

## **CMFI White Paper: The Shareholder Servicing Costs of Hidden Mutual Fund Accounts**

The Coalition of Mutual Fund Investors (“CMFI”)<sup>1</sup> has discovered several practices used by large broker-dealer intermediaries that are imposing unnecessary costs on individual investors of as much as \$8.4 billion each year. 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”).

### **The Hidden Mutual Fund Accounts Problem**

Many investors purchase mutual fund shares through third-party financial intermediaries, such as a broker, financial adviser, retirement plan provider, bank, or insurance company. At the end of each trading day, many of the larger intermediary firms aggregate all purchase, redemption, and exchange requests from their customers into one consolidated order for each individual mutual fund. A fund handles this order as a single transaction, treating the financial intermediary—instead of the underlying individual investors—as the account holder and as the shareholder of record.

Each consolidated or “omnibus” account may represent the transactions of thousands of investors of a particular mutual fund. However, no information is generally disclosed to the compliance personnel at a mutual fund about the specific trading activities of these underlying investors. Likewise, the identities of these investors are not disclosed to the fund. Under this accounting and recordkeeping structure, these shareholder accounts are hidden from a mutual fund.

### **The Size of the Hidden Mutual Fund Accounts Problem**

As of the end of 2008, the Investment Company Institute (“ICI”) reported a total of 264,499,000 mutual fund shareholder accounts, reflecting a mix of individual and omnibus accounts.<sup>2</sup> 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 estimates total mutual fund accounts at 400 million, including all retirement accounts that are held through financial

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<sup>1</sup> The Coalition of Mutual Fund Investors (“CMFI”) is an Internet-based shareholder advocacy organization established to represent the interests of individual mutual fund investors. The Coalition’s website is [www.investorscoalition.com](http://www.investorscoalition.com).

<sup>2</sup> Investment Company Institute, 2009 Investment Company Fact Book, April 2009, page 110, [available at http://www.ici.org/home/12009\\_factbook.pdf](http://www.ici.org/home/12009_factbook.pdf).

intermediaries.<sup>3</sup> KDS Partners also estimates that 50% of these accounts, or as many as 200 million accounts, use the omnibus account recordkeeping process described above.<sup>4</sup>

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.<sup>5</sup>

According to the ICI, long-term mutual fund assets totaled \$9.6 trillion at the end of 2008.<sup>6</sup> Individual investors owned 82% of these assets, for a total of \$7.87 trillion.<sup>7</sup> This \$7.87 trillion in mutual fund assets was owned by an estimated 92 million individual investors in 2008.<sup>8</sup>

With \$7.87 trillion in assets and 92 million investors, the average amount of mutual fund assets for each individual investor was \$85,543 at the close of 2008.<sup>9</sup> With an ICI estimate of four (4) mutual fund positions as the median number owned in each investor's portfolio, the total number of mutual fund positions owned by individuals is 368 million and the average value of each position was \$21,386 at the close of 2008.<sup>10</sup>

### **The Cost to a Mutual Fund of Servicing a Shareholder Directly**

A number of shareholders are serviced directly by a mutual fund's transfer agent. The identity of the shareholders and information about their transactions are fully transparent to the mutual fund through its transfer agent. Similarly, a number of shareholders transacting through financial intermediaries are transparent to the funds, through technology that has been developed for this purpose.<sup>11</sup>

According to industry disclosures, the average cost of servicing a direct (or fully transparent) investor is between \$10 and \$16 for each fund position, or an average of \$13

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<sup>3</sup> KDS Partners, Discussion of Omnibus Recordkeeping, January 2008, p. 4, available at [http://omnibusrecordkeeping.com/Publications\\_files/White%20Paper%20for%20First%20Five%20Pages%2012-06-07%20v18.pdf](http://omnibusrecordkeeping.com/Publications_files/White%20Paper%20for%20First%20Five%20Pages%2012-06-07%20v18.pdf).

<sup>4</sup> 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](http://omnibusrecordkeeping.com/Case_Studies/Entries/2009/3/16_Consulting_on_Omnibus_Accounting.html).

<sup>5</sup> Interview with representatives from KDS Partners (Nov. 20, 2009).

<sup>6</sup> Investment Company Institute, 2009 Investment Company Fact Book, April 2009, page 112, available at [www.icifactbook.org](http://www.icifactbook.org).

<sup>7</sup> Id. at 72. This calculation was derived by multiplying \$9.6 trillion by 0.82.

