THE IMPACT OF THE DISTRIBUTION CHANNELS USED BY MUTUAL FUNDS ON ABANDONED PROPERTY REPORTING OBLIGATIONS

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THE IMPACT OF THE DISTRIBUTION CHANNELS USED BY MUTUAL FUNDS ON ABANDONED PROPERTY REPORTING OBLIGATIONS

HOW ARE MUTUAL FUNDS SOLD TO THE PUBLIC?

From 1980 through 2012, the number of mutual fund investor accounts grew from slightly over 12 million to over 264 million. During this period, the industry also experienced significant growth in the percentage of these accounts that are maintained by entity other than the mutual fund company. As of 2012, 72% of mutual-fund owning households held their mutual fund shares through an employer-sponsored retirement plan. Of those households that hold shares outside of an employer-sponsored plan, 82% held funds purchased with the help of a financial professional. Unlike in 1980, when mutual funds were typically only offered through two distribution channels – the fund itself or a broker-dealer – today they are offered through several distribution channels – including employer-sponsored retirements plans – each of which may involve thousands of intermediaries. These distribution channels include:

- **Financial Advisors** – this distribution channel includes broker-dealers, investment advisers, and private money managers. There are currently 4300 broker-dealers registered under the Securities Exchange Act of 1934, with over 161,000 branch offices, and 630,000 registered representatives. In 2013, there were approximately 11,000 investment advisers registered with the U.S. Securities and Exchange Commission;

- **Defined Contribution Retirement Plans** – this distribution channel consists of 401(k) and 403(b) plans and similar types of retirement accounts;

- **Direct** – the direct channel, which continues to exist, enables investors to purchase fund shares directly from the mutual fund issuer. Note, however, that not all mutual funds provide this option to investors – some require that shares be purchased through an authorized intermediary; and

- **Discount Brokers or Fund Supermarkets** – this distribution channel is comprised of firms typically registered as broker-dealers with a business model that is different from a traditional broker-dealer. While a tradition broker-dealer may offer the funds of a limited number of mutual fund families for sale, a discount broker or supermarket typically offers hundreds of funds from a variety of different fund families for sale. Also, unlike the tradition broker-dealer, however, these firms do not provide financial advice or recommend particular funds to investors.

WHO MAINTAINS MUTUAL FUND SHAREHOLDER ACCOUNT RECORDS?

Pursuant to federal law, mutual funds (or their transfer agents) must maintain records relating to their shareholders and their accounts. These records include, among others, the information obtained from an investor to open the account, records of any purchases, sales or other transactions involving fund shares, any interest or dividends paid to investors, and tax documents. The responsibility for maintaining these records depends upon how the shares are sold to the ultimate beneficial owner. It is for this reason that an understanding of the above-listed distribution channels is necessary. Today, most fund shares are sold in a channel other than the Direct Channel. This is significant because, *it is only in the Direct Channel that the mutual fund company has a direct relationship with the investor.* In all other channels, the fund's relationship *may be* with the investor but, more likely than not, is with an intermediary that has a relationship with the investor. As such, the fund company *may not even know the identity of the beneficial owner of its shares.* Indeed, if an investor owns mutual fund shares through an employer-sponsored plan, the fund would likely know the name of the plan, but not the names of the plan's participants. The following pages discuss and illustrate (1) how various distribution channels impact the name of the shareholder who appears on the fund's records as the fund's shareholder and (2) how such records, in turn, impact the ability of mutual fundsto report abandoned property. A few notes about the following illustrations:

- They are hypothetical illustrations of how basic transactions work in each of the distribution channels. The reality of, and legal requirements associated with, particular transactions can be far more complicated.

- While each of the models is illustrated separately, it is important to note that one mutual fund complex may be accommodating all of the different models at the same time. In other words, after reviewing each of these models separately, you might picture a combined model where each of these individual models overlap such that you have a fund company that is selling shares simultaneously through financial advisors, retirement plan administrators, fund supermarkets, and discount brokers, as well as directly. In such instance, it is likely that the fund would have on its books and records only information on its direct account holders (including omnibus account holders) and not individuals or institutions that hold their shares through intermediaries interacting indirectly with the fund company.

