



September 20, 2016

Secretariat
Financial Stability Board
c/o Bank for International Settlements
CH-4002
Basel, Switzerland

VIA ELECTRONIC MAIL:
fsb@fsb.org

Subject: FSB Consultation Document - Proposed Policy Recommendations to
Address Structural Vulnerabilities from Asset Management Activities

Dear Sir or Madam:

The Coalition of Mutual Fund Investors (“CMFI”)¹ appreciates the opportunity to submit comments to the Financial Stability Board (“FSB”), regarding its proposed policy recommendations to address structural vulnerabilities in the asset management industry.²

This CMFI letter primarily addresses Recommendations 4 and 5, which ask whether regulatory authorities should be providing additional liquidity risk management tools to open-end mutual funds, to increase the likelihood that requested share redemptions can be met in all market conditions, including a severe financial crisis.

Since the financial crisis in 2008, the U.S. Securities and Exchange Commission (“SEC”) has finalized several new rules to improve the regulatory framework for money market funds.³ These SEC rules mandate enhanced daily and weekly liquidity buffers, and require funds to hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions.⁴ The rules include measures to reduce credit risks

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 in the United States (www.investorscoalition.com).

² Financial Stability Board, Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities, June 22, 2016, available at <http://www.fsb.org/2016/06/proposed-policy-recommendations-to-address-structural-vulnerabilities-from-asset-management-activities/>.

³ U.S. Securities and Exchange Commission, Money Market Fund Reform, 75 Fed. Reg. 10,060 (Mar. 4, 2010), available at <https://www.sec.gov/rules/final/2010/ic-29132ft.pdf> (hereinafter “2010 SEC Final Rule”); and U.S. Securities and Exchange Commission, Money Market Fund Reform, 79 Fed. Reg. 47,736 (Aug. 14, 2014), available at <https://www.gpo.gov/fdsys/pkg/FR-2014-08-14/pdf/2014-17747.pdf> (hereinafter “2014 SEC Final Rule”).

⁴ 2010 SEC Final Rule at 10,074 (General Liquidity Requirement).

and interest rate risks, and to require fund managers to periodically “stress test” their funds’ based on hypothetical events. Finally, these rules require institutional non-government money market funds to maintain a floating NAV and authorize the use of redemption fees and redemption gates in a liquidity crisis.⁵

More recently, the SEC has issued a regulatory proposal to require each mutual fund to establish a liquidity risk management program to “assess and periodically review the fund’s liquidity risk.”⁶ As a part of this evaluation, the SEC expects each fund to develop short-term and long-term cash flow projections by evaluating, among other indicia, both historical and expected redemption patterns by the shareholders of the fund.

Taken together, these regulatory measures should significantly reduce the risk that an open-end mutual fund will be unable to redeem shares in a severe credit market crisis. However, the effectiveness of a number of these new regulatory tools has been compromised by the structural problem of *omnibus accounts*.

The Omnibus Account Problem

Across the globe, a substantial majority of mutual fund shares are now transacted through financial intermediaries.⁷ Many of these intermediaries use omnibus accounting, in which the intermediary becomes the shareholder of record with a mutual fund, instead of the underlying beneficial owners.⁸

During each trading day, fund intermediaries aggregate all purchase and redemption requests from their customers into one consolidated order for each mutual fund. A fund handles this order as a single transaction, even though it may represent transactions by hundreds or thousands of customers of a particular financial intermediary.

The use of omnibus accounting creates significant transparency problems for mutual funds, as investor-level identity and transaction information is not typically provided to fund compliance personnel on a regular basis, or as purchase and redemption orders are processed. In the United States, this transparency problem can be solved by investor-level information-sharing between funds and their intermediaries through the Networking service operated by the National Securities Clearing Corporation (“NSCC”).

⁵ See 2014 SEC Final Rule at 27,736.

⁶ U.S. Securities and Exchange Commission, Open-End Fund Liquidity Risk Management Programs, 80 Fed. Reg. 62, 274, at 62,385 (Proposed Rule 22e-4(b)(2)(iii)) (Oct. 15, 2015), available at <https://www.gpo.gov/fdsys/pkg/FR-2015-10-15/pdf/2015-24507.pdf> (hereinafter 2015 SEC Proposed Rule”).

