CMFI
Coalition of Mutual Fund Investors

April 15, 2016

Via Electronic Mail (rule-comments@sec.gov)

Brent Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Subject: Transfer Agent Regulations, SEC File No. S7-27-15

Dear Mr. Fields:

The Coalition of Mutual Fund Investors ("CMFI")[1] appreciates the opportunity to provide comments to the Securities and Exchange Commission ("SEC"), regarding its Advance Notice of Proposed Rulemaking and Concept Release on Transfer Agent Regulations ("Transfer Agent Release").[2]

CMFI confines its comments to Section VII.C, regarding rules for mutual fund transfer agents.[3] In particular, CMFI responds to Question 122, which asks for comments regarding the problems caused by a "lack of visibility into the identities of beneficial owners" and what regulatory changes would be necessary to address the problems created by omnibus accounts and intermediary sub-accounting.[4]

A substantial majority of mutual fund shares now reside within omnibus accounts, and the lack of transparency into investor identities and transactions has resulted in a significant

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[1] The Coalition of Mutual Fund Investors ("CMFI") is an Internet-based shareholder advocacy organization established to represent the interests of individual mutual fund investors. More information about CMFI and its activities can be obtained through its website (www.investorscoalition.com).

[2] Transfer Agent Regulations, Release No. 34-76743, 80 Fed. Reg. 81, 948 (Dec. 31, 2015) (hereinafter "Transfer Agent Release").

[3] *Transfer Agent Release* at 81,990 – 81,998.

[4] *Id.* at 81,998. The SEC also states in Section VII.C.4 that it is "examining the issues or concerns that may arise in connection with the lack of visibility that issuers and transfer agents acting on their behalf may have regarding the records maintained by intermediaries for their customers who are beneficial owners of mutual funds that are being serviced through omnibus and sub-accounting arrangements." *Id.* at 81,996.

number of regulatory and prospectus compliance problems for mutual funds and their investment advisers.

SEC rules require funds and their advisers to be primarily responsible for ensuring compliance with regulatory requirements and fund prospectuses. However, the SEC has not provided mutual funds with the tools to address the omnibus accounts transparency problem.

This is a troubling state of affairs, as the processing technology currently exists to resolve—in a comprehensive manner—the omnibus accounts transparency problem, for the benefit of mutual fund investors. This technology has been available and in active use within the financial services industry since 1988. However, in CMFI's view, mutual funds and their distribution partners are not going to use this technology more robustly until the SEC promulgates a uniform regulatory rule to address these transparency issues.

For more than a decade, CMFI has advocated that the most efficient and cost-effective method to provide full transparency within omnibus accounts is for the SEC to amend Rule 22c-2, to permit funds to receive investor identity and transaction information from intermediaries on a daily basis, or as fund purchase and redemption orders are processed.

This comment letter will address these issues in greater detail through an examination of the following topics:

- Why mutual funds remain primarily responsible for compliance with their prospectus disclosures;
- How the widespread use of omnibus accounts has created an investor-level transparency problem that prevents funds from applying their prospectus policies and procedures uniformly across distribution channels;
- Why a return to using the Networking service of the National Securities Clearing Corporation would provide an efficient and cost-effective technological solution to the omnibus accounts transparency problem; and
- Why the most effective regulatory change that the SEC could implement to address these issues is to amend Rule 22c-2, to require intermediary information-sharing at the beneficial owner level on a same-day basis for all mutual funds.

SEC Rules Require Mutual Funds and Their Advisers to Be Responsible for Compliance with Statements Made in a Prospectus Document

With thousands of financial intermediaries distributing mutual fund shares, the fund industry faces an overly complex and fragmented distribution system. Despite efforts by the industry to enter into contractual arrangements to delegate certain compliance functions to

financial intermediaries, the SEC still requires mutual funds and their advisers to be principally responsible for compliance with statements that are made in a fund prospectus document.

For decades, the SEC has used its authority under the anti-fraud provisions of the Federal securities laws to ensure that statements made in a prospectus are not materially misleading. And the SEC enhanced this requirement through the promulgation of Rule 38a-1 under the Investment Company Act and Rule 206(4)-7 under the Investment Advisers Act.[5] These Rules, adopted in 2003, require funds and their advisers to develop and implement written policies and procedures reasonably designed to prevent violations of the Federal securities laws.[6]

These Rules also re-affirmed the SEC's position—after the market timing scandals—that mutual funds retain the primary responsibility for ensuring compliance with statements made in a fund prospectus:

> Failure to adhere to statements made in the prospectus may render the prospectus disclosure materially misleading and thus violate provisions of the Federal securities laws that prohibit fraud. See, e.g., section 17(a) of the Securities Act (15 U.S.C. 77q), section 10(b) of the Securities Exchange Act (15 U.S.C. 78j) and rule 10b-5 (17 CFR 240.10b-5) thereunder, and section 34(b) of the Investment Company Act (15 U.S.C. 80a-33(b)).[7]

The SEC also re-affirmed its position in these Rules that investment advisers have a fiduciary duty to act in the best interests of the funds they advise, pursuant to section 206 of the Investment Advisers Act (15 U.S.C. § 80b-6) and section 36(a) of the Investment Company Act (15 U.S.C. § 80a-35(a).[8]

These regulatory responsibilities have been increasingly hard to execute within omnibus accounts controlled by large broker-dealers and other financial intermediaries. As the SEC is well aware, fund intermediaries using omnibus accounts aggregate together all purchase and redemption requests from their customers into one consolidated order on a daily basis and for each mutual fund. A fund handles this consolidated order as a single transaction, treating the financial intermediary as the shareholder of record for each omnibus account.

