

# Oversight of Fund Service Providers

Session 4 of  
Core Responsibilities of Fund Directors  
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## Panelists

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# Agenda

- Introduction
- Board Role and Responsibilities
- Services Provided by Five Key Providers
  - Custodian, Fund Accountant, Fund Administrator, Transfer Agent, Distributor
- Selecting and Overseeing Service Providers - Process
- Topics for Board Oversight
- Provider Issues and Changes
- Conclusion

# Introduction

- In the [second webinar](#) of this series, we reviewed the advisory contract approval process, which is governed by specific provisions of the Investment Company Act of 1940
- Funds use other important service providers, which are approved and overseen by the board
  - Focus today: custodian, fund accountant, fund administrator, transfer agent and distributor
- There is no one way to select and oversee service providers
  - Process varies based on structure of fund group and overall board governance structure

# Board Role and Responsibilities

- Agreement Approval Requirements
  - Section 15 requires initial and annual approval of the agreement with the distributor (i.e., the principal underwriter)
  - No specific 1940 Act provision regarding initial or annual approval of the agreements with the custodian, fund accountant, fund administrator or TA
- Compliance Program Approval and Oversight
  - Rule 38a-1 requires board approval and oversight of specified service providers, including fund accountant, fund administrator, TA and distributor
  - Custodian not covered by Rule 38a-1

# Board Role and Responsibilities

- Key Standard: Overall Fiduciary Duty
  - State law duties of care and loyalty; “informed oversight”
  - Business judgment rule; courts defer if decision is on informed basis, in good faith, and in best interests of the fund
- Focus on Conflicts
  - Important independent director role is to focus on conflicts, such as use of service provider affiliates with adviser
- Oversight Role
  - Difficult but important line: board oversight vs. micromanagement

## Custodian - Common Duties

- Hold and safekeep assets
- Facilitate cash and securities movements
- Open and maintain bank accounts
- Collect income
- Process corporate actions
- Serve as foreign custody manager
- Securities lending (to be covered in [next webinar](#))

## Fund Accountant – Common Duties

- Maintain general ledger and official financial records
- Calculate daily net asset value
- Oversee pricing vendors
- Facilitate fair value process
- Report NAV to third parties (TA, NASDAQ)

## Fund Administrator – Common Duties

- Prepare financial statements
- Production and filing of prospectuses and other SEC filings
- Tax services (filing and testing)
- Legal and compliance support services
- Blue sky compliance (state securities laws)
- Board book and board meeting services

## Transfer Agent – Common Duties

- Maintain shareholder records
- Effect transactions for direct shareholders
- Oversee omnibus account relationships (BDs, TPAs)
- Maintain call center
- Coordinate and reconciling with custodian and fund accountant
- Establish pricing and trading procedures (i.e., late trading, frequent trading)
- Establish procedures for identity theft (“red flags”), personal information security, anti-money laundering, know-your-customer, and unclaimed property

## Distributor – Common Duties

- Distributor, a/k/a principal underwriter, is generally responsible for the overall distribution of fund shares
  - Distributor may sell through its own registered representatives
  - Distributor may enter into selling agreements with other broker-dealers (affiliated or unaffiliated)
- Distributor may be responsible for related services, such as:
  - Mailing trade confirmations and statements
  - Mailing other fund documents, such as prospectuses
  - Enforcing policies (e.g., frequent or late trading)
  - Calculating shareholder breakpoint discounts and
  - Preparing sales materials

## Selection of Service Providers – Process

- Key Factors
  - Services, fees, and conflicts of interest
- Information
  - Background and recommendation from management
  - Information from service provider (and often presentation)
  - Compliance program information from Fund CCO and service provider
- Overall Fund Structure
  - Division of responsibilities among service providers
  - Oversight responsibility of fund management and adviser
  - Fund CCO oversight

