Fund Democracy
The Mutual Fund Shareholder's Advocate

Consumer Federation of America

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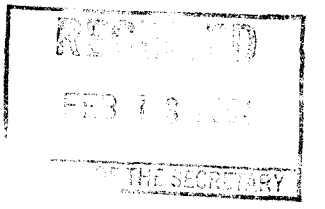
February 12, 2004



Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: File No. S7-28-03
Disclosure of Breakpoint Discounts by Mutual Funds

We are writing on behalf of the Consumer Federation of America[1] and Fund Democracy[2] to express our support for the proposed rules to improve disclosure of mutual fund breakpoint discounts. Improving prospectus disclosure of breakpoint opportunities is a relatively minor, but nonetheless useful, component of a broader campaign to ensure that mutual fund investors receive the discounts to which they are entitled. By making information about breakpoints more accessible, the proposed rule should both assist broker-dealers in understanding these programs and communicating them to customers and make it easier for investors to ascertain whether they have received all appropriate discounts.

The examination sweep conducted jointly by the Commission, the National Association of Securities Dealers, and the New York Stock Exchange provided convincing evidence that broad reforms are needed. With most of the 43 firms examined failing to provide discounts in a significant number of cases, the examination sweep showed conclusively that problems are not isolated in a few firms. The fact that, as a group, the firms examined failed to provide discounts on just under one-third of the eligible transactions provides further evidence of how widespread the problem is. And the economic damage to investors is significant, with overpayments averaging $364 and reaching a high of $10,289.

In a relatively few cases, the failure to provide breakpoints seems to stem from a knowing disregard on the part of some brokers of their obligation to ensure that customers receive appropriate discounts. That would appear to be the case, for example, at the three firms that

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[1] The Consumer Federation of America (CFA) is a non-profit association of about 300 pro-consumer groups, representing more than 50 million Americans, that was established in 1968 to advance the consumer interest through research, education, and advocacy.

[2] Fund Democracy, a nonprofit membership organization, provides a voice for mutual fund shareholders by publishing information that targets mutual fund practices, policies and rules that are harmful to fund shareholders and by lobbying for mutual fund reform.

failed to provide any indicated breakpoints. It is also suggested by the significant number of instances (151 of the 1,757 breakpoint-eligible transactions) in which investors were sold shares of several different, though similar, mutual funds and the much smaller number of transactions (7) that were just below the breakpoint, when the investor had enough money in the account to meet the breakpoint level. For those cases in which brokers are simply ignoring or actively evading their obligation to provide breakpoints, enhanced enforcement and inspections should provide an effective deterrent. Given the apparent commitment with which the SEC and NASD in particular have pursued this issue, we feel confident that the strong enforcement effort needed to provide effective deterrence is being undertaken.

More often, carelessness, shoddy procedures, and the inherent complexity of the breakpoint system appear to be the root cause of the widespread failure to provide appropriate discounts. That would appear to be the case, for example, in the many instances where brokers failed to link all eligible accounts. It would also appear to be the case in those instances where benefits of letters of intent were not received, since the broker has ready access to all the information needed to provide these benefits. The industry task force convened by the NASD has provided a number of recommendations to address this system breakdown. Perhaps most significantly, it suggested that a central breakpoint schedule and linkage database be established and made easily accessible to all registered representatives. It also recommended that standardized checklists and worksheets be used to ensure that relevant information is collected from customers at the time of the purchase, recorded, and periodically updated.

We strongly support these recommendations and believe they have the potential to do far more than improved prospectus disclosure to ensure that brokers understand breakpoint opportunities provided by the funds they sell, communicate that information effectively to customers, and collect all necessary information from the customer to provide the appropriate discount. We frankly question the task force recommendation that the Commission wait to see whether these reforms are adopted voluntarily by industry and only adopt rules if industry fails to act. As the task force itself states, "... the effectiveness of some of the recommendations will be undermined if they are not adopted by virtually all industry participants." Furthermore, a Commission mandate would give the agency and the SROs more direct influence over how these reforms take shape and thus a greater ability to ensure that they are designed to provide the maximum benefit to investors.

Improved breakpoint disclosure provides an appropriate supplement to enhanced enforcement and improved systems and procedures for ensuring proper allocation of discounts. The rule would require a mutual fund that offers breakpoint discounts to describe briefly in its prospectus: the conditions that must be met to receive that breakpoint, including a summary of shareholder eligibility requirements; the methods used to value accounts in order to determine eligibility; and whether additional information is available on its website. Where applicable, a mutual fund would also be required to disclose in its prospectus that, to receive the breakpoint, the investor may need to provide certain types of information to the mutual fund or the investor's financial intermediary.