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[5] *See* Compliance Programs of Investment Companies and Investment Advisers, 68 Fed. Reg. 74,714 (Dec. 24, 2003).

[6] *Id* at 74,715-74,716. The SEC also clarified in this final rule that the failure of a fund or an adviser to have "adequate compliance policies and procedures in place will constitute a violation of [SEC] rules independent of any other securities law violation." *Id.* at 74,715.

[7] *Id.* at 74,720, footnote 67.

[8] *Id.* at footnote 68. This footnote also cited *Rosenfeld v. Black*, 445 F.2d 1337 (2nd Cir. 1971); *Brown v. Bullock*, 194 F. Supp. 207, 229, 234 (S.D.N.Y. 1961), *aff'd* 294 F.2d 415 (2nd Cir. 1961); and In re Provident Management Corp., Securities Act Release No 5115 (Dec. 1, 1970) at text accompanying footnote 12.

Each omnibus account may represent the transactions of thousands of customers of a particular financial intermediary. However, no investor-level information is generally disclosed to each mutual fund about the identities and transactions of the underlying investors. This lack of transparency makes it difficult, if not impossible, for a mutual fund to enforce prospectus policies and procedures—as well as regulatory rules—within these intermediary accounts.

The Use of Omnibus Accounting Has Significantly Reduced the Ability of Mutual Funds to Ensure Regulatory and Prospectus Compliance

The regulatory and compliance problems within omnibus accounts would not be the subject of this much attention if only a small subset (e.g., 5%) of the overall mutual fund shareholder base was potentially impacted. However, these problems have become very significant because a substantial majority of the shares of a typical mutual fund are now being held within these non-transparent, third-party accounts.

In a Report issued in 2006, the Investment Company Institute estimated that a median of 80% of mutual fund shares sold by sales forces—as well as a significant number of direct-sold fund shares—are held within omnibus accounts (also referred to as "street name" accounts):

> Mutual funds … have a significant portion of their shares held in street name. For mutual funds sold via sales forces (either proprietary or non-proprietary) shares held in street name ranged from 78 percent to 100 percent of total fund shares, with a median of 80 percent—similar to that of closed-end funds. Even mutual funds that are marketed directly to investors had a considerable amount of their shares held in street name … half of mutual funds sold directly had at least 57 percent of total shares outstanding held in street name. Direct-sold mutual funds are offered on platforms or supermarkets, and these shareholder accounts generally are held in street name.[9]

As noted earlier, Rule 38a-1 (and corresponding Advisers Act Rule 206(4)-7) requires funds and their advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Federal securities laws and to protect the interests of shareholders and clients. In CMFI's view, it is hard to argue that prospectus policies and procedures that are inapplicable to more than 50% of the shares of a fund are effective policies and procedures. And if a stated policy or procedure lacks effectiveness, then it does not meet the

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[9] Investment Company Institute, *Costs of Eliminating Discretionary Broker Voting on Uncontested Elections of Investment Company Directors*, at 5, December 18, 2006, *available at* https://www.ici.org/pdf/wht_broker_voting.pdf. Some of these omnibus or street name accounts are transparent to the funds at the investor level through the National Securities Clearing Corporation's Networking Level 3 service. *See infra* note 34.

requirements of Rules 38a-1 and 206(4)-7 that it is a policy or procedure "reasonably designed" to prevent securities law violations and to protect shareholders and clients.

To make matters worse, regulatory and prospectus compliance problems continue to be identified in omnibus accounts. Presently, there are at least six (6) specific and significant compliance problems that have emerged as a result of the widespread use of these non-transparent accounts:

1. **Market Timing/Frequent Trading**. The lack of transparency within omnibus accounts makes it impossible for funds to apply their frequent trading policies and procedures uniformly across different distribution channels.

This problem was clearly identified more than a decade ago, when the mutual fund industry faced extraordinary criticism for permitting excessive trading activities within certain retail funds. At the time of these market timing scandals, the industry—through its association, the Investment Company Institute ("ICI")—requested additional tools to improve transparency within omnibus accounts. As an example, the President of the ICI presented the following testimony before the Senate Banking Committee on March 31, 2004:

> 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.[10]

As discussed in more detail below, the SEC finalized Rule 22c-2 in 2006, to provide funds with the ability to request investor identity and transaction information from broker-dealers and other intermediaries using omnibus accounts.[11] Unfortunately, the fund industry is not using this regulatory tool to protect investors from excessive trading in intermediary accounts. Instead, funds typically address the omnibus accounts issue by: (1) relying on intermediary policies and procedures, and (2) adding disclaimer language in fund prospectuses about the lack of visibility into omnibus accounts.[12]

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[10] 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.

[11] Mutual Fund Redemption Fees, 71 Fed. Reg. 58,257 (Oct. 3, 2006) (codified at 17 C.F.R. § 270.22c-2).