- While the following examples discuss mutual fund *shares*, they would apply equally to any proceeds associated with the account – *i.e.,* interest payments, dividend checks, etc. So, for example, a fund that does not have information on individuals who hold their account through an intermediary would be unable to

report such proceeds as abandoned property to the same extent that they could not report the mutual fund shares in the account as abandoned.

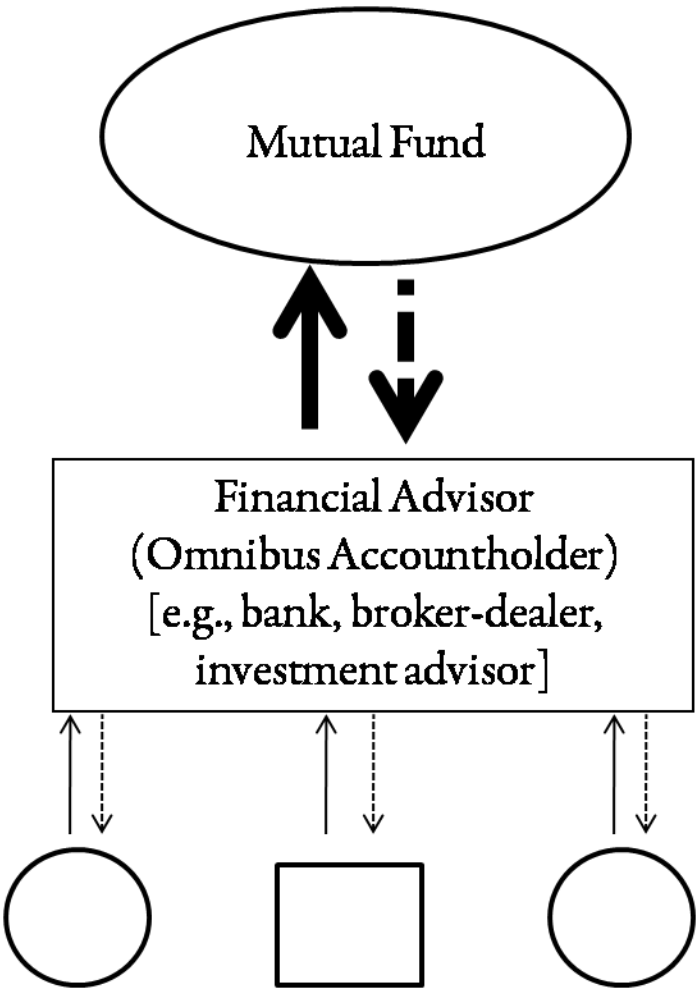
- The explanations in each of the following illustrations use the term "mutual fund" or "mutual fund complex" in their generic sense. The mutual fund is the issuer of the mutual fund securities. However, the services the fund provides to its shareholders (*e.g.,* recordkeeping, account statements, confirmations, etc.) may, in fact, be performed by one of more service providers to the mutual fund (*e.g.,* the fund's transfer agent). The following illustrations do not make this distinction and merely refer to the "fund" as providing these services.

- In the following illustrations, an unlabeled circle indicates an individual shareholder. An unlabeled box indicates an institutional shareholder. Also, the illustrations treat those institutional shareholders that interact directly with the mutual fund company as an omnibus account, because either the omnibus account holder has bundled trades of several investors into one aggregate trade and placed the one aggregate trade with the mutual fund or the institutional account holder has effected trades in its account for one or more individuals who are not identified to the mutual fund. (Not all institutions are, in fact, omnibus accounts. Instead, an institution could be trading for its own account. In our illustrations, such institutions would be akin to an individual investor.) With omnibus transactions that involve bundled trades, the omnibus account would likely net all of its shareholders' individual transactions prior to making a trade with the mutual fund. So, for example, if its bundling consisted of total purchase orders for 1000 shares on behalf of some of its clients and total redemptions of 250 shares for its other clients, it would place one order with the mutual fund to purchase 750 shares. In its records, the omnibus account holder would allocate the shares it holds for its customers into their respective accounts pursuant to their transaction orders. The fund's books and records would merely show one sale of 750 shares to the omnibus accountholder.

