

FINANCIAL INTERMEDIARY OVERSIGHT

Detailed Findings from Boston Financial's 2015
Financial Intermediary Administration Survey



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INTRODUCTION

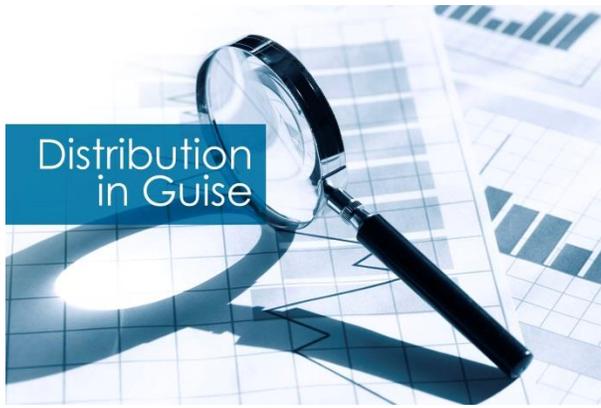
The 2015 Financial Intermediary Administration (FIA) Survey gathered information about current trends and industry best practices relative to financial intermediary oversight. Key findings were as follows:

- Nearly all participants cited Legal/Regulatory Risk relative to intermediary based shareholder activity. Financial Risk and Reputational Risk were higher than in 2014
- Intermediary oversight programs tend to be staffed with existing resources
- Fund Boards are still very focused on intermediary oversight programs
- Fund's evaluation of Sub-TA fees has evolved

Survey participants represented over \$3.7 trillion in assets under management or 23% of total industry assets of \$15.8 trillion.

Based on ICI assets under management as of 12/31/14

The findings on risk and evaluation of Sub-TA fees can likely be attributed to the “distribution in guise” exams conducted by the SEC in 2013 and 2014 that resulted in recommendations for enforcement actions against some advisors. This activity has caused some industry concerns about the SEC “regulating by enforcement” rather than through a rule making process with opportunities for industry comment prior to finalization of the rule. We saw this sentiment expressed very clearly in the survey results when we asked about major concerns and challenges regarding intermediary oversight.



Comments included “SEC rule making through enforcement,” “direction, or lack thereof, from regulatory bodies” and “uncertain regulatory landscape.”

So what exactly is this “distribution in guise” issue? Simply, funds are prohibited from paying for distribution or sales efforts. The sole exception is where the fund board has implemented a plan to pay distribution fees from fund assets under Rule 12b-1. The 12b-1 plan must be reviewed and approved by the fund directors on an annual basis and sets limits on the amount of fees that the fund will pay. The SEC wants to make sure that any fees paid for distribution are only paid through the board approved 12b-1 plan.

However, we have an environment where many intermediaries have taken over the duties that used to be performed by the fund's transfer agent. In this model, the intermediary does all shareholder processing, recordkeeping, periodic statement generation, tax reporting, etc. Many intermediaries charge the fund a fee to compensate for these additional duties. These fees are called by many different names but can be referred to generically as “Sub-TA” fees. The regulatory basis for these fees goes back to the SEC's “Supermarket Letter” from 1998. However, there are several points in the letter that touch on our current “distribution in guise” issue.

The SEC said that the primary reason a fund would choose to participate in a fund supermarket is for distribution. As a result, the SEC concludes that some portion of the fee paid to the fund supermarket must be for distribution services and that any portion of the fee that is for distribution services can only be paid under the board-approved 12b-1 plan. The SEC makes the fund's board of directors responsible for determining what portion of the fee is for distribution and what portion is for servicing activities. Therefore the board has to decide on one of three options:

- All of the fee is for distribution services and can only be paid by the fund up to the limits of the fund's 12b-1 plan
- None of the fees are for distribution related services and the entire amount can be paid by the fund for service related activities
- A portion of the fee is for distribution and a portion of the fee is for service related activities so the fee is shared between the fund and the advisor