## Ongoing Oversight - Requirements

- Distributor agreement approved annually
- Other service provider agreements approved initially
  - No 1940 Act periodic review requirements
  - Some agreements include a term or renewal provision
  - Affiliated service provider often reviewed annually in connection with advisory agreement renewal
- Compliance programs
  - Approved initially
  - CCO oversight
  - Annual CCO report to board

## Ongoing Oversight - Process

- Practices vary by fund group and by service provider
- Quarterly
  - Some service providers submit quarterly reports and meet with Board quarterly
- Annually
  - If reviewed annually, service provider may submit report on services
  - Annual CCO report
- Periodically
  - Reports or meetings triggered by contract renewal, service issues, business or regulatory changes
  - On-site visits – possible, but not required or common

## Selection and Oversight Topics

- Business and Financial Strength
  - Will the provider be able to adequately service the business long term?
  - Is the back office service business a core business or a sideline?
  - Is the provider financially healthy?
  - Is the provider's market share sufficient? Is it growing or shrinking?
  - Is the provider committed to the business long term?
  - Does the provider view itself as a mere provider to the fund or a partner of the fund?
  - Are there any lawsuits or regulatory matters that could adversely impact the provider's back office business?

## Selection and Oversight Topics

- Technology Commitment
  - Does the provider make significant annual investments in technology?
  - Is the provider's technology state-of-the-art?
  - Does the provider plan significant enhancements or upgrades to technology?
  - To what extent are manual processes being automated?

# Selection and Oversight Topics

- Controls and Compliance
  - Does the provider conduct periodic internal audits?
  - Does the provider maintain robust compliance and risk management programs?
  - Is there an independent third party review of the providers' compliance program?
  - How, when, and to whom does the provider report compliance issues?
  - How does the provider resolve and monitor compliance issues?
  - Can the provider continue to perform critical functions in the event of a disaster?
  - Does the provider have a robust data security program?

# Selection and Oversight Topics

## ■ Personnel

- Is the provider committed to hiring and retaining adequate personnel?
- Does the provider have “deep bench strength”?
- Do employees have sufficient expertise?
- Is an adequate training program in place?
- Is turnover higher than industry norms?

## ■ Service Quality

- Is the provider committed to providing high quality service?
- Does the provider appoint a senior person as responsible for service delivery?
- Will the provider provide information regarding performance against certain metrics?
- How will performance issues be addressed?
- Will the provider provide references to ascertain service quality?

## Selection and Oversight Topics

### ■ Conflicts of Interest

- Is the provider affiliated with the adviser?
- Does the provider have other business relationships with the adviser?
- Does the service provider outsource some or all of the duties? If so, how are the fees and services structured?
- What alternatives were considered? Why is the affiliate recommended rather than an unaffiliated provider?
- How do fees and services paid to an affiliate compare to those charged by unaffiliates for similar services? Is there industry data for comparisons?

## Selection and Oversight Topics

- Contract Terms and Fees
  - Are contract terms similar to those of other companies providing similar services?
  - Are fees reasonable when compared to providers of similar quality providing similar services?
  - What liabilities and risks are assumed by the provider?
  - What is the standard of care by which the provider is bound?
  - What are the contract's term and termination provisions?

# Service Providers Problems

- How does the board:
  - Respond to service issues?
  - Oversee service provider response to business, industry and regulatory changes?
- Options include:
  - Reports from adviser on its views/recommendations for provider
  - Special reports from provider
  - Delegation to existing board committee or a director, or creation of ad hoc committee
  - In-person presentation at board meeting
  - On-site visit

## Service Provider Changes

- Should the board or management periodically go through an RFP process?
  - Generally no requirement to do so
  - Balancing of a variety of factors, including current services and fees, changes in the fund complex, and changes in the industry
  - Be mindful of the costs and risks inherent in any service provider change

## Oversight – Recent Issues

- Distribution
  - Recent SEC exams focus on fund intermediary relationships, including board oversight
  - Increasing complexity of distribution relationships, including increased use of omnibus accounts, and increased variety of types of intermediaries, service provided and fees charges
  - Differing practices regarding source of payments (fund TA fee, fund administration fee, fund 12b-1 fee, adviser revenue sharing)
- Foreign exchange transactions
  - Recent focus on how funds execute FX trades and board oversight of those trades