[12] *See* Coalition of Mutual Fund Investors, *Excerpts from SEC Prospectus Filings Regarding Enforcement of Mutual Fund Market Timing and Other Short-Term Trading Policies within Third-Party Hidden Accounts – Largest Fifty (50) Retail Mutual Fund Groups*, May 31, 2015, *available at*

2. **Broker-Dealer Sales Load Discounts**. The lack of transparency within omnibus accounts is also harming mutual fund investors who are entitled to volume discounts from sales loads for large purchases (or sales load waivers for investing in a retirement or other special account). Broker-dealers are not providing these "breakpoint" discounts accurately and mutual funds are not in a position to make the appropriate calculations required by their prospectuses because broker-dealers are not sharing investor identity and transaction information with the funds.[13]

The breakpoint discount problem has been left unresolved for more than a decade. This problem was first identified in a joint examination sweep of 43 broker-dealers between November 2002 and January 2003. In this sweep, regulators discovered that sales load discounts were not properly applied in as many as one-third (1/3) of the reviewed transactions eligible for such discounts.[14]

Since this period, the Financial Industry Regulatory Authority ("FINRA") has brought more than 100 enforcement cases in order to sanction—after the fact—those broker-dealers who were caught overcharging their customers. The scale of this particular problem is staggering. Over the past 11 years, FINRA has penalized its broker-dealer members more than $98 million and required more than $210 million in investor restitution payments.[15]

A relatively recent example of this problem can be found in a June 2014 enforcement settlement between FINRA and Merrill Lynch (now a subsidiary of Bank of America), regarding

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http://www.investorscoalition.com/sites/default/files/Analysis%20of%20Omnibus%20Surveillance%20Procedures%206-10-2015.pdf (hereinafter "2015 Prospectus Excerpts").

[13] This is an especially difficult problem when a fund permits related-party investors—such as family members—to qualify for breakpoint discounts as a group. It is often the case that these related investors hold fund shares in accounts with different brokerage firms. A broker-dealer has insufficient information to properly calculate the discounts across these accounts. A mutual fund and/or its transfer agent is the only entity in a position—with full transparency of all investor identities and transactions—to accurately calculate the sales load discounts that these investors are entitled to receive under a fund's breakpoint discount policies.

[14] Press Release, SEC, NASD, NYSE Release Findings of Breakpoint Examination Sweep; Broker-Dealers To Review Transactions, March 11, 2003, *available at* https://www.sec.gov/news/press/2003-31.htm. In its Transfer Agent Release, the SEC acknowledges that these problems are the result of the use by broker-dealers of omnibus accounts ("The [Joint] Staff Report also noted that … 'the increasing prominence of omnibus account arrangements and sub-transfer agency services provided to these accounts by intermediaries such as brokers had made the tasks related to the application of breakpoints more challenging.'"). *Transfer Agent Release* at 81,996 (quoting Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds, March 2003).

[15] *See* Letter from Niels Holch, Executive Director, Coalition of Mutual Fund Investors, to Richard G. Ketchum, Chairman and Chief Executive Officer, Financial Industry Regulatory Authority, at 2, November 30, 2015, *available at* http://www.investorscoalition.com/sites/default/files/CMFI%20Letter%20to%20FINRA%20re%20Omnibus%20Accounts%2011-30-2015.pdf. The FINRA-required restitution numbers are actually much larger, as the settlement agreements for many of these cases describe the restitution process that each broker-dealer is required to perform, but do not always disclose the actual amount of restitution to be undertaken by each firm.

Merrill Lynch's failure to waive sales load charges promised in mutual fund prospectus disclosures for 41,000 small-business retirement plans and 6,800 charities and 403(b) retirement plan accounts.[16]

The use of omnibus accounting for these retirement plans required $89.2 million in customer restitution payments by Merrill Lynch and the payment of an $8 million fine to FINRA. This was the fourth enforcement proceeding brought against Merrill Lynch in the past 11 years for failure to provide sales load discounts or waivers within omnibus accounts.[17] And in this latest enforcement action, Merrill Lynch decided it was too costly to offer sales load waivers for certain retirement plans and so it just told the funds involved to eliminate the waiver policy altogether in their prospectuses![18]

A related problem also exists with back-end sales loads, called Contingent Deferred Sales Charges ("CDSCs"). Typically, these are sales charges imposed on an investor who purchases and redeems shares within a specified period of time, such as one year. These sales charges are impossible to track within omnibus accounts, when intermediaries do not share investor-level transaction information with funds.[19]

3. **Money Market Funds**. Money market funds are not able to accurately evaluate and manage their liquidity risks because of an inability to access investor identity and transaction information through the omnibus accounts structure.

In 2010, the SEC amended its Rule 2a-7 to impose a number of new liquidity requirements on money market funds, including a general liquidity requirement.[20] This recent rule mandates that funds establish internal processes to develop more information about their

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[16] Financial Industry Regulatory Authority, *Merrill Lynch, Pierce, Fenner & Smith, Incorporated*, AWC No. 2011029999301 (June 2014), *available at* http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p530006.pdf (hereinafter "2014 Merrill Lynch Enforcement Action").

[17] *See* Financial Industry Regulatory Authority, *Merrill Lynch, Pierce, Fenner & Smith, Incorporated*, AWC No. 20080141877 (June 2012); Financial Industry Regulatory Authority, *Merrill Lynch, Pierce, Fenner & Smith, Incorporated*, AWC No. 20080157013 (June 2010); and Financial Industry Regulatory Authority, *Merrill Lynch, Pierce, Fenner & Smith, Incorporated*, AWC No. EAF040109003 (February 2008).

