

# FINANCIAL INTERMEDIARY OVERSIGHT

Detailed Findings from Boston Financial's 2016  
Financial Intermediary Administration Survey



***BOSTON FINANCIAL***  
DATA SERVICES®

## INTRODUCTION

Two recent industry trends have continued into 2016 – market volatility and wide-ranging regulator activity. While markets have generally recovered from lows earlier in the year, there is no sign that regulator activity is slowing. In fact, we are seeing increased activity from multiple regulatory agencies. In addition to SEC Money Market Reform, the DOL Fiduciary Rule and FINRA actions around improper use of sales classes and sales charge waivers, the SEC released two documents that put additional focus on intermediary oversight. In January, the SEC issued specific guidance to advisors and fund boards on distribution fees. One of the areas covered in the 2016 survey is current practices of fund companies and their boards relative to this guidance. Also, the SEC issued proposed Transfer Agent Rules and included a concept release requesting comments from the industry about the roles of advisors, intermediaries and transfer agents in today’s omnibus recordkeeping environment.

---

**Survey participants represented over \$4.874 trillion in assets under management or 31% of total industry assets**

Based on ICI assets under management as of 12/31/15

---

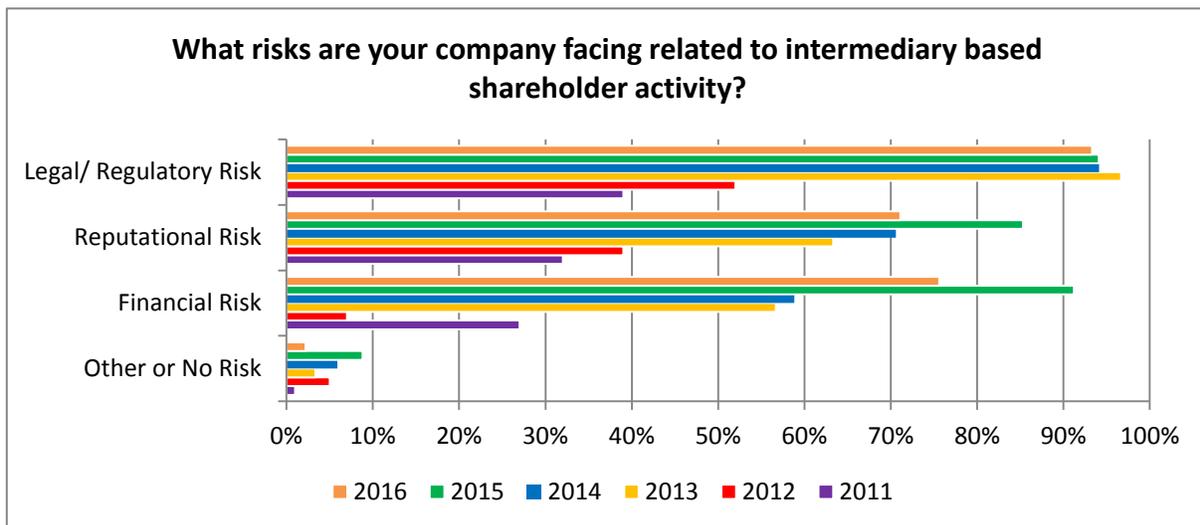
Boston Financial’s 2016 survey presents a good view of industry best practices on intermediary oversight, with responses from asset managers that represent \$4.874 trillion in assets under management, over 31% of total industry assets (as of December 31, 2015).

Key findings from this year’s survey include:

- Asset managers continue to see legal/regulatory risk as the primary risk related to intermediary-based shareholder processing.
- Fund companies have made significant progress with their oversight programs as evidenced by the fact that nearly all have an intermediary oversight program in place and satisfaction with the current program is on the rise.
- Funds are implementing the recommendations from the SEC’s guidance on distribution fees.
- Fund board focus on intermediary oversight programs continues to increase.

