
October 20, 2016

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

VIA ELECTRONIC MAIL
rule-comments@sec.gov

Subject: List of Rules To Be Reviewed Pursuant to the Regulatory Flexibility Act, File No. S7-21-16

Dear Mr. Fields:

The Coalition of Mutual Fund Investors ("CMFI")[1] appreciates the opportunity to comment on Securities and Exchange Commission ("SEC") Rule 22c-2, Mutual Fund Redemption Fees, as a part of its review of rules promulgated ten years ago under the Regulatory Flexibility Act.[2]

CMFI believes that Rule 22c-2 is not working as it was originally intended and should be amended to require broker-dealers and other financial intermediaries to provide mutual funds with investor-level identity and transaction information on a same-day basis. This information would be used—via automated utilities like the National Securities Clearing Corporation's Networking service—by mutual funds to ensure compliance with regulatory rules and prospectus policies and procedures.

## The Original Purpose of Rule 22c-2

More than a decade ago, the mutual fund industry was the subject of numerous investigations and enforcement actions involving excessive short-term trading in mutual fund shares by certain investors. This "market timing" activity harmed long-term investors by diluting the value of their shares.

[1] The Coalition of Mutual Fund Investors (www.investorscoalition.com) is an Internet-based shareholder advocacy organization established to represent the interests of individual mutual fund investors.
[2] List of Rules To Be Reviewed Pursuant to the Regulatory Flexibility Act, 81 Fed. Reg. 64,364 (September 20, 2016) (hereinafter "Regulatory Flexibility Act Release").

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In response to this problem, the SEC promulgated several new rules, including Rule 22c-2.[3] Rule 22c-2 permits mutual funds to impose a redemption fee that may not exceed two percent (2%) and is to be retained by each fund.[4] The redemption fee is intended to help each fund recoup some of the direct and indirect costs of excessive short-term trading in its shares.[5] The rule also requires most funds to enter into written agreements with broker-dealers and other financial intermediaries that permit each fund to request and obtain shareholder identity and transaction information within omnibus accounts or other opaque accounting structures.

Omnibus accounts have been a regulatory problem for many years. Each omnibus account may represent the transactions of thousands of customers of a particular financial intermediary. Individual orders to purchase, exchange, or redeem shares are aggregated together and netted against each other. Each mutual fund then receives one net purchase or net redemption order from an intermediary using omnibus accounting during each trading day.

Intermediaries using omnibus accounts do not typically provide investor-level identity or transaction information about their customers to each mutual fund. This lack of transparency makes it difficult, if not impossible, for a mutual fund to enforce prospectus policies and procedures—as well as regulatory rules—within these intermediary accounts.

The SEC has been well aware of this transparency problem for more than a decade. In its original proposal for Rule 22c-2, the SEC expressed concern about the lack of access to investor-level information within these accounts, as they had been commonly used as a vehicle for inappropriate market timing activities:

> A number of the market timing abuses identified through our examinations and investigations reveal that certain shareholders were concealing abusive market timing trades through omnibus accounts. As a result, those shareholders have often been beyond the reach of fund directors' efforts to protect the fund and its shareholders from the harmful effects of short-term trading.[6]

To respond to this problem and provide mutual funds with investor-level transparency into omnibus accounts, the SEC's Proposing Release on Rule 22c-2 required financial intermediaries to provide funds on a weekly basis with "the Taxpayer Identification Number

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[3] Rule 22c-2 is codified at 17 C.F.R. § 270.22c-2.

[4] *Regulatory Flexibility Act Release* at 64,365.

[5] *Id.*

[6] Mandatory Redemption Fees for Redeemable Fund Securities (Proposed Rule), 69 Fed. Reg. 11,762, at 11,766 (March 11, 2004). Footnote 40 of this Release cites paragraph 46 of the state civil complaint in *New York v. Canary Capital Partners, LLC,* et al. (N.Y.S. Ct. filed Sept. 3, 2003) as illustrative of this problem ("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.").