[18] *2014 Merrill Lynch Enforcement Action* at 7 (footnote 14) ("Merrill Lynch determined that the cost of changing its operating system to facilitate these [sales load] waivers would be prohibitive. Merrill Lynch asked each mutual fund family that offered such a waiver to consider limiting the waiver so that it would not apply to purchases effected through brokerage firms, thus relieving the Firm from administering the sales waivers. Six of the twelve fund families eliminated the 501(c)(3) waivers and five revised their prospectus language to require 501(c)(3) entities to purchase the funds directly from the fund company in order to receive the sales waivers. One fund family refused to limit the availability of the sales waiver, and as a result, Merrill Lynch stopped selling shares of that fund family on its retail platform.").

[19] In its Transfer Agent Release, the SEC acknowledges that "the use of different sales load structures and distribution methods, particularly with respect to redemption of mutual fund securities, as well as other fee payments to intermediaries, also adds complexity in the mutual fund context." *Transfer Agent Release* at 81,994.

[20] Money Market Fund Reform, 75 Fed. Reg. 10,060 (Mar. 4, 2010).

shareholders and their anticipated redemption needs.[21] However, this particular rule—also referred to as the "know your customer" requirement—is never going to function properly without full transparency within omnibus accounts.

The SEC acknowledged the omnibus accounts transparency problem in its final Money Market Fund Reform Release.[22] And several commenters, including CMFI, advocated that Rule 22c-2 should be extended to money market funds.[23] However, the SEC did not agree and so the Rule 22c-2 information-sharing tool is not currently available to money market funds.

This issue arose again in the SEC's more recent rulemaking on money market funds.[24] Omnibus accounts became an obstacle to imposing redemption fees and gates for these funds, as noted in previous CMFI comment letters to the SEC and the Financial Stability Oversight Board.[25]

Additionally, omnibus accounts create problems for money market funds in complying with the SEC's "natural persons" standard for retail money market funds, a rule established to ensure that only individual investors are shareholders of certain fixed Net Asset Value ("NAV") funds.[26] Without full transparency into the actual identities of the underlying investors, mutual funds will not be able to ensure compliance with this SEC requirement.

4. **SEC Pay-to-Play Rules**. Omnibus accounts remain an obstacle for investment advisers trying to comply with the SEC's "pay-to-play" rules. These rules require investment advisers to keep a record of all government entities that hold—directly or indirectly—shares of

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[21] *Id.* at 10,074.
[22] *Id.* at 10,075 ("As some commenters noted, identification of these risks may be more challenging when share ownership is less transparent because the shares are held in omnibus accounts.").
[23] *See* Letter from Niels Holch, Executive Director, Coalition of Mutual Fund Investors, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, at 9-11, Sept. 10, 2009, *available at* http://www.sec.gov/comments/s7-11-09/s71109-135.pdf; and Letter from Phillip Gillespie, Executive Vice President and General Counsel, State Street Global Advisers, to Elizabeth M. Murphy, Securities and Exchange Commission, Sept. 8, 2009, at 9, *available at* http://www.sec.gov/comments/s7-11-09/s71109-108.pdf; *see also* Letter from Paul Audet, Vice Chairman, BlackRock, Inc., to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, at 6, Sept. 4, 2009, *available at* http://www.sec.gov/comments/s7-11-09/s71109-60.pdf; and Letter from George G.W. Gatch, President & CEO, JPMorgan Funds Management, Inc., to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, at 5, Sept. 8, 2009, *available at* http://www.sec.gov/comments/s7-11-09/s71109-110.pdf.
[24] Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. 47,736 (Aug. 14, 2014).
[25] Letter from Niels Holch, Executive Director, Coalition of Mutual Fund Investors, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, September 17, 2013, *available at* http://www.investorscoalition.com/sites/default/files/CMFI%20Comment%20Letter%20re%20MM%20Fund%20Reform%209-17-2013.pdf; and Letter from Niels Holch, Executive Director, Coalition of Mutual Fund Investors, to Amias Gerety, Financial Oversight Stability Council, January 21, 2013, *available at* http://www.investorscoalition.com/sites/default/files/CMFI%20Comment%20Letter%20to%20FSOC%20re%20MM%20Funds%201-21-2013.pdf.
[26] *See* Claire Trapasso, "Money Funds Struggle to Take the Pulse of Investor Base," *Ignites*, August 20, 2014.

any of their mutual funds.[27] Fund advisers are not able to easily identify any government entities holding shares of their mutual funds through omnibus accounts.

The SEC decided to respond to this problem by issuing a no-action letter to the ICI in September 2011.[28] This letter permits advisers to keep an alternative set of records that represents a "do the best you can" approach to collecting information about underlying shareholders in omnibus accounts.

This is yet another SEC rule that would benefit from a regulatory framework that provides funds with full transparency into omnibus accounts, down to the investor level and on a standardized basis.

5. **529 College Savings Accounts**. Several large broker-dealers are working to convert into omnibus accounts those individual mutual fund accounts in state 529 plans that are sold through broker-dealers and/or investment advisors. This process started several years ago with the Virginia 529 Plan and is expected to spread to other state plans.

CMFI has been critical of this initiative in correspondence with the Virginia Plan.[29] The response from the Virginia Plan has been that the omnibus conversion did not increase costs for either the 529 Plan or its investors.[30] This assertion is somewhat disingenuous, however, as the cost structure for advisor-sold 529 plans is much more expensive to begin with—involving multiple layers of fees—than the direct-sold plans for state 529 plans.

