History of the National Securities Clearing Corporation's Networking Service

Background

The National Securities Clearing Corporation ("NSCC") provides several back office services which standardize, centralize, and automate the processing and settling of mutual fund transactions.[1] The NSCC also offers a service—called Networking—which facilitates the exchange of customer account information between mutual funds and their financial intermediaries, including broker-dealers, banks, investment advisers, and retirement plans.

The utilization of NSCC services within the mutual fund industry started in 1984, with the establishment of a joint task force between the Investment Company Institute ("ICI") and the National Association of Securities Dealers ("NASD").[2] The goal of this joint task force was to "develop automation for processing and settling mutual fund transactions."[3] The task force selected the NSCC to develop an automated order-entry clearance system, which led to the creation of the NSCC Fund/SERV mutual fund trading platform, a centralized and standardized processing system for purchasing, redeeming, and registering mutual fund shares.[4]

After the NSCC Fund/SERV service was launched, a parallel need was identified to develop a similar platform to exchange customer account information between mutual funds and their intermediaries. This need led to the NSCC Networking service. A recent paper issued by the ICI describes how this NSCC service was created:

> Once automated fund trading was established, the industry turned to the problem of sharing account data. At the time, broker-dealer systems struggled with reconciling the omnibus position on the mutual fund books with the investor positions on their books. This reconciliation process resulted in inconsistencies, for both the firms

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[1] The NSCC was established in 1976 as a clearinghouse registered with the Securities and Exchange Commission ("SEC") to provide clearing and settlement services for a wide variety of securities. Over time, the NSCC's services have expanded into mutual funds, primarily through its Fund/SERV and Networking services.

[2] Letter from Donald E. O'Connor, Vice President – Operations, Investment Company Institute, to David Kelly, President, National Securities Clearing Corporation, April 7, 1987, as cited in Securities Exchange Act Release No. 34-26376 (Dec. 20, 1988), 53 Fed. Reg. 52544 (Dec. 28, 1988) (hereinafter "ICI Networking Letter").

[3] Investment Company Institute and Independent Directors Council, Navigating Intermediary Relationships, September 2009, at 24 available at http://www.ici.org/pdf/ppr_09_nav_relationships.pdf (hereinafter "ICI Intermediary Relationships Paper").

[4] Id. See also ICI Networking Letter, supra note 2. The SEC approved the NSCC's Mutual Fund Settlement, Entry, and Registration Verification Service ("Fund/SERV") as a permanent service to NSCC participants on November 20, 1987. See Securities Exchange Act Release No. 25146 (Nov. 20, 1987, 52 Fed. Reg. 45418 (Nov. 27, 1987). Fund/Serv was first approved as a pilot program in 1986. See Securities Exchange Act Release No. 22928 (Feb. 20, 1986), 51 Fed. Reg. 6954 (Feb. 27, 1986).

> and the fund complexes, that had to be resolved manually. To remedy this costly and time-consuming problem, an ICI committee and NSCC sought an automated solution to seamlessly exchange data. The result is the Networking service used today.[5]

The reconciliation problem described above was exacerbated by the fact that broker-dealers were required to devise and maintain different communications systems to convey customer account information to each mutual fund processor. At the time, brokerage back office systems had developed into a patchwork of manual interfaces to more sophisticated systems, with a clear need for a standardized and centralized system to process mutual fund transactions. In 1980, Nigel Brooks, an industry expert from Arthur Anderson, described the problems with broker dealer-infrastructure capabilities as follows:

> 'The problem is that there is a patchwork fabric here,' says Brooks. 'So most houses don't have an automated pipeline connecting the front office with the back. Data comes out of one system and becomes input for another system. The input must be keypunched or entered in a labor intensive, time consuming method. So it's the number of manual inputs along the way that determines how far a system is from the goal of a fully automated pipeline.'[6]

A related problem involved a broker-dealer practice of periodically requesting funds to provide actual physical certificates for each mutual fund investor, to permit broker-dealers to independently verify the actual amount of shares in a customer's account.[7]