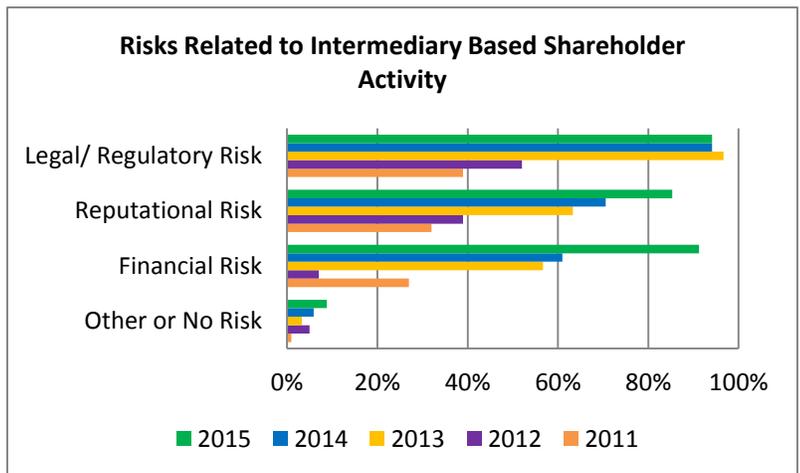
Since the fund directors are not a party to the fee negotiations, they must rely on the advisor’s management to present the facts about the fees, including quantification of the value of the services and benefits that fund shareholders derive from them. Another factor to consider is the cost of the services if provided by another entity.

While there is industry concern about “rulemaking by enforcement,” the SEC has countered that when the facts about any enforcement actions become public, the industry will see that the actions resulted from clear violations of existing regulations.

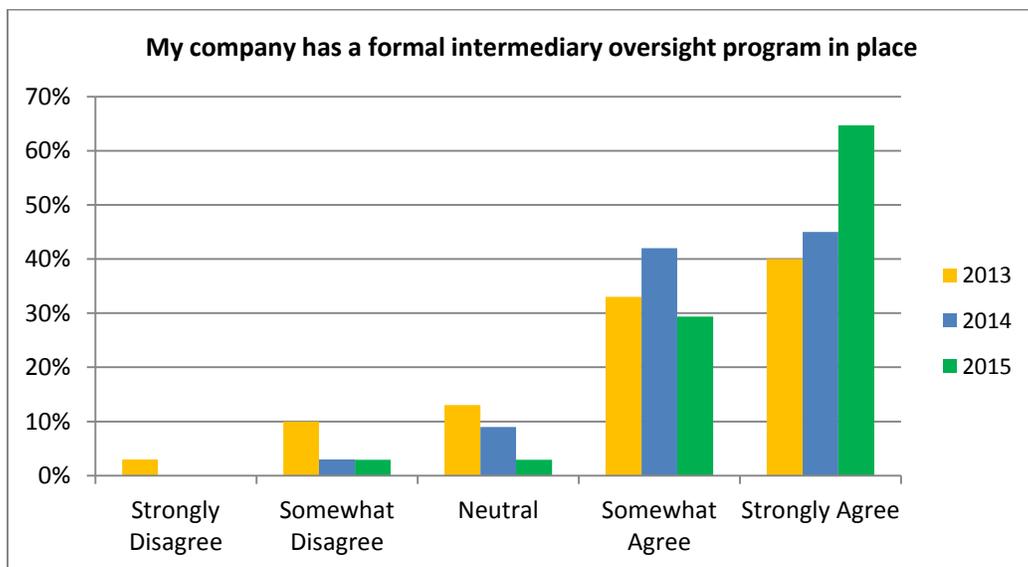
CURRENT STATE OF INTERMEDIARY OVERSIGHT

When asked about risks related to intermediary based shareholder activity, nearly all survey participants (94%) identified Legal/Regulatory Risk, consistent with what we have seen over the last three years. Financial Risk was identified by 91% of participants, up significantly from 61% last year. Reputational Risk was also up (85%) when compared to 2014 (71%). In addition, 3 out of 4 (76%) identified all three of these risks, up from 48% last year.