⁷ See, e.g., a 2012 survey of large money market fund complexes concluding that 79% of the total money market assets controlled by these fund complexes are distributed through financial intermediaries. See Investment Company Institute, “Operational Impacts of Proposed Redemption Restrictions on Money Market Funds,” at 14 (June 2012), available at http://www.ici.org/pdf/ppr_12_operational_mmf.pdf.

⁸ Omnibus accounting for mutual funds is very similar in structure to using the “street name” method to trade in corporate securities; however, mutual fund shares are purchased and redeemed in book entry form and do not require a depository to hold share certificates.

Operational Challenges in Implementing a “Know Your Investor” Requirement to Evaluate and Manage Liquidity Risk

In its 2010 money market rule, the SEC imposed a general liquidity requirement, also referred to as the “know your investor” rule, mandating that funds evaluate the risk characteristics of their shareholders and maintain adequate (and potentially larger than normal) liquidity cushions to meet reasonably foreseeable redemptions.⁹

Unfortunately, the reality of omnibus accounting is that U.S. money market funds are only going to be guessing the risk characteristics and redemption needs of their underlying shareholders until and unless there is full transparency down to the beneficial owner level. In its 2010 rule, the SEC acknowledged the challenges presented by omnibus accounts:

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. Funds may seek access to information about the investors who hold their interests through omnibus accounts in addition to considering information about the omnibus accounts, including their aggregate historical redemption patterns and the account recordholder’s ability to redeem the entire account.¹⁰

Regrettably, the SEC did not give money market funds any regulatory tools to perform this “know your investor” function in a meaningful way. Instead, the SEC stated in a footnote that funds could obtain information about investors in omnibus accounts through contractual arrangements between funds and their financial intermediaries.¹¹

Likewise, the more recent SEC regulatory proposal to require each mutual fund to establish a liquidity risk management program is also going to be ineffective because of omnibus accounts. The SEC concedes that this is a problem in its Proposed Rule, but it has so far been unwilling to provide mutual funds with the tools to address the significant transparency problem within these accounts.¹²

⁹ See *supra* footnote 4.

¹⁰ 2010 SEC Final Rule at 10,075.

¹¹ *Id.* at footnote 201.

¹² See 2015 SEC Proposed Rule at 62,307 (“[T]o the extent that mutual fund shares are being held through omnibus accounts, it could be difficult for a mutual fund to be fully aware of the composition of the underlying investor base, including investor characteristics that could affect the mutual fund’s short-term and long-term flows.”).

Operational Challenges in Applying Redemption Fees, Gates and Other Redemption Restrictions in Omnibus Accounts

The FSB specifically requested comment on several other regulatory tools designed to help mutual funds with redemption requests in a credit market crisis, including redemption fees, redemption gates, and other anti-dilution methods. Similar to the problems with developing “know your investor” liquidity risk management programs, redemption fees, gates, and other anti-dilution restrictions will be difficult, if not impossible, for mutual funds to implement within omnibus accounts, absent full transparency at the beneficial owner level.

For example, the netting of shareholder transactions by financial intermediaries causes these transactions to be executed before an aggregated order is placed with a fund. Any type of redemption restriction by a mutual fund would not apply to these underlying transactions, as a redeeming shareholder only needs another customer (or group of customers) within the same financial institution to purchase an identical dollar amount of shares, in order to execute a redemption request outside of the purview of the mutual fund involved. In contrast, a shareholder transacting directly with a mutual fund would be unable to avoid a redemption fee, a redemption gate, or another type of redemption restriction imposed on his or her shares.

1. **Redemption Fees.** Redemption fees have long been a tool for U.S. mutual funds attempting to discourage abusive short-term trading. Unfortunately, this fee collection process has been stymied by the structure of omnibus accounts. As a result, mutual funds in the United States now insert broad disclaimer language in their prospectuses making it clear that there can be *no guarantee* that intermediaries are going to collect these fees in a manner that is consistent with how direct accounts are handled. As an example, here is how one prominent fund family describes the problem of imposing redemption fees on shareholders within omnibus accounts:

For those ... funds that charge purchase and/or redemption fees, intermediaries will be asked to assess those fees on client accounts and remit these fees to the funds. The application of purchase and redemption fees and frequent trading limitations may vary among intermediaries. There are no assurances that [the fund] will successfully identify all intermediaries or that intermediaries will properly assess purchase and redemption fees or administer frequent trading limitations.¹³

Similar disclaimer language can be found in the prospectuses of the substantial majority of mutual fund complexes, explaining the *inability of any fund* to assure

¹³ Vanguard, International Growth Fund Prospectus, at 36, December 22, 2015.