The NSCC Networking service was designed to resolve these issues and address the growing complexity in the relationship between mutual funds and broker-dealers. As described in Securities Week when the NSCC announced its plans to move forward with a pilot program for the Networking service in 1987:

> The lack of accounting standards in the mutual funds industry has created a tremendous strain on the system as volume has increased and mutual funds have become more complex in their accounting methods, for example with back-end loads and dividend payments. Through the Networking system, all accounting will be done by the funds, but the broker will maintain control of the assets. A customer will still receive his or her statement from the broker and will still have to go through the broker to conduct any mutual fund business.[8]

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[5] ICI Intermediary Relationships Paper at 24.
[6] Maureen Nevin Duffy, "Wall Street's Back Office Crisis: Part 1," Wall Street Computer Review, Jan. 1, 1988.
[7] See Securities Exchange Act Release No. 34-26376 (Dec. 20, 1988), 53 Fed. Reg. 52544 (Dec. 28, 1988). See also Securities Exchange Act Release No. 34-31487 (Nov. 27, 1992), 57 Fed. Reg. 56611 (Nov. 30, 1992).
[8] "NSCC to Expand Clearing Service to Offer Fund Networking Service," Securities Week, Nov. 9, 1987.

Development of the NSCC Networking Service

As noted above, the NSCC developed its Networking service at the request of a joint ICI-NASD task force seeking "to create a system that will permit an ongoing exchange of data and information between mutual funds and brokers [by] bringing efficiencies to brokers and funds and eliminating much of the paperwork and other problems that presently exist."[9]

In correspondence between the ICI and NSCC in April 1987, the benefits of—and need for—such a Networking service were described as follows:

> For example, some of the benefits of the proposed networking exchange will be (1) the ability to reconcile all street name accounts held by the brokers, (2) the establishment of account transfer links such as are now being developed in the ACATS system, (3) provision for complete dividend reporting by mutual funds for accounts held in the names of brokers, (4) the ability of mutual funds to provide brokers with accurate and complete regulatory reports such as IRS Forms – 1099B, 1099DIV, Form 5498 and others, (5) the elimination of the need for brokers to hold street name certificates, (6) the elimination of costly, duplicative systems and accounting records now maintained by brokers, (7) the creation of the much needed standardization of forms, systems and data bases as a result of creating the central hub, and (8) ongoing developments – brokers will have expenses reduced and obtain better recordkeeping; mutual funds will be able to continue to be innovative in their product introduction without [sic] need to worry whether the broker's data processing system can handle the latest mutual fund product.[10]

An original description of the Networking service, as noted in a request for approval by the Securities and Exchange Commission ("SEC"), stated the following:

> The proposal will provide Fund/Serv broker-dealer participants with the ability to provide mutual funds, through a centralized and automated facility, with the information to establish sub-accounts for each customer to reflect customer positions within the broker-dealer's omnibus account at the mutual fund.
>
> Fund members will be able to transmit such customer account information such as: name of customer, address, account number, tax identification number, number or dollar amount of shares,

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[9] ICI Networking Letter, supra note 2. This joint task force was reactivated on March 17, 1987 as the Broker/Dealer Advisory Committee. See ICI Networking Letter, supra note 2.

[10] ICI Networking Letter, supra note 2.

> dividends, purchases and redemptions, and name of registered representative. Because of differing arrangements between broker-dealers and mutual funds, information submitted by broker-dealers to the fund will vary. NETWORKING can accommodate variable information, because it provides broker-dealers and mutual funds with a wide array of optional data fields and free-formatted fields.[11]

When an account is "Networked," the mutual fund shares are reconciled between broker and fund records and converted from physical shares to electronic book-entry form. Networking then permits a customer's account to appear identically on a broker's user records and, at the same time, on the records of a mutual fund or its transfer agent.[12]

In December of 1988, the SEC moved forward to approve this new service, with the following rationale:

> NETWORKING provides participants with the ability to transmit mutual fund customer account information in a centralized and automated fashion. Before NETWORKING, broker-dealers were required to devise and maintain different communications systems to convey customer account information to each mutual fund processor. Thus, the Commission believes NETWORKING provides broker-dealers with a more efficient means of communicating customer account information between broker-dealers and funds, and will further enhance the prompt and accurate clearance and settlement of customer-side mutual fund transactions.
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> . . . .
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> … NETWORKING also may decrease communication, trade processing and account maintenance costs for the funds and broker-dealers because NETWORKING will facilitate the development and implementation of a standard data format and data transmission format to replace the myriad of different formats which currently exist among mutual fund groups. NETWORKING also may enable broker-dealers to adapt more quickly and inexpensively to new types of mutual fund products or enhancements to existing products because of increased standardization and lower software programming requirements.[13]

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[11] Securities Exchange Act Release No. 34-26376 (Dec. 20, 1988), 53 Fed. Reg. 52544 (Dec. 28, 1988).

[12] See Securities Exchange Act Release No. 34-31487 (Nov. 27, 1992), 57 Fed. Reg. 56611 (Nov. 30, 1992). Because Networking is a centralized and standardized service, account information appears identically on the records of both sides of fund transactions. See "DTCC's Networking Service for Fund Industry Enhanced to Support Greater Transparency of Breakpoints; Move Follows Regulatory Recommendations by Joint NASD/Industry Task Force," Business Wire, Apr. 13, 2005, available at http://www.dtcc.com/news/press/releases/2005/networking_service.php.

[13] Securities Exchange Act Release No. 34-26376 (Dec. 20, 1988), 53 Fed. Reg. 52544 (Dec. 28, 1988).

Expansion of the NSCC Networking Service

After its initial approval and implementation, the NSCC Networking service was expanded quickly to include additional applications, according to the 1989 NSCC Annual Report:

> Networking, which opened the doors for electronic communication between fund groups and broker/dealers for those financial and non financial transactions not supported in Fund/SERV, continued to meet developmental milestones in its first full year of operation as the number of participants and subaccounts supported increased. The electronic lines of communication established in Networking have led to additional applications as well, such as the introduction of a Dividend Cash Settlement feature which enables fund groups and broker/dealers to settle dividend monies within NSCC's settlement system. As a result of the Dividend Cash Settlement feature, cash dividend payments are now made by fund groups in federal funds with broker/dealers receiving credit, including interest earned on the overnight investment of the dividend payment, in next-day funds on Settlement Date.[14]

Expansion of the Networking service to include other financial intermediaries started in 1992, when the NSCC was authorized to allow members of the Depository Trust Company ("DTC"), which includes many banks, to have access to its Networking service.[15]

In its proposed rule change filing with the SEC, the DTC stated that permitting its bank and broker participants to access the NSCC Networking service will increase the efficiency of mutual fund processing by allowing for:

- Centralized and standardized data communication for exchanging customer account information.
- Centralized dividend collection and payment.
- Elimination of physical certificates.
- Reduced correspondence to and from fund groups.
- More accurate and timely posting of mutual fund positions and dividend payments on customer statements.
- Improved tracking and reporting of daily dividend accrual funds.

[14] National Securities Clearing Corporation, 1989 Annual Report, at 5-6 (on file with CMFI).

[15] Securities Exchange Act Release No. 34-31487 (Nov. 27, 1992), 57 Fed. Reg. 56611 (Nov. 30, 1992) ("The proposal will enable participating mutual funds and participants who utilize Fund/Serv through DTC to exchange electronically, in a standardized format, non-trade account data such as subaccount information, closing position balances, and dividend processing records."). The Depository Trust Company was formed in 1976 to facilitate the process of replacing paper certificates as evidence of a securities investment with an electronic book entry process for ownership positions in securities.