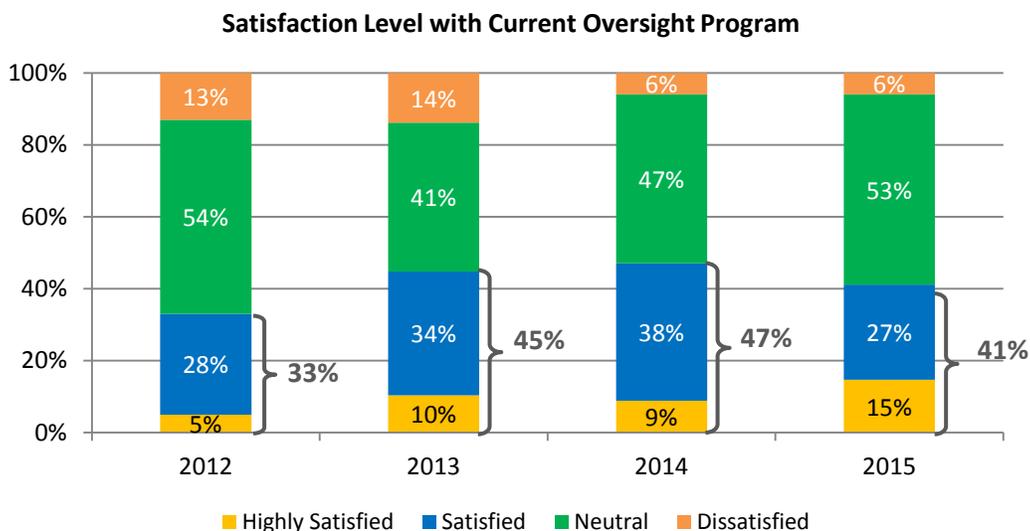
Legal/Regulatory Risk likely reflects the SEC focus on the omnibus model in general and the fees associated with it. Feedback we received about intermediary oversight concerns included *“The SEC has not detailed the requirements for Intermediary Oversight. While the industry discusses best practices, there remains a wide array of methods for addressing this area, and without specific guidance from the regulators, these practices will continue to change.”* Financial Risk can result from the increasing amounts of these fees. An enforcement action would result in both Financial and Reputational Risk.



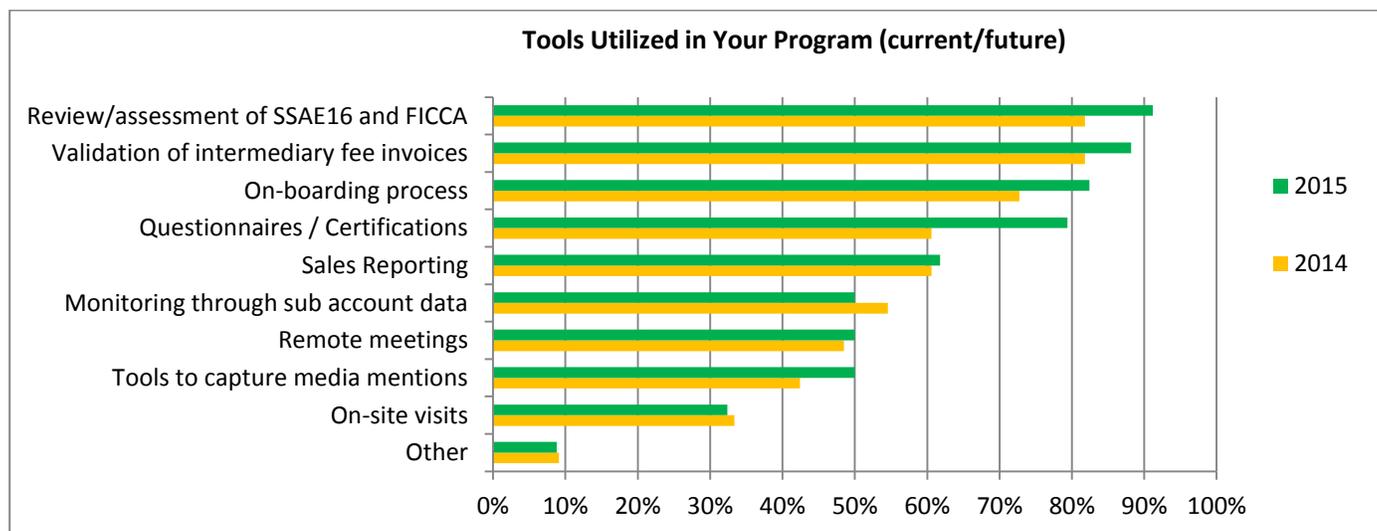
We know from our interactions with clients, that most are working at implementing and/or enhancing their intermediary oversight programs. This is reflected in the survey results with 94% of participants indicating that they have an intermediary oversight program in place. This follows the progression that we have seen over the last three years (87% in 2014, 73% in 2013). An analysis of results by assets under management (AUM) demonstrates that larger fund companies are further along than small organizations. All participants with AUM over \$25 billion have an intermediary oversight program in place. However, only 83% with \$10 to \$25 billion AUM and 80% with AUM less than \$10 billion have a program in place.