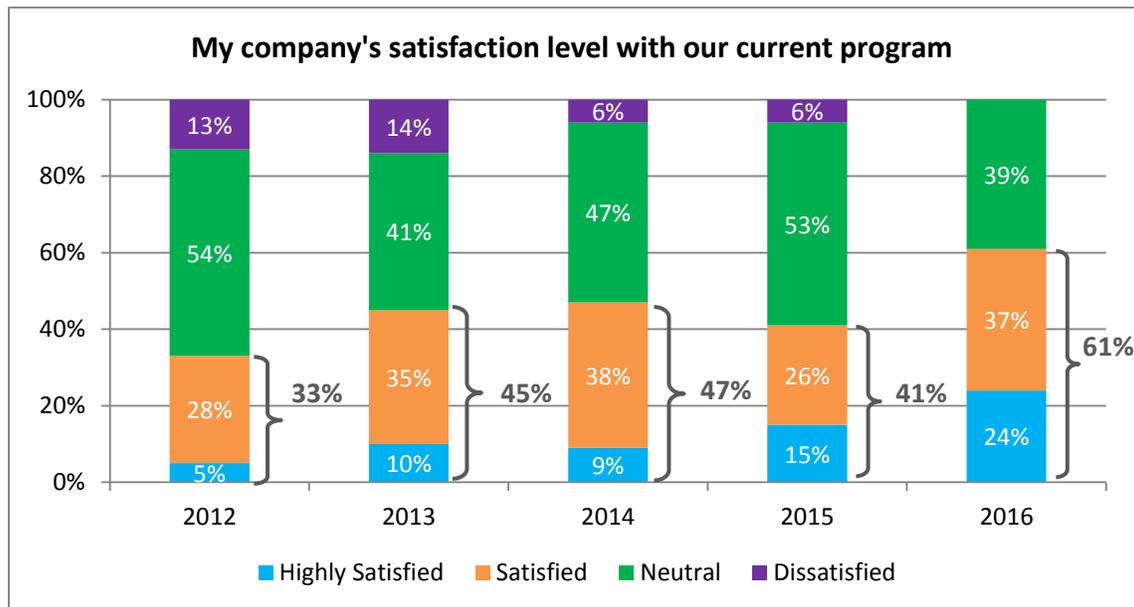
## RISKS

Legal/regulatory risk was a near unanimous choice from 93% of survey participants. This result is similar to what we have seen the past few years and should not be a surprise to anyone given the increase in regulatory activity. The 2016 results for financial risk and reputational risk declined from 2015 levels; both are now closer to the levels from 2013 and 2014. In addition, 62% of participants identified all three as areas of risk their companies are facing.



## CURRENT STATE OF OVERSIGHT PROGRAMS

Nearly all participants (91%) indicated that they have an intermediary oversight program in place, which is consistent with the 2015 results. Satisfaction levels with current intermediary oversight programs showed significant upward movement. Both “highly satisfied” (24%) and “satisfied” (37%) increased from last year (15% and 26% respectively). The total of 61% is up significantly over the satisfaction levels for the prior three years (45%, 47% and 41%). Asset managers that are “highly satisfied” tend to be the larger firms, with 80% of them having AUM of \$75 billion or more. Clearly, these results demonstrate that the work to create intermediary oversight programs is beginning to deliver results to fund companies.



We asked participants who are not “highly satisfied” with their current program to tell us what steps they are taking to enhance the program.

- Asset managers of all sizes mentioned FICCA and other audit reports:
  - *“Implementing annual summary reports to evidence review of annual SOC1 and FICCA documents”*
  - *“Find better ways (least disruptive) to obtain FICCA/SSAE16 reports”*
  - *“More diligent review of FICCA”*
  - *“Increase understanding of all audit reports”*
- Several participants indicated that they are planning to broaden the scope or coverage to other intermediaries:
  - *“More coverage of lower tier intermediaries in terms of AUM”*
  - *“Expanding to more intermediary types across more products”*
  - *“Expanding oversight beyond BDs”*
  - *“Enhance oversight program to extend to DCIO business model”*
- Others plan to look at expanding their use of technology and available data:
  - *“We are looking for alternative ways to gain intelligence with our current firm interactions with our intermediaries such as payment validation, Blue Sky, 22c-2 and prospectus reviews”*
  - *“Exploring the use of sub-account files for daily testing”*
  - *“Evaluating automated solution to house all of our oversight related data”*
  - *“Implement electronic systems to enhance workflow and reporting”*
- The most common sentiment is that intermediary oversight programs are a “work in progress”:
  - *“We are consistently reviewing our program looking for ways to make the process more efficient . . . increasing the value add”*
  - *“Our program is still in its early stages of rollout, so too soon to declare our satisfaction as high”*

