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The Omnibus Revolution
Managing risk across an increasingly complex service model

Delivering results that make a difference

Mutual Funds

Introduction

Over the last decade, mutual fund shareholder servicing has been transformed dramatically as increasing numbers of intermediaries serving as fund distribution partners move to provide shareholder subaccounting through an omnibus model. In this structure, intermediaries such as broker/dealers and retirement plan recordkeepers maintain account information and transaction histories directly for their customers in subaccounting systems. The intermediary aggregates and often nets its customers' purchase and sale transactions as it places trade orders through one or more omnibus positions maintained at the funds' transfer agent.

As a result of the shift to intermediary subaccounting, the number of accounts held directly at fund transfer agents has declined, while the number of intermediary servicing relationships has grown. This trend has created a new set of complexities for fund management as funds face an increasingly fragmented network of intermediary service providers that provide both distribution and subaccounting services on behalf of the funds and their shareholders.

While the outsourcing of services is an established practice in the mutual fund industry, such delegation typically brings with it the responsibility for compliance oversight of the outsourced providers. Applying the conventional vendor diligence and oversight used to evaluate traditional arms-length service arrangements, however, has presented challenges in the intermediary context.

These challenges arise, at least in part, as a result of intermediaries serving as both fund distribution partners and service providers. As a consequence, the omnibus trend may pose significant questions for fund management, including:

- How can the funds' service and risk management structure be reshaped to align effectively with the increasing prominence of intermediary subaccounting?
- How can this service and risk management structure manage financial, regulatory, and reputational risks in a cost-effective manner for an expanding enterprise of intermediary relationships?
- How can sufficient leverage be maintained in conducting intermediary oversight activities and in fee negotiations when the funds may be heavily dependent on these same counterparties for asset growth?

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Trends and drivers

In search of distribution

The growth in the omnibus model has its roots in the 1990s, when the fund industry expanded into new distribution channels. At that time, these new channels included retirement plans, variable insurance products, and fund supermarkets, which often employed omnibus models to address complex product features. Specific technical, business, and regulatory requirements were typically addressed by intermediaries on product-specific subaccounting systems. The subaccounting arrangements generally created a mutually beneficial framework that allowed funds to support complex customer servicing and other needs without having to establish (through fund transfer agents or alternative arrangements) the technical and process capabilities to do so.

In contrast to these newer distribution channels, broker/dealers had historically served as fund distribution partners.

Many of the technical product and service features needed to support broker/dealer trading and customer account needs had been addressed through the networking tools of the National Securities Clearing Corporation (NSCC).[1] Over time, brokers migrated to intermediary subaccounting services based on a combination of factors, including a desire to more completely control the customer relationship and to capture the revenue associated with subaccounting. As the market revealed the willingness of funds to pay for intermediary servicing,

1 NSCC networking enables automation of mirror accounting between the broker and the fund's transfer agent, with trading initiated by the broker while leveraging the transfer agent system to drive fund rules and compliance logic through the trading process.

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and the technology/service infrastructure for maintaining subaccounts became commoditized, an increasing number of brokerage firms began to consider the omnibus model. While historically broker omnibus arrangements included minimum account and/or asset levels prior to considering a fund family for omnibus conversion, these developments have continued to drive down account and asset thresholds, resulting in a broader base of brokers and fund families being impacted by omnibus growth.

By 2003, the traditional clearing model using NSCC networking was overtaken by intermediary subaccounting as the dominant clearing methodology for broker/dealers. Following a brief lull in momentum when the fund industry focused on implementing market-timing transparency rules,[2] the trend in broker/dealer conversions to intermediary subaccounting has once again accelerated. Today, most major brokers have completed the selection of an omnibus platform and are now in the process of converting their account base one fund family at a time. When combining this broker trend with the continued expansion of other channels using the omnibus model, the number of intermediary subaccounts has begun to dwarf the number of direct transfer agent accounts for many fund families.

Shifting economics

As discussed, the shift to intermediary subaccounting has not occurred independently of fee implications. The pricing mechanisms underlying intermediary arrangements, however, are generally different than those of other fund service providers. At the outset, intermediary contracts are typically initiated from a distribution perspective. As a result, the incorporation of service fees can often represent a secondary component of the contract negotiation. In addition, subaccounting services and fees often comingled by the intermediary with distribution services and fees. This comingling often leaves fund management with the task of allocating costs into the respective distribution and shareholder servicing expense categories, which is necessary to meet regulatory requirements.[3]

Apart from these dynamics, fund management may also find that, as more intermediaries provide subaccounting services, intermediary subaccount fees in the aggregate begin to eclipse the costs associated with the fund's traditional transfer agent. In these circumstances, fund management may need to contend with new fee pressures, while at the same time wrestling with potential new risks that may be presented by an increasingly complex web of intermediary relationships.[4]

Fragmented servicing structure

As a result of the migration to intermediary subaccounting, an increasing number of shareholder accounts are now housed on a disparate array of subsystems. This can make funds dependent on each intermediary's policies, procedures, and internal controls, as well as its operations staff to manage service delivery and compliance obligations. Overseeing this expanding network can present operational and logistical challenges. Additional challenges may arise due to the important role intermediaries play in fund distribution and asset growth.