Participants who have a program in place reported satisfaction levels (41%) that were slightly lower than the 2014 survey (47%). This is a reflection of lack of clear requirements from the SEC about what funds are required to do as part of an intermediary oversight program and where the line is drawn between fund responsibilities and those that fall to the intermediary. One participant expressed concern about “*setting a precedent of doing more dealer due diligence than is necessary or appropriate.*”



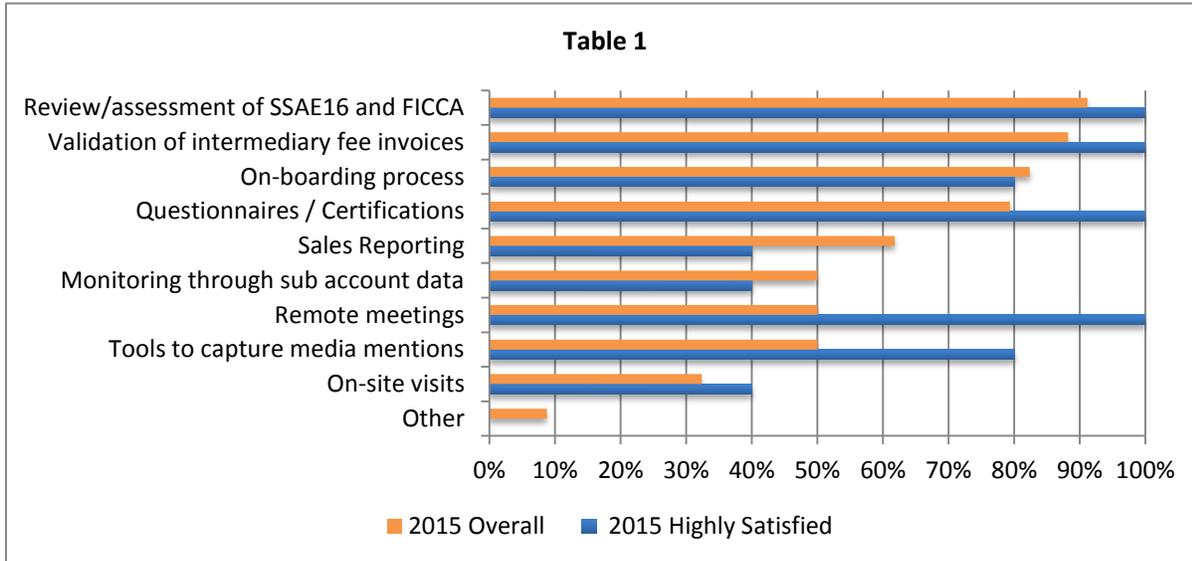
For participants who were not “highly” satisfied with their current intermediary program, we asked how they planned to enhance the program. Many mentioned more formalized processes to review FICCA and SSAE 16 reports. Others identified steps to improve intermediary cooperation, enhanced use of available data and implementing or expanding on site due diligence visits. A frequent theme was to stay on top of industry best practices as a benchmark for the current program.



The most frequently used tools in current intermediary oversight programs are review and assessment of firm’s SSAE 16 or FICCA; validation of intermediary fee invoices; on-boarding process, including intermediary evaluation; and questionnaires/certifications sent to firms. The use of all of these tools increased slightly from last year. Three interesting differences become apparent when reviewing the results by AUM. Invoice validation is used by all firms with assets of \$75 billion or more, 86% of firms with assets between \$10 billion and \$75 billion and only 60% of firms with assets less than \$10 billion. On site visits were reported by 60% of the largest (\$75 billion or more AUM) fund companies but only 10% for everyone else. Finally, tools to capture media mentions about firms were reported by 80% of participants with assets of

\$75 billion or more, 75% of those with assets between \$25 and \$75 billion, 33% of those with assets between \$10 and \$24 billion and 20% of those with assets under \$10 billion.

