CMFI
Coalition of Mutual Fund Investors

August 18, 2010

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

Dear Chairman Schapiro:

The Coalition of Mutual Fund Investors ("CMFI")[1] has documented several practices being used by large broker-dealers to increase their revenues from mutual fund activities. CMFI estimates that these practices are imposing annual costs on individual investors of as much as: (1) $2.2 billion in account maintenance charges, (2) more than $4.18 billion in shareholder servicing payments, and (3) more than $2.09 billion in revenue-sharing payments.

Attached to this letter is a CMFI White Paper, which explains in greater detail these broker-dealer practices and the harm they are causing to individual investors. The CMFI White Paper also recommends several solutions that will address these practices through regulatory action.

Investors who are using mutual funds to save for their retirement, or to send their children to college, are seeing their assets and investment earnings being depleted by these broker-dealer costs. And, ironically, a number of these large broker-dealer intermediaries were recipients of bailout money from the federal government's Troubled Asset Relief Program ("TARP").

As the primary distributors of fund shares, large broker-dealers have substantial leverage over mutual funds. These broker-dealers are using this leverage to convert individual mutual funds accounts onto the "street name" accounting platforms operated by brokerage firms.[2] This conversion allows certain mutual fund shareholder accounts to reside only on the books of broker-dealers, creating an opportunity for brokerage firms to

[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. You can learn more about the Coalition and its advocacy activities at www.investorscoalition.com.

[2] Within the financial services industry, this accounting and recordkeeping process is called "omnibus sub-accounting." The consolidated account of an individual brokerage firm's customers is recognized on a mutual fund's books and records as an "omnibus account."

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charge significant fees to mutual funds and their individual investors, in addition to the fees already being charged for sales and distribution.

CMFI believes that this conversion of mutual fund accounts onto the accounting platforms of brokers has been increasing steadily over the past decade, and will continue to increase as brokerage firms seek additional sources of revenue and as they emerge from the recent financial crisis.

The fees charged by broker-dealers for maintaining shareholder accounts are primarily paid by mutual funds as an expense from fund assets, thereby imposing costs on shareholders who have no customer relationship with these brokerage firms. These fees are also being paid for account maintenance and shareholder servicing activities that—under existing regulatory rules—are already the responsibility of broker-dealers to perform for their customers.

Remarkably, the payment of these fees to broker-dealers is not creating additional protections for individual investors. In fact the opposite is taking place, as trading activities and investor identities within these broker-controlled shareholder accounts remain *hidden* from mutual fund compliance personnel attempting to apply prospectus policies and procedures in a uniform and consistent manner across shareholder classes.

In addition to the cost to investors of these account maintenance and shareholder servicing fees by large broker-dealers, the lack of transparency within hidden mutual fund accounts raises a number of significant regulatory problems:

- Mutual funds are not able to monitor excessive short-term trading activities in these intermediary accounts on a real-time basis;

- Investors in sales load funds may not be receiving the proper volume or breakpoint discounts, as promised in fund prospectus filings;

- 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 this broker-dealer accounting structure; and

- Distributions to individual investors from the SEC Fair Funds program cannot be made in a precise and timely manner because of the lack of transparency within these hidden accounts at the investor level.

One very positive step the SEC has taken in this area is to promulgate an intermediary information-sharing rule—Rule 22c-2—to address the lack of transparency within hidden mutual fund accounts. However, CMFI's most recent review of mutual fund prospectus filings indicates that funds are <u>not</u> taking advantage of the Rule by

requesting investor-level information from broker-dealers.[3] Given the leverage large broker-dealers have over mutual funds as their primary distribution agents, it is no surprise that this new Rule has proven to be somewhat ineffective.

Unless some action is taken, these increasing broker-dealer costs and continuing regulatory problems affecting hidden mutual fund accounts will continue to negatively impact the 87 million Americans who rely on mutual funds to save for retirement, college education, and other important goals.

CMFI requests that the SEC engage in a further evaluation of this problem and take appropriate regulatory action to protect individual investors from these unnecessary costs and ensure full transparency within these hidden shareholder accounts.

Thank you for your consideration of this CMFI research and White Paper.

Sincerely,

Niels Holch

Niels Holch
Executive Director
Coalition of Mutual Fund Investors

Attachment

cc: The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes
Andrew Donohue, Division of Investment Management
Robert Plaze, Division of Investment Management
Lori Schock, Office of Investor Education and Advocacy
Richard Ferlauto, Office of Investor Education and Advocacy
Henry Hu, Division of Risk, Strategy, and Financial Innovation

[3] 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, March 1, 2010, available at http://www.investorscoalition.com/Prospectus_Filings.pdf.

Coalition of Mutual Fund Investors

CMFI White Paper:
The Costs of Providing Shareholder Services to Hidden Mutual Fund Accounts

August 18, 2010
Coalition of Mutual Fund Investors
Washington, D.C.

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I. Introduction

Mutual funds have become the most important investment vehicle for individual investors, as more than 90 million Americans use these funds to save for retirement, college education, and other important goals.

The Coalition of Mutual Fund Investors ("CMFI")[1] has discovered several practices used by large broker-dealer intermediaries that are imposing costs on individual investors each year of as much as $2.2 billion in account maintenance charges, more than $4.18 billion in shareholder servicing payments, and more than $2.09 billion in revenue-sharing payments. These practices are also preventing mutual fund compliance personnel from enforcing, in a uniform manner, the policies and procedures disclosed in prospectus documents filed with the Securities and Exchange Commission ("SEC").

Investors who use mutual funds to save for their retirement, or to send their children to college, are seeing their assets and investment earnings being depleted by these unnecessary broker-dealer costs. And, in an ironic twist, a number of these large broker-dealer intermediaries were recipients of bailout money from the federal government's Troubled Asset Relief Program ("TARP").

II. The Hidden Mutual Fund Accounts Problem

Many investors purchase mutual fund shares through financial intermediaries. It is common practice for a number of these intermediaries—and especially the largest ones—to aggregate the purchase, redemption, and exchange requests of their customers into one consolidated order for each mutual fund, on a daily basis. A fund handles this order as a single transaction, treating the financial intermediary—instead of the underlying investors—as the account holder and as the shareholder of record.[2]

Each consolidated or "omnibus" account often represents the transactions of thousands of investors in a particular mutual fund. However, no information is generally disclosed to mutual fund compliance personnel about the specific trading activities of the underlying investors at the time of each transaction. Likewise, the identities of these investors are not disclosed to a fund. Under this accounting and recordkeeping structure, these shareholder accounts and underlying trading activities are hidden from a mutual fund.[3]

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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. Information about CMFI and its advocacy activities is available at www.investorscoalition.com.

[2] The consolidated account that is recognized on a mutual fund's books and records is called an "omnibus account." This accounting and recordkeeping process works in a similar fashion to purchasing corporate securities in "street name."

[3] The SEC has promulgated an intermediary information-sharing rule—Rule 22c-2—to address the lack of transparency within hidden mutual fund accounts. See 17 C.F.R. § 270.22c-2(c)(5). According to mutual fund prospectus filings, this information-sharing tool is not being used regularly by fund compliance personnel. Since mutual funds are highly dependent on broker-dealers to distribute their fund shares, it is not an effective approach to have funds request information from the same broker-dealers which enjoy

III. The Size of the Hidden Mutual Fund Accounts Problem

According to the Investment Company Institute ("ICI"), total mutual fund assets, including money market funds, were $11.1 trillion at the end of 2009.[4] Long-term mutual fund assets, comprising stock, hybrid, and bond funds, totaled $7.8 trillion, of which $7.28 trillion were held by individual investors.[5] The ICI also reported that this $7.28 trillion in long-term mutual fund assets were owned by as many as 87 million individual investors in 237,483,000 shareholder accounts, reflecting a mix of individual and omnibus accounts.[6] However, this ICI data does not include the individual accounts of certain 401(k) and other retirement plans.

A 2008 industry study by KDS Partners estimated total mutual fund accounts at 400 million, including all retirement accounts that are held through financial intermediaries.[7] KDS Partners also estimated in this study that 50% of these accounts, or as many as 200 million accounts, use the omnibus account recordkeeping process described above.[8] According to industry experts, the 400 million mutual fund accounts—including the subset of the 200 million accounts using omnibus recordkeeping—are considered to be mutual fund positions, i.e., one shareholder position in one mutual fund.[9]

With $7.28 trillion in long-term mutual fund assets and 87 million investors, the average amount of long-term fund assets for each individual investor was $83,678 in 2009.[10] With an ICI estimate of four (4) mutual fund positions as the median number owned in each investor's portfolio, the average value of each position was $20,920 at the close of 2009.[11]

The practice of hiding individual accounts through broker omnibus accounting is

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significantly more leverage and power within the financial services marketplace. See Coalition of Mutual Fund Investors, Excerpts from SEC Prospectus Filings Regarding Enforcement of Market Timing and Other Short-Term Trading Policies within Third-Party Hidden Accounts, March 1, 2010, available at http://www.investorscoalition.com/Prospectus_Filings.pdf.

[4] Investment Company Institute, 2010 Investment Company Fact Book, April 28, 2010, at 126, available at www.icifactbook.org.

[5] Id. at 93.