- “Program is in process of being built and not 100% complete”
- “We continue to enhance our selection/review methodology . . . areas to review to ensure we are reviewing items with the highest risk”
- “We are always looking for enhancements”

### Resources

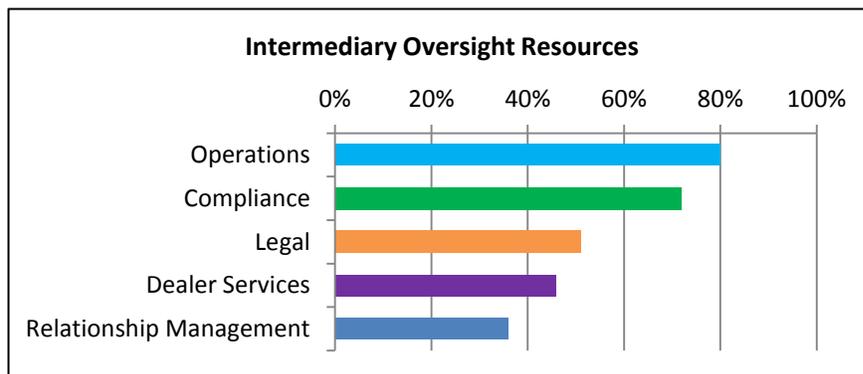
As we did in 2015, we explored the resourcing of intermediary oversight programs. The 2016 results indicate that only 5% of programs use solely dedicated resources. The predominant approach (71%) is to assign intermediary oversight tasks to existing resources. One-fourth (24%) use a combination of existing and dedicated resources. All of these results are in line with those from 2015. Larger asset managers (AUM \$75 billion or more) used dedicated resources much more frequently than smaller asset managers.

The use of dedicated resources does not correlate to higher satisfaction levels with the intermediary oversight program. None of the participants who indicated that they were highly satisfied with their oversight program used solely dedicated resources. Most of that group (60%) assigns oversight tasks to existing resources.

- **No asset manager with AUM under \$75 billion utilizes solely dedicated resources for their oversight team**
  - **95% of this group used only existing resources**
- **43% of the large firms used a combination of dedicated and existing resources**
  - **9.5% used solely dedicated resources**