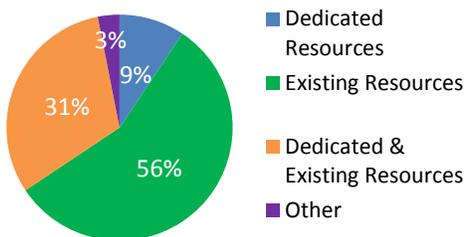
Finally, we explored characteristics of intermediary oversight programs identified as “highly” satisfied and compared them with the overall results (Table 1). All of the programs rated “highly” satisfied utilized FICCA/SSAE 16, intermediary invoice validation, questionnaires/ certifications and remote meetings (conference calls). Another interesting point was that 80% of them used tools to capture media mentions about firms versus 50% overall.



INTERMEDIARY OVERSIGHT TEAMS

This year we explored the size and makeup of intermediary oversight teams. Only 9% of participants resource their intermediary oversight team solely with dedicated resources. The most common response (56%) was that the intermediary oversight tasks are assigned to existing resources, with 31% using a combination of dedicated and existing resources. Interestingly, all of the participants that use solely dedicated resources have AUM of \$75 billion or more. We did not find any correlation between how the intermediary oversight program is resourced and satisfaction level with the program.

Intermediary Oversight Resources



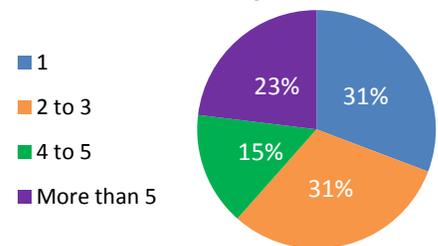
Where existing resources are used, we asked where they are located. The predominant responses were Compliance (83%) and Operations (72%). Less than half identified Dealer Services (48%), Legal (48%) and Relationship Management/ National Accounts (38%).

having just 1 to 3 resources (31% 1 resource; 31% 2 to 3 resources). 15% reported 4 to 5 resources and only 23% had teams with more than 5 resources.

Interestingly, bigger is not always better. The size of the team did not correlate to the satisfaction level with the intermediary oversight program. None of the participants who reported more than 5 resources rated their satisfaction level at either “highly satisfied” or “satisfied.”

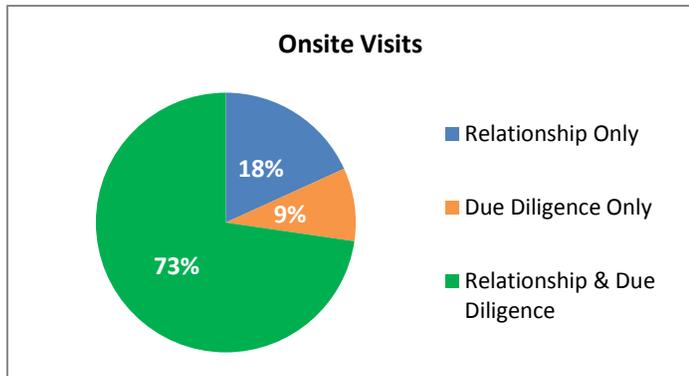
We also captured information about the size of intermediary oversight teams and found that they are relatively small. 62% reported

Size of Oversight Team



ONSITE VISITS

For participants who use onsite visits as part of their oversight program, the majority (73%) are for both relationship and due diligence purposes. Only 9% (all with AUM of \$75 billion or more) are for due diligence only, and 18% relationship only.



Those involved in the onsite visits include Dealer Services (64%), Relationship Management/National Accounts (64%), Operations (46%) and Compliance (36%).

Meeting agendas are generally developed jointly with the intermediary (78%), with agendas developed solely by the fund used to a lesser extent (44%). One third (33%) include a review of transactions or audit information provided to the intermediary firm prior to the meeting.