investors that prospectus policies and procedures—including redemption fees—can be applied uniformly within omnibus accounts.¹⁴

An inability to apply market timing redemption fees within omnibus accounts has been a problem for more than a decade. This is one reason why many fund boards have pulled back from using redemption fees to deter frequent trading activities.¹⁵ Other funds simply explain in their prospectuses that none of their market timing policies can be uniformly applied within omnibus accounts.¹⁶

If the FSB is going to consider the use of redemption fees to create disincentives for investors to withdraw funds during a run, or in a financial crisis, then mutual funds should be provided the ability to “look through” omnibus accounts to ensure uniform application of any redemption fee applied for this purpose.

2. **Redemption Gates.** The imposition of redemption gates in a crisis presents a similar dilemma for investor accounts in omnibus form. Hedge funds commonly use this regulatory tool to permit fund managers to limit the percentage of a fund’s NAV that can be withdrawn from a fund during a redemption period.

Redemption gates are typically set at between 10-25% of NAV for a specific redemption date. If redemption requests exceed the gate limit, a fund may reduce redemption requests on a pro rata basis until the gate limit is reached. Alternatively, a fund may honor redemption requests in some type of priority order. Any unfilled or outstanding redemption requests are carried over until the next redemption period.

A mutual fund attempting to apply redemption gates to its entire shareholder base will be unable to apply this restriction uniformly, with so many of its investors in omnibus accounts. Consider the following three examples:

- A. **Net Redemption Order.** A mutual fund imposes a redemption gate of 12% of its NAV on a particular trading day. The fund receives redemption requests totaling 15% of NAV and reduces all redemption requests on a pro rata basis by 20%.

¹⁴ See Coalition of Mutual Fund Investors, Excerpts from SEC Prospectus Filings Regarding Enforcement of Mutual Fund Market Timing and Other Short-Term Trading Policies within Third-Party Hidden Accounts (Largest Fifty (50) Retail Mutual Fund Groups), June 10, 2015, available at <http://www.investorscoalition.com/sites/default/files/Analysis%20of%20Omnibus%20Surveillance%20Procedures%206-10-2015.pdf>.

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 See *supra* footnote 14.

- A direct shareholder seeking to redeem \$1,000 in shares that day will receive \$800, with a redemption request of \$200 carried over until the next trading day.
 - An omnibus account seeking to redeem \$1,000 in shares that day will also receive \$800 for its customers, with a redemption request of \$200 carried over until the next trading day.
 - In an omnibus account with 3 customers seeking to redeem \$1,000 in shares that day and 2 customers seeking to purchase \$1,000 in shares that day, the financial intermediary will be able to provide the redeeming customers with \$933.33 each.¹⁷ A redemption request of \$66.67 will be carried over for each redeeming customer.
 - These 3 redeeming customers will share equally in the \$200 “holdback” imposed by the mutual fund that day, providing a \$133.33 windfall over the direct shareholder.
- B. **No Order Placed.** A mutual fund imposes a redemption gate of 12% of its NAV on a particular trading day. The fund receives redemption requests totaling 15% of NAV and reduces all redemption requests on a pro rata basis by 20%.
- A direct shareholder seeking to redeem \$1,000 in shares that day will receive \$800, with a redemption request of \$200 carried over until the next trading day.
 - An omnibus account that does not place an order that day will not be subject to any pro rata reduction in a redemption request.
 - In an omnibus account with 2 customers seeking to redeem \$1,000 in shares that day and 2 customers seeking to purchase \$1,000 in shares that day, the financial intermediary will not place an order with the mutual fund because the purchase and redemption requests are netted against each other.¹⁸
 - These four transactions will be handled by the financial institution outside of the purview of the fund, as there is no order placed that day and no

¹⁷ In this fact pattern, the financial intermediary collects \$2,000 in purchase orders internally and submits only a \$1,000 redemption request to the fund. The intermediary can be expected to divide the \$2,800 in proceeds received for redemptions evenly over the three redeeming shareholders, permitting each shareholder to receive \$933.33 each, instead of \$800 each.

¹⁸ In this fact pattern, the financial intermediary uses the \$2,000 in purchases to fulfill the \$2,000 in redemption requests, adjusting each customer’s holdings accordingly.

change to the omnibus account's overall position on the share register of the fund.

- The 2 redeeming customers will receive the full \$1,000 requested, without the \$200 "holdback" imposed by the mutual fund that day, providing a \$200 windfall over the direct shareholder.