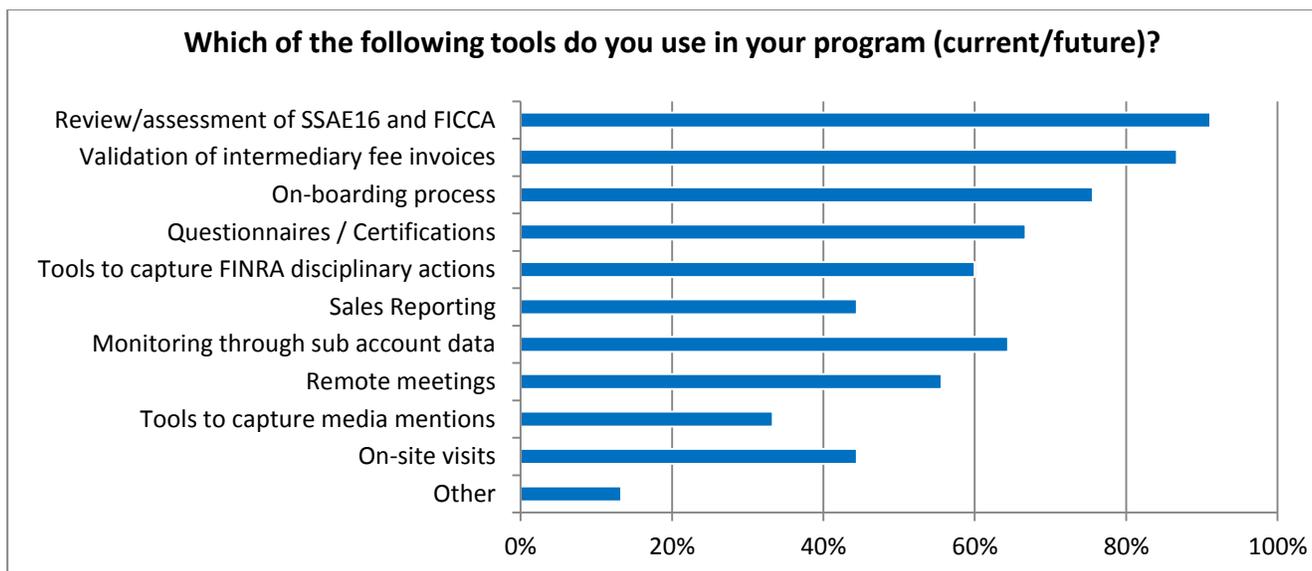
Another key finding is that the size of intermediary oversight teams is increasing. In 2015, 31% of participants had a single resource on their oversight team and an additional 31% indicated the team was two to three resources. In 2016, no one indicated a single member team and those with teams of two to three members declined to 25%. However, 42% of 2016 respondents indicated the oversight team was four to five resources and one-third identified more than five resources. Both of these represent significant increases from the 2015 result when 15% identified four to five resources and 23% identified more than five.

We asked respondents who indicated they used only existing resources or a combination of existing and dedicated resources to tell us where the existing resources are located. The predominant responses were Operations (80%) and Compliance (72%), followed by Legal (51%), Dealer Services (46%) and Relationship Management (36%). All of these results follow a similar pattern to 2015.



### Tools

The primary tools used in current intermediary oversight programs are SSAE16 and FICCA (91%), validation of intermediary fee invoices (87%), on-boarding process including intermediary risk assessment (76%), questionnaires/certifications (67%), monitoring through sub-account files (64%), and tools to track FINRA disciplinary actions (60%).



Those participants who are “highly satisfied” with their current intermediary oversight program tend to use the following tools more frequently than all participants:

- SSAE16 and FICCA – 100% vs. 91% overall
- Remote meetings, conference calls – 90% vs. 56% overall
- On-site due diligence visits – 70% vs. 44% overall
- Questionnaires / Certifications – 90% vs. 67% overall
- Tools to track media mentions – 50% vs. 33% overall

We also asked participants to identify which tools they expect to add to their intermediary oversight program over the next year. The top four choices were:

- Validation of intermediary fee invoices (29%)
- Monitoring through sub-account position and activity files (23%)
- SSAE16 and FICCA (23%)
- Questionnaires and certifications (20%)

Not surprisingly, those participants who said they were “highly satisfied” with their current program did not identify any new tools that they plan to implement but instead mentioned a change in focus and optimizing what is already in place.

## DISTRIBUTION FEES

In January, the SEC issued guidance to funds and their boards about distribution fees paid by fund shareholders. We wanted to see where funds stand versus this guidance. As a baseline, we found that 89% of fund companies have a board approved 12b-1 plan and 93% pay sub-accounting fees to intermediary firms.