OMNIBUS CONVERSIONS

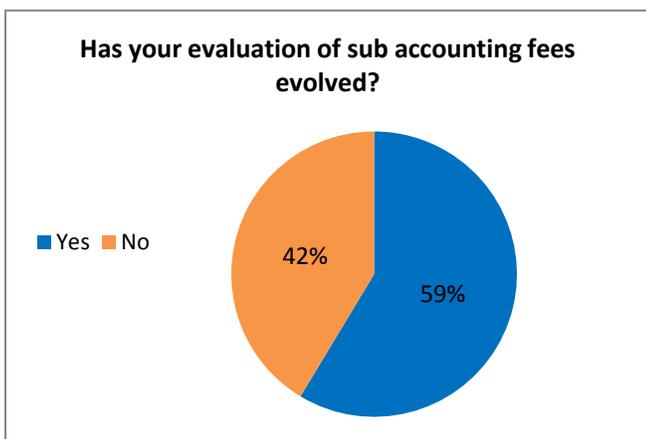
In the 2014 FIA Survey, 52% of participants indicated that they agreed to new omnibus conversions during the past year. In 2015, this was down slightly to 47%. We will continue to monitor this to gauge whether omnibus conversions are beginning to slow.

The most common condition agreed to by an intermediary firm requesting a conversion was to provide sub-account position and activity files (87%). Intermediaries frequently agreed to support the intermediary oversight program (67%) and there were often new fees associated with the business (50%). These new fees were more common for larger assets managers: 71% for \$75 billion or more AUM, 50% for AUM \$25 – 75 billion, 25% for AUM \$10-\$25 billion and 0% for AUM less than \$10 billion.

SUB ACCOUNT FEES

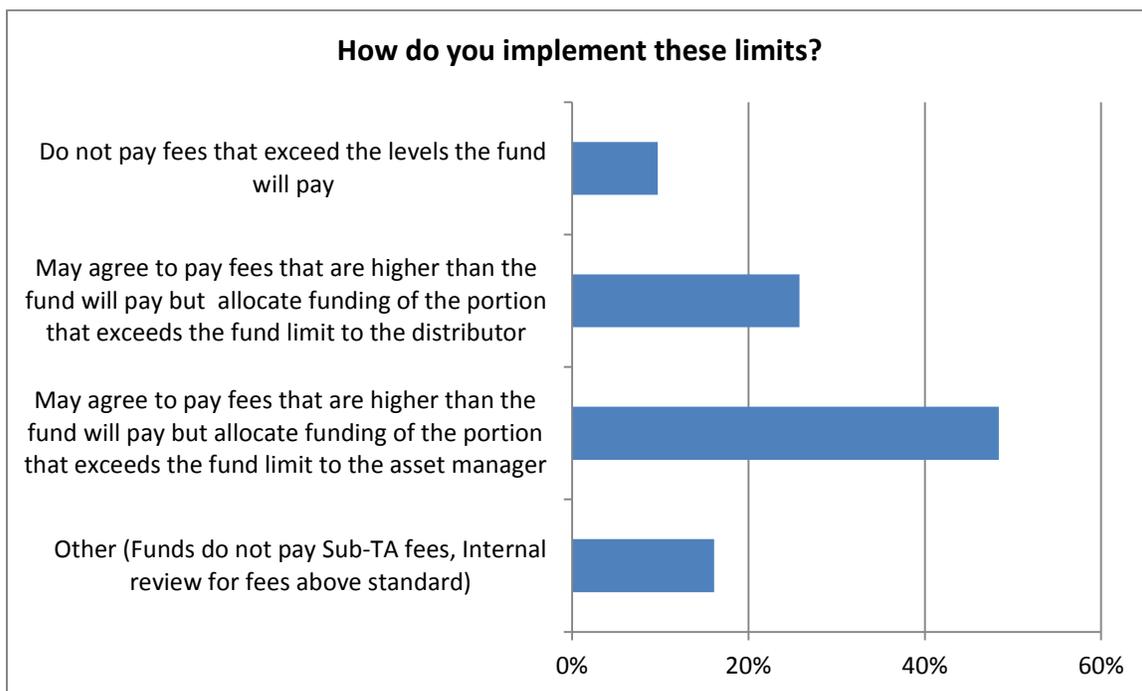
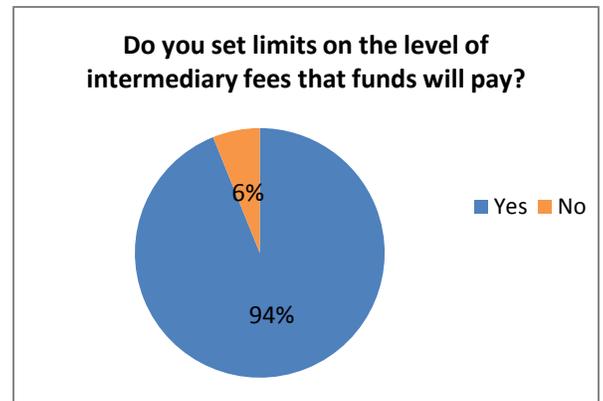
While Sub-TA fees have been in existence for a number of years, there is certainly more focus on them now than ever before. When asked if their evaluation of sub accounting fees evolved, 59% said yes. Larger asset managers have been exposed to these fees longer and to a greater extent than smaller asset managers, as reflected in the survey results. 87% of asset managers with assets of \$75 billion or more have evolved their evaluation of these fees. This drops to 62% of AUM

