



October 20, 2005

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

Subject: The Use of Technology to Protect Mutual Fund Investors

Dear Mr. Chairman:

As you settle into your new responsibilities, I want to bring to your attention a specific opportunity before the Commission to use existing mutual fund processing technology to advance the interests of individual investors.

I am the Executive Director of the Coalition of Mutual Fund Investors ("CMFI"), a Washington, D.C.-based shareholder advocacy organization.

The opportunity I am referring to involves the use of omnibus accounts in mutual fund transactions. As I am sure you are aware, almost 50 percent of mutual fund transactions are conducted through third-party financial intermediaries, such as broker-dealers, financial advisers, and retirement plan providers. Some of these intermediaries utilize omnibus record keeping, which aggregates ownership into a single omnibus account. This practice obscures individual account ownership and prevents mutual fund companies from exercising appropriate oversight.

At the end of each trading day, these third-party intermediaries also consolidate all of their customer transactions into one "omnibus account" order, which is then transmitted to a mutual fund (or its transfer agent) for processing. This practice hides individual account activity that may be prohibited by a fund, but cannot be detected by fund oversight procedures.

The use of third-party intermediaries to promote and market mutual funds provides many benefits to individual investors. However, the lack of transparency in these omnibus accounts, especially at the individual investor level, has created a number of regulatory problems which have yet to be adequately resolved by the Commission or the financial services industry.

One example is the issue of breakpoint discounts. Investors purchasing mutual funds with sales loads are often offered “volume” discounts by a mutual fund. However, the third-party intermediaries utilizing omnibus accounts do not have access to all of the investor information required to properly apply these breakpoint or volume discounts. As a result, the investor is not receiving the benefit of these promised discounts. A 2003 study commissioned by the National Association of Securities Dealers (NASD) demonstrated that omnibus record keeping results in a much higher percentage of breakpoint problems than other record keeping arrangements.<sup>1</sup>

In 2004, the Commission promulgated final regulations to address this issue; however, the Commission’s regulations only require more investor disclosure and do not solve the underlying problem.<sup>2</sup> The Commission’s regulations place much of the responsibility for ensuring the proper calculation of breakpoints discounts on the individual investor, when it should really be handled by the mutual fund or its transfer agent.

A second example of the regulatory problems caused by omnibus accounts is in the area of market timing. Everyone now agrees that short-term trading abuses are harmful to the interests of long-term investors. Excessive short-term trading increases transaction costs and dilutes the interests of those investors who are not participating in market timing activities. The Commission has considered new regulations to address this issue; unfortunately, it has become very clear that mutual funds are not able to enforce their anti-market timing policies, including redemption fees, on third-party financial intermediaries using omnibus accounts. The reason is that the mutual fund only has one shareholder of record in an omnibus account—the broker-dealer, the financial advisor or the retirement plan provider. Hidden within these consolidated accounts and orders are hundreds of thousands of individual investors whose identities and activities are unknown to the mutual fund and its compliance personnel. This lack of transparency hinders mutual funds from enforcing their policies and procedures in a uniform manner. As a result, shareholders who transact directly with the funds are treated differently from those shareholders who remain invisible to the funds by transacting through third-party financial intermediaries.

A number of mutual funds have responded to this growing regulatory problem by amending their prospectus filings to specifically exempt omnibus accounts from their policies and procedures. CMFI has conducted and published two publicly available studies regarding this problem. In our latest study, published on May 5, 2005, CMFI

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<sup>1</sup> See Report of the Joint NASD/Industry Task Force on Breakpoints, National Association of Securities Dealers, July 2003.

<sup>2</sup> Disclosure of Breakpoint Discounts by Mutual Funds, U.S. Securities and Exchange Commission, 69 Fed. Reg. 33262 (June 14, 2004).

found that 97% of the largest mutual fund complexes have excluded, waived, or limited the enforcement of redemption fees in omnibus accounts held by third-party financial intermediaries, where the outside financial institution maintains the underlying shareholder account.<sup>3</sup>

Individual investors now face a bifurcated mutual fund compliance system in which investors are treated differently based on the distribution channel they choose to use (i.e., “direct purchase” or “omnibus account”). And it is not in the economic interests of the third-party financial intermediaries to ensure the uniform treatment of these two different types of shareholders, as these financial institutions are often collecting extra commissions for failing to calculate sales load discounts properly and generating the extra trading activity involved in market timing. In addition, many of these financial intermediaries are collecting shareholder servicing fees from mutual funds for administering these third-party shareholder accounts. In short, the economic interests of these financial institutions are not aligned with the economic interests of the individual investor.