[6] Id. at 81, 132. The calculation for the number of shareholder accounts at the end of 2009 was derived by subtracting 33,466,000 money market fund accounts from the total of 270,949,000 mutual fund accounts in Table 9 of the Investment Company Fact Book.

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

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

[9] Interview with representatives from KDS Partners (Nov. 20, 2009).

[10] This calculation was derived by dividing $7.28 trillion in assets by 87 million investors.

[11] This calculation was derived by dividing $83,678 by 4.

widespread within the mutual fund industry, with as many as 100 million shareholder positions being handled in this manner under the omnibus accounting structure.[12] If this estimate is accurate, as much as $2.09 trillion in assets may be found in hidden accounts managed by financial intermediaries.[13]

IV. The Mutual Fund Fees Being Charged by Large Broker-Dealers

As noted above, shareholders investing through broker-dealers and other intermediaries are typically subject to omnibus accounting and recordkeeping, where orders are aggregated into net purchase and redemption requests. In many cases, the broker-dealer or other intermediary will handle recordkeeping and other shareholder servicing tasks and will be listed as the shareholder of record on behalf of the underlying investors, who are the beneficial owners of the mutual fund shares.

In the case of the larger broker-dealers, the records of individual shareholders are generally hidden from a mutual fund and the individual trades made by the customers of the broker-dealer are not disclosed to the management and board of trustees for each fund.

Broker-dealers are distributors of mutual funds and many mutual funds are very dependent on them as a source of additional investment funds. Through these distribution arrangements, broker-dealers have substantial leverage to demand that mutual funds allow individual shareholder accounts to be kept on the books of the broker-dealer in large omnibus accounts, hidden from the mutual funds and their board of trustees, who would otherwise act as fiduciaries for fund shareholders. Broker-dealers press mutual funds to allow the accounting to be done on the books of the broker-dealer because this presents an opportunity for the brokerage firms to charge significant fees to the funds, in addition to sales commissions and other fees being charged for distribution.

Unlike the fund's transfer agent, the broker-dealer fees charged to the fund for recordkeeping and other shareholder servicing activities are not subject to competitive bids, as would be the case in a true "arm's length" negotiation. As a result, these fees are not typically discounted to reflect economies of scale or large volumes of accounts,

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[12] According to industry estimates, more than 100 million mutual fund positions are subject to omnibus accounting that hides shareholder information from mutual fund personnel. See Mike DeNofrio, Executive Vice President and Senior Managing Director, PNC Global Investment Servicing, "From Niche to Norm: The Evolution of Subaccounting," The 2009 Mutual Fund Service Guide, Money Management Executive, at 66, available at http://www.mmexecutive.com/media/pdfs/Mutual_Fund_Service_Guide_2009.pdf ("Today, all major broker/dealers use [omnibus] subaccounting to process shareholder accounts at more than 800 fund companies. It is estimated that more than 100 million mutual fund accounts are subaccounted."). This non-transparent structure is called omnibus sub-accounting within the financial services industry. The remaining 50% of shareholder accounts using omnibus recordkeeping, or 100 million positions, are partially or fully transparent to fund compliance personnel through the Networking services of the National Securities Clearing Corporation ("NSCC") or through the use of other transparency methods linking financial intermediaries and funds. For more information the NSCC Networking services, see page 22 of this White Paper and Attachment #3 to this White Paper.

[13] This figure is derived by multiplying the average value for each fund position of $20,920 by 100 million positions.

according to industry experts. If a fund wants a particular broker-dealer to distribute its shares, the fund must agree to let the broker-dealer handle recordkeeping and shareholder servicing tasks for its customers, at a price generally dictated by the brokerage firm.

A number of the fees charged by a broker-dealer for hidden account maintenance and shareholder servicing activities are paid by mutual funds as a fund expense, thereby including direct shareholders and participants who have no relationship with a broker-dealer and whose account information is fully transparent.

According to public disclosures on the websites of the largest brokerage firms, a broker-dealer is typically able to collect at least three different fees from mutual funds for account maintenance and shareholder servicing activities. These fees generally are of the following types: (1) account maintenance fees from mutual fund assets; (2) fees from Rule 12b-1 plans administered by mutual funds; and (3) revenue-sharing fees paid by a mutual fund's investment adviser to a broker-dealer.

Attached to this White Paper is a summary of what several of the largest broker-dealers are being paid—on an annual basis—for account maintenance and shareholder servicing activities, based on a review of their public disclosure documents. See Attachment #1. As you can see, several of these broker-dealers are affiliated with financial institutions that received bailout funds from TARP. What follows is a description of each of these three different types of fees:

A. Broker Charge #1: The Account Maintenance Fee

The account maintenance fee is paid for each shareholder whose account is hidden within a broker-dealer omnibus account. According to public sources, large broker-dealers are typically being paid by mutual funds and their shareholders between $19 and $25 for each shareholder position held in a fund, for an average of about $22 per position per year.[14] For example:

- Merrill Lynch/Bank of America and Edward Jones have disclosed that they receive up to $19 annually for each position in a mutual fund.[15]

- Raymond James has disclosed that it receives up to $20 each year for each client mutual fund position.[16]

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[14] CMFI recently conducted a review of the public disclosures on mutual fund fees being charged by thirty (30) large broker-dealers. The average account maintenance fee in this review of public disclosures was $22 per position per year. See Attachment #1 to this White Paper.

[15] Merrill Lynch Wealth Management, Mutual Fund Investing at Merrill Lynch, November 2009, at 5, available at http://www.mldirect.ml.com/publish/weekly_pdfs/MF_DisclosureDocument.pdf; and Edward Jones, Other Fees and Compensation Received by Edward Jones from Mutual Fund Companies, http://www.edwardjones.com/en_US/products/investments/mutual_funds/fees_and_compensation/index.html (last visited Apr. 20, 2010).

[16] Raymond James, A Guide to Mutual Fund Investing at Raymond James, www.raymondjames.com/disclsoure_mutual_funds.htm (last visited June 9, 2010).

- Morgan Stanley/Smith Barney has disclosed that it receives up to $21 a year for each client position in a fund.[17]

- An independent pension fiduciary has estimated in Congressional testimony an average of $22 per year for each participant account in a 401(k) or similar retirement plan.[18]

- Wachovia/Wells Fargo has disclosed that it receives up to $25 a year for each client account with an individual fund.[19]

- A recent lawsuit against the American Funds family alleges that it may be paying as much as $25 per account per year.[20]

These payments are made to broker-dealers and other intermediaries for every mutual fund position in each investor account held by a broker. At an average charge of $22 for each position—and with industry analysts estimating as many as 100 million mutual fund positions within omnibus accounts being charged these account maintenance fees—this results in total charges to investors of $2.2 billion each year.[21]

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[17] Morgan Stanley/Smith Barney, Mutual Fund Share Classes and Compensation, June 2009, at 7, available at http://www.smithbarney.com/pdf/gp3214.pdf. Smith Barney and Morgan Stanley are engaged in a joint venture, as of June 1, 2009.

[18] Matthew D. Hutcheson, Independent Pension Fiduciary, Testimony before the U.S. House Committee on Education and Labor, March 6, 2007, at 14, available at http://edworkforce.house.gov/testimony/030607MatthewHutchesontestimony.pdf.

[19] Wells Fargo Advisors, A Guide to Investing in Mutual Funds, undated, at 9, available at https://saf.wellsfargoadvisors.com/emx/dctm/Marketing/Marketing_Materials/Mutual_Funds/e6244.pdf.

[20] Fourth Amended Complaint at 50-51, In Re American Mutual Funds Fee Litigation, No. 04-5593 (C.D. Cal. filed May 16, 2008) ("Inflated sub-transfer agency fees paid by the Funds and their investors were really used to pay for revenue sharing arrangements. For example, instead of charging $5 per account for the year, the broker would charge $25 per account per year. The inflated amount would be used to settle revenue sharing agreements."), available at http://www.investorscoalition.com/InReAmericanFundsComplaint508.pdf.

[21] This calculation is derived by multiplying the average charge of $22 per position by 100 million fund positions within omnibus accounts, which equals $2.2 billion. To ascertain the amount of any potential overcharges by these large broker-dealers, this total should be offset by the average cost of servicing a direct (or fully transparent) investor in a fund. According to a CMFI review of the public disclosures by several large mutual fund complexes, this cost is between $10-16 for each fund position, or an average of $13 per position. If this estimate is accurate, it would cost $1.3 billion to provide direct and/or fully transparent account maintenance services to 100 million investor positions, at an average of $13 per position, resulting in unnecessary charges of the difference between $2.2 billion and $1.3 billion, or approximately $900 million per year. See John Hancock Bond Trust, et al., Transfer Agency and Service Agreement, Exhibit H, Exhibit B, filed Sep. 25, 2007, available at http://www.secinfo.com/dUQQm.ukr.d.htm#1stPage; Phoenix Investment Series Fund, et al., Sub-Transfer Agency and Service Agreement, Exhibit H.2, Schedule 2.1, filed Aug. 30, 2006, available at http://www.secinfo.com/dsv4e.vmp.9.htm#1stPage; and Matthew D. Hutcheson, Testimony Before the House Committee on Education and Labor, Mar. 6, 2007, at 15, available at http://edlabor.house.gov/testimony/030607MatthewHutchesontestimony.pdf.