\$25 – 75 billion, 33% of AUM \$10-25 billion and 0% for AUM less than \$10 billion.



For those who have evolved their evaluation, it included addition of new tools, enhanced use of data, and new reporting. Several are also trying to tie fees to specific services. One participant commented: *“As the industry has evolved dramatically in recent years, so has our evaluation of sub-recordkeeping arrangement. The proportion of our business that trades in an omnibus environment today is significantly higher than 10 years ago, and as a result, there is more focus than ever on Sub-TA fees.”*

94% limit the amounts of Sub-TA fees that the funds will pay. Most (74%) indicated that they will pay fees that are higher than what the funds will pay, and allocate the portion that exceeds the fund limit to the distributor (26%) or asset manager (48%). Only 10% reported that they will not agree to a fee that exceeds the fund limits. Also, the fund limits are not typically disclosed in the fund prospectus or SAI (67%).



FUND BOARDS AND INTERMEDIARY OVERSIGHT

Fund Board focus on intermediary oversight remains consistent with results from the 2014 survey. This year, 71% reported that the fund board has increased its focus on intermediary oversight versus 70% last year. For smaller asset managers (AUM less than \$10 billion), focus is less (40% in 2015, 50% in 2014).

Fund board information requests and questions are frequently about intermediary fees and the connection to the SEC exam activity is evident. Examples include:

- *“information on fees and services performed for those fees”*
- *“additional information on reasonableness of fees”*
- *“deeper analysis of Sub TA fees and allocation methods”*
- *“additional education to the board surrounding distribution, Sub-TA and marketing support payments”*
- *“how to analyze distribution in guise”*

Others indicated that they provide regular updates to the boards:

- *“Semi-annual updates on our overall program accomplishments”*
- *“results of our due diligence”*
- *“provide periodic updates to the board on core components of our omnibus oversight program”*
- *“full review of our oversight program”*

Two comments highlight what may be the next challenge for intermediary oversight programs. Once a determination has been made that some or the entire fee is for service related activities, fund boards may want some assurance that those services are being performed by the intermediary.

- *“Describe the process . . . in place to monitor services being performed by intermediaries”*
- *“. . . how can we validate that the intermediary is actually performing the services outlined in our contracts”*

OTHER CHALLENGES

We received numerous comments that further highlight some of the challenges being faced relative to intermediary oversight.

- Intermediary cooperation
 - *“responsiveness of intermediaries to get what we want”; “willingness of intermediaries to provide requested information”*
 - *“[intermediary] business engagement”*
 - *“situations where intermediary partners refuse to cooperate with requests because they see them as going too far”*
 - *“we still, as a small fund complex, have little or no leverage with the financial intermediaries”*
- Resources and expense
 - *“scalability”; “resources to do the work”*
 - *“commit heavy resources to synthesizing data and reporting”*
 - *“cost and transparency”*
- Transparency and data
 - *“availability of data”; “intermediary transparency”*
 - *“centralized database for all materials related to program”*
- FICCA
 - *“getting bank/trust/TPA intermediaries to move to the FICCA reporting format”; “FICCA adoption at the firm level”; “inconsistent intermediary responses / acceptance of producing a FICCA”*
 - *“more widespread adoption of ICI’s FICCA by intermediary firms”*
- Intermediary fees
 - *“reconciliation of invoices”; “looking for ways to automate invoice validation”*
 - *“accurate invoicing of fees”*
 - *getting confirmation and clarity of fee breakdowns and programs from intermediaries”*