To document this point, CMFI released a study in January 2012, which compared the fees being paid by investors in 31 different state advisor-sold plans. The study found that these advisor-sold plans are more than twice as expensive as the direct-sold plans in each state's 529 program.[31] CMFI has argued for measures to reduce investor costs in these advisor-sold plans,

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[27] Political Contributions by Certain Investment Advisers, 75 Fed. Reg. 41,018 (July 14, 2010).
[28] Investment Company Institute, SEC No-Action Letter, September 12, 2011, *available at* http://www.sec.gov/divisions/investment/noaction/2011/ici091211-204.htm.
[29] Letter from Niels Holch, Executive Director, Coalition of Mutual Fund Investors, to The Honorable Manju Ganeriwala, Treasurer, Commonwealth of Virginia, December 17, 2010, *available at* http://www.investorscoalition.com/sites/default/files/CMFI%20Letter%20to%20Manju%20Ganeriwala%20re%20529%20Plans%2012-17-2010.pdf.
[30] Letter from Mary G. Morris, Chief Executive Officer, Virginia 529 College Savings Plan, to Niels Holch, Executive Director, Coalition of Mutual Fund Investors, September 27, 2011, *available at* http://www.investorscoalition.com/sites/default/files/Letter%20from%20Virginia%20529%20Plan%209-27-2011.pdf.
[31] *See* Coalition of Mutual Fund Investors, *Comparison of Investor Fees and Costs in Section 529 College Savings Plans*, January 30, 2012, *available at* http://www.investorscoalition.com/sites/default/files/Comparison%20of%20Investor%20Fees%20and%20Costs%20in%20Section%20529%20College%20Savings%20Plans%201-30-2012.pdf. *See also* Mark Jewell, "Investors can rein in college savings plan fees," *Associated Press*, April 26, 2012, *available at* http://www.investorscoalition.com/sites/default/files/Associated%20Press%20Column%20re%20529%20Fees%204-26-2012.pdf.

as well as for steps to ensure continued transparency by intermediaries down to the individual account level.

6. **SEC Fair Fund Distributions**. In response to the mutual fund market timing scandals of more than a decade ago, the SEC collected approximately $3.5 billion in penalties from various mutual fund advisers and other parties for harmful market timing activities.

The SEC directed the creation of more than 25 Fair Fund Distribution Plans, to pay out this $3.5 billion in restitution payments to investors adversely affected by these market timing activities. The issue of omnibus account transparency was a recurring theme in the design of these Distribution Plans and CMFI commented on this issue when the SEC solicited public input on these Distribution Plan proposals.[32]

It is not clear whether all investor-level distributions through intermediaries were made successfully, as there is limited information on the public record about this issue. However, it is clear that these distributions would have been easier to make—and would have been calculated more accurately—if funds were permitted to have full transparency within omnibus accounts.

The Technology Exists to Solve the Omnibus Accounts Transparency Problem

Fortunately, the technology exists to solve this regulatory and compliance problems—and the technology has been available for this purpose since 1988.

Full transparency at the investor-level within omnibus accounts can be accomplished efficiently and in a cost-effective manner through the order and account processing systems of the National Securities Clearing Corporation ("NSCC"). A substantial majority of mutual funds, large broker-dealers, and other financial intermediaries already use the NSCC Fund/SERV and Networking services, and the technology is in place through the NSCC to share investor-level information—in an automated manner—at a cost of only $0.10 for every 100 records processed.[33]

In its Transfer Agent Release, the SEC acknowledges the transparency benefits provided by NSCC Networking for intermediary accounts:

> 'Networking' of a single investor's account or position potentially gives Mutual Fund Transfer Agents more transparency through to beneficial owners than is available to Operating Company Transfer Agents, because

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[32] *See, e.g.*, Letter from Niels Holch, Executive Director, Coalition of Mutual Fund Investors, to Nancy M. Morris, Secretary, Securities and Exchange Commission, October 16, 2006, *available at* http://www.investorscoalition.com/sites/default/files/SECCommentLetterMFS.pdf.

[33] *See* National Securities Clearing Corporation, Rules and Procedures, at 293, December 31, 2015, *available at* http://www.dtcc.com/legal/rules-and-procedures.

> the recordkeeping for such accounts is primarily kept on the Mutual Fund Transfer Agent's system. 'Networking' is a service provided by NSCC by which Mutual Fund Transfer Agents can also exchange general shareholder account data with intermediaries such as brokers that provide sub-transfer agency services. This service provides for different levels of securityholder account networking between mutual funds and intermediaries. Networked accounts are in the name of the intermediary on the master securityholder file but can represent both individual customers and omnibus accounts.[34]

When an account is "networked," mutual fund shares are recorded in electronic book-entry form and reconciled between broker-dealer and fund records. Networking then permits a customer's account to appear identically on a broker's system and, at the same time, on the records of a mutual fund, or its transfer agent.[35]

The NSCC's Networking service was established and first approved by the SEC more than twenty-five (25) years ago.[36] In its Order approving this service in December of 1988, the 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, 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

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[34] *Transfer Agent Release* at 81,996. Level 3 Networking is the most common use of this service. As noted in footnote 511 of the Transfer Agent Release, Level 3 Networking permits the intermediary to handle all aspects of the customer relationship and the customer does not interact with the mutual fund or its transfer agent.