<sup>8</sup> Id.

<sup>9</sup> This calculation was derived by dividing \$7.87 trillion in assets by 92 million investors. Since the Wilshire 5000 stock market index increased more than 25% in 2009, this average investor portfolio balance should have increased to more than \$100,000 by December 31, 2009.

<sup>10</sup> Id. at 73. This calculation was derived by dividing \$85,543 by 4.

<sup>11</sup> Intermediaries using technology that permits transparency at the shareholder level typically use the Networking service of the National Securities Clearing Corporation (NSCC).

per position.<sup>12</sup> The cost of servicing the four mutual fund positions in an average direct investor's portfolio, therefore, ranges from \$40 to \$64, or an average of \$52.<sup>13</sup>

Fees charged by the fund's transfer agent are under the direct supervision of the fund's board or trustees. Most trustees require the transfer agent's fees to be subject to servicing arrangements that are competitively bid. The oversight of this function is the responsibility of the fund's Chief Compliance Officer ("CCO"), who reports directly to the board of trustees.

### **The Cost of Servicing a Shareholder Investing through Brokers and Other Intermediaries**

As noted above, shareholders investing through brokers 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 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. This results in a single account on the fund's transfer agent records, representing thousands of individual investors.

In the case of brokers, the records of individual shareholders are generally hidden from the mutual fund because they are aggregated by the broker into very large omnibus accounts and shown as a single broker account on the books of the fund. Trades made by the customers of the broker are hidden from the management and board of trustees for the fund. The practice of hiding individual accounts through broker omnibus accounting is widespread within the mutual fund industry, with as many as 100 million shareholder positions being handled in this manner under the omnibus accounting structure.<sup>14</sup>

Brokers 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, brokers have substantial leverage to demand that mutual funds allow individual shareholder accounts to be kept on the books of the broker in large omnibus accounts, hidden from the mutual funds and their board of trustees, who would otherwise act as fiduciaries for the shareholders. Brokers press mutual funds to allow the accounting to be done on the books of the broker because this presents an opportunity for

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<sup>12</sup> 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](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](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, page 15, [available at http://edlabor.house.gov/testimony/030607MatthewHutchesontestimony.pdf](http://edlabor.house.gov/testimony/030607MatthewHutchesontestimony.pdf).

<sup>13</sup> This calculation is derived by multiplying these average cost estimates by four (4) positions.

<sup>14</sup> The Coalition of Mutual Fund Investors (CMFI) estimates that at least 50% of the 200 million shareholder positions, or 100 million positions, use omnibus accounting that hides shareholder information from mutual fund personnel. The remaining 50%, 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 with funds and their compliance personnel.

the brokers to charge significant fees to the funds, in addition to the fees already charged for sales and distribution.

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

The fees charged by a broker for hidden account maintenance are paid by mutual funds as a fund expense, thereby including direct shareholders and participants who have no relationship with the broker and whose account information is fully transparent.

According to public disclosures on the websites of the major brokerage firms, a broker is typically able to collect at least three different fees from mutual funds for shareholder servicing activities.

### **Broker Fee #1: The Account Maintenance Fee**

First, an account maintenance fee is paid for each shareholder whose account is hidden within the broker omnibus account. According to public sources, financial intermediaries are being paid by mutual funds and their shareholders an average of between \$19 and \$25 for each shareholder position held in a fund. These fees are in lieu of the fee charged by the fund's transfer agent, which averages \$13 per position. For example:

- Merrill Lynch/Bank of America has disclosed that it receives up to \$19 for each position in a mutual fund.<sup>15</sup>
- Morgan Stanley/Smith Barney has disclosed that it receives up to \$21 a year for each client position in a fund.<sup>16</sup>
- 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.<sup>17</sup>
- Wachovia/Wells Fargo has disclosed that it receives up to \$25 a year for each client account with an individual fund.<sup>18</sup>

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<sup>15</sup> 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](http://www.mldirect.ml.com/publish/weekly_pdfs/MF_DisclosureDocument.pdf).

<sup>16</sup> 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.

<sup>17</sup> Matthew D. Hutcheson, Independent Pension Fiduciary, Testimony before the U.S. House Committee on Education and Labor, March 6, 2007, p. 14, available at <http://edworkforce.house.gov/testimony/030607MatthewHutchesontestimony.pdf>.

