mutual Fund Breakpoint Review, Other Violations," Financial Industry Regulatory Authority Press Release, March 23, 2009, available at www.finra.org/Newsroom/NewsReleases/2009/P118216.

[28] CMFI has written extensively about the technology and the services of the National Securities Clearing Corporation (NSCC). For more information, go to the Regulatory Page of the CMFI website at www.investorscoalition/regulatory.htm.

systems, and the NSCC Networking service charges only 10 cents for every 100 records processed.

After Rule 22c-2 was enacted, CMFI advocated for a better use of the Rule by requiring daily or "same-day" disclosure of investor transaction and identity information within these third-party hidden accounts.[29] However, a simpler mechanism that better protects mutual fund investors is one in which all shareholders are fully disclosed and registered on a mutual fund's books and records, so that a fund can honor its prospectus policies and procedures in a uniform and efficient manner.

With almost daily media reports of fraud, trading abuses, and excessive fees by a wide variety of financial intermediaries and institutions, the time has come to reform the distribution system for mutual funds by eliminating the use of third-party hidden accounts. This solution is the only approach that honors the goal of the Investment Company Act that a mutual fund be operated and managed for the benefit of its shareholders and not its managers or distributors.

Coalition of Mutual Fund Investors
Washington, D.C.
March 30, 2009

Attachment: ICI Redemptions/Exchanges from
Stock Funds (1999-2009)

[29] The Investment Company Institute recently expressed support for more robust shareholder due diligence procedures by money market funds regarding third-party omnibus accounts. In a recent Report, the ICI noted that transparency procedures could include a process for funds to request and monitor (periodic and daily) account level data (registration, position, and trading activity) for money market fund investors." See Report of the Money Market Working Group, Investment Company Institute, March 17, 2009, available at http://www.ici.org/pdf/ppr_09_mmwg.pdf.