[35] *See* Order Approving Proposed Rule Change Relating to the Development of an Interface With the National Securities Clearing Corporation's Networking Service for Mutual Fund Transactions, Depository Trust Company, 57 Fed. Reg. 56,611 (Nov. 30, 1992). Because Networking is a centralized, standardized, and automated service, account information appears identically on the records of both sides of fund transactions. On the mutual fund side, all shareholders would be fully disclosed on the books and records of each fund.

[36] *See* Coalition of Mutual Fund Investors, *History of the National Securities Clearing Corporation's Networking Service,* October 3, 2014, *available at* http://www.investorscoalition.com/sites/default/files/History%20of%20NSCC%20Networking%2010-3-2014.pdf.

> mutual funds with a wide array of optional data fields and free-formatted fields.[37]

NSCC Networking has been expanded over the years to provide similar communication and reconciliation services to other financial intermediaries, including banks, third-party administrators of defined contribution plans ("TPAs"), and unit investment trusts ("UITs").

Historically, NSCC Networking has been lauded by the mutual fund industry. More than twenty years ago, the specific benefits of the Networking service to funds and broker-dealers were highlighted in the 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 also offers centralized settlement of cash dividends and capital gains distributions.[38]

NSCC Networking also was championed for many years by the broker-dealer industry. In April 1997, the Securities Industry Association[39] 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 refinements to automated systems which will further reduce [Networking] costs.[40]

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[37] Order Granting Approval of a Proposed Rule Change Concerning NETWORKING, National Securities Clearing Corporation, 53 Fed. Reg. 52544 (Dec. 28, 1988).

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

[39] 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").

[40] 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, April 28, 1997, *available at* http://www.sifma.org/regulatory/comment_letters/comment_letter_archives/31224869.pdf.

Despite the operational and compliance efficiencies provided by NSCC Networking over many years now, large broker-dealers and other intermediaries have transferred as many as 200 million individual mutual fund accounts or positions from NSCC Networking to an omnibus accounts structure on their own proprietary platforms.[41]

Brokerage firms claim that their omnibus sub-accounting model is more efficient operationally; however, this model is only productive for the brokerage industry. The reality is that mutual funds are paying higher fees and charges to broker-dealers than the cost of using NSCC Networking (and losing investor-level transparency in the process).

CMFI's research indicates that broker-dealers are charging mutual funds between $19 and $25 for each shareholder account or position, or an average of about $22 per mutual fund position each year.[42] This is about double the cost of using NSCC Networking, which typically involves a per position payment of between $5 and $8 to a broker-dealer and between a $3 and $5 payment to a fund's transfer agent, or an average of about $10.50 per mutual fund position each year.[43]

More recently, the mutual fund industry has not been supportive of NSCC Networking, despite its many benefits as a cost-effective regulatory and compliance tool. In its comment letter to the SEC in response to this Transfer Agent Release, the ICI notes that greater visibility into omnibus accounts results in "redundant shadow recordkeeping" and "duplicative systems."[44]

This conclusory statement by the ICI distorts the facts. NSCC Networking is a standardized and automated system that allows for both the broker-dealer and the mutual fund transfer agent to perform recordkeeping, regulatory, and compliance tasks in a manner that provides full transparency at about one-half of the cost of broker-dealer subaccounting. More

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

[42] *See* Coalition of Mutual Fund Investors, *CMFI White Paper: The Costs of Providing Shareholder Services to Hidden Mutual Fund Accounts*, August 18, 2010, *available at* http://www.investorscoalition.com/sites/default/files/CMFIWhitePaperAug18.pdf.

[43] *See* Letter from Niels Holch, Executive Director, Coalition of Mutual Fund Investors, to Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations, Securities and Exchange Commission, at 5, June 17, 2014, *available at* http://www.investorscoalition.com/sites/default/files/CMFI%20Letter%20to%20SEC%20Director%20Andrew%20Bowden%20re%20Omnibus%20Accounts%206.pdf.

[44] Letter from David Blass, General Counsel, Investment Company Institute, to Brent J. Fields, Secretary, Securities and Exchange Commission, at 49, March 10, 2016 ("If the mutual fund transfer agent had such visibility, it may be compelled to conduct redundant 'shadow' processing or recordkeeping on the associated records, thereby creating duplicative systems, processes, and staffing and rendering wasteful the subaccounting fees that funds pay to intermediaries to perform these same services."). The ICI also states that investors within omnibus accounts are the customers of the broker-dealer and not the mutual fund. *Id.* at footnote 127. However, these investors are also the shareholders of a mutual fund, with rights and privileges established by the Investment Company Act and other Federal securities laws.

than 90 million mutual fund accounts controlled by financial intermediaries were still using this system as of only a few years ago.[45] And at least one large broker-dealer, Robert W. Baird & Co., still processes a significant portion of its client transactions involving mutual fund shares through the NSCC Networking system.[46]

In 2009, the ICI released an extensive report on omnibus accounts and intermediary relationships.[47] This report highlighted the automated and standardized systems used in NSCC Networking and the efficiency with which funds and their intermediaries can exchange shareholder data.[48] This ICI report then compared NSCC Networking to the inefficiencies that result when funds and their intermediaries try to exchange account information outside of NSCC Networking:

> Not surprisingly, managing the exchange of account data outside of the [NSCC] Networking system is a labor-intensive, time-consuming process. Information may be provided through secure Internet portals to fund repositories, via telephone contact or fax transmission, or on hard copy documentation. Because the exchange is not standardized or fully automated, many inquiries between funds and intermediaries need follow-up to clarify the request or the response. Often this necessitates multiple contacts between fund complexes and intermediaries to resolve questions or issues.[49]

It is disappointing that the ICI has changed its historical position and is now resistant to the use of NSCC Networking as a solution to the many regulatory and compliance problems that have been created by omnibus accounts.[50] It was an ICI task force that helped to create the Networking service in the 1980's and its automated and standardized systems have only become more cost-effective and efficient in exchanging investor-level information between funds and their intermediaries for trading, regulatory, and prospectus compliance purposes.

