Mutual Fund Directors Digest

The Omnibus Revolution: Managing risks and challenges associated with an increasingly complex service model

Background

In the past, virtually all shareholder services, such as maintaining shareholder account information and processing purchase and redemption orders, were provided by fund transfer agents. This has changed as more funds have been sold through intermediary channels, including by broker/dealers and retirement plans. Today, depending on the fund family, the primary point of shareholder services may have transitioned from the funds' transfer agent to mostly unaffiliated intermediaries.

Many funds are attracted to and use intermediaries as important distribution partners in fund asset growth. Intermediaries also increasingly provide shareholder services through sub-accounting systems as part of an "omnibus" account model. In this structure, an intermediary maintains account information and transaction histories directly for its customers who are fund shareholders; the intermediary then aggregates and often nets its customers' purchase and redemption transactions as it places trade orders through one or more omnibus positions maintained at the funds' transfer agent. For intermediaries, the advantages of this structure generally include an intermediary's ability to maintain direct control of its customer relationships. Intermediaries also usually receive fee income for providing shareholder services in addition to compensation for fund distribution.

Issues for Directors to consider

The shift to intermediary sub-accounting and the resulting proliferation of different intermediaries providing shareholder services has impacted the fund industry in a number of ways, including changes in economic models and more fragmented service structures. These developments underscore the need for enhanced oversight processes to monitor intermediary services and related compensation while also managing potential regulatory and other risks.

For Directors, intermediary relationships typically warrant periodic discussion with fund management. Specifically, two key questions arise relating to how the risks associated with intermediary sub-accounting are being managed: What oversight is in place relative to the services provided by intermediaries, and what oversight is in place regarding the amount and nature of the fees being paid to intermediaries?

- **Services:** Given a potentially large, diverse and expanding group of intermediaries, there may be challenges associated with monitoring the specific services being performed by each intermediary to ensure that regulatory requirements and contractual obligations are being met
- **Fees:** Because intermediaries may provide both distribution and shareholder services, it may be difficult to differentiate the respective distribution and shareholder service components of fees paid to intermediaries. In addition, as more and more intermediaries collect fees for shareholder services, aggregate fees paid to intermediaries for shareholder services may begin to eclipse the costs associated with the funds' traditional transfer agent's overall service costs

An evaluation of the funds' oversight framework as well as other applicable considerations will allow for enhancements, as appropriate, to mitigate potential risks that could result in financial, regulatory or reputational harm.

Conclusion

Additional details regarding intermediary sub-accounting, can be found in our recent publication "The Omnibus Revolution".

As oversight practices continue to evolve, Directors may want to ask fund management if it has adequately responded to the shift to intermediary sub-accounting. Specific questions that Directors may wish to consider include:

- Are the services that each intermediary has been contracted to perform clearly defined and understood?
- Is the same true of the fees paid to each intermediary, particularly in terms of the respective distribution and shareholder services components?
- Have fund management's oversight responsibilities been clearly defined, assigned and documented for monitoring the services performed by and fees paid to intermediaries?
- How does management know that intermediary interactions with fund shareholders are consistent with prospectus disclosures (e.g., applicable sales charges and breakpoints)? Is the oversight approach that is being applied risk-based given different intermediary types and relationships, and has the oversight approach been integrated into the enterprise-wide risk management program?
- Has the role, duties of and fees paid to the funds' transfer agent been revisited lately?
- Are the funds paying higher shareholder service fees to intermediaries than they are to the transfer agent for the same services and, if so, can the difference be justified?
- Is there an opportunity to enhance the content or timing of existing Board reporting regarding intermediary relationships?

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