B. Broker Charge #2: The Rule 12b-1 Fee

In addition to account maintenance fees, large broker-dealers are charging mutual funds and their advisers as much as 0.25% (i.e. 25 basis points) of shareholder assets in Rule 12b-1 fees, for marketing, sales support, distribution, and shareholder servicing activities.[22] These fees are deducted directly from the assets of each mutual fund and are called a "service fee" under National Association of Securities Dealers ("NASD") Rules.[23] These 12b-1 fees affect all shareholders and retirement plan participants in the mutual fund, even if they are not customers of any broker-dealer.

A current Morgan Stanley Smith Barney disclosure document on mutual fund compensation describes Rule 12b-1 fees as follows:

> 12b-1 fees are named after a Securities and Exchange Commission rule. They are fees paid out of the assets of your mutual fund share class on a continuing basis to cover marketing and distribution costs and sometimes to cover costs of providing shareholder services. The amount of the 12b-1 fee is set as a percentage of the fund's total assets attributable to the share class.[24]

Similarly, language from a current Raymond James disclosure document on mutual fund investing provides the following explanation regarding these fees:

> *Shareholder Servicing Fees.* Mutual fund companies will also pay Raymond James fees to provide shareholder liaison services to you. These shareholder services may include responding to your inquiries and providing information on your investments. Raymond James may receive these shareholder services fees in amounts not to exceed 0.25% annually of the assets invested in a particular mutual fund.[25]

NASD Rule 2830(b)(9) defines these service fees as "payments by an investment company for personal service and/or the maintenance of shareholder accounts." In 1993, NASD described these service fees as follows:

> The term 'service fees' is defined in subparagraph (b)(9) of the Amended Rules to mean 'payments by an investment company for

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[22] See Attachment #1 to this White Paper.

[23] NASD refers to the National Association of Securities Dealers, which, in 2007, consolidated its responsibilities with the regulatory, enforcement, and arbitration functions of the New York Stock Exchange ("NYSE") to become FINRA, the Financial Industry Regulatory Authority (www.finra.org). Pursuant to NASD Rule 2830(d)(5), services fees may not exceed 0.25% of the average annual net assets of an investment company.

[24] Morgan Stanley Smith Barney, Mutual Fund Share Classes and Compensation, June 2009, at 2, available at http://www.smithbarney.com/pdf/gp3214.pdf.

[25] Raymond James, A Guide to Mutual Fund Investing at Raymond James, http://www.raymondjames.com/disclosure_mutual_funds.htm (last visited July 31, 2010).

> personal service and/or the maintenance of shareholder accounts.' As noted in the explanatory section of NASD *Notice to Members 90-56* (September 1990), the term 'service fees' is not intended to include transfer agent, custodian, or similar fees paid by funds. In addition, the phrase is not intended to include charges for the maintenance of records, record-keeping, and related costs. *Notice to Members 92-41* (August 1992) states that 'service fees are intended to be distinguished from other fees as a payment for personal service provided to the customer. It is essentially intended to compensate members for shareholder liaison services they provide, such as responding to customer inquiries and providing information on their investments. It is not intended to apply to fees paid to a transfer agent for performing shareholder services pursuant to its transfer agent agreement. This fee does not include recordkeeping charges, accounting expenses, transfer costs, or custodian fees.' Finally, the fact that a fund pays a fee pursuant to a 'shareholder servicing' or similarly described plan does not conclusively determine whether the fee or any portion thereof constitutes a 'service fee' for purposes of the Rules.[26]

CMFI's review of broker-dealer disclosures indicates that Rule 12b-1 fees average between 0.20-0.25% of shareholder assets.[27] These fees are being paid to broker-dealers for every mutual fund position in each investor account held by a broker-dealer. A charge of 0.20% of assets on an average account value of $20,920 equals an annual cost of $41.84 for each fund position.[28] If an assumption is made that these charges are being made to provide shareholder services to 100 million mutual fund positions within omnibus accounts, this results in total charges of $4.18 billion each year.[29]

C. Broker Charge #3: The Revenue-Sharing Fee

A third source of payments to brokers for shareholder servicing activities comes directly from an investment adviser to a mutual fund, in the form of revenue-sharing payments. These payments can range from 0.10% to 0.50% (i.e., 10 to 50 basis points) of shareholder assets invested.[30]

A recent comment letter by Charles Schwab & Co. to the Financial Industry Regulatory Authority ("FINRA") describes the purpose of revenue-sharing payments as follows:

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[26] NASD Notice to Members 93-12, 1993, Question #17, available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=1627 .

[27] See Attachment #1 to this White Paper.

[28] This calculation is derived by multiplying $20,920 by 0.20%.

[29] This calculation is derived by multiplying the estimated average charge of $41.84 for each fund position by 100 million positions.

[30] See Attachment #1 to this White Paper.

> 'Revenue sharing' typically describes those payments made by a mutual fund's advisor or affiliate out of its reasonable profits to a brokerage firm or a bank platform for distribution services (e.g., to promote or give preference to one issuer's security over others). But at times, it is used more generally to describe other arrangements pursuant to which the advisor compensates a firm for an array of services provided, such as shareholder servicing, administrative and recordkeeping services, that would otherwise be borne by the fund or other service provider to the fund, such as a transfer agent.[31]

Mutual funds are generally required to make revenue-sharing payments in order to promote their fund shares within a broker-dealer organization. Here is how this process works at Morgan Stanley Smith Barney, according to a current disclosure document:

> Representatives of Fund Families are, subject to the discretion of Branch Office Managers, provided access to branch offices and advisors for educational, marketing and other promotional efforts. Although all fund families are provided with such access, some fund families devote more staff and resources to these activities and therefore may have enhanced opportunities to promote their funds to advisors. This fact could, in turn, lead advisors to focus on those funds when recommending mutual fund investments to clients instead of on funds from those fund families that do not commit similar resources to education, marketing and other promotional efforts. Fund families that do not remit revenue-sharing payments typically will not be provided such access and will not participate in or receive other promotional support.[32]

Large broker-dealers are also very dependent on revenue-sharing payments from mutual fund companies. One brokerage firm, Edward D. Jones & Co., has disclosed that revenue sharing payments from fund companies totaled more than one-half (57%) of the firm's net income in 2009:

> Edward Jones receives payments known as revenue sharing from certain mutual fund companies, 529 plan program managers, insurance companies and retirement plan providers (collectively referred to as 'product partners'). ... We want you to understand that Edward Jones' receipt of revenue sharing payments creates a potential conflict of interest in the form of an additional financial

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[31] Letter from Bari Havlik, SVP and Chief Compliance Officer, Charles Schwab & Co., Inc. to Marcia E. Asquith, Office of the Corporate Secretary, FINRA (Aug. 3, 2009), at 4, available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/noticecomments/p119759.pdf.

[32] Morgan Stanley Smith Barney, Revenue Sharing Fund Families: What Every Investor Should Know, http://www.smithbarney.com/products_services/mutual_funds/investor_information/revenueshare.html (last visited July 31, 2010).

> incentive and financial benefit to the firm, its financial advisors and equity owners in connection with the sale of products from these product partners. For the year ended December 31, 2009, Edward Jones received revenue sharing payments of approximately $94.2 million from mutual fund and 529 product partners and $30.7 million from insurance product partners. For that same period, Edward Jones' net income was $164.3 million.[33]

Over the past several years, broker-dealers have improved their public disclosures of the revenue-sharing payments they are receiving from mutual fund advisers. In September 2003, NASD proposed amendments to Rule 2830 which would require broker-dealers to disclose their revenue-sharing arrangements.[34] While these amendments were not subsequently adopted, the SEC did sanction a broker-dealer in 2004 for inadequate disclosure of revenue-sharing payments, an enforcement proceeding that may have prompted other broker-dealers to improve their disclosure of these payments by mutual fund advisers.[35]

As noted earlier, revenue-sharing payments of between 0.10-0.50% of shareholder assets are being paid to broker-dealers by investment advisors for every mutual fund position in each investor account held by a broker-dealer. A charge of 0.10% of assets on an average account value of $20,920 equals an annual payment of $20.92 for each fund position.[36] If an assumption is made that these revenue-sharing payments are being made to provide marketing support and shareholder services to 100 million mutual fund positions within omnibus accounts, this results in total charges of $2.09 billion each year.[37]

V. The Costs to Investors of Account Maintenance and Shareholder Servicing Fees

The cost of account maintenance and shareholder servicing payments to brokers exceeds the cost that is borne by the funds for those accounts maintained on their books and not hidden in broker-dealer omnibus accounts.

As noted above, CMFI's research indicates that funds and their investment advisers are often making three different payments for account maintenance and

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[33] Edward D. Jones & Co., Revenue Sharing Arrangements with Mutual Fund Companies: Disclosure Information, http://www.edwardjones.com/en_US/disclosures/rev_sharing/disclosure_information/index.html (last visited Aug. 15, 2010). The calculation provided above was derived by dividing $94.2 million by $164.3 million, which equals 57.33%.

[34] NASD Notice to Members 03-54, September 2003, available at http://www.finra.org/Industry/Regulation/Notices/2003/P003151. These proposed amendments were never adopted.