- In the following illustrations, a thin line indicates a discrete transaction (*i.e.,* the transaction of a single customer); a thick line indicates aggregate transactions (*i.e.,* the bundling of individual transactions by an omnibus account holder into one transaction as discussed above). A solid line (thin or thick) represents purchase proceeds; a broken line indicates fund shares sold to the investor.

THE FINANCIAL ADVISOR MODEL

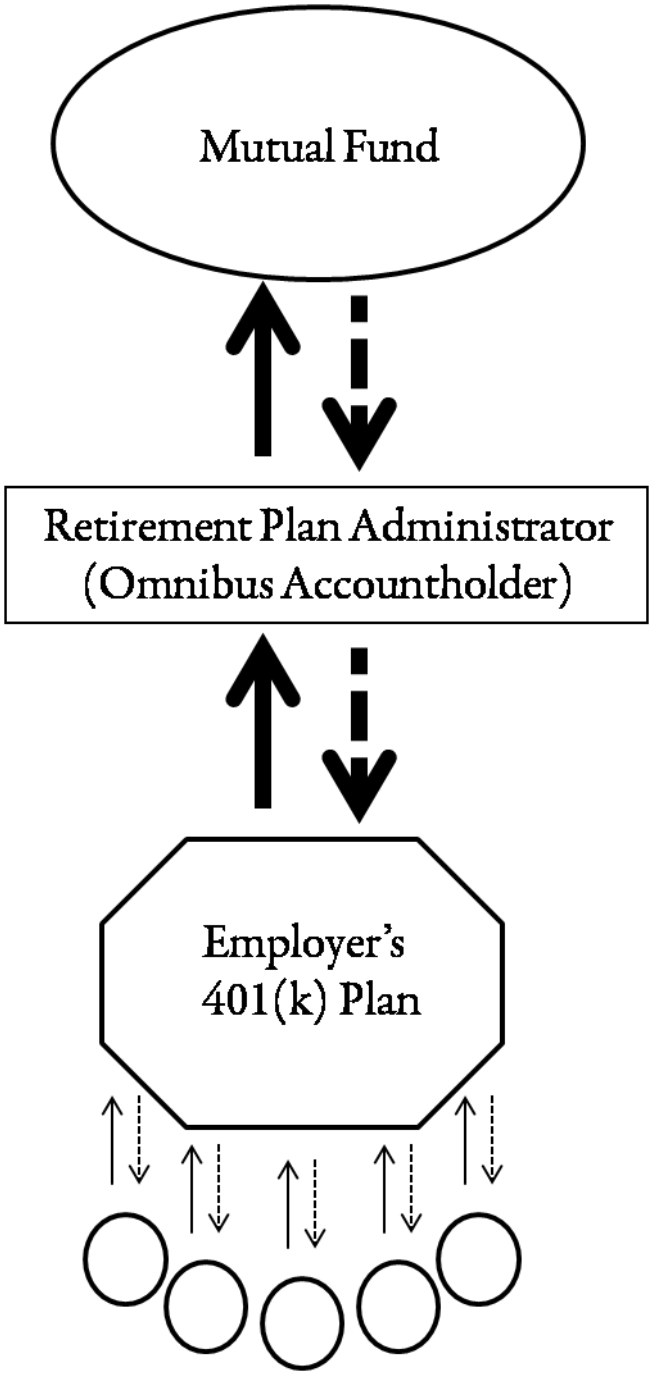
With this model, rather than interacting with the mutual fund company directly, investors interact with it via a Financial Advisor such as a bank, broker-dealer, or investment advisor. Rather than holding accounts with the mutual fund, customers of the Financial Advisor open an account with the Financial Advisor and it is the Financial Advisor that is legally responsible for collecting and maintaining all required information on such customers. The Financial Advisor is also responsible for providing customer support services such as confirmations, account statements, annual reports, prospectuses, etc. If the customer has a question about its account, it contacts the Financial Advisor rather than the fund company since it is the Advisor that would have all relevant records. These customers could be either individuals or institutions. When the customer wants to buy or sell mutual fund shares in its account at the Financial Advisory, it contacts the Financial Advisor who places the trade through the Advisor's account with the mutual fund company. According, rather than placing the trade in the investor's name, the trade is placed in the Financial Advisor's name and, on the fund's books and records, the trade appears as a sale to the Financial Advisor. The fund is not provided, does not have, and may not be legally entitled to the underlying information on each of the investors who are fund shareholders through the Financial Advisor. Instead, it is the Financial Advisor that has this information. This mechanics of this model are as follows:



