“Managing Financial Intermediaries: Challenges & Opportunities”

Results from Boston Financial’s 2012 Financial Intermediary Administration Survey
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This year, Boston Financial conducted our second Financial Intermediary Administration Survey. Building upon the questions in our 2011 survey, we measured our mutual fund clients’ opinions on their current Financial Intermediary (FI) practices, how they interact with their FIs, and what tools they need to better manage their overall compliance and operational obligations.

The wide adoption of an omnibus recordkeeping model by FIs has increased the challenge of supervising these relationships. Generating sufficient information to manage and monitor activity remains difficult. Omnibus accounting and the maintenance of sub-accounts requires increased transparency. Fund companies and FIs alike are well-aware of the need to comply with existing regulation while also preparing for expected regulation. What is less clear, however, is how that can be done.

The key findings in this survey are:

1. **Legal/Regulatory Risk** is the most common risk that fund companies face today
2. **Regulatory Issues** and **Prospectus Compliance** are key areas where fund companies need better tools
3. **Operations teams** are now playing a more **significant role** in addressing the risks that fund companies face
4. Almost everyone expects the **need for managing Financial Intermediaries to increase** over the next three years

**Overall**

**Areas of Risk**

Assuming the industry widely accepts that the growth in omnibus/sub-accounting poses risks in monitoring activity and managing relationships, we asked survey respondents to categorize areas where such risks are most prevalent. We allowed respondents to select multiple answers so the results truly are independent of each other. Overall, most responders (82%) selected Legal/Regulatory Risk. Reputational Risk (61%) and Financial Risk (54%) followed. Other risks identified were Operational Risk, Relationship Risk and Oversight/Reporting. [Figure 1] These responses follow the same pattern as the 2011 results.

![Figure 1: “What risks are your companies facing that are related to the shift towards omnibus/sub-accounting?”](image)
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Current Practices

Results from the 2012 survey show a clear — and interesting — sentiment shift in current fund company FI practices. Respondents were asked whether their company has formal policies and procedures to oversee intermediaries. [Figure 2] Overall, 59% agree with the statement. Yet, 20% disagree that they have formal policies in place and 21% were neutral. This represents a very significant shift from 2011 when three-quarters (75%) of respondents agreed that they have policies and procedures in place and only 10% disagreed.

Why the dramatic shift? The need for FI oversight has been well-communicated and well-understood over the past few years, so why do fund companies feel less prepared? As fund companies have taken a closer look at their overall operations, previous tools and methodologies have been more closely evaluated and tested. In many cases, and as the industry has evolved, what was used in the past has been found to be insufficient to cover the necessary responsibilities. As well, many fund companies have found that they can’t obtain all the data they require. As a result, many supervisory practices lacked the depth needed for true oversight.

FI Oversight Going Forward

Almost all respondents (91%) expect the need to manage FIs will increase between now and 2015. A small number of responses indicated an expectation for no change (8%), and no one felt that the needs would decrease. [Figure 3]

While the overall sentiment is the same as 2011, there is a pronounced shift in the perceived level of increase. 2011 results were split fairly equally between “Significantly Increase” and “Increase”, but 2012 responses have overwhelmingly shifted to “Increase”. It is likely that as the FI market has begun to mature, and as awareness of the specific FI oversight issues have become more widely discussed, the needs are better understood. As well, a lack of additional SEC activity on this topic may have dampened fears about
Areas of Need

The survey measured the relative importance of four key areas: Enhanced Intermediary Relationships, Risk Management, Cost Efficiency, and Regulatory Compliance. As expected, all of these areas are important. However, their relative importance is interesting. Not surprisingly, Regulatory Compliance received the highest “Critical” rating (54%). However, Cost Efficiency obtained an even higher “Very Important” response rate (59%).

<table>
<thead>
<tr>
<th>Area</th>
<th>Unimportant</th>
<th>Slightly Unimportant</th>
<th>Important</th>
<th>Very Important</th>
<th>Critical</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enhanced Intermediary Relationships</td>
<td>0%</td>
<td>0%</td>
<td>14%</td>
<td>46%</td>
<td>41%</td>
</tr>
<tr>
<td>Risk Management</td>
<td>0%</td>
<td>3%</td>
<td>16%</td>
<td>51%</td>
<td>30%</td>
</tr>
<tr>
<td>Cost Efficiency</td>
<td>0%</td>
<td>3%</td>
<td>19%</td>
<td>59%</td>
<td>19%</td>
</tr>
<tr>
<td>Regulatory Compliance</td>
<td>0%</td>
<td>0%</td>
<td>11%</td>
<td>35%</td>
<td>54%</td>
</tr>
</tbody>
</table>

Figure 4: “My company assigns the following values (i.e. level of importance) relative to our intermediary business."