('TIN'), and the amount and dates of all purchases, redemptions, or exchanges for each shareholder within an omnibus account during the previous week."[7] In this Release, the SEC acknowledged that broker-dealers using the Networking service of the National Securities Clearing Corporation ("NSCC") were already providing this information to funds for prospectus compliance purposes.[8]

The SEC explained that the purpose of this information-sharing requirement was to provide mutual funds with a regulatory tool to be able to ensure the uniform application of redemption fees and other anti-market timing policies in intermediary accounts.[9]

In the final version of Rule 22c-2, the SEC backed off its proposal to require weekly information-sharing. Instead, the SEC placed responsibility on mutual funds to determine when to request investor-level information from their intermediaries, for the purpose of ensuring proper enforcement of redemption fees and other restrictions on short-term trading:

> The rule we are adopting make funds responsible for determining when they need a financial intermediary's assistance in monitoring and enforcing fund market timing policies. … We expect funds that are susceptible to market timing will use it regularly.[10]

Rule 22c-2 was amended again in 2006, and it has not been evaluated by the SEC since that time.[11]

**The Information-Sharing Provisions in Rule 22c-2 Are Not Being Used**

Unfortunately, ten years later, the information-sharing provisions of Rule 22c-2 are not being utilized as a tool by mutual funds and their intermediaries. Funds have largely delegated responsibilities to intermediaries to address market timing and fund lawyers have added broad disclaimer language to prospectuses, stating that market timing policies cannot be enforced within omnibus accounts because of a lack of transparency.[12]

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[7] *Id.* This information-sharing requirement was also recommended by the National Association of Securities Dealers Omnibus Account Task Force, in a report issued on January 30, 2004, *available at* https://www.sec.gov/rules/proposed/s71104/s71104-26.pdf.

[8] *Id.* at 11,769, footnote 70 ("Broker-dealers using National Securities Clearing Corporation already submit TINs to fund transfer agents for certain types of 'networking' arrangements.").

[9] *Id.* at 11,767 ("Fund managers can use information they receive about transactions in omnibus accounts to take steps to better enforce market timing policies, including barring market timers from the fund.").

[10] Mutual Fund Redemption Fees (Final Rule), 70 Fed. Reg. 13,328, at 13,332 (March 18, 2005).

[11] Mutual Fund Redemption Fees (Proposed Rule), 71 Fed. Reg. 11,351 (March 7, 2006); and Mutual Fund Redemption Fees (Final Rule), 71 Fed. Reg. 58, 257 (October 3, 2006).

[12] *See* Coalition of Mutual Fund Investors, *Excerpts from SEC Prospectus Filings Regarding Enforcement of Mutual Fund Market Timing and Other Short-Term Trading Policies within Third-Party Hidden Accounts*, June 10, 2015, *available at*

An example of the "disclaimer" approach used by the fund industry can be found in the prospectus disclosures of the Janus Funds:

> Although the Funds take steps to detect and deter excessive trading pursuant to the policies and procedures described in this Prospectus and approved by the Trustees, there is no assurance that these policies and procedures will be effective in limiting excessive trading in all circumstances. For example, for share classes sold through financial intermediaries, the Funds may be unable to completely eliminate the possibility of excessive trading in certain omnibus accounts and other accounts traded through intermediaries. Omnibus accounts may effectively conceal the identity of individual investors and their transactions from the Funds and their agents. This makes the Funds' identification of excessive trading transactions in the Funds through an omnibus account difficult and makes the elimination of excessive trading in the account impractical without the assistance of the intermediary. Although the Funds encourage intermediaries to take necessary actions to detect and deter excessive trading, some intermediaries may be unable or unwilling to do so, and accordingly, the Funds cannot eliminate completely the possibility of excessive trading.[13]

For the typical mutual fund, omnibus accounts hold the substantial majority of fund shares, as most investors now transact in mutual funds through intermediaries.[14] This growth in the use of omnibus accounts has created a Rule 38a-1 compliance issue for mutual funds that do not have information about the identity or the transactions of more than a majority of their shareholders.

Rule 38a-1—and corresponding Advisers Act Rule 206(4)-7)—requires funds and their advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Federal securities laws and to protect the interests of shareholders and clients. In CMFI's view, it is hard to argue that prospectus policies and procedures that are inapplicable to *more than 50% of the shares* of a fund are effective policies and procedures. And, if a stated

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http://investorscoalition.com/sites/default/files/Analysis%20of%20Omnibus%20Surveillance%20Procedures%206-10-2015.pdf

[13] *Id.* at 9, Janus Investment Fund Prospectus, January 28, 2015, page 75. This same disclosure language is contained in the latest version of the Janus Investment Fund Prospectus, January 28, 2016, page 80, *available at* https://janus.onlineprospectus.net/janus/47103E601/index.html?where=eengine.goToDocument('Statutory Prospectus').