One of the recommendations made by the SEC was that the fund board put a process in place to determine if any portion of an intermediary’s sub-transfer agent fee is for distribution related activities. Additionally, the advisor is required to provide the fund board with sufficient information to support the board’s analysis. Most of the participants (80%) agree that their fund board has a process in place to determine if a portion of the fund paid sub-accounting fees is for distribution related activities. The information provided to the board includes the following:

- Regular reporting
  - *“Reports summarizing and comparing contractual terms and fees paid”*
  - *“15c process, quarterly reporting, benchmarking, identification of outlier payments, identification of services of fees, notification of rate changes”*

- *“Detail analysis of fees paid at the intermediary level”*
- *“Annual Board Report with detailed analysis of fees paid to intermediaries”*
- *“Quarterly reports detailing payments made to intermediaries for sub-TA fees and an annual worksheet detailing all intermediary relationship”*
- Additional data to assist in the evaluation of fee rates
  - *“Industry data and survey results around average fees to allow benchmarking with peers”*
  - *“Comparative cost data between Sub-TA accts and those held directly with the TA”*
  - *“Evaluation of services provided and fees paid”*
  - *“List of services provided by firm”*
  - *“Benchmarking of rates paid for sub-accounting against TA costs and ICI TA Survey five year trend analysis”*
- Several participants are still working on helping their boards to better understand the environment.
  - *“Education regarding contract negotiation, class structure, what each firm is paid and how fees are determined”*
  - *“Presentations regarding omnibus account process”*

85% of participants indicated their fund boards have established a maximum sub-accounting fee that can be paid from fund assets. Several factors are used to set this maximum, including:

- Independent industry data or surveys (71%)
- Comparative analysis of sub-accounting fees paid to similar intermediaries for the same services (57%)

More than two-thirds (69%) base this maximum on the current fees paid to the fund’s transfer agent while nearly half (46%) use all three of these factors when setting the maximum fund paid sub-accounting fee.

Even when the fund board has established a maximum sub-accounting fee that can be paid from fund assets, fund companies may face a situation where they agree to pay an intermediary a sub-accounting fee that exceeds the board established maximum that can be paid from fund asset. This situation is very common – 71% of participants indicated they have agreed to pay an intermediary a sub-accounting fee that exceeded the maximum that can be paid by fund assets. In 76% of these situations, the amount that exceeds the board established maximum is paid by the advisor. Others (20%) allocate this funding to the distributor.

**76% agree that all their intermediary agreements include a clear list of services provided by the intermediary in exchange for the fees**

Three out of four respondents (76%) agree that all of their intermediary agreements include a clear list of services provided by the intermediary in exchange for the fees. The remaining 24% indicated some agreements include the clear list of services but some do not.

## OMNIBUS CONVERSIONS

Omnibus conversions continue to slow. For the third year, the percentage of participants reporting new omnibus conversions declined (45%). This compares to 47% in 2015 and 52% in 2014. While the conversion activity may be slowing, the conditions that intermediary firms agree to continue to evolve. Agreement to provide FICCA (60%) and SSAE16 (55%) were both up significantly over last year’s results, 25% and 31% respectively. Both results reflect broader adoption of these tools by intermediary firms and asset managers as tools for intermediary oversight. While an agreement to provide sub-account files is the most common condition (85%), it has remained remarkably consistent over time (88% in both 2014 and 2015). However, an agreement from the intermediary to support the fund’s oversight program by responding to reasonable questions and requests for information has steadily increased over the last three years: 59% in 2014, 69% in 2015 and 80% in 2016. Changes to fee arrangements continue to trend down, with 40% selecting this condition for new omnibus conversions.

## BOARD INTEREST IN INTERMEDIARY OVERSIGHT

Given the widespread use of the omnibus model and the SEC distribution fee guidance, fund board interest continues to climb. This year, 80% of participants indicated their fund board had increased focus on the intermediary oversight program over the last year. This is up from 71% last year and 70% in 2014.