The 2011 survey asked about the need for improved tools. We modified the question this year to gain insight on where the improved tools should focus (Shareholder Servicing, Prospectus Compliance or Regulatory Issues). Sixty-two percent (62%) of responders agreed that improved tools are necessary for Regulatory Issues; 53% felt that improved tools are necessary for Prospectus Compliance. Only 38% agreed that improved tools are required for Shareholder Servicing. This selection also had the highest neutral selection (44%) and 18% disagreed that tools were needed here. Clearly, asset managers feel more accountable for regulatory and prospectus compliance.

<table>
<thead>
<tr>
<th>Area</th>
<th>Strongly Disagree</th>
<th>Somewhat Disagree</th>
<th>Neutral</th>
<th>Somewhat Agree</th>
<th>Strongly Agree</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011 Shareholder Servicing</td>
<td>0%</td>
<td>0%</td>
<td>12%</td>
<td>35%</td>
<td>54%</td>
</tr>
<tr>
<td>2012 Prospectus Compliance</td>
<td>3%</td>
<td>15%</td>
<td>44%</td>
<td>29%</td>
<td>9%</td>
</tr>
<tr>
<td>2012 Regulatory Issues</td>
<td>0%</td>
<td>12%</td>
<td>32%</td>
<td>53%</td>
<td>9%</td>
</tr>
</tbody>
</table>

Figure 5: “My company needs better tools to improve our intermediary relationship management in these areas.”

**INTERNAL ENVIRONMENT AND CURRENT PRACTICE**

Previous questions highlighted the overall management company view of their preparedness and needs as well as where the risks lie. To gain a more granular view, we asked a series of questions about who is currently responsible for intermediary oversight and what tools are being used.

**Oversight Techniques**

We allowed survey responders to select multiple responses of techniques they use for intermediary oversight. The overall results [Figure 6] are very similar to 2011, with some interesting differences. Most of the options were selected by more responders in 2012 than in 2011. This can be attributed to the fact that more management
companies have established intermediary oversight programs than in the past. Three techniques lead this increase – Questionnaires/Certifications, Conference Calls and Review SSAE16.

Figure 6: “Which types of reports or activities are used to assist your company in intermediary oversight review.”

Business Area Responsibility

Responders ranked ten business areas’ level of involvement [Figure 7] in addressing the risks related to FIs. The overall rankings are as follows:

Figure 7: “Which individuals or groups are most focused on addressing the risks to your company related to the shift towards omnibus/sub-accounting?”
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While the 2012 results are very similar to 2011, one change stands out. In 2011 the CCO was identified as the individual most focused on these risks. In 2012, Operations was identified most often.

Making a distinction between the areas most focused on the overall risks related to omnibus/sub-accounting (Figure 8), we asked what business groups were responsible for actual intermediary oversight. Similar to the results above, Operations and Compliance staff are largely charged with managing their FI relationship. The primary group identified was Operations (87%) followed by Compliance Team (76%). Tightly grouped together were National Accounts (45%), Relationship Managers (42%), Legal (34%), Distributor (32%), and Dealer Service (32%). Non-sales teams are largely responsible for supporting intermediary oversight but sales and relationship management play an active role.

![Figure 8: “The primary individuals or groups that support the activities outlined . . . are:”](image)

Level of Engagement with FIs

Engagement with FIs is a time-consuming responsibility. Customers overwhelmingly interact with their key intermediaries on a daily basis (67%) with some interacting weekly (14%), monthly (9%) or quarterly (9%). This represents a dramatic shift from 2011 when only 12% reported regular or frequent meetings and 28% noted that meetings are occasional.

Telephone and e-mail are the predominant communication methods, favored by 95% of responders. Face-to-face interaction is used by 74% of responders, with questionnaires and surveys used by 52%. Other methods identified included mail, internet portals/websites, NSCC and DST Vision®.

While more frequent interaction with FIs is a common theme, the types of communication highlight potential risks. E-mail captures information electronically, but doesn't provide a structured way to aggregate data for sharing and broader evaluation. Without centralized databases as common sources of information, data can be inconsistent and inadequate for oversight. Even though the majority of responders (94%) use sales reporting/CRM systems as part of their oversight process, inconsistency risks are present. These systems are adequate for asset management sales groups, but are not widely used by operations teams. As such, contacts and data are not always updated — or relevant. As well, the teams frequently doing FI operational oversight do not have access to key data or patterns.
## NEW SERVICES/TOOLS

While there is no shortage of data from FIs or fund companies themselves, it isn’t always useful or actionable. Tools and experience are needed to synthesize the significant volume of information, yet many Fund Companies lack resources and financial support to build or expand their capabilities. Fund companies rated Payment Administration, Sub-Account Activity Analysis and Business Intelligence on Intermediary Fee Types and Structures as the most important services. [Figure 9] These capabilities were rated very important to critical by 72%, 65% and 61%, of respondents, respectively. The below graph represents levels of criticality by color with red being highest down to green being lowest importance.