[35] See In the Matter of Edward D. Jones & Co., L.P., SEC Administrative Proceeding File No. 3-11780 (Dec. 22, 2004), available at http://www.sec.gov/litigation/admin/33-8520.htm.

[36] This calculation is derived by multiplying the estimated average value per fund position of $20,920 by 0.10%.

[37] This calculation is derived by multiplying the average charge per fund position of $20.92 by 100 million positions.

shareholder servicing activities. First, the average account maintenance payment of $22 per position. Next, a Rule 12b-1 payment of between 0.20-0.25% of fund assets. Finally, a revenue-sharing payment from the fund adviser to broker-dealers of between 0.10-0.50% of shareholder assets invested.

If one assumes that a broker-dealer receives, on average, a combined payment of 0.30% for both 12b-1 fees and revenue-sharing arrangements, this results in an added cost of $62.76 for each fund position in an omnibus or hidden account with an average balance of $20,920.[38] The three fees together—the $22 account maintenance fee and 0.30% in Rule 12b-1 and revenue-sharing payments—are adding $84.76 in costs for servicing each position within a brokerage account.[39]

With an estimated 100 million mutual fund positions being charged these account maintenance and shareholder servicing fees, the widespread use of omnibus or hidden accounts is permitting large broker-dealers to collect fees of as much as $2.2 billion for account maintenance activities, more than $4.18 billion in 12b-1 charges for shareholder servicing activities, and more than $2.09 billion in revenue-sharing payments.[40] Together, these fees potentially represent charges of as much as $8.47 billion each year.[41]

VI. Existing Broker Obligations to Maintain and Service Customer Accounts

In addition to the significant costs to investors of these broker-dealer fees, the account maintenance and shareholder services being provided by broker-dealers for these fees are already required to be provided by them under current regulatory rules.

One example of this fact is can be found in a lawsuit filed against the Davis Funds, alleging an excessive use of 12b-1 fees for shareholder servicing payments. The Amended Complaint filed in this case discusses the type of services being provided by broker-dealers and specifically asserts that these activities are already required to be performed by broker-dealers under existing NASD, New York Stock Exchange ("NYSE"), and FINRA requirements:

> The majority of servicing efforts paid by the [Davis New York Venture] Fund and its shareholders are for post-sale shareholder services.

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[38] This calculation is derived by multiplying the estimate value per position of $20,920 by 0.30%.

[39] The amount of estimated fees per mutual fund position is derived by multiplying 0.30% by $20,920, which equals $62.76, and then adding the $22 average account maintenance fee. Of course, these three fees are never aggregated and reported in one place in their entirety because they are always characterized as being for different purposes. Nevertheless, these fees all enrich large broker-dealers at the expense of the mutual funds and their individual investors.

[40] See supra notes 21, 29, and 36.

[41] Id. This calculation is derived by multiplying $84.76—the total fees for each mutual fund position—by the estimate of 100 million positions subject to these fees through a non-transparent structure using omnibus accounts. As noted earlier, this non-transparent structure is also called omnibus sub-accounting within the financial services industry.

> Post-sale 'servicing efforts' include, among other activities, operational and compliance functions with respect to the shareholder's brokerage account, such as providing monthly or quarterly account statements, confirmations of transactions, and suitability analyses of the client's account. Suitability includes the following activities, among others—assisting customers in rebalancing their portfolios; reviewing customer holdings on a regular basis; reassessing customer needs and investment strategies, and helping investors generally understand their investments.
>
> The broker-dealer is legally obligated to provide all customers with the post-sale shareholder services described immediately above pursuant to its operations and compliance obligations.
>
> These obligations exist under the applicable statutes and New York Stock Exchange and NASD/FINRA regulatory regimes.[42]

A review of NASD/FINRA rules confirms this assertion. NASD Rule 2340 requires a broker-dealer to send quarterly account statements to each of its customers, containing a description of "any securities positions, money balances, or account activity."[43] NASD Rule 2340(d)(1) defines "account activity" to include purchases, sales, interest credits or debits, charges or credits, dividend payments, transfer activity, securities receipts or deliveries, and journal entries relating to securities or funds in the possession or control of the broker-dealer.[44]

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

> (a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

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

[43] NASD Rule 2340: Customer Account Statements, available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3647. NYSE Rule 409 has similar requirements. FINRA has proposed the adoption of NASD Rule 2340 as FINRA Rule 2231 in the consolidated FINRA rule book and the deletion of most of NYSE Rule 409. This consolidated Rule would require customer account statements to be sent on a monthly basis for any account with activity. See Proposed Rule Change to Adopt FINRA Rule 2231, SR 2009-028, filed April 22, 2009, available at http://www.finra.org/Industry/Regulation/RuleFilings/2009/P118534.

[44] Id.

(b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:
  (1) the customer's financial status;
  (2) the customer's tax status;
  (3) the customer's investment objectives; and
  (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.
(c) For purposes of this Rule, the term 'non-institutional customer' shall mean a customer that does not qualify as an 'institutional account' under Rule 3110(c)(4).[45]

Taken together, NASD Rules 2340 and 2310 require brokers to perform recordkeeping and shareholder servicing activities as part of their current obligations to customers.

VII. Broker Compensation for Servicing Activities Already Required to be Performed

The Davis Funds that are the subject of the fee litigation mentioned above confirm in prospectus filings that payments are being made to brokers and other third-party intermediaries for both suitability analyses and account recordkeeping activities, both of which are already required to be performed for these customers.[46] The section of the most recent prospectus filing for the Davis Funds had the following to say about payments for broker suitability analyses:

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

[45] NASD Rule 2310: Recommendations to Customers (Suitability), available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3638. In written interpretations issued in 1990, the NASD explained how broker-dealers should comply with this Rule: "The requirement of 'reasonable effort' can be met by prepared questionnaires for customers to complete and return or by telephone inquiry. It is not necessary to obtain a written statement from a customer in each instance in order to be in compliance with the rule." NASD Notice to Members 90-12, 1990, available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=1313; NASD Notice to Members, 90-52, 1990, available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=1273. On July 30, 2010, FINRA proposed to the SEC that NASD Rule 2310 be replaced by new FINRA Rule 2111. The proposed Rule would codify various interpretations regarding the scope of the suitability rule, clarify the information to be gathered as part of a suitability analysis, and create a clear exemption for recommended transactions involving institutional customers, subject to specified conditions. See http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p121835.pdf.

[46] See Davis New York Venture Fund, Prospectus, December 1, 2009, at 14, available at http://www.davisfunds.com/pdf/DNYVFProspABC.pdf.

not limited to, assessing a client's investment needs and recommending suitable investments on an ongoing basis.[47]

Likewise, the section of the Davis Funds prospectus disclosing recordkeeping payments to broker-dealers and other intermediaries states the following:

> Recordkeeping services typically include: (i) establishing and maintaining shareholder accounts and records; (ii) recording shareholder account balances and changes thereto; (iii) arranging for the wiring of funds; (iv) providing statements to shareholders; (v) furnishing proxy materials, periodic Davis Funds reports, prospectuses and other communications to shareholders as required; (vi) transmitting shareholder transaction information; and (vii) providing information in order to assist Davis Funds in their compliance with state securities laws. Each Davis Fund typically would be paying these shareholder servicing fees directly if a Qualifying dealer did not hold all customer accounts in a single omnibus account with each Davis Fund.[48]

At least two other fund families—BlackRock and MFS—disclose the purpose of these arrangements with similar specificity and note that administrative payments to financial intermediaries can come from 12b-1 fees, other fund assets, and/or through revenue-sharing from the investment adviser. BlackRock's latest prospectus filing states the following:

> In return for the shareholder servicing fee, Financial Intermediaries (including BlackRock) may provide one or more of the following services to their customers who own Investor A, Investor B and Investor C Shares:
>
> - Responding to customer questions on the services performed by the Financial Intermediary and investments in Investor A, Investor B and Investor C shares;
> - Assisting customers in choosing and changing dividend options, account designations and addresses; and
> - Providing other similar shareholder liaison services.[49]

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

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[47] Id.
[48] Id. at 16.
[49] BlackRock Focus Growth Fund, Inc., Prospectus, December 29, 2009, at 19, available at https://www2.blackrock.com/webcore/litService/search/getDocument.seam?serviceName=PUBLICSERVICEVIEW&ContentID=24790&VenueID=100&venue=PUB_IND.

> Service fees compensate ... financial intermediaries for shareholder servicing and account maintenance activities, including, but not limited to, shareholder recordkeeping (including assisting in establishing and maintaining customer accounts and records), transaction processing (including assisting with purchase, redemption and exchange requests), shareholder reporting, arranging for bank wires, monitoring dividend payments from the Funds on behalf of customers, forwarding certain shareholder communications from the Funds to customers, corresponding with shareholders and customers regarding the Funds (including receiving and responding to inquiries and answering questions regarding the Funds), and aiding in maintaining the investment of their respective customers in the Funds.[50]

Other funds disclose the same arrangements, although with much less specificity.[51] In almost all instances, brokers are receiving mutual fund payments for account maintenance and shareholder services that they are already required to perform for their customers, adding increased costs to all fund shareholders.

