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Opinion: Why Reform Is Needed for Intermediary Payments
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A looming issue for the mutual fund industry is the cost of payments being made by funds to financial intermediaries for shareholder servicing and recordkeeping activities within omnibus accounts. These payments are generally being made for shareholder account maintenance, monthly or quarterly statement preparation, transaction processing and confirmations, compliance and reporting activities and investor suitability analyses. These payments are separate and apart from fund advisory fees and sales load charges.

Aside from the lack of transparency within omnibus accounts, payments by funds to their intermediaries for these services are estimated to add an average of $48 to the cost of maintaining a third-party investor account. This increases the cost structure for the average account by approximately 25 basis points each year.

The latest industry research indicates that investor accounts subject to omnibus recordkeeping now number 200 million, including 401(k) and other retirement plans. Many financial intermediaries are receiving from funds an average of $22 for each share position held in a third-party account. These fund payments contrast with an estimated cost of $10 per account to provide many of these same services to direct shareholders in a fund.

If one assumes that an average investor in a brokerage or retirement account has positions in mutual funds from four different fund families, then this comparison leads to a conclusion that an excess of $48 is being charged for each third-party account on an annual basis. With 200 million omnibus accounts, these excess payments can be as much as $9.6 billion each year, or an extra shareholder expense of 25 basis points on a median account balance of $19,000. And through the use of 12b-1 fees, direct fund payments and revenue-sharing arrangements, all of these shareholder servicing costs are coming out of the pockets of individual investors, either directly or indirectly.

One irony of this payment system is the fact that brokers and other intermediaries are already responsible for managing their own customer relationships, maintaining shareholder accounts and records and providing regular account statements and reports. In the case of brokers, Financial Industry Regulatory Authority (Finra) rules already require each broker to provide a suitability analysis prior to a transaction, as well as provide the same post-sale shareholder services that are being compensated by funds. For retirement plans, Erisa rules require even higher standards for recordkeeping and shareholder servicing activities.

Another irony of this payment system is the fact that funds are not able to enforce their prospectus policies and procedures within these third-party accounts. Investor identities and transactions are hidden from fund compliance personnel, forcing funds to have to disclose in prospectus filings that little is known about what is transpiring within these accounts.

Independent fund directors are now in the awkward position of authorizing 12b-1 plans and other payment arrangements to intermediaries that both increase costs and restrict the ability of their funds to ensure uniform treatment of all investors.

As a starting point, directors should ensure that funds and their intermediaries are fully disclosing all payments by and to all parties involved in the sale or distribution of fund shares. This disclosure should be irrespective of the stated purpose of such payments, although each party should be permitted to include in its disclosures a description of the purpose of any of these payments.

To address the lack of uniformity in the application of fund prospectus policies and procedures within omnibus accounts, a full transparency model should be implemented. This should be done either through the daily disclosure of shareholder information from intermediaries to funds under SEC Rule 22c-2, or by registering all shareholders directly with a fund.

Mutual fund investors should not be responsible for costs that are primarily designed to increase fund assets and benefit the sales and distribution system for the industry. Individual investors also should receive uniform treatment in the application of prospectus policies and procedures. Whatever is promised in a fund prospectus should be administered evenly, without any regard to the distribution channel an investor has selected.

The political climate in Washington today is much more investor-friendly as a result of the financial crisis. Independent directors should take the lead in addressing these problems with the fund distribution system and not risk more draconian solutions being imposed by a Congress that is frustrated with Wall Street.

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