- Cross-referencing of user and mutual fund customer account numbers (responsibility of the fund), enabling the fund to process Networking data based on the user's identification number only.
- Easier access to funds' special features and services (for example, dividend reinvestment, letter of intent, and rights of accumulation calculations).[16]

The NSCC's many technological and infrastructure capabilities were highlighted its 1992 Annual Report, by a senior executive of Edward D. Jones & Co., a large broker-dealer:

> Through this decade and into the next century, the industry will continue to be challenged by two powerfully dynamic forces: rapidly changing business requirements and technology innovations.
>
> NSCC has changed the way technology is applied to systems development, recognizing that our members' business objectives and technology capabilities are extremely diverse.
>
> Processing flexibility is a critical element in how NSCC responds to firms on the leading edge of technology, while continuing to support participants further down the curve.
>
> NSCC has been working to create a mix of solutions, capable of running on multiple types of participant technology platforms.
>
> As a result of helping the industry minimize risk, standardize and eliminate redundant functions, and reduce firm operating costs, NSCC is increasingly being called upon to address a wider range of issues.[17]

The specific benefits of the Networking service to funds and broker-dealers were also highlighted in the same 1992 NSCC Annual Report, by the President of the ICI:

> Networking, introduced in 1988, provides a standardized communications pipeline through which customer account level activity can be exchanged in both directions between broker/dealers and funds. *Using the system, brokers are able to carry customers' mutual fund positions on their stock record in much the same manner as they do for corporate security positions*. Networking

[16] Form 19b-4, Proposed Rule Change by The Depository Trust Company, Mar. 2, 1992, at 3, available in SEC File No. SR-DTC-92-2.
[17] John Bachmann, Managing Principal, Edward D. Jones & Co., National Securities Clearing Corporation 1992 Annual Report, at 19-20 (on file with CMFI).

> also offers centralized settlement of cash dividends and capital gains distributions.[18] (emphasis added)

The 1993 NSCC Annual Report noted that large broker-dealers continued to expand their use of the Networking service, with an example being the merger of Smith Barney and Shearson:

> While Smith Barney had been using NSCC's Networking system since 1988, the merger with Shearson brought an additional 300,000 subaccounts into the system and substantial growth is also expected in 1994. Networking is an automated record-keeping system that acts as a communications pipeline for updating non-trade related customer mutual fund account information between funds and broker/dealers, ensuring more accurate and efficient account maintenance and client support. The number of firms and funds joining Networking continues to grow, reflecting an industry-wide move toward more effective asset management and improved service delivery.[19]

Expansion of the Networking service continued over the next several years and, in May of 1997, third party administrators ("TPAs") of defined contribution plans were permitted to join NSCC and access Networking and other NSCC Mutual Fund Services.[20] Later that same month, unit investment trusts ("UITs") were permitted to process transactions and account data through NSCC Mutual Fund services, including Networking.[21]

In April 1997, the Securities Industry Association[22] had the following to say about the effectiveness and efficiency of the NSCC Networking service:

> Indeed, automated sub-accounting through [NSCC] Networking is already significantly reducing the cost of processing dividend reinvestment, rights of accumulation and other privileges of mutual fund ownership, and making it more economically feasible for broker-dealers to hold non-proprietary fund positions. Additionally, broker-dealers with proprietary funds are showing increased willingness to enter into reciprocal agreements with other broker-dealers to enable such funds to be transferred between them. We believe that this trend will continue, as will technological

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[18] Matthew P. Fink, President, Investment Company Institute, National Securities Clearing Corporation 1992 Annual Report, at 15-16 (on file with CMFI).

[19] National Securities Clearing Corporation, 1993 Annual Report, at 6 (on file with CMFI).

[20] Securities Exchange Act Release No. 34-38553 (Apr. 28, 1997), 62 Fed. Reg. 24523 (May 5, 1997). This NSCC service has been named Defined Contribution Clearance & Settlement ("DCC&S").

[21] Securities Exchange Act Release No. 34-38632 (May 14, 1997), 62 Fed. Reg. 27821 (May 21, 1997).

[22] The Securities Industry Association ("SIA") formerly represented the broker-dealer industry. SIA merged with the Bond Markets Association in 2006 to become the Securities Industry and Financial Markets Association ("SIFMA").

> refinements to automated systems which will further reduce [Networking] costs.[23]

The Increase in Subaccounting by Large Broker Dealers

Despite the growth and success of the NSCC Networking service, large broker-dealers prefer to operate their own proprietary recordkeeping systems for mutual fund accounts. Within the financial services industry, these proprietary systems are referred to as "subaccounting" or "sub-transfer agency" systems.