[14] *See, e.g.*, Investment Company Institute, *Costs of Eliminating Discretionary Broker Voting on Uncontested Elections of Investment Company Directors*, at 5, December 18, 2006, *available at* https://www.ici.org/pdf/wht_broker_voting.pdf ("Mutual funds … have a significant portion of their shares held in street name. For mutual funds sold via sales forces … shares held in street name ranged from 78 percent to 100 percent of total fund shares, with a median of 80 percent ….").

policy or procedure lacks effectiveness, then it does not meet the requirements of Rules 38a-1 and 206(4)-7, as a policy or procedure "reasonably designed" to prevent securities law violations and to protect shareholders and clients.

This problem has been exacerbated by the significant reduction in the use of redemption fees by the fund industry.[15] According to Broadridge Financial Solutions, the number of mutual fund share classes that use redemption fees has dropped by approximately 50% since January 2009.[16] And Morningstar data indicates that less than 10% of the 27,027 share classes of mutual funds in its database currently use redemption fees to address market timing problems.[17]

The transparency problems with omnibus accounts and the lack of meaningful tools to address excessive short-term trading have left investors unprotected from market timers and subject to the risks of ongoing dilution in the value of their fund shares.

**SEC Goals on Market Timing Are Not Being Met**

The SEC should be concerned that its original goals in promulgating Rule 22c-2 are not being met. The evidence is overwhelming that market timing policies and procedures are not being applied properly in intermediary accounts. Redemption fees are no longer being used and the fund industry has been overwhelmed with the problems created by omnibus accounts.

Some in the fund industry argue that the growth of exchange-traded funds ("ETFs") have provided the market timers with another vehicle to implement arbitrage and frequent trading strategies. However, the annual redemption rate of long-term mutual funds has not changed since the year 2000, when market timing was active in a number of fund families. And the combined redemption and exchange rate for long-term funds remains over 25% on an annual basis.

Attached is a table from the Investment Company Institute's 2016 Fact Book (Table 26), providing the annual redemption rates for long-term mutual funds, from 1985 to 2015. The average redemption rate for all types of funds (i.e., equity, hybrid and bond funds) was 25.7% in

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[15] *See, e.g.*, Beagan Wilcox Volz, Putnam Says Goodbye to Last Redemption Fees, *Ignites*, June 13, 2013; Beagan Wilcox Volz, Vanguard Cuts Redemption Fees on 33 Funds, *Ignites*, May 24, 2012; Hannah Glover, Invesco Axes Redemption Fees, Adds Purchase Blocks, *Ignites*, October 12, 2011; Maura McDermott, Funds Drop Redemption Fees as Market Timing Fears Wane, *BoardIQ*, July 5, 2011; and Hannah Glover, J.P. Morgan Dumps Redemption Fees, *Ignites*, March 22, 2011.

[16] Jill Gregorie, Despite Waning Adoption, Redemption Fees Here to Stay: Lawyers, *Ignites*, September 22, 2016.

[17] *Id.*

2000 and 25.2% in 2015.[18] If you include exchange redemptions in the calculations, the annual redemption rate was 39.9% in 2000 and 27.8% in 2015.[19]

This data shows that the redemption rate has not moved since the market timing scandals over a decade ago. An average redemption rate of 25% or more is high for long-term mutual funds and, in CMFI's view, indicates that market timing is still a problem for investors.

**Other Regulatory and Prospectus Compliance Problems Exist with Omnibus Accounts**

In addition to an inability to enforce market timing policies and procedures within omnibus accounts, these accounts have also made it difficult to ensure regulatory and prospectus compliance in several other areas:

1. **Broker-Dealer Sales Load Discounts**. The lack of transparency within omnibus accounts is also harming mutual fund investors who are entitled to volume discounts from sales loads for large purchases (or sales load waivers for investing in a retirement or other special account). Broker-dealers are not providing these "breakpoint" discounts accurately and mutual funds are not in a position to make the appropriate calculations required by their prospectuses because broker-dealers are not sharing investor identity and transaction information with the funds.[20]

The breakpoint discount problem has been left unresolved for *more than a decade*. This problem was first identified in a joint examination sweep of 43 broker-dealers between November 2002 and January 2003. In this sweep, regulators discovered that sales load discounts were not properly applied in as many as *one-third (1/3)* of the reviewed transactions eligible for such discounts.[21]

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[18] Investment Company Institute, *2016 Investment Company Fact Book*, Table 26, at 197, *available at* http://www.icifactbook.org/. This redemption rate is calculated by taking the sum of regular redemptions for the year as a percentage of average net assets at the beginning and end of the period.