- A recent lawsuit against the American Funds family alleges that it may be paying as much as \$25 per account per year.<sup>19</sup>

These payments are made to brokers and other intermediaries for every mutual fund position in each investor account held by a broker. If one assumes an average account maintenance fee of \$22 per position, this charge is about \$9 more per position, on average, than what is being paid to maintain the position of a direct investor on the books and records of the mutual fund. If an investor has purchased four (4) different mutual funds in his or her brokerage account, the broker is receiving an average of \$88 each year for this account, even though only one account statement is prepared and mailed and only one suitability analysis is conducted for each investor.

### **Broker Fee #2: The Rule 12b-1 Fee**

For funds with Rule 12b-1 plans, the second fee paid to brokers from fund assets is an amount up to 0.25% (i.e. 25 basis points) of the value of each position for hidden account services.<sup>20</sup> This affects all shareholders and retirement plan participants in the mutual fund, even if they are not customers of the broker.

### **Broker Fee #3: The Revenue-Sharing Fee**

A third source of payments to brokers for shareholder servicing activities can come directly from investment advisers to the mutual funds, in the form of revenue-sharing payments. These payments can range from 0.10% to 0.50% (i.e., 10 to 50 basis points).<sup>21</sup>

### **The Estimated Costs of Shareholder Servicing Payments to Brokers**

The cost of these payments to brokers exceeds the cost that is borne by the funds and retirement plans if the accounts are maintained on the books of the funds and not hidden in the broker omnibus accounts. The fund is often making three different payments for shareholder servicing. First, the average account maintenance payment of \$22.00 per position. Next, a Rule 12b-1 payment is made from fund assets of as much as

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<sup>18</sup> 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](https://saf.wellsfargoadvisors.com/emx/dctm/Marketing/Marketing_Materials/Mutual_Funds/e6244.pdf).

<sup>19</sup> 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>.

<sup>20</sup> CMFI has documented these 12b-1 fees from the public website disclosures of thirty (30) brokers and other intermediaries.

<sup>21</sup> This range of revenue-sharing fees has been documented by CMFI through a review of public website disclosures of thirty (30) brokers and other intermediaries.

0.25%. Finally, a revenue-sharing payment from the fund adviser is made to the intermediary of between 0.10% and 0.50%.

If one assumes that a broker is receiving, on average, a combined payment of 0.35% for both 12b-1 fees and revenue-sharing payments, a mutual fund is paying each broker \$96.85 for each fund position in an omnibus or hidden account with an average balance of \$21,386.<sup>22</sup> A shareholder or retirement plan participant whose account is kept on the books of the fund would only cost the fund \$13 for this same position, on average.

For the entire account or portfolio held by the average shareholder or retirement plan participant—with an assumption of four (4) mutual fund positions—the cost for the shareholder whose account is kept on the books of the fund is \$52.<sup>23</sup> The total yearly cost to a fund for the shareholder whose account is hidden in a broker's omnibus account is \$387.40.<sup>24</sup>

The difference in costs to funds and their shareholders and retirement plan participants whose records are kept by the fund as compared to the costs when the records are hidden in omnibus broker accounts is very significant, unfairly expensed to shareholders and retirement plan participants, and not adequately disclosed to the customers of the broker.

On a per position basis, the difference in payments is \$96.85-\$13.00, or \$83.85. For the average account or portfolio, with an assumed number of four (4) mutual fund positions, the different is \$387.40-\$52.00, or \$335.40.

If one assumes that 50% of the 200 million mutual fund positions within omnibus accounts are subject to these payments to brokers, the total in unnecessary broker fees for these hidden accounts is \$8.39 billion each year.<sup>25</sup>

### **Investors Should Not Pay Unnecessary Broker Fees**

An investor should not be paying unnecessary fees for shareholder servicing and recordkeeping activities. As an alternative, each fund shareholder should pay no more than the minimum charges paid by a direct shareholder for these same activities, even though fund shares are purchased through an intermediary distribution channel. Direct shareholders should not be bearing the burden of inflated payments being made on behalf of other shareholders in hidden accounts, especially when they do not obtain any benefits from these broker or intermediary payments.

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<sup>22</sup> This calculation is derived by adding the \$22.00 average account maintenance fee to \$74.85, which is 35 basis points of the position value of \$21,386.

<sup>23</sup> This calculation is derived by multiplying the per position cost of \$13.00 by the assumed four (4) positions.

<sup>24</sup> This calculation is derived by multiplying \$96.85, the cost of one position, by the assumed four (4) positions.