Under a subaccounting system, a mutual fund maintains a single account on its books for each broker-dealer, which is called an "omnibus account." Each trading day, the transactions of the customers of a broker-dealer are aggregated together into one net purchase or redemption order for each fund.

Unless a broker also uses the NSCC Networking service (or its functional equivalent), the identities, transaction histories, and chosen account privileges of the underlying shareholders are not disclosed to the mutual fund. This lack of transparency forces a mutual fund to be largely reliant on the broker-dealer to apply the policies and procedures outlined in each fund's prospectus.

By the end of 2003, subaccounting surpassed NSCC Networking as the preferred method of clearing mutual fund accounts.[24] According to PNC Global Investment Servicing ("PNC"), which claims to operate the financial industry's largest subaccounting system, more than 151 million mutual fund accounts are now cleared through subaccounting, while only 94 million are cleared through NSCC's Networking service.[25]

According to PNC, the following explains the dramatic growth in subaccounting within the broker-dealer industry:

> First, it's a matter of product design. Advice-based products, such as mutual fund wraps, include multiple funds across asset managers. Additionally, these programs have complex asset allocation and

[23] Letter from Stuart Kaswell, Senior Vice-President and General Counsel, Securities Industry Association, to Barry Barbash, Director, Division of Investment Management, Securities and Exchange Commission (Apr. 28, 1997), available at http://www.sifma.org/regulatory/comment_letters/comment_letter_archives/31224869.pdf.

[24] Christine Gill, Senior Vice President and Managing Director, PNC Global Investment Servicing, "Sub-Accounting's Rise Through a Distribution Lens," NICSA News, Dec. 7, 2009, at 1, available at http://www.nicsa.org/web/newsletter/NICSA120909.pdf (hereinafter "Gill Article").

[25] Id. PNC Global Investment Servicing discloses in separate public statements that its SuRPAS subaccounting platform has grown from servicing 14 million accounts in 2000 to 73 million accounts as of December 31, 2009. See Press Release, PNC Financial Services Group, Inc., "PFPC Leads Subaccounting Market; SuRPAS System Captures 7 Million New Shareholder Accounts in 2001" (Feb. 13, 2002), available at http://pnc.mediaroom.com/index.php?s=43&item=459&printable; and PNC Global Investment Servicing Inc., PNC Global Investment Servicing Highlights, available at http://www.pncgis.com/pncgis/pdf/info/PNCGIS_Highlights.pdf (last visited May 4, 2010).

> rebalancing logic. Broker/dealers have determined that the best way to support the operational requirements of these products, in the most cost effective manner, is to sub-account them.
>
> Second, it's due to the rise in holistic services. The broker-dealers' strategy is to have as much oversight and management of the investor experience as possible, and sub-accounting does just that. This method of recordkeeping helps broker/dealers continually reinforce their brand with respect to all client interactions, providing more opportunities to capture a greater share of the investor's wallet.[26]

The Mutual Fund Market Timing Investigations

The lack of transparency within broker-dealer omnibus accounts was a significant issue for state and federal regulators when a number of market timing investigations were initiated, beginning in the summer and fall of 2003. In one of the more prominent cases, the New York Attorney General described the problem as follows:

> Timers . . . trade through brokers or other intermediaries . . . who process large numbers of mutual fund trades every day through omnibus accounts where trades are submitted to mutual fund companies en masse. The timer hopes that his activity will not be noticed among the 'noise' of the omnibus account.[27]

The mutual fund industry responded initially by acknowledging the problem and requesting additional tools to make sure that funds can enforce restrictions on excessive short-term trading within omnibus accounts. In testimony on Capitol Hill in March 2004, the Chairman of the ICI stated the following:

> A particular challenge that funds face in effectively implementing restrictions on short-term trading is that many fund investments are held in omnibus accounts maintained by an intermediary (*e.g.*, a broker-dealer or a retirement plan record keeper). Often in those cases, the fund cannot monitor trading activity by individual investors in these accounts. Steps clearly need to be taken to enable mutual funds to enforce more effectively restrictions they establish on short-term trading when such trading takes place through omnibus accounts.[28]

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[26] Gill Article at 2.