[19] *Id.* This redemption rate is calculated by taking the sum of regular redemptions and exchange redemptions for the year as a percentage of average net assets at the beginning and end of the period.

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

[21] Press Release, SEC, NASD, NYSE Release Findings of Breakpoint Examination Sweep; Broker-Dealers To Review Transactions, March 11, 2003, *available at* https://www.sec.gov/news/press/2003-31.htm. In its recent Concept Release on Transfer Regulations, the SEC acknowledged that these problems are the result of the use by broker-dealers of omnibus accounts ("The [Joint] Staff Report also noted that … 'the increasing prominence of omnibus account arrangements and sub-transfer agency services provided to these accounts by intermediaries such as brokers had made the tasks related to the application of breakpoints more challenging.'"). Transfer Agent Regulations (Concept Release), 80 Fed. Reg. 81,948, at 81,996 (December 31, 2015)(quoting Joint

Since this period, the Financial Industry Regulatory Authority ("FINRA") has brought *more than 100 enforcement cases* in order to sanction—after the fact—those broker-dealers who were caught overcharging their customers. The scale of this particular problem is staggering. Over the past 11 years, FINRA has penalized its broker-dealer members *more than $98 million* and required *more than $210 million* in investor restitution payments.[22]

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

In 2010, the SEC amended its Rule 2a-7 to impose a number of new liquidity requirements on money market funds, including a general liquidity requirement.[23] This rule mandates that funds establish internal processes to develop more information about their shareholders and their anticipated redemption needs.[24] However, this particular rule—also referred to as the "know your customer" requirement—is never going to function properly without full transparency within omnibus accounts.

The SEC acknowledged the omnibus accounts transparency problem in explaining the final version of its money market fund rules.[25] And several commenters, including CMFI, advocated that Rule 22c-2 should be extended to money market funds.[26] However, the SEC did not agree and so the Rule 22c-2 information-sharing tool is not currently available to money market funds.

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SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds, March 2003).

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

[23] Money Market Fund Reform (Final Rule), 75 Fed. Reg. 10,060 (March. 4, 2010).

[24] *Id.* at 10,074.

[25] *Id.* at 10,075 ("As some commenters noted, identification of these risks may be more challenging when share ownership is less transparent because the shares are held in omnibus accounts.").

[26] *See* Letter from Niels Holch, Executive Director, Coalition of Mutual Fund Investors, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, at 9-11, Sept. 10, 2009, *available at* http://www.sec.gov/comments/s7-11-09/s71109-135.pdf; and Letter from Phillip Gillespie, Executive Vice President and General Counsel, State Street Global Advisers, to Elizabeth M. Murphy, Securities and Exchange Commission, Sept. 8, 2009, at 9, *available at* http://www.sec.gov/comments/s7-11-09/s71109-108.pdf; *see also* Letter from Paul Audet, Vice Chairman, BlackRock, Inc., to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, at 6, Sept. 4, 2009, *available at* http://www.sec.gov/comments/s7-11-09/s71109-60.pdf; and Letter from George G.W. Gatch, President & CEO, JPMorgan Funds Management, Inc., to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, at 5, Sept. 8, 2009, *available at* http://www.sec.gov/comments/s7-11-09/s71109-110.pdf.

This issue arose again in the SEC's more recent rulemaking on money market funds.[27] Omnibus accounts remain an obstacle to imposing redemption fees and gates for these funds, as noted in previous CMFI comment letters to the SEC and the Financial Stability Oversight Board.[28]

Additionally, omnibus accounts create problems for money market funds in complying with the SEC's "natural persons" standard for retail money market funds, a rule established to ensure that only individual investors are shareholders of certain fixed Net Asset Value ("NAV") funds.[29] Without full transparency into the actual identities of the underlying investors, mutual funds will not be able to ensure compliance with this SEC requirement.

3. **SEC Pay-to-Play Rules**. Omnibus accounts are also an obstacle for investment advisers trying to comply with the SEC's "pay-to-play" rules. These rules require investment advisers to keep a record of all government entities that hold—directly or indirectly—shares of any of their mutual funds.[30] Fund advisers are not able to easily identify any government entities holding shares of their mutual funds through omnibus accounts.

The SEC decided to respond to this problem by issuing a no-action letter to the ICI in September 2011.[31] This letter permits advisers to keep an alternative set of records that represents a "do the best you can" approach to collecting information about underlying shareholders in omnibus accounts.