Abandoned Property Considerations: As noted above, in the Financial Advisor model, the mutual fund does not have information on the ultimate beneficial owners of its shares (*i.e.,* the customers of the Financial Advisor). Instead, its records list the Financial Advisor as the mutual fund's shareholder. If any of the Financial Advisor's customers become a "lost shareholder," the fund would be unaware of this. As such, the mutual fund would not be responsible for notifying state or federal officials about such lost shareholders. Instead, this responsibility would fall to the Financial Advisor. (Of course if the Financial Advisor became a "lost shareholder," the mutual fund would have reporting responsibility.) Also note that, a customer of a Financial Intermediary who becomes a "lost shareholder" may likely own property (*e.g.,* stocks or bonds) in addition to its mutual fund shares in its account at the Financial Advisor. The Financial Advisor would be required to treat its customer as a "lost shareholder" for all such property held – not just the customer's mutual fund shares.

THE DEFINED CONTRIBUTION RETIREMENT PLAN MODEL

This model describes the relationship between participants in an employer-sponsored benefit plan, such as a 401(k) or 403(b) plan, and the mutual funds that are offered as investment choices as part of the plan. With this model, rather than interacting with the mutual fund company directly, investors interact with it via the employee benefit plan. Rather than administering the plan itself, the employer will likely enter into a relationship with a Plan Administrator. Working with the employer, the Plan Administrator selects a menu of mutual funds or other investments that will be offered by the plan. Employees of the employer typically invest in the investment options they select through payroll deductions. These deductions (*i.e.,* the employees' contribution to the plan) are aggregated by the Plan Administrator and used to purchase – in the name of the Plan – shares in the mutual funds being offered. Like the Financial Advisor in the previous model, the Plan Administrator is responsible for opening and maintaining the participants' accounts and providing customer support services such as account statements, informational materials and seminars, and other similar services. (Note that, unlike shares purchased through other models, pursuant to ERISA, investors in retirement plans are not required to be provided confirmations of each transaction nor prospectuses of the mutual funds they invest in). If an employee participating in the plan has a question about his or her account, it contacts the Plan Administrator rather than the employer or fund company, since it is the Plan Administrator that would have all relevant records and information. Mutual fund transactions in an employee's plan account are effected with the mutual fund company through the Plan Administrator's account with the mutual fund. On the fund's books and records, such trades would appear as a sale to the Plan Administrator rather than to any individual plan participant. With this model, the fund does not have the underlying information on each of the plan participants who are fund shareholders through the plan or through the Plan Administrator's account. Instead, it is the Plan Administrator that has this information. This model operates very similarly to the Financial Advisor model. The key difference between the two is that the intermediary interacting with the mutual fund is the Plan Administrator and it is the employer, not the plan participants, who select the intermediary. Also, likely the Plan Administrator may not provide customer services (investment adviser, branch office locations, etc.) that are provided by Financial Advisory intermediaries. This mechanics of this model are as follows:

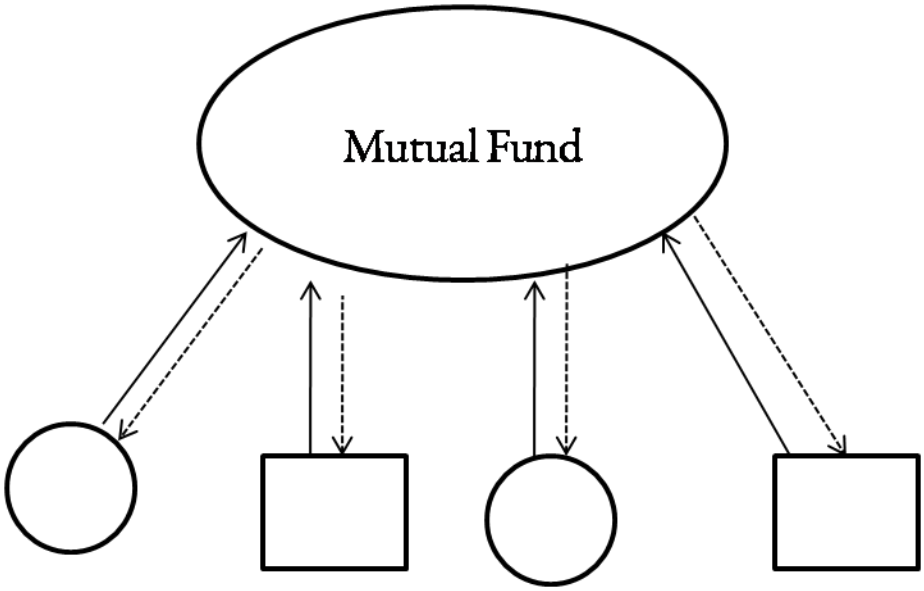


Employees Participating in the Plan

Abandoned Property Considerations: As noted above, in the Defined Contribution Retirement Plan model, the mutual fund does not have information on the individuals who are participating in the employer's retirement benefit plan and who own their shares through the plan. Instead, the mutual fund's records list the Plan Administrator as the mutual fund's shareholder. If any of plan participants become a "lost shareholder," the fund would be unaware of this. Because of this, the mutual fund would not be responsible for notifying state or federal officials about such lost shareholders. Instead, this responsibility would fall to the Plan Administrator. (Of course if the Plan Administrator became a "lost shareholder," the mutual fund would have reporting responsibility.) However, there is an important caveat that distinguishes the abandoned property considerations of this model from all other models. Unlike the other models discussed in this paper, the provisions of the Employee Retirement Securities Act of 1974 ("ERISA") impose very specific duties and responsibilities on those employers that establish retirement plans. Importantly, to ensure the nationwide uniform treatment of retirement plans subject to ERISA, ERISA preempts state laws – including any provisions of state law relating to abandoned property. Accordingly, while this model illustrates the limited information available to a mutual fund, it is likely that, pursuant to ERISA's preemption of state law, the person(s) with full access to the account holders' information would have no duties under state law to report any abandoned ERISA accounts. Indeed, in Advisory Opinion 94-41A (1994), the U.S. Department of Labor ("DOL"), which oversees ERISA's implementation, concluded that state escheatment laws are preempted by ERISA. Notwithstanding this, in 2004, the DOL permitted plan fiduciaries to *voluntarily* transfer a missing participant's account to a state unclaimed property fund as a legitimate way to dispose of the account. (*See* Field Assistance Bulletin 2004-2.) However, under ERISA, states may not compel plan fiduciaries to comply with any provisions of their unclaimed property law.