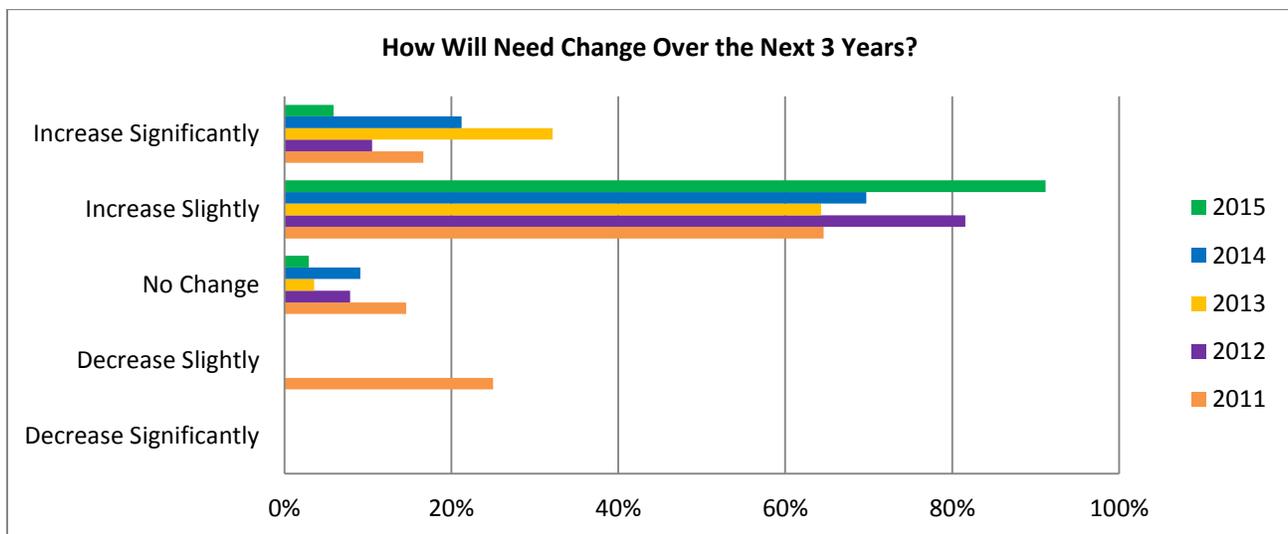
THE FUTURE OF INTERMEDIARY OVERSIGHT

Nearly all participants (97%) feel that the need for managing financial intermediary oversight will increase over the next three years, consistent with what we have seen for the last three years. However, there is a subtle shift in the sentiment. In 2015, only 6% think the need will increase significantly, compared to 21% in 2014 and 32% in 2013. SEC activity and interest was cited as the primary driver of the increase (97%), along with fund board interest (79%) and senior management interest (76%). Changes to the business model were also mentioned by 24%.

In terms of how this increased need would impact resource requirements, opinions were varied, with 38% indicating they did not expect to increase resources assigned to intermediary oversight. One commented that *“existing resources will be asked to do more.”* For those expecting increases, levels were:

- 1 to 15% (21%)
- 15-25% (33%)
- 25-50% (17%)
- Over 50% (4%)

The two tools participants most commonly plan to incorporate into their intermediary oversight program over the next year, are review and assessment of firm’s SSAE 16 or FICCA and validation of intermediary fee invoices (38%), followed by monitoring through sub-account data and questionnaires / certifications sent to firms (35%).



CONCLUSION

Intermediary oversight continues to be an area of focus across the industry. In the current environment, each fund needs to evaluate the practices and tools that are available and use those that best match their business and distribution partners. We do not believe that any one represents a perfect solution. Rather, the survey results point towards higher satisfaction with programs that use a broad array of practices and tools. We suggest whatever tools and practices you decide to use, you make sure you can articulate those decisions, document your intermediary oversight process, and provide evidence that you “do what you say you are going to do.”

To learn more about our FIA solutions, please contact: Gary Harris, (610) 608-9518, GHarris@bostonfinancial.com, or contact your Boston Financial relationship manager.