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

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

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[27] Money Market Fund Reform; Amendments to Form PF (Final Rule), 79 Fed. Reg. 47,736 (August 14, 2014).
[28] Letter from Niels Holch, Executive Director, Coalition of Mutual Fund Investors, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, September 17, 2013, *available at* http://www.investorscoalition.com/sites/default/files/CMFI%20Comment%20Letter%20re%20MM%20Fund%20Reform%209-17-2013.pdf; and Letter from Niels Holch, Executive Director, Coalition of Mutual Fund Investors, to Amias Gerety, Financial Oversight Stability Council, January 21, 2013, *available at* http://www.investorscoalition.com/sites/default/files/CMFI%20Comment%20Letter%20to%20FSOC%20re%20MM%20Funds%201-21-2013.pdf.
[29] *See* Claire Trapasso, "Money Funds Struggle to Take the Pulse of Investor Base," *Ignites*, August 20, 2014.
[30] Political Contributions by Certain Investment Advisers (Final Rule), 75 Fed. Reg. 41,018 (July 14, 2010).
[31] Investment Company Institute, SEC No-Action Letter, September 12, 2011, *available at* http://www.sec.gov/divisions/investment/noaction/2011/ici091211-204.htm.

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

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

This point is illustrated further by a recent enforcement settlement involving Calvert Investment Management over a faulty process it used to make restitution payments to its shareholders for improperly valuing several illiquid securities held in its fund portfolios between 2008 and 2011.[33] The SEC was critical of the remediation process used by Calvert for shareholders in omnibus accounts, stating that "a shareholder who transacted through an intermediary and a shareholder who transacted directly with the Calvert Funds potentially received different distribution amounts despite having engaged in identical transactions in shares of the Calvert Funds."[34]

As a remedy, the SEC is requiring Calvert to engage in an outreach program with its intermediaries to identify and reimburse any shareholders of the Funds transacting through omnibus accounts.[35] Of course, this outreach process would be unnecessary if intermediaries were providing funds with investor-level transparency on an ongoing basis.

## A Transparency Solution for Omnibus Accounts is Less Expensive for Investors than the Current System

Full transparency at the investor-level within omnibus accounts can be accomplished efficiently and in a cost-effective manner through the order and account processing systems of the NSCC. A substantial majority of mutual funds, large broker-dealers, and other financial intermediaries already use the NSCC Fund/SERV and Networking services, and the technology is in place through the NSCC to share investor-level information—in an automated process—at a cost of only $0.10 for every 100 records processed.[36]

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

[33] Administrative Proceeding Order, *In the Matter of Calvert Investment Management*, Inc., File No. 3-17630 (October 18, 2016).

[34] *Id.* at 6.

[35] *Id.* at 10-12.

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

In its recent Concept Release on Transfer Agent Regulations, the SEC acknowledged the transparency benefits provided by NSCC Networking for intermediary accounts:

> 'Networking' of a single investor's account or position potentially gives Mutual Fund Transfer Agents more transparency through to beneficial owners than is available to Operating Company Transfer Agents, because the recordkeeping for such accounts is primarily kept on the Mutual Fund Transfer Agent's system. 'Networking' is a service provided by NSCC by which Mutual Fund Transfer Agents can also exchange general shareholder account data with intermediaries such as brokers that provide sub-transfer agency services. This service provides for different levels of securityholder account networking between mutual funds and intermediaries. Networked accounts are in the name of the intermediary on the master securityholder file but can represent both individual customers and omnibus accounts.[37]

When an account is "networked," mutual fund shares are recorded in electronic book-entry form and reconciled between broker-dealer and fund records. Networking then permits a customer's account to appear identically on a broker's system and, at the same time, on the records of a mutual fund, or its transfer agent.[38]

The NSCC's Networking service was established and first approved by the SEC more than twenty-five (25) years ago.[39] NSCC Networking has been expanded over the years to provide similar communication and reconciliation services to other financial intermediaries, including banks, third-party administrators of defined contribution plans ("TPAs"), and unit investment trusts ("UITs").

Historically, NSCC Networking has been strongly supported by the mutual fund industry. More than twenty years ago, the specific benefits of the Networking service to funds and broker-dealers were highlighted in the 1992 NSCC Annual Report, by the President of the Investment Company Institute:

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[37] Transfer Agent Regulations (Concept Release), 80 Fed. Reg. 81,948, at 81,996. Level 3 Networking is the most common use of this service. As noted in footnote 511 of the Concept Release, Level 3 Networking permits the intermediary to handle all aspects of the customer relationship and the customer does not interact with the mutual fund or its transfer agent.