[27] State of New York v. Canary Capital Partners, LLC, Canary Investment Management, LLC, Canary Capital Partners, Ltd. and Edward J. Stern at 16 (NY S. Ct. filed Sept.3. 2003), available at http://fl1.findlaw.com/news.findlaw.com/nytimes/docs/nys/nyscanary90303cmp.pdf.

[28] Statement of Paul G. Haaga, Jr., Executive Vice President, Capital Research and Management and Chairman, Investment Company Institute, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, at 11 (Mar. 31, 2004), available at http://www.investorscoalition.com/haagamarch31testimony.pdf.

However, a senior SEC official noted in a May 2004 speech at the ICI General Membership Meeting that the fund industry appeared to be opposed to more transparency within omnibus accounts, through comment letters filed with the SEC. At the same time, leaders of the industry were privately acknowledging a need to "look through" these accounts, for the purpose of identifying and preventing excessive short-term trading:

> While I am on the subject of assuming responsibility to protect investors, let me talk a moment about omnibus accounting. Fund managers complained to us about their lack of ability to 'look through' omnibus accounts to identify harmful market timers, and to apply redemption fees to their transactions. Earlier this year the Commission proposed a rule that would fix this problem. The rule was proposed at the request of the fund industry and after extensive consultation with the industry through the good offices of the NASD. And last week, we received some truly astounding comment letters opposing the requirement that intermediaries provide fund managers with omnibus trade information. A lot of arguments were made that do not seem to hold much water, and some of us are left wondering whether fund managers are unwilling to accept the responsibility of using this data to protect fund investors from market timers.
>
> These are the kinds of positions that baffle us and cause us to question whether there is only lip service being paid to the primacy of the interests of fund investors.[29]

In response to the market timing investigations, the SEC went on to promulgate new Rule 22c-2, requiring mutual funds to have written agreements with all of their financial intermediaries, in order to facilitate information-sharing at the individual investor level.[30] 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.[31]

The mutual fund and brokerage industries have responded to the information-sharing requirements of Rule 22c-2 by developing additional standardized processes to share investor information in intermediary subaccounts. One of these initiatives is called Client Data Share ("CDS"). It can be used by broker-dealers utilizing NSCC Networking, or it can support a standardized data exchange involving omnibus accounts outside of the NSCC system. The ICI describes this compliance tool as follows:

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[29] Paul F. Roye, Director, SEC Division of Investment Management, Speech by SEC Staff: Remarks before the ICI General Membership Meeting (May 20, 2004), available at http://www.sec.gov/news/speech/spch052004pfr.htm.

[30] See 17 C.F.R. § 270.22c-2(c)(5).

[31] Id.

> CDS is designed to address a number of compliance obligations between fund complexes and broker-dealers. CDS began as an initiative to address some of the recommendations contained in the *Report of the Joint NASD/Industry Task Force on Breakpoints* and has since evolved to help address not only breakpoints, but also SEC broker-dealer books and records requirements, as well as compliance with the SEC redemption fee rule, Rule 22c-2. Through CDS, fund complexes and broker-dealers exchange information that provides each side a more complete view of account and investor data residing on the other's records.[32]

To facilitate information-sharing between mutual funds and other intermediaries—such as banks and retirement plan recordkeepers—the NSCC has developed the Standardized Data Reporting ("SDR") system.[33] This capability can be used by these intermediaries when a fund makes an information request for subaccount information pursuant to Rule 22c-2.

These and other enhancements to the Networking service to facilitate compliance with Rule 22c-2[34] have been lauded by the ICI:

> '[Networking is] an extraordinarily efficient and cost-effective way for the industry to gain access to a level of transparency necessary to ensure compliance with the funds' market timing policies,' explained Kathy Joaquin, director of Operations & Distribution, Investment Company Institute. 'A key benefit is that funds and intermediaries can use technology that already exists to request and transmit data needed in standardized formats through a secure industry facility.'[35]

These improvements to the Networking service were also strongly supported by a fund executive from a large fund family involved in their development:

> This enhancement to Networking required close coordination and cooperation among members of the overall working group and the various task forces involved. Our goal was to create a solution that addressed the need for funds and firms to be able to request and

