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New Report Delves Into Growing Role of Intermediaries

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A new report attempts to answer some questions surrounding the increasingly prominent role of intermediaries that distribute fund shares and provide services to shareholders. The report, issued this month by the Investment Company Institute and Independent Directors Council, seeks to guide the dialogue among boards and advisers concerning intermediaries' services and fees.

Intermediaries can be banks, financial advisors, fund supermarkets for retail and institutional investors or platforms for institutional investors. Depending on the type, intermediaries may provide financial advice and maintain shareholder records and account information, send dividends and capital gains distributions and provide year-end tax reporting. If intermediaries didn't perform these services for their clients, funds and their transfer agents would have to provide them.

For boards, oversight of intermediaries is complex and can be expensive and time-consuming. Legislation such as the USA Patriot Act, SEC compliance and records rules and IRS and Department of Labor regulation has increased the obligations for funds in scrutinizing intermediaries.

According to the ICI, 86% of household owners of mutual funds hold them through intermediaries.

"Due to the large number of shareholders who prefer to use intermediaries, intermediaries have become a bridge between mutual funds and fund shareholders," the ICI-IDC report, "Navigating Intermediary Relationships," states. "For the shareholder, having the intermediary deliver these services, instead of the fund complex or its transfer agent, provides the shareholder a simple method to manage his or her mutual fund investments, regardless of how many different fund complexes the shareholder has invested with."

The paper was developed as a background for fund directors interested in further understanding the evolving role of intermediaries and their interactions with funds. The paper breaks down the structure and players involved in fund distribution, including intermediaries that sell fund shares to investors, fund transfer agents that provide operational support to intermediaries and the ways in which intermediaries are compensated.

The ICI identifies two of the most significant intermediary trends: defined contribution plans' becoming the fastest-growing account base and broker-dealers' shifting away from individual accounts held on the books of the fund complex and toward omnibus accounts.

"Both of these movements reduce the number of individual accounts on the fund complexes' books relative to all shareholder accounts and leave fund complexes with less information about the accounts and activities of beneficial shareholders of the fund," the ICI report states.

Omnibus accounts are master accounts in which each day's purchases and redemptions are netted into a single transaction. The result is sent to the fund's transfer agent. Typically, funds don't have information about the investors in the individual accounts, the report states.

In some cases, intermediaries use omnibus accounts for individual investor accounts with similar features, such as dividend reinvestment. In others, the omnibus accounts may represent many different individual investor accounts; the accounts are referred to as super omnibus accounts, the report states.

Intermediaries were roundly criticized this month in a paper published by The Coalition of Mutual Fund Investors that suggests that omnibus accounts favored by certain intermediaries add an additional $48 in expense per year per account and 25 basis points to funds' cost structure.

MarketWatch columnist and fund industry critic Chuck Jaffe published a column based on the coalition's findings, but concluded that the costs have mainly caused confusion and that the fees might be more easily grasped "if service costs were expressed to shareholders in absolute dollar terms and removed from the expense ratio."

The additional cost paid to intermediaries that maintain omnibus accounts is due to the fact that the arrangements are not subject to normal market forces, the coalition report states.

"A further complication is the fact that trustees of a mutual fund are not able to compare pricing for shareholder servicing and recordkeeping activities when approving these arrangements because of a lack of competitive bidding or arm's length bargaining," a footnote in the report states.

According to the coalition, shareholders pay between $19 and $25 per account to intermediaries. Comparatively, if a fund shareholder purchased shares directly from the fund, he or she would pay about $10 for the fund's transfer agent to maintain the account, the coalition report states.

The coalition suggests that investors receive disclosure of all payments by and to any party involved in distribution. To distinguish between shareholder servicing and distribution, intermediaries should be permitted to include in disclosures a description of the purpose of any payments.

"Direct shareholders should not be bearing the burden of inflated payments being made on behalf of other shareholders in hidden accounts, especially when they do not obtain any benefits from these broker or intermediary payments," the report states. "Disclosure of these payments will help address the non-competitive nature of the relationship between a fund and the third-party intermediaries responsible for distributing its shares."

Fund advisers decide which intermediaries to do business with to reach potential investors and negotiate costs. It's often unlikely that intermediaries will explain their business model, or how they came up with the amount they charge to distribute funds and provide services to investors.

Jon Fossel, an independent director on one of the **OppenheimerFunds** boards, says directors often start by looking at overall expenses charged to shareholders and whether they're comfortable with them. If not, directors begin to drill down.

When it comes to what are essentially servicing fees, "directors are between a rock and a hard place," says Fossel. Large intermediaries in their dealings with the fund adviser will explain that they maintain omnibus accounts and it costs a certain amount to maintain them. Therefore, the fund and its transfer agent don't have to maintain them, and it doesn't cost as much.

"On the surface, that's reasonable," says Fossel. But boards, in reviewing expenses, want to be satisfied that the amount being paid to intermediaries is in fact reasonable.

"If they're saying the management company ought to be paying 25 basis points for shareholder servicing, is that what it would cost if the management company did it themselves? Or is that what it costs to have the large brokerage firm do it?" says Fossel.

The trouble, says Fossel, is that the intermediaries often don't provide the funds with a choice. Therefore, if boards aren't convinced the expenses are reasonable, and they aren't comforted by the fund adviser's explanation or an intermediary's explanation and they're not comfortable with the overall amount of expenses charged to shareholders, directors may need to push back, he says, and the adviser may need to cover more of the costs.

Nick D'Angelo, director in **PricewaterhouseCoopers**'s asset management group, says he has seen in recent years fund advisers spending more time asking questions regarding intermediaries' practices and shareholder serviceprocess. These discussions provide the fund adviser with insights into the intermediaries' control environment as well as shareholder servicing cost structures.

In addition, the adviser's compliance staff often keeps an inventory of different intermediaries selling funds and their associated risk rating, reviews internal control reports and periodically visits with the intermediary, says D'Angelo.

The paper provides a short list of broad questions for directors to ask in their oversight.

Suggested Oversight Questions

- What types of intermediaries sell the fund's shares?
- What is the distribution strategy associated with each of the intermediary partners?
- What services are provided to fund shareholders by each type of intermediary partner?
- How are the intermediaries compensated for their services?
- Do the distributor, adviser and/ or any other party pay any of the intermediaries additional amounts (through revenue-sharing payments)? If so, what is the purpose of these payments, and how are they calculated?
- What are the processes for overseeing intermediaries' compliance with regulations and fund policies, such as redemption fee policies?

ICI report: "Navigating Intermediary Relationships"

The ICI report states that funds pay intermediaries directly or indirectly through the fund transfer agent for managing the relationship with the fund shareholder. Funds also pay transfer agents for servicing intermediaries. Some fees charged directly to investors compensate intermediaries, the report states.

"Each fund complex tailors the structure of intermediary arrangements and related compensation to its unique business model and the competitive forces within the industry," the report states. "As a result, compensation structures may vary from one fund complex to another, and most fund complexes employ a combination of fee structures to compensate their intermediary business partners."

So-called subaccount and sub-transfer agent fees for maintaining financial records and providing tax reporting and account statements are considered in the context of what the fund would pay to provide the same services to investors with accounts held and serviced by the fund's transfer agent.

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