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

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

> Networking, introduced in 1988, provides a standardized communications pipeline through which customer account level activity can be exchanged in both directions between broker/dealers and funds. Using the system, brokers are able to carry customers' mutual fund positions on their stock record in much the same manner as they do for corporate security positions. Networking also offers centralized settlement of cash dividends and capital gains distributions.[40]

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

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

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

NSCC Networking is a standardized and automated system that allows for both the broker-dealer and the mutual fund transfer agent to perform recordkeeping, regulatory, and compliance tasks in a manner that provides full transparency at about *one-half* of the cost of broker-dealer sub-accounting. More than 90 million mutual fund accounts controlled by

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

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

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

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

financial intermediaries were still using this system as of only a few years ago.[44] And at least one large broker-dealer, Robert W. Baird & Co., still processes a significant portion of its client transactions involving mutual fund shares through the NSCC Networking system.[45]

It is disappointing that the financial services industry continues to be resistant to the use of NSCC Networking as a solution to the many regulatory and compliance problems that have been created by omnibus accounts. This service was created by the mutual fund and brokerage industries in the 1980's and its automated and standardized systems have only become more cost-effective and efficient in exchanging investor-level information between funds and their intermediaries for trading, regulatory, and prospectus compliance purposes.

**The SEC Should Amend Rule 22c-2 to Require Same-Day Transparency in Omnibus Accounts**

As noted earlier, Rule 22c-2 is not being actively used by mutual funds and their advisers. Funds continue to rely on intermediaries to enforce prospectus policies and procedures, or they defer to an intermediary's policies and procedures to address excessive trading within omnibus accounts. This has resulted in a lack of uniformity in the application of frequent trading policies and procedures across intermediary distribution channels.

In order to protect investor interests, the SEC should amend Rule 22c-2 to mandate that intermediaries share investor identity and transaction information with funds on a daily and ongoing basis.[46] A mandated requirement that this information be exchanged daily would ensure that funds receive this information in a manner that can assure appropriate and timely oversight of transactions within all intermediary accounts.

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

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

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

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

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

The lack of transparency that exists within omnibus accounts should be addressed immediately to ensure that all fund policies and procedures—from market timing policies to sales load breakpoint discounts—are applied uniformly to all shareholders and across all distribution channels.[47]

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

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

## Conclusion

The SEC requires funds and their advisers to be primarily responsible for ensuring compliance with regulatory rules and the policies and procedures outlined in fund prospectuses. Despite the SEC's position, fund oversight of investor-level activities within omnibus accounts is largely inadequate, as a fund only has access to aggregated shareholder identification and transaction data for evaluation, instead of receiving individual account-level information.

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

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

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

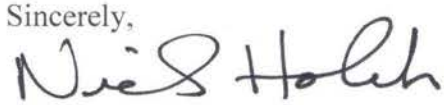
Fortunately, these regulatory problems can be addressed with a relatively simple solution. Funds and their intermediaries should return to using the NSCC Networking system, which permits the parties to exchange account-level information in an automated, standardized, and cost-effective manner. This information-sharing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

Using the NSCC systems to provide same-day transparency at the investor-level will permit funds to comply with SEC regulatory rules and their prospectus policies and procedures in an effective and inexpensive manner. In fact, the cost of going back to NSCC Networking is substantially less than the fees and charges being paid to financial intermediaries for sub-accounting.

The needs of mutual fund distributors should not be favored over the interests of those individual shareholders who invest in mutual funds for their retirement and other savings goals. Instead of having investors pay more for omnibus accounts and receive fewer protections, the SEC should support a regulatory framework that costs less and uses technology to provide the necessary transparency to resolve the regulatory and compliance problems discussed in this letter. It should also be a goal of the SEC to ensure that regulatory rules and prospectus policies and procedures are applied uniformly across all distribution channels. This is not occurring today and the SEC has an opportunity in its review of Rule 22c-2 to address this problem in a meaningful manner.

Thank you for the opportunity to present CMFI's views on Rule 22c-2. If the SEC staff needs more information from CMFI on these issues, please contact me at [redacted] or at [redacted].

Sincerely,



Niels Holch
Executive Director
Coalition of Mutual Fund Investors

Attachment

cc: The Honorable Mary Jo White
The Honorable Kara Stein
The Honorable Michael Piwowar
David Grim, Director, Division of Investment Management