VIII. Existing Broker Obligations to Disclose Special Compensation Arrangements

Unfortunately, from the perspective of the individual shareholder, broker-dealers are also not disclosing these account servicing arrangements with the level of detail required in the current NASD Rules.

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

[51] See Franklin Rising Dividends Fund, Statement of Additional Information, February 1, 2010, at 17 ("... [Franklin Funds] may also pay servicing fees ... to certain financial institutions (primarily to help offset their costs associated with client account maintenance support, statement preparation and transaction processing ...."), available at https://www.franklintempleton.com/retail/jsp_app/products/literatureview.jsp; Oppenheimer International Growth Fund, Prospectus, March 30, 2010, at 39 ("The Distributor uses the service fees to compensate brokers, dealers, banks and other financial intermediaries for maintaining accounts and providing personal services to Class B, Class C or Class N shareholders in the applicable share class."), available at https://www.oppenheimerfunds.com/digitalAssets/International%20Growth%20PSP%20w%20supp%205.15.09-2e814b381cc1c010VgnVCM100000e82311ac____.pdf; Eaton Vance Emerging Markets Fund, Statement of Additional Information, May 1, 2010, at 25 ("... from such service fee the principal underwriter expects to pay a service fee to financial intermediaries, as compensation for providing personal services and/or the maintenance of shareholder accounts ...."), available at http://individuals.eatonvance.com/includes/loadDocument.php?fn=EMGIFPSAI.pdf&dt=fundPDFs; and American Century Capital Growth Fund, Prospectus, March 1, 2010, at 25, available at http://prospectus.americancentury.com/summary.asp?doctype=pros&clientid=amercentll&fundid=02508H204 ("Certain financial intermediaries perform recordkeeping and administrative services for their clients that would otherwise be performed by American Century Investments' transfer agent. In some circumstances, the advisor will pay such service providers a fee for performing those services. Also, the advisor and the fund's distributor may make payments to intermediaries for various additional services, other expenses and/or the intermediaries' distribution of the fund out of their profits or other available sources.").

NASD Rule 2830(l)(4) requires broker-dealers to disclose cash compensation from a mutual fund in the current prospectus of a fund.[52] If special cash compensation arrangements are made available by a fund to broker-dealers on a non-uniform basis, then the name(s) of the broker-dealers and the details of the arrangements are also to be disclosed in a current investment company prospectus.[53]

In 1989, NASD explained the intent of these requirements as follows:

> When underwriters offer cash and noncash concessions to all members that retail their securities on a uniform basis, a general description of such compensation is permitted in prospectuses. When 'special deals' or 'special arrangements' are made with individual members that are not made available to all retailing members, the details of the arrangements and the names of the members must be included in the prospectus.[54]

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

> For disclosure of cash and non-cash compensation that does not involve special compensation arrangements, the usual disclosure practices relating to underwriting compensation require the disclosure of the maximum cash compensation and the type of non-cash compensation to be provided to all participating members. As stated in the rule language, any variations from the standard schedule of concessions must be disclosed if concessions are not uniformly paid to all members purchasing the same dollar amounts of securities.[55]

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[52] NASD Rule 2830: Investment Company Securities ("No member shall accept any cash compensation from an offeror unless such compensation is described in a current prospectus of the investment company."), available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3691. This disclosure is now permitted in the Statement of Additional Information of an investment company. See NASD Notice to Members 99-55, July 1999, Question #18, available at http://www.finra.org/Industry/Regulation/Notices/1999/P004216.

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

[54] NASD Notice to Members 89-51, 1989, available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=1366. See also NASD Notice to Members 91-25, May 1991, available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=1202.

[55] NASD Notice to Members 94-14, March 1994, available at http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=1520. See also, NASD Notice to Members 94-41, 1994, available at http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=1492.

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

> While it is anticipated that most special compensation arrangements would be non-cash in nature, the exact details of any special cash compensation arrangements entered into by the underwriter(s) with any member(s) and the identity of the member(s) must also be disclosed.[56]

These NASD rules and interpretations were upheld in 1998.[57] In 2003, NASD proposed amendments to this disclosure regime, but these amendments were never adopted.[58] In its 2003 Notice to Members, NASD did acknowledge that differential cash compensation arrangements and revenue sharing payments may create conflicts of interest:

> These compensation arrangements can create conflicts of interest by encouraging members and their registered representatives to recommend certain funds to maximize their compensation, rather than to best meet their customers' needs. They may provide point-of-sale incentives that could compromise proper customer suitability considerations and may present a situation in which the salesperson's interests are not, in some circumstances, fully aligned with the interests of customers.
>
> Disclosure of revenue sharing and differential cash compensation arrangements would enable investors to evaluate whether a registered representative's particular product recommendation was inappropriately influenced by these arrangements. Disclosure of these arrangements could be an important adjunct to existing suitability, sales practice, and disclosure requirements and may help ensure that there is an appropriate match between the needs of an investor and the most appropriate investment company.[59]

Similarly, the conflicts of interest which can result from these broker-dealer compensation arrangements are discussed in a current disclosure document by Wells Fargo Advisors, regarding the receipt by this broker-dealer of differential compensation for shareholder servicing, account maintenance, and other activities:

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[56] Id.

[57] NASD Notice to Members 98-75, 1998, available at http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=2011 ("In the case where special cash compensation arrangements are made available by an offeror to a member, which arrangements are not made available on the same terms to all members to distribute the securities, the disclosure must include the name of the recipient member and the details of the special arrangements.").

[58] See NASD Notice to Members 03-54, September 2003, available at http://www.finra.org/Industry/Regulation/Notices/2003/P003151.

[59] Id. at 566.

> It is important for clients to understand that compensation received for networking and omnibus services, revenue sharing, training, education and other services varies from fund family to fund family and even from fund to fund within a particular family. Accordingly, a potential conflict of interest exists when Wells Fargo Advisors receives more compensation from one fund family (or from one fund) than it receives from peer fund families (or from peer funds).[60]

In June 2007, a NASD Hearing Panel ruled that the terms in Rule 2830 defining broker-dealer compensation were not clear enough and "substantial uncertainty" exists in the application of the Rule.[61] In its decision, the Hearing Panel cited several NASD Notices which discussed specific circumstances in which an "interpretive ambiguity" existed in the application of the Rule.[62]

In an effort to consolidate NASD and NYSE regulatory provisions, FINRA has proposed a new Rule 2341, based on NASD Rule 2830.[63] Unfortunately, this proposed rule introduces new definitional terms that may be more difficult to apply than the current terms in Rule 2830 and, as such, will not improve the disclosure regime for broker-dealer compensation.

As a result of these conflicting interpretations in applying Rule 2830, many broker-dealers do not disclose account maintenance and shareholder servicing fees with any degree of specificity, even though disclosure documents clearly state that broker-dealer fees for these services are not uniform and vary across brokerage firms.

Similarly, mutual funds generally disclose these fees in summary fashion, even though disclosure documents indicate that differential compensation is being paid.[64] Funds also do not typically disclose how much each intermediary is receiving and how these payments are calculated or determined.[65] Some fund families only disclose the

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[60] Wells Fargo Advisors, A Guide to Investing in Mutual Funds, undated, at 11, available at https://saf.wellsfargoadvisors.com/emx/dctm/Marketing/Marketing_Materials/Mutual_Funds/e6244.pdf.

[61] NASD Disciplinary Proceeding No. E8A2003062001, Hearing Panel Decision, June 28, 2007, available at http://www.finra.org/web/groups/industry/@ip/@enf/@adj/documents/ohodecisions/p036412.pdf.

[62] Id. at 8, 9. See Notice to NASD Members 96-68, October 1996, available at http://www.finra.org/Industry/Regulation/Notices/1996/P004833; and Notice to NASD Members 97-50, August 1997, available at http://www.finra.org/Industry/Regulation/Notices/1997/P004654.

[63] FINRA Regulatory Notice 09-34, June 2009, available at http://www.finra.org/Industry/Regulation/Notices/2009/P119014. As of July 31, 2010, this proposed Rule had not been filed with the SEC for its approval.

[64] See e.g., Oppenheimer International Growth Fund, Statement of Additional Information, March 30, 2010, at 43-45, available at https://www.oppenheimerfunds.com/digitalAssets/FINAL%20-%20International%20Growth%20SAI%20497%2005.08.09%20with%20financials-7ac13653a8c1c010VgnVCM100000e82311ac____.pdf; and American Funds Growth Fund of America, Statement of Additional Information, November 1, 2009, at 28-33, available at https://www.americanfunds.com/pdf/mfgepb-905_gfab.pdf.

[65] See Id.

maximum level of payments to any individual intermediary in a prospectus and then provide a list of the eligible intermediaries in the Statement of Additional Information.[66]

All of these approaches to disclosure, however, do not provide enough information to an investor to evaluate conflicts of interest and do not appear to meet the "exact details" standard in the NASD Rules.

IX. The Need to Survey Broker Compensation Practices in Servicing Hidden Mutual Fund Accounts

Unfortunately, it is not possible to ascertain the exact amounts of these broker-dealer fee arrangements, as there is no one authoritative study which sets forth all charges that broker-dealers require mutual funds to pay to them. As noted above, current disclosures by broker-dealers of these fees are generally in broad categories, such as "distribution costs," which enable participants to avoid disclosure of many charges by characterizing them in any manner that they choose. However, it is the control by a broker-dealer over the distribution of a mutual fund's shares that enables the broker-dealer to compel the mutual fund to pay these charges in question.