C. **Net Purchase Order**. A mutual fund imposes a redemption gate of 12% of its NAV on a particular trading day. The fund receives redemption requests totaling 15% of NAV and reduces all redemption requests on a pro rata basis by 20%.

- A direct shareholder seeking to redeem \$1,000 in shares that day will receive \$800, with a redemption request of \$200 carried over until the next trading day.
- An omnibus account seeking to purchase \$1,000 in shares that day will not be subject to any redemption restriction during that trading day.
- In an omnibus account with 3 customers seeking to purchase \$1,000 in shares that day and 2 customers seeking to redeem \$1,000 in shares that day, the financial intermediary will be able to provide the redeeming customers with the full \$1,000 requested, without the \$200 "holdback" imposed by the mutual fund that day, providing a \$200 windfall over the direct shareholder.¹⁹

The mutual fund industry certainly recognizes these operational problems, as evidenced by recent industry white papers and comment letters submitted to the SEC.²⁰

¹⁹ In this fact pattern, the financial intermediary collects \$3,000 in purchase orders internally and fulfills the \$2,000 in redemption requests. The intermediary then submits only a \$1,000 purchase order to the fund.

²⁰ See, e.g., BlackRock ViewPoint, "Money Market Funds: The Debate Continues," March 2012, at 4, available at https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=PUB_INS&source=CONTENT&ServiceName=PublicServiceView&ContentID=1111160156 ("If omnibus relationships are treated as a single account, massive inequities could result. Consider an omnibus account with 100 clients each holding 1% of a fund. Clients would not be affected by the minimum account balance rule until after 97 of the 100 redeem in full."); and Treasury Strategies, Inc., "Proposed Holdback Requirement for Money Market Mutual Funds," April 2012, at 14, available at http://www.treasurystrategies.com/sites/default/files/TSI_MM_Fund_Holdback.pdf ("If half of a bank's customers were investing in [money market funds] on a particular day and the other half were redeeming their [money market funds], the net transaction between the bank and the fund might be zero. Thus, there would be no holdback since there was no trade!").

Problems with Implementing Swing Pricing within Omnibus Accounts

The FSB also asks about the use of “swing pricing” as a regulatory tool to improve liquidity risk management by mutual funds. Swing pricing is a process by which the daily net asset value of a fund’s shares is adjusted under certain circumstances to “pass on to purchasing or redeeming shareholders more of the costs associated with their trading activity.”²¹

Swing pricing could help a mutual fund better manage liquidity risks and it could also protect existing shareholders from dilution when a fund is subject to unusually large share outflows or inflows.²²

A typical swing pricing model permits funds to establish a “swing threshold” based on a level of net redemptions or purchases that exceed a normal range. When net purchases or redemptions exceed this swing threshold, it triggers a pre-determined adjustment—called the “swing factor”—to a fund’s NAV on any given day the swing threshold is exceeded.

On a day in which net purchase orders exceed the threshold, the NAV would be adjusted upward for both purchases and redemptions. On a day in which net redemption orders exceed the threshold, the NAV would be adjusted downward for both purchases and redemptions.

The symmetry of the typical swing pricing model, however, would disadvantage certain shareholders in the process, both new and existing. As an example, assume a hypothetical in which a mutual fund establishes its swing threshold at 3% and its swing factor at 1.5%. On any trading day that a large investor purchases an amount of shares that causes total purchases to exceed the 3% threshold, all other investors purchasing and redeeming shares that day would be subject to an NAV that is artificially increased by 1.5%. All purchasing shareholders would have to incur an extra cost—very similar to a sales load—for making the mistake of buying shares on the same day as a large investor. And redeeming shareholders would be obtaining a 1.5% windfall over what the unadjusted NAV should be on that trading day.

Conversely, when net redemptions exceed the 3% swing threshold on a trading day, the NAV for all transactions would be adjusted downward by 1.5%. An investor purchasing shares that day would receive a 1.5% benefit, by being able to buy shares at a discount from the actual NAV. An investor redeeming shares that day would receive 1.5% less than the unadjusted NAV.

In both of these examples, swing pricing would work to capture costs from some of the shareholders transacting in fund shares that day. On a day when net purchases are

²¹ See 2015 SEC Proposed Rule at 62,276 (Oct. 15, 2015).

