

INTERMEDIARY OVERSIGHT FOR MUTUAL FUNDS

With the SEC's continued emphasis on fee transparency and, ultimately, on the protection and education of the end investor, programs to oversee intermediary relationships and fee arrangements are critical for mutual funds.

INTERMEDIARY OVERSIGHT PROGRAMS: WHAT SHOULD FUNDS BE DOING?

The SEC released long-anticipated updated guidance on mutual fund distribution and sub-accounting fees in January 2016. The completion of their focused sweep exams "highlighted the need to clarify and update" the 1998 guidance to address the current distribution landscape. The guidance reiterates the objective of transparency of fees, reminds us of the potential effects on the end investor. It also outlines a framework for mutual fund boards to reference when establishing processes to evaluate fee arrangements. SEC sweep exams and subsequent guidance demonstrate that intermediary oversight programs are a must-have. The primary focus is to ensure that funds are not engaging in "distribution in guise" outside of the framework of a Rule 12b-1 distribution fee plan. In other words, a fund's oversight program should aim to ensure an understanding and awareness of what fees are being paid by the fund to the intermediary firm, and to evaluate what services are being provided. In essence, the oversight process should ask, "Is the fund – and ultimately the investor – getting what it paid for through fees?"

The SEC expects funds to demonstrate an understanding of their fee arrangements and the services that the intermediaries provide to earn these fees. Chief compliance officers have a responsibility to ensure that the funds have a comprehensive oversight program in place.

Ensure that your oversight program is documented, and is reviewed on a regular basis. As the distribution environment continues to evolve, programs should evolve as well, and continued attention to this key component of your comprehensive compliance programs will help you to meet the needs of the changing business.

THE RISE OF OMNIBUS RECORDKEEPING AND RULE 12B-1

As U.S. mutual fund distribution and servicing arrangements have become more complex, financial intermediary firms have moved toward omnibus recordkeeping arrangements. This has resulted in a number of complex fee arrangements.

Agreements between funds and intermediaries frequently include subaccounting, administrative and other servicing fees. As a result, the SEC has questioned whether, in some cases, funds may be paying for distribution or sales activities outside the framework of an approved 12b-1 plan. The SEC has focused on the processes around evaluating and overseeing these complex arrangements.

CORE COMPONENTS OF AN OVERSIGHT PROGRAM

A comprehensive oversight program considers and responds to three core components: fee negotiations and decisions, fee invoicing and reconciliation, and operational oversight.

1. FEE NEGOTIATIONS AND DECISIONS

- What services are being provided under the fund's sub-accounting agreements?
- What are the total fees being paid?
- What portion is paid by the fund?
- What portion is paid by the adviser?
- Who makes the decisions related to the fee arrangements?
- Is the negotiation and decision process defined and documented?

2. FEE INVOICING AND RECONCILIATION

- Who reviews the incoming invoices?
- Do the invoices reflect the correct rates, as agreed?
- Do the amounts billed align with expectations?
- Are there any significant variances that require further research?
- Who approves payments?

3. OPERATIONAL OVERSIGHT

- What risk considerations should you assess?
- What due diligence will you do on controls, and how often?
- Will you request Financial Intermediary Controls and Compliance Assessment (FICCA) reports, questionnaires or certifications?
- What actions will be taken if intermediary firms do not respond?
- What will you do if you identify issues?

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