<sup>25</sup> This calculation is derived by multiplying the excessive annual fee per position of \$83.85 by 100 million shareholder accounts estimated to be hidden from mutual fund personnel.

As noted earlier, payments to brokers typically do not involve competitive bidding or arm's length bargaining. Instead, payments are established based on what is generally known within the industry to be the amount which must be paid for these sales and distribution services.<sup>26</sup>

Funds are already providing most of these services to shareholders; the only extra service being provided by brokers to their customers—investor suitability analyses—is already required of them through existing regulatory rules. The costs of a broker's relationship with its customers should be borne by the broker itself, and not by a mutual fund or its shareholders.

### **Investors Also Deserve Full Transparency in Hidden Fund Accounts**

Another problem to consider is the fact that these unnecessary fees and charges by intermediaries are not resulting in more protection or services for individual investors. In fact, the opposite is occurring.

Almost all fund complexes defer to their financial intermediaries to enforce each fund's own short-term trading policies. Fund companies then add language to prospectus filings to warn investors that a lack of information about hidden accounts means that each fund cannot guarantee that its policies and procedures will be applied within these accounts.<sup>27</sup> Based on current fund prospectus disclosures about hidden accounts, it is very clear that funds are receiving fewer and fewer services from their financial intermediaries, despite making excessive payments to them. As hidden accounts grow, funds risk losing control over almost every transaction occurring in these third-party accounts.

In addition to eliminating unnecessary broker fees, the problem of hidden accounts should be addressed by requiring full disclosure of the identities and transactions of shareholders purchasing fund shares through a financial intermediary. Full transparency within these accounts can be accomplished by the daily disclosure of shareholder information from intermediaries, or by registering all shareholders directly with a fund.

Only through a full transparency model will a mutual fund be able to ensure that its prospectus policies and procedures are administered in a uniform and efficient manner across all distribution channels. The current decentralization of the mutual fund

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<sup>26</sup> Competitive bidding for sales and distribution services is a rare occurrence within the mutual fund industry. Fees and commissions are paid based on compensation levels that are either established in a prospectus or are generally known to be the expected amounts to be paid to acquire these services. A further complication is the fact that trustees of a mutual fund are not able to compare pricing for shareholder servicing and recordkeeping activities when approving these arrangements because of a lack of competitive bidding or arm's length bargaining.

<sup>27</sup> 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, September 30, 2009, available at <http://www.investorscoalition.com/AnalysisofOmnibusSurveillanceProcedures9-30-09.pdf>.

recordkeeping function has created diseconomies of scale.<sup>28</sup> Compliance functions that can be performed once now require repetitive steps with multiple recordkeepers for each fund. The cost of oversight is also higher, with so many intermediaries involved.

In addition to the benefits described above, a full transparency model provides solutions to other regulatory problems:

- Each fund will be able to monitor short-term trading activities on a real-time basis;
- Investors will be able to receive properly calculated breakpoint discounts on sales load charges;
- A money market fund will be able to manage its liquidity risks more effectively by reviewing and monitoring all investor activities on a daily basis; and
- Distributions from the SEC's Fair Fund program and money market liquidation payments can be made in a more precise and timely manner than under the current processes that rely on "best efforts" in third-party hidden accounts.

### **Conclusion**

Federal regulators and policymakers need to protect investor interests by tackling the payment of unnecessary fees and the lack of transparency caused by hidden mutual fund accounts managed by financial intermediaries.

The Investment Company Act intended that a mutual fund be operated and managed for the benefit of its shareholders and not its managers or distributors. This is one reason that a mutual fund is organized as a trust, with fiduciary duties. As a result of this fiduciary relationship, funds need to place the interests of their shareholders above all other interests.

Unnecessary fees being paid to brokers should be eliminated and complete transparency within all shareholder accounts held by brokers and other intermediaries should be established as a regulatory requirement.

These steps will save shareholders as much as \$8.4 billion each year and ensure that mutual fund prospectus policies and procedures are applied and enforced in a uniform manner across all distribution channels.

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<sup>28</sup> If a fund's transfer agent has access to account-level identity and transaction information and an investor buys fund shares through multiple intermediaries, the investor would benefit from a lower cost structure. Because of hidden accounts, some funds have changed their prospectus language to disallow these economies of scale and prohibit fund compliance personnel from monitoring prospectus policies and procedures at the individual investor level.

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