We asked about the information requested or questions asked by the board. Key areas of focus include:

➤ SEC guidance on distribution fees:

- *“Detail to assist in determining whether any portion of a fee paid to an intermediary was for distribution vs. shareholder”*
- *“Affirmation that policies and procedures include items referenced in the SEC IM Guidance”*
- *“Practices in the context of the SEC’s guidance on distribution in guise”*
- *“Fees are their biggest concern”*
- *“Analysis of fees vs. sub-accounting fees”*
- *“Performed an analysis of existing caps in place for sub-TA as well as other fees”*
- *“Information concerning distribution in guise”*
- *“More reporting on fees paid, regardless of source”*
- *“Board requested the total dollar amount of fee payments to intermediaries, as well as the nature of intermediary relationships and the services provided”*
- *“Main focus is fee analysis and benchmarking against direct TA with justification for the cap set. Detailed analysis of IM Guidance and how we have addressed the points in the guidance.”*
- *“Proof of fees paid to intermediaries is in line with industry norms”*
- *“In light of the IM guidance, our Board has asked more questions about our intermediary oversight program”*
- *“Breakdown of fees paid by intermediary; list of services”*
- *“Additional education to the board surrounding distribution and sub-ta payments”*

---

80% of participants indicated their fund board had increased focus on their intermediary oversight program over the last year

---

➤ Status of their intermediary oversight program:

- *“Reporting on intermediaries who have had sub-standard assessment scores”*
- *“More details about the utilization of the FICCA”*
- *“Detailed overview of processes from all appropriate areas within the organization”*
- *“Visits held with intermediaries”*
- *“How are we doing oversight? Who has not supplied information requested?”*

➤ Cybersecurity

## FUTURE OUTLOOK

Most participants (91%) believe the need for managing financial intermediary oversight will increase over the next three years. While this result is similar to 2015 (97%), there is a shift in the number of responders who think that the need will increase significantly. Last year only 6% of responders felt the need would increase significantly, compared to 20% in 2016. Sentiment on how this increase will impact the resource requirements of intermediary oversight programs is split. 36% see no change in resources. Since most intermediary oversight programs utilize existing resources this seems to point to organizations “doing more with what I’ve got.” At the same time there is equal sentiment (36%) that the resource requirement will increase 20 to 25%.

91% believe the need for managing financial intermediary oversight will increase over the next three years

The two primary drivers of this sentiment remain the SEC (98%) and the fund board (78%). Both of these results are similar to 2015 (97% and 79% respectively). However, there is a significant decline in senior management (48% from 76%) as a driver of future requirement increases. Changes in the business model also declined from 24% to 17%.

In closing, we asked participants about their major concerns and challenges regarding intermediary oversight.

Several themes emerged including concerns about a lack of transparency and lack of cooperation from intermediaries coupled with insufficient regulatory guidance.

#### Major Concerns/Challenges Regarding Intermediary Oversight

- Lack of transparency
- Lack of cooperation from intermediaries
- Insufficient regulatory guidance
- Regulatory challenges including Money Market Reform and DOL Fiduciary Rule
- FICCA adoption
- Resourcing
- SEC guidance on distribution fees

#### CONCLUSION

Over the six year history of this survey, we have seen continual progress by fund companies on the implementation of intermediary oversight programs. The details of each program can be very different based on the size of the business, management, and the board's focus on these issues. However, today we know nearly all have some kind of program in place. Although the satisfaction level with the current programs is starting to increase, there is still significant frustration around insufficient guidance from the regulator on intermediary oversight, which can best be summarized by two comments from this survey – *“What is enough oversight?”* and *“. . . will eventually provide guidance that differs from the industry's common practice approach so far.”*

If you prefer the glass is half full view, there is some good news. In this year's concept release, the SEC acknowledges the omnibus model is much different than the manner in which the industry did business in the past and asks for input on what role the asset manager, intermediary and transfer agent should have regarding oversight. No one can predict when we will get clearer guidance. In the meantime, there are practical steps you can take. Whatever kind of intermediary oversight program you decide to implement, make sure you can document your program's objectives and how you arrived at them. Document your process; record and maintain records for any issues uncovered and any actions taken. In this way, you can demonstrate that you *“did what you said you were going to do.”*

***To learn more about our FIA solutions, please contact: Ken Larsen, (617) 483-8106, [KLarsen@bostonfinancial.com](mailto:KLarsen@bostonfinancial.com), or contact your Boston Financial relationship manager.***