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Rulemaking Must Reflect Realities of Funds' Access to Shareholder Information

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We are seeing a troubling development in Washington. In high-profile areas such as [money market funds](#) and anti-money laundering measures, regulators continue to pursue rules premised on the notion that mutual funds know or can obtain detailed information on each of their underlying shareholders.

Why is this troubling? In some instances, it is practically impossible for funds to get the information in question. And, as history too often shows, rules that are premised on practical impossibilities don't tend to work.

The key here is to understand investors' significant and increasing use of financial intermediaries. We'd like to review this important business reality, and why the Securities and Exchange Commission (SEC) and other regulators must take it into account as they proceed with rulemakings.

The Important Role of Financial Intermediaries for Fund Investors

Today, most retail mutual fund shareholders do not purchase their shares directly from a mutual fund company, but purchase instead through intermediaries. [ICI research](#) shows that 69 percent of mutual fund-owning households own funds through an employer-sponsored retirement plan. Of the investors who own mutual funds outside of such a plan, 80 percent bought their shares through a professional adviser such as a broker-dealer, a bank trust department, or an insurance company.

Many of these intermediaries hold their customers' positions in consolidated or "omnibus" accounts with a fund. While an omnibus account is held on the books of a fund in the name of the financial intermediary, the account includes the shares of multiple investors in that fund who are customers of the intermediary. That means that when an intermediary submits its mutual fund transactions for an omnibus account, it often consolidates the transactions of all of its customers that are purchasing or redeeming shares of the same fund that day into one or a few "summary" transactions to be processed with the mutual fund. Omnibus accounts provide efficiencies that enable intermediaries to serve their customers better.

As we'll see, investor use of financial intermediaries results in an information challenge for fund recordkeepers. As intermediaries continue to play an essential role on behalf of investors, they also now have an increasing impact on how funds operate.

Investor Use of Financial Intermediaries Limits Information for Funds

If a customer opens an account directly with a fund, the fund recordkeeper is required by law to maintain certain ownership and account information on the investor. But fund recordkeepers have little if any information about underlying customers that invest through an intermediary's omnibus account. Instead, the shareholder reflected on the fund's records is the financial intermediary (e.g., the broker-dealer, bank trust department, insurance company, or retirement plan administrator).

With omnibus accounts, the fund recordkeeper is not tracking which of the intermediary's customers are buying or selling shares, how many of these customers are making transactions, or the number of individual transactions involved. Instead, the fund's recordkeeper is tracking only the aggregate activity and overall total balance for the intermediary. The intermediary maintains the records of each individual customer's transactions and provides information, such as trade confirmations, statements, tax

documents, and shareholder communications to those customers.

In sum, investors' extensive use of financial intermediaries to effect mutual fund transactions results in a mutual fund recordkeeper having limited information on the underlying shareholders. Indeed, federal privacy laws prohibit these intermediaries from sharing information with the fund except in limited circumstances. While the fund's lack of information does not affect the shareholder's legal rights, it does impair the fund's ability to comply with any requirement predicated on the fund knowing the identity of its underlying shareholders.

The Practical Difficulties of Requiring Intermediaries to Provide Shareholder Information to Funds

So why not solve the funds' lack of underlying shareholder information by requiring financial intermediaries to provide information on their customers to the funds? Two practical difficulties arise.

The first difficulty is regulatory. The SEC lacks legal authority over many financial intermediaries. While broker-dealers are subject to the SEC's authority, and the SEC could legally compel them to provide funds the information, the SEC has no such authority over banks, retirement plans or their administrators, insurance companies, or other financial intermediaries.

The second is a business problem of duplication. If the SEC were to require broker-dealers to provide funds information on all their accountholders holding mutual fund shares, funds would end up maintaining duplicative records (i.e., "shadow" recordkeeping). This would be operationally burdensome, redundant, and cost prohibitive, thereby adversely impacting all shareholders in a fund because the fund would be required to absorb this expense.

Rulemakings That Ignore These Realities Run into Trouble

Unfortunately, regulators keep overlooking these realities, imposing requirements that funds find impossible to comply with because the funds lack recordkeeping information about shareholders who purchased shares through financial intermediaries that utilize omnibus account arrangements. In the recent past, there have been two occasions—one relating to the SEC's redemption fee rule and another to its "pay-to-play" prohibitions—when the SEC imposed such requirements on mutual funds. In both instances, the SEC ultimately revised the requirements to align them with the realities of the mutual fund business.

Despite this history, we see regulators repeating the mistake. There are now two proposals under consideration premised on this misunderstanding of mutual funds.

- **Money market funds:** Reforms are being considered by the SEC that would require a fund to restrict investors' access to a portion of their money market fund assets when redeeming proceeds from a money market fund account. Without a direct relationship with shareholders—which is often lacking when investors own money market funds through an intermediary—the fund is unable to restrict shareholders' access singlehandedly.
- **Anti-money laundering requirements:** These proposed rules may require funds to have certain information on individuals or entities (including beneficial owners) who own mutual fund shares, whether or not they are purchased through an intermediary. Currently, funds are required to verify the identity of named accountholders, which in many cases is the financial intermediary.

As the regulators consider future rulemakings relating to funds' recordkeeping and compliance obligations, we hope that they remain cognizant of investors' increasing use of financial intermediaries and the implications these types of arrangements have on the information available to a mutual fund recordkeeper about its underlying shareholders. In particular, they should avoid imposing on funds any legal duty that is predicated on the fund having information about underlying shareholders owning shares through a financial intermediary that utilizes omnibus accounts. As history has repeatedly demonstrated, compliance with any such obligations is impossible.

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