We support each of these recommendations. In particular, by requiring that a summary of eligibility requirements be included in the prospectus, the Commission has struck an appropriate balance between overwhelming investors with too much information in the prospectus and relegating too much important information to the SAI, which is rarely read.

Investors who take the time to read the prospectus should benefit from the new disclosures, which should make it easier for them to determine whether they have received all appropriate discounts and how they might achieve additional discounts.

We fear, however, that many investors never carefully read their prospectus, although we do not have conclusive proof that this is the case. Once the pressure of responding to recent scandals subsides, we strongly urge the Commission to conduct a comprehensive study of whether and how investors use prospectuses. Do they generally receive them before or after the sale? When they receive them, do they read them? What information do they look at? Are there other sources of information they consult or other disclosure documents that they read more carefully? In particular, what sources of information do they consult in advance of the sale and factor into their purchase decision? As part of such a study, we would also urge the Commission to look at fund and broker-dealer websites, including how they are currently used and how they could be used to enhance investor understanding of the products and services they purchase.

We are curious, in this regard, why the Commission stopped short of the task force recommendation to require an explanation of breakpoint eligibility requirements on fund websites. We believe fund and broker-dealer websites have the potential to be quite useful in conveying this information for the growing number of investors who are Internet-savvy. Ideally, websites could be used to provide the information in an interactive, question-answer format that would allow investors to enter relevant data needed to determine their eligibility for breakpoints. With this in mind, we recommend that the Commission reconsider its decision to encourage, rather than require, that this information to be provided on websites of funds that maintain websites. If the Commission continues to rely on "encouragement" to promote website disclosure, it should carefully monitor whether and how mutual fund companies respond.

Improved prospectus disclosure should be accompanied by better pre-sale discussion of these issues with investors. As we noted above, we believe standardized checklists and worksheets could be used to walk investors through the rules governing breakpoints and to elicit from them the information needed to determine their eligibility. We believe such an approach would be far more effective than prospectus disclosure in conveying key information to investors and getting them to act on it. These worksheets could also serve as a pre-sale disclosure document that would be reviewed with the investor by the registered representative.

We also believe it would be beneficial to provide follow-up disclosure on the confirmation. Such disclosure would not need to be extensive, nor should it be. Instead, it could provide the level of the next breakpoint and a brief statement that investments in different funds, through different accounts, and even by certain family members may be counted toward breakpoint eligibility. In addition, the confirmation should direct the investor to detailed information on how to obtain such discounts.

The one area where the task force recommendations fall far short, in our view, is in their failure to deal effectively with issues related to settlement of transactions. The examination sweep provided convincing evidence that different methods of settling transactions result in dramatically different error rates in providing breakpoints. Specifically, the examination sweep found that funds that used Fund/SERV predominately had twice as many missed transactions on average as firms that used paper applications predominately, and the missed discounts were about 50 percent greater. There does not appear to be anything inherent to Fund/SERV that

causes this disparity. Instead, the problem appears to lie with the way in which brokers use Fund/SERV to settle transactions without providing identifying information. By depriving transfer agents of the information they need to provide an automated search for other accounts that could be aggregated to qualify for a breakpoint, this method of settling transactions removes what is obviously an important backup within the system.

We are encouraged by the fact that the Commission has continued to press this issue and has established a task force to develop solutions. Given the damage resulting from use of omnibus accounts in this area, as well as in preventing detection of excessive and late trading, we believe it is imperative that the Commission act to end this practice. In the meantime, broker-dealers who rely on omnibus accounts and other methods of settling their transactions without providing identifying information should be required to show that their method is just as accurate as other methods that do provide identifying information. If they cannot show comparable compliance, they should be forced to start providing identifying information when settling mutual fund transactions until they can demonstrate that they have fixed any shortcomings in their system.

Another shortcoming of the task force report is that it does not analyze what sets apart the two firms that had perfect records in providing breakpoint discounts. Looking at the practices used by firms with the best record of success could provide additional suggestions for reform. Because the report does not provide that analysis, however, it is impossible to know whether those practices are reflected in the report's recommendations.

The ability of mutual fund investors to obtain the discounts to which they are entitled is a fundamental right. Sloppy procedures, the inherent complexity of the discount programs, and growing use of omnibus accounts have worked together to produce a system that routinely fails to live up to its responsibility in this area. The Commission and the NASD are to be congratulated for uncovering this problem and adopting a multi-faceted approach to solving it. This rule proposal is a relatively minor, but nonetheless, useful component of that broader reform effort. We support its adoption. But we also believe more must be done, particularly to address problems related to effective settlement of mutual fund transactions. We look forward to working with you to achieve those reforms.

Respectfully submitted,

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cc: William H. Donaldson, Cynthia A. Glassman, Harvey J. Goldschmid, Paul S. Atkins, Roel C. Campos