[32] ICI Intermediary Relationships Paper at 10.
[33] ICI Intermediary Relationships Paper at 11.
[34] Another compliance enhancement to NSCC's mutual fund services was the development of the Mutual Fund Profile Service. This Service provides (1) an automated and centralized repository of individual mutual fund information, and (2) a facility for users to input and apply data for prospectus compliance purposes. See Press Release, Depository Trust & Clearing Corporation, "DTCC Subsidiary Targets July 2007 to Launch New Mutual Fund Profile Service," Feb. 5, 2007, available at http://www.dtcc.com/news/press/releases/2007/funds_profile_service.php.
[35] Press Release, The Depository Trust & Clearing Corporation, "DTCC Delivers Short-Term Trading Compliance Solution for Fund Industry," Apr. 10, 2006, available at http://www.dtcc.com/news/press/releases/2006/marketing.php.

> supply data in a standardized manner, and yet had the flexibility to be expanded in the future as needed ….[36]

Unfortunately, the implementation of Rule 22c-2 has become even more expensive for funds because of the need for fund compliance personnel to develop surveillance processes to oversee non-transparent broker and other intermediary subaccounts. Since many funds are now relying on their financial intermediaries to detect market timing activities and enforce other prospectus policies, the funds have had to establish a surveillance and oversight mechanisms that add unnecessary compliance expenses that are, ultimately, borne by investors.

Instead of taking advantage of the cost and transactional efficiencies of the NSCC Networking service (or having the opportunity to deduct added surveillance costs from the payments being made to brokers for subaccounting activities), the funds have had to bear these additional Rule 22c-2 costs, in addition to the increased payments being made for decentralized recordkeeping by brokers and other intermediaries.

Conclusion

The NSCC Networking service provides significant operational efficiencies between brokers and funds, through the creation of a standardized, centralized, and automated system to share investor-level account information. Unfortunately, brokers discovered several years ago that they can generate additional fee revenue from funds by moving investor accounts away from the Networking service to a more segregated and non-transparent sub-accounting system. Fund payments to brokers have increased through the years and are now more costly to funds and their shareholders than the fees charged for using the NSCC Networking service.

Brokers argue that sub-accounting creates more efficiencies for brokerage operations, but the reality is that the financial services industry is replacing a very cost-effective and automated information-sharing system with a decentralized and fragmented subaccounting framework that delivers inadequate transparency at the individual investor level and is more expensive to operate. It is hard to establish that the sub-accounting model is the more efficient approach for recordkeeping when fewer services are being provided and funds are now paying brokers significantly more in fees than they were paying for the NSCC Networking service.

In addition to promulgating a regulatory requirement that provides transparency at the investor-level for these hidden accounts, Federal regulators should evaluate the services being provided under omnibus sub-accounting and take steps to eliminate those fees for services already required to be provided by broker-dealers under Financial Industry Regulatory Authority ("FINRA") rules and applicable law. Broker-dealer fees that are not established through competitive bidding and are not benefitting all shareholders should also be restricted.

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[36] Id. The quote is from Stuart J. Bateman, Senior Vice President, Franklin Templeton Investments. Mr. Bateman chaired the Investment Company Institute's Standardized Data Reporting Working Group.

As additional steps, Federal regulators should require the disclosure of all fees and other remuneration being paid to larger broker-dealers for recordkeeping and shareholder servicing activities within omnibus accounts. Similarly, mutual funds should be required to disclose the costs of establishing and maintaining mutual fund surveillance programs for non-transparent omnibus accounts, so that investors can be informed about the expenses associated with these broker-dealer arrangements. Finally, fund prospectus materials and monthly account statements should contain a legend with appropriate disclosure language regarding the use of omnibus sub-accounting by broker-dealers or other intermediaries.[37]

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[37] This disclosure should contain the following language: "A broker-dealer or other intermediary may receive fees to manage your account that are not being charged by other financial institutions selling or distributing Fund shares. A broker-dealer or other financial intermediary also may not be applying the Fund's policies and procedures to your account in the same manner as other investors, unless your account transactions are disclosed to the Fund on an ongoing basis."