Fund management has a strong interest in assuring that intermediary servicing is performed in a manner that complies with applicable regulatory and fund-specific requirements. While many funds employ structured oversight programs to monitor their transfer agents, it is likely not practical to deploy matching levels of diligence across a growing group of intermediaries. In developing effective and sustainable intermediary oversight programs, the implementation of a holistic risk-based approach should balance program costs with potential exposures. The end-state goal is for management to be able to assess effectively the service capabilities and related compliance responsibilities of the funds' expanded universe of new vendors.

2 Mutual Fund Redemption Fees, Final Rule, Release No. IC-26782, File No. S7-11-04; (May 23, 2005).

3 For example, the payment of fund distribution fees and expenses is subject to rule 12b-1 of the Investment Company Act, while fund distribution and service fees are subject to different maximum caps under regulations imposed by the Financial Industry Regulatory Authority (FINRA).

4 On the other side of the equation, as more shareholder accounts migrate to intermediary servicing, the fund's transfer agent may experience reverse economies of scale as the transfer agent and fund level overhead expenses, for example, are allocated across a declining account base. Fund management should also consider the potential impact of the omnibus model on the fund's transfer agent and address any related risks as part of the funds' risk management framework.

Certain risks revealed … what's next?

The market timing and late trading issues of 2003 represented an important wake-up call for the industry. These issues underscored the significant risks and adverse consequences that can be associated with omnibus arrangements. In certain cases, the lack of transparency into the account activities of an intermediary's customers hindered fund management's ability to effectively identify noncompliant trading practices. The ensuing 22c-2 market timing rule[5] helped address certain transparency challenges by requiring fund management to obtain agreement from intermediaries to provide on-request access to underlying account information. Subsequent enforcement actions regarding breakpoint compliance[6] and the more recent "pay-to-play" issues[7] have continued to highlight the risks and dependencies between funds and their intermediaries.

Specific risks may vary by intermediary type and relationship. These risks can include inconsistent application of fund requirements, such as investment and account minimums, sales load breakpoints, and redemption and contingent deferred sales charge (CDSC) fees. Regulatory and reporting requirements, such as compliance with forward pricing rules, proper application of trade dates and dividends, proxy administration, blue sky compliance, escheatment, and performance of required regulatory mailings, should also be considered. In addition, data privacy implications may impact the funds if intermediary security breaches occur. Risk considerations should adapt to the changing regulatory landscape to incorporate new requirements, such as those governing anti-money laundering compliance, cost basis reporting and the soon-to-apply Foreign Account Tax Compliance Act.[8] Finally, the intermediary's general service quality and corporate reputation may come into play depending on how closely the intermediary's customers associate service delivery back to the funds. Although contractual and regulatory obligations may legitimately rest with the intermediary, funds should consider the potential reputational impact if their brand and underlying shareholder accounts are publicly linked to compliance failures or other issues.

Given an expanding group of intermediary relationships, the prospect of implementing a robust intermediary oversight program may appear daunting. The question

Risk considerations should adapt to the changing regulatory landscape to incorporate new requirements

for fund management, however, is whether this increasingly significant component of the funds' service and cost structure can be left relatively unchecked. Performing a structured assessment of the risks associated with the new operating model and making a conscious choice as to the value of implementing monitoring controls is a critical decision point in responding to the paradigm shift. As was the case with the market timing and breakpoint issues of the past, it is difficult to predict when and where the next compliance or other flash point may erupt. With the increasing prominence of omnibus subaccounting, it could be just a matter of time. As a consequence, now is the time for fund management to assess whether it is sufficiently prepared.

Developing a strategy

Fund practices continue to emerge that are designed to help mitigate the risks associated with the omnibus model. These include intermediary site visits and questionnaires, data analytics, and increased due diligence. In 2008, the fund industry worked collaboratively through the Investment Company Institute (ICI) to develop a new independent attest report, *Financial Intermediary Controls & Compliance Assessment*, which can be undertaken on an intermediary's behalf. The reports are designed to address specific areas with respect to intermediary subaccounting, such as transaction processing, reconciliations, and fee calculations, as illustrated in the appendix. Using existing American Institute of Certified Public Accounting (AICPA) standards, this report, similar to a SSAE 16 (formerly a SAS 70)[9] , is designed for distribution to fund sponsors that rely on the intermediary's services. While none of the foregoing activities taken alone can be considered a silver bullet in mitigating risk, together they may represent an effective toolkit within a holistic oversight program.