Remarkably, there is a simple and cost-effective solution to the regulatory problems caused by omnibus accounts. For several years, CMFI has been advocating that third-party financial intermediaries disclose investor-level identity and transaction information within their omnibus accounts to the mutual funds so that fund policies and procedures—including sales load discounts, redemption fees, and anti-market timing rules—can be enforced uniformly across all shareholder classes. The Commission and its regulatory staff agree with this approach. In its final rule regarding redemption fees, the Commission required that all financial intermediaries have a written agreement with each mutual fund with which it does business.<sup>4</sup> In the agreement must be a provision permitting the mutual fund to access investor identity and transaction information within omnibus accounts. CMFI strongly supports this concept.

A problem with the disclosure of this information, however, is the cost of this regulatory requirement. The current regulation requires the disclosure of this information “upon request.” Thus a mutual fund may ask for this information on a daily, weekly, monthly, quarterly, or any other basis, such as when a fund’s trading surveillance procedures trigger a need for additional information at the individual investor level. With thousands of mutual funds and intermediaries involved in mutual fund transactions, this is going to be a very expensive information-sharing requirement unless common

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<sup>3</sup> An Evaluation of the Redemption Fee and Market Timing Policies of the Largest Mutual Fund Groups, Coalition of Mutual Fund Investors, May 5, 2005, available at <http://www.investorscoalition.com>

<sup>4</sup> Mutual Fund Redemption Fees, U.S. Securities and Exchange Commission, 70 Fed. Reg. 13328 (March 18, 2005).

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standards are established for sharing this information between funds and their intermediaries.

As luck would have it, 80-90 percent of the largest mutual funds and their intermediaries are processing orders through the National Securities Clearing Corporation ("NSCC"), the only SEC-registered clearance, settlement and information services agency for mutual fund transactions. Through its Fund/SERV, Networking and Defined Contribution Clearance & Settlement processing platforms, the NSCC is able to permit the exchange of investor-level information from omnibus accounts between mutual funds and their intermediaries on a same-day basis. The cost of these services is estimated to be about 36 cents per account per year. If industry reports are accurate that there are approximately 80 million omnibus accounts, then the total cost of using the NSCC systems will be about \$29 million a year. This is significantly less than the \$630 million annual cost estimated by the SEC staff in its redemption fee rulemaking.<sup>5</sup>

Using the NSCC processing platforms is a far more cost-effective solution for both the mutual funds and their intermediaries. Instead of having each financial institution revamp its computer compliance systems to anticipate differing information sharing requests, it makes much more sense to take advantage of the fact that the substantial majority of the largest funds and their intermediaries are already using an order and account information processing system that requires only some modest adjustments to solve all of the regulatory problems associated with omnibus accounts.

It has been more than two years since the regulatory investigations uncovered the breakpoint discount and market timing problems occurring in omnibus accounts. The Commission has a real opportunity to solve this problem in a very cost-effective manner by using technology already in place and used by almost all of the largest players in the financial services industry. (A longer discussion of the merits of this approach can be found in the CMFI's recent comment letter to the Commission, sent in response to its request for additional comments regarding its final rule for mutual fund redemption fees.<sup>6</sup>)

On behalf of the Coalition of Mutual Fund Investors, I urge you to conduct an internal study generally regarding omnibus accounting and specifically of the capabilities of the NSCC order and account processing platforms, to ascertain if these platforms can provide a standardized and cost-effective method for sharing investor-level information

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<sup>5</sup> *Id.* at 13339 (March 18, 2005)

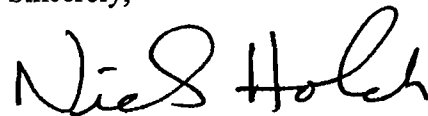
<sup>6</sup> Additional Comments: Mutual Fund Redemption Fees, Comment Letter of the Coalition of Mutual Fund Investors, File No. S7-11-04, available at <http://www.investorscoalition.com>

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between mutual funds and their third-party financial intermediaries. It would be a large step forward for the Commission to resolve this problem without significant compliance costs that will be eventually be passed on to investors.

Thank you for your consideration of this request. If CMFI or I can be of additional assistance to the Commission, please let me know.

Sincerely,

A handwritten signature in black ink that reads "Niels Holch". The signature is written in a cursive, slightly slanted style.

Niels Holch  
Executive Director  
Coalition of Mutual Fund Investors

cc: The Honorable Paul S. Atkins  
The Honorable Roel C. Campos  
The Honorable Cynthia A. Glassman  
The Honorable Annette L. Nazareth  
Meyer Eisenberg, Division of Investment Management  
Robert Plaze, Division of Investment Management