Opinion

Shifting the Paradigm on Intermediary Fees

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Guest columnist Niels Holch is executive director of the Coalition of Mutual Fund Investors.

Fund directors should respond aggressively to increased regulatory scrutiny of intermediary fees because there's no end in sight to challenges of these arrangements.

That was made clear after the Securities and Exchange Commission completed a multi-year evaluation of distribution payments to intermediaries. As part of the review, the SEC examined whether certain payments were made as "disguised" distribution and then issued deficiency letters to several mutual fund complexes. And in the brokerage world, the Financial Industry Regulatory Authority has stepped up its oversight of the application of sales load discounts and waivers by broker-dealers within omnibus accounts. As a result, Merrill Lynch has been the subject of enforcement processes involving thousands of investor accounts. Meanwhile, Raymond James recently self-reported a case where it mistakenly overcharged clients for investing in certain funds.

These developments make it imperative for independent directors to reexamine the processes they use to oversee shareholder interests and to avoid violating regulations. Overall, fund board oversight should include at least four areas of focused attention to ensure that intermediaries are distributing funds in a compliant manner:

Disguised Distribution. Fund boards should examine all intermediary payments to ensure that fund distribution arrangements are within an approved Rule 12b-1 plan. Payments for services outside of a 12b-1 plan are permitted but only if they are not primarily intended to result in the sale of fund shares. Directors need to inquire more deeply into the purposes of such payments and draw a hard line on ones that have even an indirect distribution purpose and are not within the scope of a 12b-1 plan.

What passed muster previously might not anymore, as the SEC looks for distribution payments in guise.

Reasonable Fees. Whether inside or outside a 12b-1 plan, fund directors should take a sharp look at intermediary fee arrangements to ensure they are in the best interests of shareholders.

Fund advisers will always push to grow assets under management. And advisers will continue to tell directors that distribution payments are the price of admission to certain broker-dealers and intermediary platforms. But fund boards have a solemn responsibility to be the "independent watchdogs" of shareholder interests and need to be more aggressive in declining to approve excessive fee structures.

Competitive Pricing. Too many fees are set by relying on price lists provided by intermediaries or by a cursory examination of "what everyone else is doing." Fund boards must demand more competitive pricing from intermediaries for services that are readily available in the open market. And directors should also avoid paying for services to intermediary customers that are already required to be performed under existing SEC and Finra rules.

One example is recordkeeping. The average payment for standard recordkeeping is $20 to $25 per account or position, according to reviews of transfer agency agreements and company annual reports that discuss such arrangements. However, recordkeeping charges set through actual competitive bidding are much lower, typically about $10 per account or position. Fund boards should require competitive pricing for these services, including a reliance on competitive bidding whenever possible.

Board approval of inflated payments for intermediary services is nothing other than a payment for distribution, whether disguised or not.

Better Account-Level Transparency. A continuing regulatory problem for funds and their boards is the lack of transparency within intermediary-controlled omnibus accounts. It is next to impossible for funds to ensure the proper application of their prospectus policies and procedures within these consolidated accounts, including frequent trading restrictions, sales load discounts and waivers, and other shareholder privileges. Boards that look the other way on their omnibus arrangements are taking a significant compliance risk under SEC Rule 38a-1.

These transparency issues were never a problem when broker-dealers and other intermediaries used the networking service of the National Securities Clearing Corporation to share account-level information with funds. This NSCC service standardizes the information-sharing process and is automated. Fund boards should take a page from the pre-omnibus days and demand that all intermediaries provide account-level transparency to funds on a same-day basis. This would not disrupt distribution activities and would ensure a more cost-effective process for fund compliance with prospectus policies and procedures.

Without question, mutual funds face heightened regulatory scrutiny about their distribution arrangements with intermediaries. But while funds and their advisers are very reliant on these relationships to gather assets, a new paradigm needs to be established in place of the existing one.

Funds should no longer be “price takers” in their intermediary relationships. Instead, fund boards should work to reduce distribution fees, eliminate payments for services that are unnecessary and implement measures to enforce prospectus policies within omnibus accounts. Independent directors who take these steps will be changing the current distribution framework, protecting shareholder interests, and improving regulatory and prospectus compliance.