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[45] The Depository Trust & Clearing Corporation, *Annual Report 2010: Sailing to the End of the Map*, at 49, publication date unknown, *available at* http://dtcc.com/about/annual-report.

[46] *See* Robert W. Baird & Co., *Important Information about Your Mutual Fund Investment*, at 7, May 1, 2015, *available at* http://content.rwbaird.com/RWB/Content/PDF/Help/Important-Information-About-Mutual-Fund.pdf ("Baird processes client transactions in mutual fund shares held at Baird on a networked basis, which means that Baird executes a trade for each client with the mutual fund company on an individual client basis and that Baird must maintain certain records.").

[47] Investment Company Institute, *Navigating Intermediary Relationships*, September 2009, *available at* https://www.ici.org/pdf/ppr_09_nav_relationships.pdf.

[48] *Id.* at 21.

[49] *Id.*

[50] One reason for the change in position may be the significant number of broker-dealers, banks, and insurance companies who are represented on the ICI's Board of Governors through their fund affiliates. These financial service companies are generally more supportive of the status quo on the omnibus accounts issue. *See* https://www.ici.org/about_ici/leadership/bog_list.

The SEC Should Amend Rule 22c-2 to Require a Uniform Regulatory Approach

As noted in its Transfer Agent Release, the SEC promulgated Rule 22c-2 in 2005 and 2006, in order to provide funds with a transparency tool within omnibus accounts, for the purpose of enabling funds to obtain the investor-level information they need to monitor short-term trading in omnibus accounts and to enforce their market timing policies.[51]

Rule 22c-2 requires mutual funds to have written agreements with all of their financial intermediaries, in order to facilitate information-sharing at the individual investor level.[52] The Rule requires a broker-dealer (or other intermediary) to provide shareholder identification and transaction information for any or all of its customers at the request of a fund.[53]

The mutual fund and brokerage industries responded to the information-sharing requirements of Rule 22c-2 by developing additional standardized processes—based on the NSCC Networking platform—to share investor information in intermediary subaccounts.[54] These and other enhancements to the Networking service to facilitate compliance with Rule 22c-2 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.'[55]

Unfortunately, this regulatory tool is not being actively used by the funds. Funds continue to rely on intermediaries to enforce prospectus policies and procedures, or they defer to an intermediary's policies and procedures to address excessive trading within omnibus accounts. This has resulted in a lack of uniformity in the application of frequent trading policies and procedures across intermediary distribution channels.

A review by CMFI of recent prospectus filings of the largest mutual fund complexes confirms that investor-level data is not being requested by funds and, instead, funds are inserting

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[51] Mutual Fund Redemption Fees, 71 Fed. Reg. 58,257 (Oct. 3, 2006) (codified at 17 C.F.R. § 270.22c-2); *see also* Mutual Fund Redemption Fees, 71 Fed. Reg. 11,351 (Mar. 7, 2006) and Mutual Fund Redemption Fees, 70 Fed. Reg. 13,328 (Mar. 18, 2005).
[52] *See* 17 C.F.R. § 270.22c-2(c)(5).
[53] *Id.*
[54] Examples include NSCC Client Data Share ("CDS") and NSCC Standardized Data Reporting ("SDR").
[55] 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.

disclaimer language in their prospectuses telling investors that the funds cannot access investor-level information from their intermediaries, in order to apply their market timing policies and procedures.[56]

Prospectus disclaimers that apply to the substantial majority of fund shares being transacted through intermediaries leave a misleading impression with investors that their interests are being adequately protected. This approach should change.

The mutual fund industry is highly competitive and needs certain regulatory rules to be standardized and required. In order to protect investor interests, the SEC should amend Rule 22c-2 to mandate that intermediaries share investor identity and transaction information with funds on a daily and ongoing basis.[57] A mandated requirement that this information be exchanged daily would ensure that funds receive this information in a manner that can assure appropriate and timely oversight of transactions within all intermediary accounts.

As noted above, this requirement of "same-day" information sharing can be easily accomplished through NSCC Networking Level 3, with full transparency on the mutual fund side and full customer account control on the financial intermediary side.

The relationships between a mutual fund management company and its distributors are complicated, and it is clear that, given the superior economic leverage of the largest broker-dealers distributing fund shares, funds are not going to use Rule 22c-2 unless its use is required and the technology is available to standardize and automate the information-sharing function.

Mandated regulatory solutions can be very beneficial to an industry that is competitive and diverse. A good discussion of the benefits of mandated rules for this industry can be found in a 2008 letter to the SEC, written by the Mutual Fund Directors Forum, a nonprofit organization dedicated to helping independent mutual fund investors:

> "… the fact that specific board action is mandated often imposes a beneficial discipline on fund management and others involved in daily fund operations. A specific requirement of board oversight often necessitates the adoption of practices and procedures and the preparation of reports that enable oversight. Regulatory provisions that require directors to address specific issues thus ensure that the management company's attention is directed at issues that Congress and the Commission have

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[56] *See 2015 Coalition Prospectus Excerpts*, *supra* note 12.