<table>
<thead>
<tr>
<th>Service</th>
<th>Critical</th>
<th>Very Important</th>
<th>Important</th>
<th>Slightly Important</th>
<th>Unimportant</th>
</tr>
</thead>
<tbody>
<tr>
<td>FI loss recovery</td>
<td>11%</td>
<td>36%</td>
<td>57%</td>
<td>0%</td>
<td>3%</td>
</tr>
<tr>
<td>Business Intelligence on FI Fees</td>
<td>10%</td>
<td>51%</td>
<td>38%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Management of sub-account data delivery</td>
<td>14%</td>
<td>24%</td>
<td>43%</td>
<td>11%</td>
<td>8%</td>
</tr>
<tr>
<td>Sub-Account Analysis</td>
<td>14%</td>
<td>51%</td>
<td>30%</td>
<td>3%</td>
<td>3%</td>
</tr>
<tr>
<td>Payment Administration</td>
<td>23%</td>
<td>49%</td>
<td>18%</td>
<td>10%</td>
<td>0%</td>
</tr>
<tr>
<td>Certifications / Surveys</td>
<td>0%</td>
<td>35%</td>
<td>46%</td>
<td>16%</td>
<td>5%</td>
</tr>
<tr>
<td>Inspections</td>
<td>0%</td>
<td>27%</td>
<td>32%</td>
<td>30%</td>
<td>11%</td>
</tr>
<tr>
<td>Spec packs</td>
<td>0%</td>
<td>19%</td>
<td>54%</td>
<td>27%</td>
<td>0%</td>
</tr>
<tr>
<td>Contract Environment</td>
<td>8%</td>
<td>27%</td>
<td>46%</td>
<td>8%</td>
<td>11%</td>
</tr>
<tr>
<td>On-Boarding</td>
<td>3%</td>
<td>16%</td>
<td>46%</td>
<td>27%</td>
<td>8%</td>
</tr>
</tbody>
</table>

*Figure 9: “Please assign the appropriate value (i.e. level of importance) to each of the following ten (10) intermediary management tools or services.”*

Services that are not important to customers, generating high rankings as “slightly unimportant” and “unimportant” are Inspections, On-Boarding and Creating Spec Packs. These generated total unimportant rankings of 41%, 35% and 27% respectively. It is interesting that firms were very likely to outsource Inspections, yet they did not see this service of great importance.

## MANAGING RISK WITH FINANCIAL INTERMEDIARY ADMINISTRATION SOLUTIONS

As the survey data shows, most fund companies recognize that they have only just begun to develop their FI oversight programs. While larger funds with more extensive resources may be further along in the process, no one seems to have finalized an approach. Industry associations are making strides to help establish guidelines and parameters for managing some aspects of intermediary relationships. In April 2012, the ICI Operations Committee formed a specific Omnibus Sub-Group to focus on industry best practices and standards for omnibus servicing. The ICI has also published a Financial Intermediary Controls and Compliance Assessment document of potential guidelines for review/attestation. Nonetheless, no standard guidelines have yet been adopted across the industry. Oversight of FIs is still evolving but is a critical need for all funds.

There is a clear need for tools and infrastructure to help all parties better understand and manage their exposures. Cost reduction and outsourcing remain key strategies for Fund Companies, but oversight must be a critical objective.

Boston Financial’s Financial Intermediary Administration Solutions (FIA Solutions™) was established to assist fund companies with their FI management needs. Developed in conjunction with a client advisory group, we
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built a set of solutions to promote greater transparency and help manage a range of risks. Responding to the most pressing needs for capabilities (as evidenced in Figure 9), we offer the following:

- **FIRMport™** - Provides a comprehensive view of all aspects of a fund company’s intermediary relationships through a dynamic on-line portal that also includes enhanced business intelligence, trending, and proactive alerts.

- **Intermediary Payment Administration** - Offers a full service solution with automated tools for the validation and approval of all intermediary compensation payments, while also supplying trending and reporting functionality.

- **Intermediary Operational Reviews** - Enhances a fund company’s oversight and due diligence practices by documenting an in-depth, on-site review of an intermediary’s processes and procedures and capturing all observations in a detailed report.

These capabilities address specific needs, but also help fund companies achieve their overall objective of managing legal/regulatory and reputational risk.

As the largest provider of transfer agency services in the U.S., Boston Financial is focused on understanding current fund company needs and challenges and monitoring sentiment about the business landscape. As the industry evolves, we will continue to conduct client surveys and discussions with a range of experts. Using input from these sessions as well as from direct client engagement, we will further refine our FIA Solutions offering, to introduce new and enhanced capabilities.

To learn more about our FIA solution, please contact: Jim Mock, (816) 843-8192, JRMock@bfdsmidwest.com.