## Conclusion

- Boards have an important role in selecting and overseeing service providers
  - Key legal requirements:
    - Board's overall fiduciary oversight duty
    - Board's approval and oversight duties (agreements and compliance)
- Focus is on service provider qualifications, nature and quality of services, conflicts of interest, and fees
- Directors should determine the approach that is most appropriate for the funds and service providers they oversee

## Resources

- IDC website
  - › [www.idc.org](http://www.idc.org)
  - › Fundamentals for Newer Directors, <http://fundamentals.idc.org>
- IDC papers
  - › Considerations for Board Composition: From Recruitment Through Retirement
  - › Investment Performance Oversight by Fund Boards
  - › Overview of Fund Governance Practices, 1994-2012
  - › Board Oversight of Exchange-Traded Funds
  - › Board Oversight of Target Retirement Date Funds
  - › Fund Board Oversight of Risk Management

## Resources

- IDC papers cont'd.
  - › Board Oversight of Subadvisers
  - › Board Oversight of Fund Compliance
  - › Board Oversight of Derivatives
  - › Board Oversight of Certain Service Providers
  - › Board Consideration of Fund Mergers
  - › Director Oversight of Multiple Funds
  - › Board Self-Assessments: Seeking to Improve Mutual Fund Board Effectiveness
  - › Implementing the Independent Chairperson Requirement

## Resources

- SEC website
  - › [www.sec.gov](http://www.sec.gov)
- ABA Fund Directors' Guidebook
  - › [www.abanet.org](http://www.abanet.org)
- ICI Investment Company Fact Book
  - › [www.icifactbook.org](http://www.icifactbook.org)
- Matt Fink, "The Rise of Mutual Funds" (Oxford Press, 2008)
- Robert Pozen & Theresa Hamacher, "The Fund Industry: How Your Money is Managed" (Wiley Finance, 2011)

## Panelist Biographies

- **George J. Sullivan, Jr.** is the lead independent trustee and audit committee chairman of various investment companies affiliated with the SEI Funds. He also serves as a trustee and chairman of the audit committee of State Street Navigator Securities Lending Trust, a regulated investment company. His past experience includes chief operating officer of a hedge fund adviser, general partner of Teton Partners, L.P., a global hedge fund and a senior vice president at Fidelity Investments. George is a certified public accountant, alumnus of Price Waterhouse and a graduate of Boston College.
- **Tom Forrester** is a senior vice president at State Street Global Services where their capabilities in asset servicing, operations outsourcing and analytics enable their clients to manage operational risk, optimize their cost structures, enhance the value of their services and act on growth opportunities – across all major markets. Tom leads a division in US Investor Services that includes some of State Street’s largest and most strategic relationships, including many with both back-and middle-office servicing mandates. Previously, Tom was responsible for bank operations and client service delivery for institutional clients serviced from the Kansas City, MO office where he oversaw more than 1,300 employees. He joined State Street’s US Mutual Fund Services group in 1988. Since then, Mr. Forrester has held a number of leadership positions outside of the Investor Services division, including a role in State Street’s Strategy Development Office where he focused on assessing industry trends and developing strategies to address those changes. Tom holds a Bachelor of Arts degree in business economics from Brown University.

## Panelist Biographies

- **Christopher E. Palmer** is a partner and leader of the business law department in Goodwin Procter's Washington, D.C. office, and is a member of the financial institutions group. He represents mutual funds, investment advisers, insurance companies and broker-dealers on the development, regulatory approval, sale and administration of a variety of investment products, including mutual funds and variable and fixed life insurance and annuity contracts. He also represents mutual fund independent directors. Mr. Palmer advises companies on securities law matters, including reporting and corporate governance matters. Mr. Palmer earned his BA, *egregia cum laude*, from St. John's University (Minnesota) and JD, *magna cum laude*, from Georgetown University Law Center.