[57] This can be accomplished through an amendment to 17 C.F.R. § 270.22c-2(c)(5)(i) that would replace the phrase "promptly upon request by a fund" with the phrase "on a same day basis or as fund share orders are submitted."

previously determined present a risk for fund shareholders. This, by itself, may serve to reduce those risks."[58]

The lack of transparency that exists within omnibus accounts should be addressed immediately to ensure that all fund policies and procedures—from market timing policies to sales load breakpoint discounts—are applied uniformly to all shareholders and across all distribution channels.[59]

This proposed regulatory framework is preferable to the status quo, where it is becoming more expensive for funds to develop and manage various surveillance processes to oversee omnibus accounts. Since many funds rely on their financial intermediaries to detect market timing activities and enforce other prospectus policies, the funds have had to establish somewhat cumbersome oversight mechanisms that add unnecessary compliance expenses to each fund. These extra compliance expenses are, ultimately, borne by investors.

An SEC requirement of same-day information-sharing, especially through the NSCC, resolves all of these transparency problems at a cost that is significantly less expensive for investors than what the funds are paying today in sub-accounting fees and omnibus surveillance costs.

Conclusion

In Question 122 of the Transfer Agent Release, the SEC requests comments on the inability of mutual funds and their transfer agents to have any "visibility" into investor-level information within omnibus accounts. The SEC also asks for recommendations on how to address this problem.

A substantial majority of fund shares reside within these non-transparent accounts and the SEC requires funds and their advisers to be primarily responsible for ensuring compliance with regulatory rules and the policies and procedures outlined in fund prospectuses.

Despite the SEC's position, fund oversight of investor-level activities within omnibus accounts is largely inadequate, as a fund only has access to aggregated shareholder identification and transaction data for evaluation, instead of receiving individual account-level information.

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

[59] Another benefit of full transparency at the investor level would be the ability of funds to monitor account activity to ensure that a prolonged period of dormancy does not trigger state escheatment requirements. This is a growing problem in those states that assume a shareholder is lost if there is no contact for a certain period of time. Shareholders with a long time horizon who are automatically reinvesting their dividends, interest, and capital gains can unknowingly be subject to these aggressive state escheatment rules, even though these shareholders would not be considered as "lost" under SEC rules.

The lack of transparency within omnibus accounts has forced funds to be dependent on broker-dealers and other intermediaries to apply the policies and procedures outlined in their fund prospectuses. Each fund then has to establish complex (and costly) surveillance and oversight procedures to ensure that broker-dealers and other intermediaries are complying with regulatory rules, prospectus policies and procedures, and distribution agreements.

This system is clearly not working correctly and a number of very significant regulatory and prospectus compliance problems that have arisen because of omnibus accounts:

- Mutual fund frequent-trading policies and procedures are not being applied uniformly;

- Sales load discounts promised in fund prospectuses are not being are not being calculated accurately and provided to eligible investors;

- Money market funds are not able to comply with new SEC liquidity rules that require a more robust evaluation of the underlying characteristics of their investors within omnibus accounts;

- Money market funds are not able to impose redemption fees and gates uniformly on investors in omnibus accounts, nor can they ensure that the SEC's "natural persons" requirement is satisfied for certain retail funds;

- Fund advisers cannot fully comply with recordkeeping requirements in the SEC's pay-to-play rules without exemptive relief;

- Section 529 college savings accounts are incurring more costs and losing investor-level transparency, as broker-dealers seek to convert advisor-sold accounts into their omnibus accounting structure; and

- Numerous problems occurred within omnibus accounts as the SEC oversaw a process to distribute $3.5 billion in restitution payments to investors who were harmed by improper market timing activities.

Fortunately, these regulatory problems can be addressed with a relatively simple solution. Funds and their intermediaries should return to using the NSCC Networking system, which permits the parties to exchange account-level information in an automated, standardized, and cost-effective manner. This information-sharing should be required to occur on a daily, or same-day, basis through an amendment to Rule 22c-2.

Using the NSCC systems to provide same-day transparency at the investor-level will permit funds to comply with SEC regulatory rules and their prospectus policies and procedures

in an effective and inexpensive manner. In fact, the cost of going back to NSCC Networking is substantially less than the fees and charges being paid to financial intermediaries for sub-accounting.

Instead of paying more for omnibus accounts and losing investor-level transparency, the SEC should support a regulatory framework that costs less and uses technology to provide the necessary transparency to resolve the regulatory and compliance problems discussed in this letter. The needs of mutual fund distributors should not be favored over the interests of those individual shareholders who invest in mutual funds for their retirement and other savings goals.

It should also be a goal of the SEC to ensure that regulatory rules and prospectus policies and procedures are applied uniformly across all distribution channels. This is not occurring today and the SEC has an opportunity in this rulemaking to address this problem in a meaningful manner.

If the SEC staff needs more information from CMFI on these issues, please contact me at 202-6241461 or at nielsholch@att.net. Thank you again for the opportunity to present our views on these important issues.

Sincerely,

Niels Holch

Niels Holch
Executive Director
Coalition of Mutual Fund Directors

cc: The Honorable Mary Jo White
The Honorable Kara Stein
The Honorable Michael Piwowar
Stephen Luparello, Director, Division of Trading and Markets
David Grim, Director, Division of Investment Management