²² See *id.* at 62,286.

above the swing threshold, the purchasing shareholders would be reimbursing the fund for its trading and impact costs that day by paying 1.5% more than the actual NAV. Likewise, when net redemptions are above the swing threshold, the redeeming shareholders would help the fund recover its trading and impact costs by receiving 1.5% less than the actual NAV.

Unfortunately, other shareholders—both new and existing—will be harmed by this pricing model. In the first scenario—net purchases above the threshold—any investor redeeming shares will be receiving a windfall of 1.5% over the actual NAV that day. In the second scenario—net redemptions above the threshold—any investor purchasing shares will be able to buy shares at a 1.5% discount that day. Both of these actions are harmful to certain new investors, are dilutive to existing shareholders, and they offset the benefits of the swing pricing concept.

Swing pricing takes too broad an approach to solving the underlying problem, which involves only circumstances where net redemptions exceed normal thresholds. In CMFI's view, it is far more efficient—and fairer to shareholders—for each fund to charge an appropriate redemption fee in this situation, to recover for the fund the trading and impact costs being imposed on the fund. These costs should be recovered only from the same shareholders whose actions are causing the funds to incur these increased costs and not from other shareholders who are not adding to a fund's costs through their transactions.

As noted earlier, the problem facing the mutual fund industry, however, in implementing redemption fees for this purpose is—once again—the problem of omnibus accounts. This problem can only be addressed by providing mutual funds with investor-level transparency within omnibus accounts held by intermediaries.

Regulators Should Consider Providing Mutual Funds with Full Transparency within Omnibus Accounts

In the United States, the SEC permits full transparency within omnibus accounts through its Rule 22c-2, when requested by a mutual fund to address short-term trading abuses that are inconsistent with prospectus policies and procedures.

Rule 22c-2 was promulgated more than a decade ago in response to the market timing problems in the U.S. mutual fund industry.²³ The Rule requires financial intermediaries to provide funds with shareholder-level identity and transaction information, when requested by the funds.²⁴ The intent of the Rule is to provide funds with a tool to deter market timers through the use of redemption fees and other types of trading restrictions. The Rule also seeks to ensure that financial intermediaries are properly

²³ See, e.g., Mutual Fund Redemption Fees, SEC Release No. IC-27504, 71 Fed. Reg. 58,257 (Oct. 3, 2006); Mutual Fund Redemption Fees, SEC Release No. IC-27255, 71 Fed. Reg. 11,351 (Mar. 7, 2006); and Mutual Fund Redemption Fees, SEC Release No. IC-26782, 70 Fed. Reg. 13,328 (Mar. 18, 2005).

²⁴ 17 C.F.R. § 270.22c-2(a)(2)(i) and 22c-2(c)(5).

implementing fund policies and procedures regarding excessive short-term trading activities by shareholders.

This evaluative process could work even more effectively if shareholder-level information is exchanged on a daily basis, as opposed to the periodic information-sharing approach currently in use as a result of SEC Rule 22c-2.²⁵ A “same-day” or per order disclosure regime can occur in a very cost-efficient manner through the NSCC Networking service mentioned above, a processing platform that is used today to share account-level information between the substantial majority of mutual funds and their financial intermediaries.

Full transparency at the investor-level can also be achieved outside of the United States by adapting SWIFT messaging standards to transmit several layers of ownership information as a transaction settles.²⁶ Information-sharing models from the payments industry can be utilized as well to solve this transparency problem.²⁷

Conclusion

Any type of regulatory proposal to address liquidity risk issues—such as the use of “know your investor” programs, redemption fees, and redemption gates—will not be able to be implemented effectively until mutual funds have the ability to “look through” omnibus accounts on a daily basis, both to evaluate their liquidity needs on an ongoing basis and to ensure, in times of stress, that any restrictive measures to address a run on a fund are applied fairly to all shareholders, irrespective of the distribution channel they have chosen for their mutual fund investments.

Thank you for your consideration of these views. If the FSB requires additional information, please contact me in the United States at 202-624-1461 or via email at nielsholch@att.net.

Sincerely,



Niels Holch
Executive Director
Coalition of Mutual Fund Investors

²⁵ Even though a mutual fund can request daily shareholder identity and transaction information under Rule 22c-2, the substantial majority of funds use this tool on a periodic basis and only sparingly.

²⁶ See Lexi Deluca, *The Omnibus Dilemma*, *Global Custodian*, December 23, 2014, available at <http://www.globalcustodian.com/Custody/The-Omnibus-Dilemma/>.

²⁷ *Id.*