Given a lack of specific information about these broker-dealer fees, CMFI believes that the SEC should conduct a survey—one that is specific and encompassing—to amass the information necessary to accurately determine how much broker-dealers are receiving from the mutual funds whose shares they sell. This survey should identify, in a detailed fashion, all sources of payments and revenue—other than commissions on purchases and sales of securities for a fund's portfolio—from mutual funds (and their investment advisers) to broker-dealers. This survey should also evaluate what account maintenance and shareholder servicing activities are being provided over and above those services that broker-dealers are already required to provide to their customers under existing regulatory rules.

These fees are even more objectionable when one considers how broker-dealers handle the different types of investments that may be included in the account of a brokerage customer. For example, if a person holds municipal bonds, shares of stock, or exchange-traded funds ("ETFs") in a brokerage account, the broker-dealer keeps track of these positions in its accounting system as part of its required services to its customer,

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[66] See, e.g., American Funds AMCAP Fund, Prospectus, May 1, 2010, at 32 ("The level of payments made to a qualifying firm in any given year will vary and in no case would exceed the sum of (a) .10% of the previous year's American Funds sales by that dealer and (b) .02% of American Funds assets attributable to that dealer."); and American Funds AMCAP Fund, Statement of Additional Information, May 1, 2010, at 36. Both documents are available at https://www.americanfunds.com/funds/prospectuses.htm. See also, Franklin Custodian Funds, Statement of Additional Information, February 1, 2010, at 45-46, available at https://www.franklintempleton.com/retail/jsp_app/products/literaturereview.jsp; BlackRock Focus Growth Fund, Inc., Statement of Additional Information, December 29, 2009, at II-60-62, available at https://www2.blackrock.com/webcore/litService/search/getDocumentFromSymbol.seam?sym=MDFOX&Source=RegIndex&Venue=PUB_IND&doctype=98; and Columbia Acorn Trust, Statement of Additional Information, May 1, 2010, at 87-90, available at http://www.columbiafunds.com/NR/rdonlyres/4B9353DA-E290-47E9-A315-91B80FE4246D/0/SAI_Acorn.pdf.

usually at no charge to the account holder. More importantly, the broker-dealer does not send the municipal government that issued the bonds, the issuer of corporate shares, or the issuer of an ETF an invoice for account maintenance or servicing of the customer's account at the brokerage firm.[67] So why should brokerage firms be allowed to charge on-going account maintenance and shareholder servicing fees to mutual funds for keeping track of mutual fund shares held by the customers of these broker-dealers?

Another problem with these fee arrangements is that a broker-dealer has an incentive to encourage its customers to invest in multiple mutual fund positions, compared to transacting in other securities, as account maintenance fees are paid on a per position basis. At $22 per position, a brokerage account with four (4) mutual fund positions will generate $88 in account maintenance charges, in addition to Rule 12b-1 fees and revenue-sharing payments for that same customer.

To facilitate an SEC survey of these issues, attached are proposed questions that should be asked of broker-dealers, to obtain more industry data about fee structures, policies, and practices. See Attachment #2.

X. Additional Regulatory Problems with Hidden Mutual Fund Accounts

In addition to unnecessary fees being charged for account maintenance and shareholder servicing activities by large broker-dealers, the lack of transparency in these hidden mutual fund accounts raises a number of significant regulatory problems:

- Mutual funds are not able to monitor excessive short-term trading activities in these intermediary accounts on a real-time basis;

- A number of regulatory studies and enforcement actions by the SEC, NASD and FINRA indicate that investors paying sales loads on fund shares in omnibus accounts are not receiving the proper volume or breakpoint discounts, as promised in fund prospectus filings;

- 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; and

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[67] Under SEC rules, issuers of certain securities do have to reimburse broker-dealers and other intermediaries for the cost of distributing proxy materials for shareholder meetings; however, this cost is miniscule compared to the account maintenance and shareholder servicing costs being charged to mutual funds by broker-dealers. Similarly, there are ETFs which make Rule 12b-1 or revenue-sharing payments to brokers for general marketing and educational services; however, these payments are not for recordkeeping services. See SSgA Funds Management, SPDR Series Trust Statement of Additional Information, at 58-59, Oct. 31, 2009, available at https://www.spdrs.com/library-content/public/SPDR%20Series%20Trust%20SAI.pdf; and BlackRock Fund Advisors, iShares Trust Statement of Additional Information Supplement, Mar. 4, 2010, available at http://us.ishares.com/content/stream.jsp?url=/content/en_us/repository/resource/sai/sai_trust430.pdf&mimeType=application/pdf.

- Distributions to individual investors from the SEC Fair Funds program cannot be made in a precise and timely manner because of the lack of transparency within these hidden accounts at the investor level.

XI. Existing Technology Platforms Should be Utilized to Ensure Full Transparency in Hidden Mutual Fund Accounts

Full transparency within hidden mutual fund 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 large broker-dealers and mutual funds already use the NSCC's FundSERV and Networking services, and the technology is in place through the NSCC to share investor-level information at a cost of only 10 cents for every 100 records processed.

These NSCC services were developed more than twenty (20) years ago to standardize, centralize, and automate mutual fund transactions. NSCC processing platforms provide significant operational efficiencies for both funds and their financial intermediaries. Large broker-dealers, however, continue to demand that funds pay increasing fees to support their omnibus sub-accounting model, causing more and more mutual fund accounts to be converted onto the accounting platforms of brokerage firms over the past decade.

These broker-dealers claim that their omnibus sub-accounting model is more efficient operationally; however, this model is only productive for brokerage firms. The reality is that mutual funds are paying higher fees and charges to these broker-dealers than the cost of using the NSCC platforms described above. The information-sharing systems that provide transparency through omnibus accounts in a highly efficient and standardized manner have been replaced with a decentralized and fragmented system of broker-dealer sub-accounting that is more expensive for funds and not providing adequate investor protections.

Attached to this White Paper is a history of the NSCC Networking service, which describes in detail the migration of large broker-dealers away from this cost-effective and transparent processing platform, in order to generate additional fees and charges for recordkeeping and shareholder servicing activities within omnibus accounts. See Attachment #3.

XII. Conclusion

Mutual funds and their individual investors should not be paying unnecessary fees to large broker-dealers for account maintenance and shareholder servicing activities that broker-dealers are already required to provide under FINRA rules and applicable law. These servicing activities include: (1) providing regular account statements to customers; (2) handling investor inquiries and other aspects of the customer relationship; (3) conducting individual customer suitability analyses prior to the execution of any

recommended transactions; and (4) reporting required information to the Internal Revenue Service ("IRS").[68]

As noted earlier, these fees are not being charged when broker-dealers hold municipal bonds, corporate shares, and ETFs in their customer accounts. Under the existing regulatory framework, broker-dealers are responsible for holding these positions for their customers without compensation from the issuers of such securities, except for proxy processing services.

Brokers-dealers are distributors of mutual funds and many mutual funds are very dependent on them as sources for additional investment funds. Through these distribution arrangements, large broker-dealers have substantial leverage to demand that mutual funds allow individual shareholder accounts to be kept on the books of the brokerage firm in large omnibus accounts, hidden from the mutual funds and their board of trustees. Broker-dealers have a vested interest in pressing mutual funds to allow the accounting to be done on the books of the broker-dealer because this presents an opportunity for them to charge significant fees to the funds, in addition to the fees already charged for sales and distribution.

Unlike the transfer agent for a fund, the broker-dealer fees charged to the fund for recordkeeping are not subject to competitive bids. If a fund wants a particular broker-dealer to distribute its shares, the fund must agree to let the brokerage firm handle recordkeeping and shareholder servicing tasks for its customers, at a price dictated by the broker-dealer and without any discounted fees to reflect economies of scale or large volumes of accounts.

The fees charged by a broker-dealer for maintaining these hidden accounts are primarily paid by mutual funds as an expense from fund assets, thereby depleting the assets and investment earnings of shareholders who have no relationship with the brokerage firm. And, as noted above, funds should not be paying for account maintenance and shareholder servicing activities that broker-dealers are already responsible for providing to their customers.

Remarkably, these fees are not creating additional protections for individual investors, who have a right to expect that the policies and procedures outlined in fund prospectuses will be applied uniformly and fairly across all shareholder classes and in a manner independent of an investor's choice of distribution channel. In fact the opposite is taking place, as these hidden mutual fund accounts remain shielded from mutual fund compliance personnel.

In CMFI's view, mutual fund directors have a duty of oversight that is more robust than simply relying on assurances by broker-dealers (and other intermediaries) that

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[68] See, e.g., NASD Rule 2340: Customer Account Statements, available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3647; and NASD Rule 2310: Recommendations to Customers (Suitability), available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3638.

prospectus policies and procedures are being enforced in a similar manner. In fact, broker-dealers and other financial intermediaries with commission-based compensation systems have economic interests that are in direct conflict with a fund's responsibility to enforce its policies and procedures in a uniform manner for all shareholders. A mutual fund will never be able to adequately protect its shareholders by relying on intermediaries with such divergent economic interests.