THE DIRECT MODEL

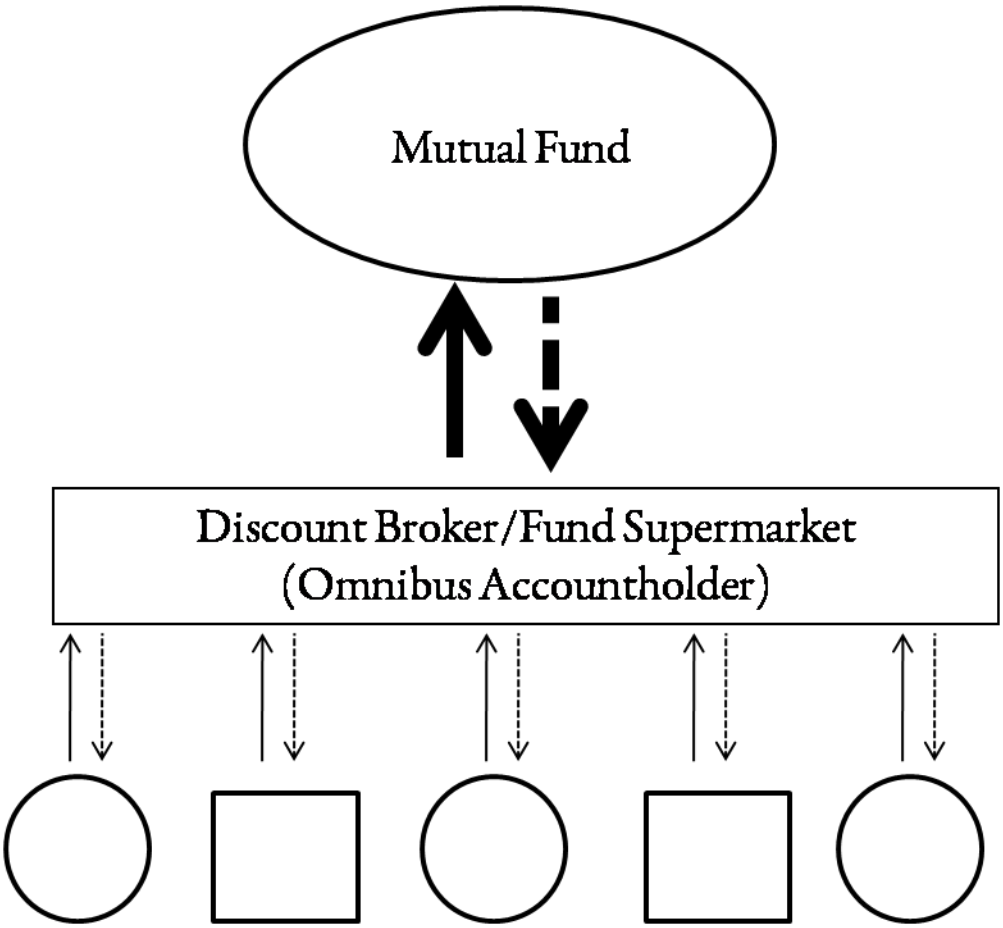
Unlike the previous examples, in this model the mutual fund has a direct relationship with each of its shareholders. It opens and maintains each of their shareholders' accounts and is responsible for interacting with the shareholder about the account. So, for example, the mutual fund is responsible for collecting all required information on the customer when the account is opened and maintaining this information. The mutual fund is also responsible for providing customer support services such as confirmations, account statements, annual reports, prospectuses, etc. If the customer has a question about its account, it contacts the mutual fund for answers or assistance since it is the mutual fund that has all relevant records. These customers could be either individuals or institutions and the accounts could be investment accounts or accounts with special tax treatment such as IRA and Roth IRA accounts. When the customer wants to buy or sell mutual fund shares, its places it trade directly with the mutual fund company and the fund maintains information on all such transactions on its books and records. In other words, unlike the other models, in this model, the fund has the detailed information on each of its direct shareholders. This mechanics of this model are as follows:



Abandoned Property Considerations: Unlike the other models, in the Direct model, the fund interacts directly with each of its shareholders and maintains required information about them and their transactions. Consequently, if any of its shareholders become a "lost shareholder," the fund would be aware of this and would have responsibility for trying to find the shareholder. If the shareholder cannot be found, the mutual fund would be responsible for reporting this to state and federal officials and escheating any property at the appropriate time.

THE DISCOUNT BROKER/FUND SUPERMARKET MODEL

This model is very similar to the Financial Advisor model. The key difference between the two is the identity of the intermediary that interacts with the mutual fund on behalf of its customers. With the Financial Advisor model, this intermediary might be a full-service broker-dealer, a bank, or an investment adviser. With the Discount Broker/Fund Supermarket model the intermediary is either a Discount Broker-Dealer or a Fund Supermarket. [Generally speaking, a Discount Broker is a broker-dealer that executes transactions for lower fees than a full-service broker-dealer and that provides fewer services (*e.g.,* no or less research or advice) to customers. A Fund Supermarket is a broker-dealer that provides access to a variety of mutual funds from a variety of mutual fund families. The benefit of a supermarket, in addition to perhaps lower fees, is that it enables investors to buy funds from many different complexes and receive information about the variety of their holdings on a single report.] As with the Financial Advisor model, with the Discount Broker/Fund Supermarket model, rather than interacting with the mutual fund company directly, investors interact with it via the Discount Broker or Fund Supermarket. Indeed, the investor is a customer of the Discount Broker or Supermarket and it is this entity that is responsible for collecting all required information on the customer and maintaining it. The Discount Broker/Fund Supermarket is also responsible for providing customer support services such as confirmations, account statements, annual reports, prospectuses, etc. If the customer has a question about its account, it contacts the Discount Broker/Fund Supermarket rather than the fund company since it is the entity that would have all relevant records. [Note that, as with the other models, the customer of the Discount Broker or Fund Supermarket could be either individuals or institutions.] When the customer wants to buy or sell mutual fund shares, it contacts the Discount Broker/Fund Supermarket, which, in turn, places the trade through its account with the mutual fund company. Rather than placing the trade in the investor's name, the trade is placed in the name of the Discount Broker/Fund Supermarket and, on the fund's books and records, the trade appears as a sale to the Discount Broker or Fund Supermarket. As such, the fund does not have the underlying information on each of the investors who are fund shareholders through these entities – the Discount Broker or Fund Supermarket has this information. This mechanics of this model are as follows:



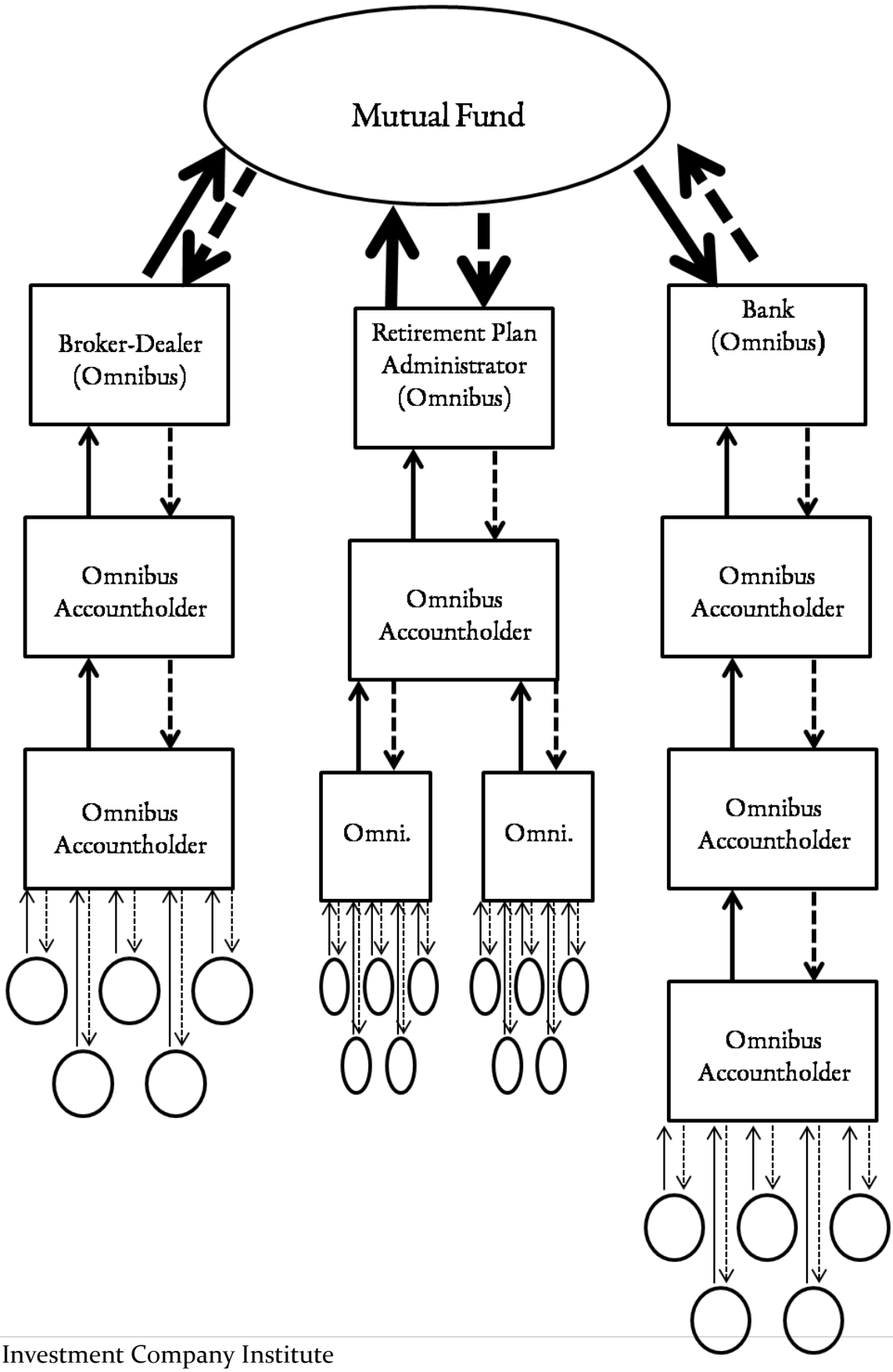
Abandoned Property Considerations: As noted above, in the Discount Broker/Fund Supermarket model, the mutual fund does not have information on the ultimate beneficial owners of its shares (*i.e.,* the customers of the Discount Broker or Fund Supermarket). Instead, its records list the Discount Broker or the Fund Supermarket as the mutual fund's shareholder. If any customer of the Discount Broker or Fund Supermarket becomes a "lost shareholder," the fund would be unaware of this. As such, the mutual fund would not be responsible for notifying state or federal officials about such lost shareholders. Instead, this responsibility would fall to the Discount Broker or