5 See note 2 above.

6 These enforcement actions involved, among other things, cases where the sales commission discount was found to be inaccurately applied by certain intermediaries.

7 In 2011, issues arose in connection with the "pay-to-play" rule when funds had difficulties identifying government entity clients held in intermediary subaccounts to meet the rule's compliance requirements governing political contributions and the provision of advisory services to government entities. See rule 206(5)-4 of the Investment Advisers Act.

8 The nature of an intermediary's regulatory obligations and related oversight may be another consideration. For example, the focus of self-regulatory organizations, such as FINRA for broker/dealers, is different than that of the Department of Labor for retirement plans and State Insurance Commissions for variable annuity products.

9 In 2011, Statement on Standards for Attestation Engagements No.16 (SSAE 16) replaced Statement on Auditing Standards No.70 (SAS 70) as the professional standard for service organizations who perform processing on behalf of other entities, such as fund transfer agents, to obtain an independent assessment about the effectiveness of internal controls that are relevant to their customers' financial statement audits. The SSAE 16 report, which can be distributed to specified interested parties, has become an accepted means for assessing controls at a service organization around specific services.

Developing an appropriate oversight model is an evolutionary process that should be refined over time. Fund management should also adapt its business and risk management approach in a manner that aligns with the magnitude of change that has occurred as a result of intermediary subaccounting. This means that traditional business assumptions and approaches may need to be recalibrated and reengineered, which, in turn, may require a refreshed strategy and management commitment. Potential risk management and oversight considerations include, among others:

- Enhancing the contracting process to encompass shareholder-servicing capabilities and due diligence assessment activities in addition to evaluating the intermediary's distribution potential
- Implementing a scalable monitoring strategy that tracks available data points that correlate to key performance responsibilities (e.g., rate of CDSC collections and order history of regulatory mailings)
- Leveraging questionnaires or performing targeted inquiries and documentation reviews of sample processing activity
- Developing a better understanding of each intermediary's operating environment (e.g., systems, procedures and controls) as well as its regulatory regime
- Monitoring publicly available information regarding the intermediary (e.g., press releases and enforcement actions)
- Requesting or requiring an independent controls attestation regarding the intermediary's processing and compliance capabilities

Regardless of the specific activities and approaches that are chosen, it is recommended that the process be designed in a manner that is comprehensive, can be consistently performed across the business on an ongoing basis, and will be scalable in light of changing business needs. Management should also be prepared to address potentially difficult business decisions that may arise in connection with fund distribution partners through this increased scrutiny. As is the case with many compliance-related programs, management should keep in mind that performance will likely be judged as much on the consistency of execution against established policies as on the successful avoidance of problems.

Are you prepared?

Fund management should continue to ask if it has responded to and sufficiently addressed the new risks and challenges that are now presented in the omnibus model. Consideration of the following questions may help fund management determine where it stands:

1. Are the funds paying higher servicing fees to intermediaries than they are to the transfer agent for the same services and, if so, can the difference be justified?
2. Are the specific services that each intermediary has been contracted to perform clearly defined and understood?
3. What level of confidence exists in the intermediaries' capabilities to deliver the contracted services, and is there an ability to know if they failed to do so?
4. Have the downside risks of a failure(s) to perform been objectively assessed, and is the potential impact acceptable to the business?
5. Is the oversight approach that is being applied consistent, and has it been integrated into the enterprise-wide risk management program?

Positive responses to each of these questions may suggest a business environment that is actively responding and adapting to the challenges of the new operating model. If the reverse is true, it may be time to consider embarking on a strategic assessment to understand the impact of the omnibus model and determine a course of action to manage effectively the risks involved.

Appendix

Figure 1

Financial intermediary controls and compliance assessment

An ICI Working Group, comprised of representatives of the mutual fund industry and accounting firms, developed a list of 17 separate topical areas to be considered when performing assessments of intermediary's control environments which were incorporated into an audit report framework.. The objective of the report is to provide fund sponsors with reasonable assurance that investor transactions are properly executed and that shareholder accounts are properly maintained. The intermediary may then distribute this report to each fund company it serves. While all of these topical areas were considered to be of interest based on input of the representative funds companies, only 12 areas would be considered testable and subject to an auditor's report per AICPA standards.

Control areas subject to independent auditors' report		
Code of ethics	Privacy protection	Anti-money laundering
Document retention and recordkeeping	Transaction processing	Beneficial owner account setup and maintenance
Cash and share reconciliations	Escheatment	Shareholder communications
Sub-account billing and invoice processing	Fee calculations	Information technology (including internet and VRU)

While the remaining 5 topical areas would not be subject to the auditors report, management may opt to provide a narrative as part of the report to offer the user insight into the intermediary's approach and status of addressing these matters. These topical areas are as follows:

Control areas incorporated through management narrative				
Financial viability	Management reporting (quality control)	Risk management	Third party oversight	Business continuity and disaster recovery

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