Fund directors are not fulfilling their fiduciary duties when they approve plans to pay inflated fees (or fail to properly supervise payments to support the fund sales and distribution system) that cause even more non-uniform treatment of shareholders. Fund directors should also ensure than fund distribution payments are price-competitive and made in arm's length negotiations with broker-dealers.

CMFI believes that the SEC has been slow to address these issues, especially given the fact that these fee structures are inconsistent with the Congressional intent of the Investment Company Act, in which the fund distribution system is not to be favored over the interests of long-term shareholders.[69]

On July 21, 2010, the SEC issued a proposed rule to reform the structure and operation of its Rule 12b-1, but the SEC's proposal does not directly address the problems created by account maintenance, shareholder servicing, and revenue-sharing fees being paid to large broker-dealers for omnibus sub-accounting.[70] The SEC has also announced its intention to reconsider its 2004-2005 point of sale rule, to address conflicts of interest in the sale of mutual funds.[71]

Despite these actions, the SEC has not reviewed and evaluated, in a detailed fashion, what services large broker-dealers are providing to mutual funds and their individual investors for these fees. And there has been no regulatory scrutiny of the fact that these fees are generally for services that broker-dealers are already required to provide under FINRA rules and applicable law.

One step the SEC has taken in this area is to promulgate an intermediary information-sharing rule—Rule 22c-2—to address the lack of transparency within hidden

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[69] Section 1 of the Investment Company Act specifically states that "... the national public interest and the interest of investors are adversely affected ... (2) when investment companies are organized, operated, [or] managed ... in the interest of underwriters, brokers, or dealers ... rather than in the interest of all classes of such companies' security holders; (3) when investment companies issue securities containing inequitable or discriminatory provisions, or fail to protect the preferences and privileges of the holders of their outstanding securities ... (5) when investment companies, in keeping their accounts ... employ unsound or misleading methods, or are not subject to adequate independent scrutiny ...." 15 U.S.C. § 80a-1.

[70] See Mutual Fund Distribution Fees, SEC Release Nos. 33-9128, 34-62544, and IC-29367, July 21, 2010, available at http://www.sec.gov/rules/proposed/2010/33-9128.pdf.

[71] SEC Release No. 33-8998, Jan. 13, 2009,
at 64, available at http://www.sec.gov/rules/final/2009/33-8998.pdf ("We intend to consider additional steps in the future that would further enhance investors' access to ... enhanced information about broker and intermediary compensation and conflicts of interest before the investment decision. For example, we continue to consider appropriate disclosures at the point of sale by financial intermediaries ....").

mutual fund accounts.[72] However, CMFI's most recent review of mutual fund prospectus filings indicates that funds are not taking advantage of the Rule and asking broker-dealers for investor-level information.[73] Even during the infrequent times when Rule 22c-2 is being used by mutual funds, investor identity and transaction information are not being shared on a real-time basis. Given the leverage large broker-dealers have over mutual funds as the funds' distribution agents, it is no surprise that this new Rule has proven to be ineffective.

Broker-dealers can be expected to continue to expand the use of omnibus sub-accounting, as they emerge from the financial crisis and seek additional sources of revenue. The SEC should take action to ensure that these brokerage firms—and particularly those that were TARP recipients—do not place the burden of their recovery efforts on the backs of average Americans' savings, retirement, and college funds, through continued extraction of unnecessary hidden account fees from mutual funds.

To remedy these problems, policymakers and regulators should consider taking the following steps:

1. Require Full Transparency within Omnibus Accounts. The SEC should require full transparency within broker-dealer and other intermediary sub-accounts on a real-time basis. This can be accomplished by amending SEC Rule 22c-2 to require investor-level information to be shared by broker-dealers (and other intermediaries) as orders are being placed or on a same-day basis. This level of transparency will permit fund compliance personnel to apply prospectus policies and procedures to investor accounts in a uniform manner across all distribution channels. And, as noted earlier, this can be accomplished in a cost-effective manner by utilizing the NSCC Networking service and other technology platforms that operate in a similar manner.

2. Eliminate Unnecessary Broker-Dealer Fees. The SEC should evaluate the account maintenance, shareholder servicing, and revenue-sharing fees being charged by large broker-dealers. The SEC should eliminate any fees being charged for services that broker-dealers are already required to provide under FINRA rules and applicable law. The SEC should also restrict those fees which are not established through competitive bid processes and do not benefit all shareholders. As noted above, these three sources of fee revenue for large broker-dealers are very significant, averaging as much as $8.47 billion per year.

3. Improve Disclosure of Broker-Dealer Fees to Investors. In addition to eliminating any unnecessary fees, the SEC should require the disclosure of all fees, revenue-sharing payments, and other remuneration being paid to large broker-dealers for account maintenance and shareholder servicing activities

[72] This Rule requires broker-dealers and other intermediaries to share investor-level information within omnibus accounts, at the request of mutual fund compliance personnel. See supra note 3.
[73] See supra note 3.

within omnibus accounts. These disclosures should include the dollar amount that a broker-dealer is receiving for each account, with this figure being disclosed in monthly shareholder account statements. Similarly, the SEC should require disclosure of 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.

4. Insert Fee Legend in Fund Prospectus Documents and Monthly Account Statements. Finally, the SEC should require that a legend be inserted in at least three different locations: (a) next to the fee table in a fund prospectus; (b) in the appropriate section of a summary prospectus; and (c) in monthly shareholder account statements. This legend should be required for any fund which is: (a) paying fees to broker-dealers for omnibus sub-accounting; and (b) unable to receive ongoing investor-level information about fund shareholders in these intermediary accounts. If required, the legend should contain the following language regarding the use of omnibus sub-accounting by broker-dealers or other intermediaries:

> *"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."*

Unless some or all of these recommended actions are taken by the SEC, broker-dealer costs can be expected to increase further and regulatory problems within hidden mutual fund accounts will continue to negatively impact the more than 85 million Americans who rely on mutual funds to save for retirement, college education, and other important goals. As the Investor's Advocate, the SEC needs to address these practices and fee structures through additional regulation, to ensure that the interests of individual investors are placed ahead of the needs of the brokerage industry.

CMFI White Paper – Attachment #1

Broker-Dealer Shareholder Servicing & Account Maintenance Fees
Updated: 4/20/2010
Note: All amounts in BASIS POINTS or DOLLARS
Account and Networking Fees are per mutual fund position
Revenue Sharing Fees are from investment adviser (and/or its affiliate)

AVERAGES:
Revenue-Sharing Fee: 0.15-0.20 Basis Points
Rule 12b-1 Fee: 0.20-0.25 Basis Points
Account/Client Position Fee: $19.00-$25.00
Networking Fee: $8.00-$9.00

Broker- Dealer	Revenue Sharing Fees	Standard 12b-1 Fee	Account Fee	Networking Fee
Ameriprise Financial				Undisclosed
-Asset-Based Payment	Up to 0.25%	Up to 0.25%	Up to 0.40%	
-Sales-Based Payment	Up to 0.25%			
AXA Advisors		Up to 0.25%	Undisclosed	$4.00
-Asset-Based Payment	Up to 0.10%			
-Sales-Based Payment	Up to 0.20%			
Citigroup $			Up to $21.00	$6.00
-Equity Assets	Up to 0.12%	Up to 0.25%		
-Fixed Income Assets	Up to 0.09%	Up to 0.25%		
Edward Jones			$19.00	$11.00
-Asset-Based Fee	Up to 0.13%	Up to 0.25%		
-Sales-Based Fee	0.125%			
Financial Network Investment Corporation		Up to 0.25%	Undisclosed	Undisclosed
-Asset-Based Fee	Up to 0.10%			
-Sales-Based Fee	Up to 0.25%			
FSC Securities		Up to. 0.25%		

Broker- Dealer	Revenue Sharing Fees	Standard 12b-1 Fee	Account Fee	Networking Fee
-Asset-Based Fee	Up to 0.45%			
-Sales-Based Fee	Up to 0.25%			
John Hancock Financial Network	Undisclosed	Up to 0.25%	Undisclosed	Undisclosed
H.D. Vest		Up to 0.25%	Undisclosed	Undisclosed
-Asset-Based Fee	0.05-0.15%			
-Sales-Based Fee	0.10-0.25%			
ING Financial Partners		Up to 0.25%	Undisclosed	Undisclosed
-Asset-Based Fee	Up to 0.10%			
-Sales-Based Fee	Up to 0.25%			
INVEST Financial		Up to 0.25%	Undisclosed	Undisclosed
-Asset-Based Fee	Up to 0.10%			
-Sales-Based Fee	Up to 0.40%			
Investment Centers Of America		Up to 0.25%	Undisclosed	Undisclosed
-Asset-Based Fee	Up to 0.10%			
-Sales-Based Fee	Up to 0.40%			
Janney		Up to 0.25%	Undisclosed	$3.00-$10.00
-Asset-Based Fee	0.10%			
-Sales-Based Fee	0.05%			
Lincoln Financial Advisors		Up to 0.25%	Undisclosed	Undisclosed