Fund Supermarket. (Of course if the Discount Broker or Fund Supermarket became a "lost shareholder," the mutual fund would have reporting responsibility.)

CHAINS OF INTERMEDIARIES

With the exception of the Direct Model, each of the above illustrations portrayed situations in which the investor interacted with the mutual fund through a single intermediary. In reality, there can be chains of intermediaries in which the ultimate beneficial owner of the shares is many steps removed from the mutual fund. In these situations, the fund's books and records would record the account of the intermediary interacting with the fund directly. Like the mutual fund, the intermediary directly interacting with the fund may not know the identity of the ultimate beneficial owner of the shares. Instead, its records would likely only contain the name of the intermediary with which it directly interacts – and so on down the chain. In these instances the only intermediary with the detailed information about the ultimate beneficial owner of the shares may be the intermediary at the end of the chain that is interacting directly with the shareholder. A chain of intermediaries could occur with any of the illustrated models – including the direct model. A graphic illustration of a chain of intermediaries appears on the next page.

It bears noting that chains of intermediaries are common. An example of a chain might be an account held by a government entity, such as a Teachers Retirement Fund. The Retirement Fund hires a plan administrator to manage its account and handle all administrative services for the Retirement Fund, including maintaining all Retirement Fund records and managing it. The plan administrator, in turn, might establish an account at a bank that will act as custodian for the Retirement Fund and hold all employees' plan contributions. The Retirement Fund might also enter into an agreement with a retirement plan adviser to help it decide which mutual funds to offer to the Retirement Fund's participants. The retirement plan adviser likely has a relationship with a broker-dealer, which will be responsible for effecting all transactions on behalf of the Retirement Fund. The broker-dealer will establish an account at one or more mutual funds in order to effect transactions on behalf of the Retirement Fund. In this example of a chain, the mutual fund would only know the identity of the broker-dealer that opens an account with the mutual fund to effects transactions on behalf of the Retirement Plan's participants. [The broker-dealer, in turn, may hold an account in the name of the retirement plan advisor, rather than the Retirement Fund.] The mutual fund may be 4 or 5 steps removed from the Retirement Fund's participants, who would be the ultimate beneficial owners of the shares purchased by the Retirement Fund.


Mutual Fund
Broker-Dealer (Omnibus)
Retirement Plan Administrator (Omnibus)
Bank (Omnibus)
Omnibus Accountholder
Omnibus Accountholder
Omnibus Accountholder
Omnibus Accountholder
Omni.
Omni.
Omnibus Accountholder
Omnibus Accountholder

Abandoned Property Considerations: As with the other models, with the Chain of Intermediaries Model, only the entity that knows the customer's identity (*i.e.,* likely the last link in the intermediary chain that interacts with the customer directly) would be in a position to know when a shareholder becomes lost. This entity would be responsible to report the lost shareholder to state or federal officials and to escheat the shareholder's account as and when required by law.