Broker- Dealer	Revenue Sharing Fees	Standard 12b-1 Fee	Account Fee	Networking Fee
-Asset-Based Fee	Up to 0.35%			
-Sales-Based Fee	Up to 0.25%			
Merrill Lynch/ Bank of America$		Up to 0.35%	$19.00	Undisclosed
-Asset-Based Fee	Up to 0.20%			
-Sales-Based Fee	Up to 0.25%			
MetLife Securities	Undisclosed	Up to 0.25%	Undisclosed	Undisclosed
J.P. Morgan Chase$	Up to 0.25%	Up to 0.25%	Undisclosed	Undisclosed
Morgan Stanley$ /Smith Barney		Up to 0.25%	$21.00	$6.00
-Equity Assets Fee	0.12%			
-Fixed Income Assets Fee	0.09%			
National Planning Corporation		Up to 0.25%	Undisclosed	Undisclosed
-Asset-Based Fee	Up to 0.10%			
-Sales-Based Fee	Up to 0.40%			
Northwestern Mutual Investment		Up to 0.25%	Undisclosed	Undisclosed
-Annual Asset Fees	Up to 0.10%			
-Sales Fees	Up to 0.10%			
Piper Jaffray		Up to 0.25%	$10.00	Undisclosed
-Asset-Based Fee	Up to 0.42%			
-Sales-Based Fee	Up to 0.42%			

Broker- Dealer	Revenue Sharing Fees	Standard 12b-1 Fee	Account Fee	Networking Fee
PNC Investments	Undisclosed	Up to 0.25%	Undisclosed	Undisclosed
Raymond James	Up to 0.05%	Up to 0.25%	Up to $20.00	Undisclosed
Royal Alliance Associates		Up to 0.25%	Undisclosed	Undisclosed
-Asset-Based Fee	Up to 0.45%			
-Sales-Based Fee	Up to 0.25%			
Charles Schwab				
-No Transaction Fee Funds	Unknown	Up to 0.45%		
-Transaction Fee Funds	Unknown	Up to 0.25%	$20.00-$30.00	$3.00-$8.00
SII Investments		Up to 0.25%	Undisclosed	Undisclosed
-Asset-Based Fee	Up to 0.10%			
-Sales-Based Fee	Up to 0.40%			
Stifel Nicolaus		Up to 0.25%	$10.00	Undisclosed
-Asset-Based Fee	Up to 0.40%			
-Sales-Based Fee	Up to 0.15%			
Transamerica	0.10-0.50%	Up to 0.25%	Undisclosed	Undisclosed
UBS		Up to 0.25%	Undisclosed	$12.00
-Assets Fee/Equity	Up to 0.10%			
Assets Fee/Fixed Income	Up to 0.075%			
-Sales	Up to 0.10%			

Broker- Dealer	Revenue Sharing Fees	Standard 12b-1 Fee	Account Fee	Networking Fee
Vanguard		Up to 0.35%	Unknown	$16.00
Wells Fargo$ /Wachovia	Up to 0.15%	Up to 0.25%	$25.00	$12.00
$ = Banks that received Government bailout from the Troubled Asset Relief Program				

CMFI White Paper – Attachment #2

DRAFT SEC SURVEY QUESTIONS FOR BROKER-DEALERS

Omnibus Accounts

1. At each year end, December 31, for the years 2004-2009, in total and the average per brokerage account, how many customer positions in registered investment companies marketed as mutual funds did your firm and its affiliates maintain within a recordkeeping structure using omnibus accounts? In how many different mutual funds?

2. As of December 31, 2009, state the aggregate market value of all customer positions in mutual funds and the average market value of each such position maintained by your firm and its affiliates.

3. During calendar year 2009, what is the total revenue that your firm and its affiliates received from each mutual fund in which your firm and/or its affiliates maintained a recordkeeping structure using omnibus accounts, regardless of the source or purpose of any payments, and other than commissions for the purchase and sale of securities on behalf of any mutual fund? What is the average payment per customer position you received from mutual funds in 2009?

4. During calendar year 2009, what is the total revenue that your firm and its affiliates received from investment advisers to mutual funds for maintaining a recordkeeping structure using omnibus accounts? What is the average revenue-sharing payment per customer position that you received from these advisers in 2009?

5. With respect to the amounts set forth in questions 3 and 4 above, what percentage of these payments will repeat annually for so long as the mutual fund positions are held and maintained within omnibus accounts?

6. With respect to the amounts set forth in questions 3 and 4 above, state the percentage of this revenue that is retained by your firm and its affiliates. State the percentage of the revenue that is retained by individual brokers maintaining the direct relationships with your customers.

7. With respect to the amounts set forth in questions 3 and 4 above, what portions thereof are reported by your firm and/or its affiliates to your customers, and by what means and with what frequency?

Competitive Bidding for Recordkeeping and Shareholder Services Contracts

8. With respect to the amounts set forth in question 3 and 4 above, state what proportion of any of your contracts with either mutual funds or their investment advisers were obtained through a Request for Proposal or other competitive bidding process.

9. If you are receiving payments for recordkeeping and shareholder services pursuant to contracts that were not negotiated as a part of a Request for Proposal or other competitive bidding process, how were the level of payments determined and what relationship do they bear to the cost of providing the services provided and the value received therefrom by the mutual funds? If these payments received by your firm and its affiliates from mutual funds and their investment advisers are similar, how were these payment levels established?

10. Do the payments that you receive from mutual funds and their investment advisers for recordkeeping and shareholder services decrease as the volume of customer positions or accounts increases?

11. Do the payments that you receive from mutual funds and their investment advisers decrease for those accounts holding multiple fund positions?

Types of Recordkeeping and Shareholder Services

12. State with specificity the recordkeeping and other shareholder services that your firm and its affiliates are being paid or reimbursed for by mutual funds and their investment advisers, in exchange for the payments set forth in response to questions 3 and 4 above. For each service provided to your customers within omnibus accounts, state whether your firm or its affiliates are already required to perform this service under FINRA rules and applicable law, regardless of whether or not a mutual fund and/or its investment adviser is making a payment or reimbursement.

Transparency within Omnibus Accounts

13. During 2009, how many requests for beneficial owner identity and transaction information were received by your firm and/or its affiliates from each mutual fund with an information-sharing agreement, pursuant to SEC Rule 22c-2? How many mutual funds did not ask for any beneficial owner identity and transaction information during 2009?

14. Do any of the information-sharing agreements you have with mutual funds require you to provide beneficial owner identity and transaction information on a same-day basis?

15. Do any of the information-sharing agreements you have with mutual funds require you to provide beneficial owner identity and transaction information on a weekly, monthly, annual, or other periodic basis?

16. Has any mutual fund asked for this information on a daily, weekly, monthly, annual, or other periodic basis, even though not required by an information-sharing agreement?

17. For any mutual fund that does not require same-day information-sharing at the beneficial owner level, what internal regulatory framework has your firm and/or its affiliates established to ensure that you are applying the individual prospectus policies and procedures for the mutual funds held by your customers, so that each fund position is in compliance with the Federal securities laws? What are your policies and procedures to ensure that each individual investor receives the maximum breakpoint discount on sales load charges to which he or she is entitled, pursuant to the policies and procedures of each mutual fund whose shares you sell?

18. During 2009, how many transactions have been flagged by your firm and/or its affiliates as being in violation of a mutual fund's market timing or frequent trading policies or procedures?

19. For those mutual funds that rely on your firm and/or its affiliates to collect redemption fees, what dollar amount in redemption fees was collected in 2009?

20. For those mutual funds that rely on your firm and/or its affiliates to implement your own market timing and frequent trading policies and procedures, what policies and procedures have you and your affiliates implemented to protect investors from excessive short-term trading? How do you ensure compliance with either a fund's policies and procedures or your own policies and procedures regarding excessive short-term trading?

21. During 2009, how many on-site examinations by mutual funds and/or their advisers were conducted to evaluate the omnibus account compliance systems at your firm and/or its affiliates? What percentage of mutual funds required submission of a certification of such compliance from an independent third party auditor? What percentage required submission of a certification of such compliance from an officer of your firm? What percentage did none of the preceding?

CMFI White Paper –Attachment #3

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

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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).

> mutual fund books with the investor positions on their books. This reconciliation process resulted in inconsistencies, for both the firms 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

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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).

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]

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.

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[8] "NSCC to Expand Clearing Service to Offer Fund Networking Service," Securities Week, Nov. 9, 1987.
[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.

> 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 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.
>
> . . . .
>
> ... 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

[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.

because of increased standardization and lower software programming requirements.[13]

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.

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

- More accurate and timely posting of mutual fund positions and dividend payments on customer statements.
- Improved tracking and reporting of daily dividend accrual funds.
- 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'*

[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).

> *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.[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-

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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").

> 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.[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:

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[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).

> 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 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

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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.

on short-term trading when such trading takes place through omnibus accounts.[28]

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

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[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.

[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.

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:

> 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:

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[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.

> 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 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, the SEC should evaluate the services being provided under omnibus sub-accounting and eliminate those fees for services already

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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.

required to be provided by broker-dealers under 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.

As additional steps, the SEC 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, the SEC should require disclosure of 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, the SEC should require that fund prospectus materials and monthly account statements contain a legend with appropriate disclosure language regarding the use of omnibus sub-accounting by broker-dealers or other intermediaries.[37]

[37] As noted in the CMFI White Paper, 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."