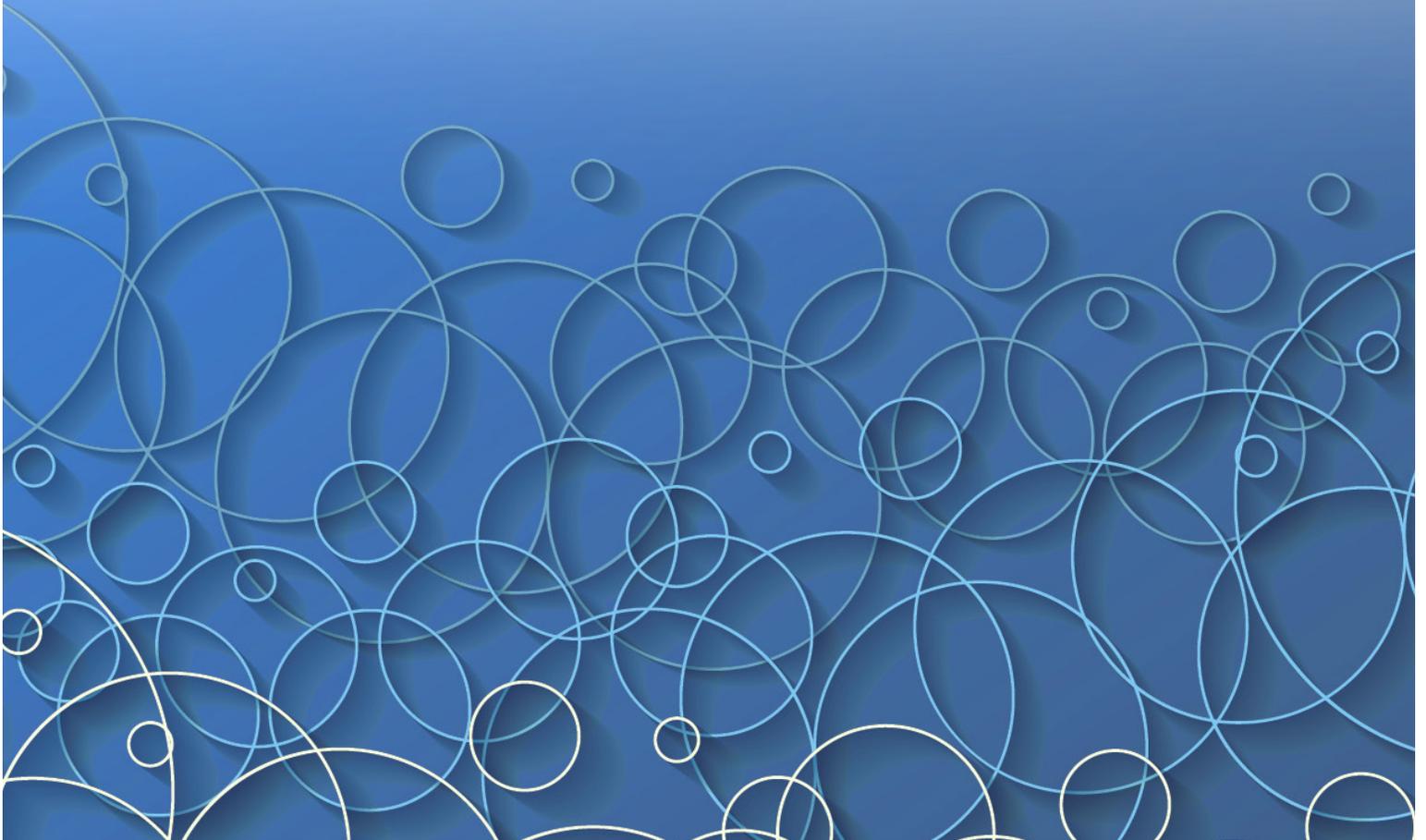


Navigating Intermediary Relationships

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Foreword

The Investment Company Institute published its first *Navigating Intermediary Relationships* white paper in 2009. In acknowledging the increasing prominence of intermediary distribution of mutual funds, the paper stated its purpose was to “describe the participation and impact of intermediaries in the mutual fund industry.”

As we move into the third decade of the 21st century, this revision carries forward many of the same themes of the original publication. Investors primarily buy and sell fund shares through intermediaries. However, a combination of market-, regulatory-, and technology-driven changes within and around the mutual fund industry have introduced important updates to how intermediaries offer mutual fund shares and are compensated for services provided to investors. These changes, in turn, have affected how fund management oversees intermediary activities related to the fund shareholders that intermediaries support.

Key updates to this paper include a deeper exploration of omnibus¹ recordkeeping, which has emerged as the predominant method for intermediaries to offer mutual fund shares to investors, primarily due to the increased capabilities of intermediary subaccounting systems to match those of mutual fund transfer agents. The growth of omnibus recordkeeping affects the roles, responsibilities, and compensation of intermediaries and fund transfer agents, with even greater emphasis on intermediary oversight by funds and their boards of directors.

The paper also reflects updates related to regulatory activities that affect intermediary relationships with funds and fund shareholders. The activities of key fund industry regulators such as the Securities and Exchange Commission (SEC) and Department of Labor (DOL) have encouraged intermediaries to clarify the role they play when offering investment advice to fund shareholders, how they are compensated for advice given, and to either disclose or eliminate conflicts of interest. Regulatory activities have also focused on fund distribution and investor servicing roles of intermediaries and the compensation received for each.² In response, many intermediaries have reviewed their activities, and, in some cases, altered business practices regarding methods and compensation for servicing investors. A noticeable trend is the adoption by certain intermediaries of asset-based fees for advice that are unbundled from the products the intermediary offers the investor.³

¹ Omnibus accounts hold mutual fund shares that are registered with the mutual fund’s transfer agent in the name of the financial intermediary. The intermediary maintains the underlying shareholder account information on its own recordkeeping systems—a process known as subaccounting—and reports share transactions to the funds on an aggregate basis. The intermediary or its agent handles all communications and servicing of its customer accounts. As a result, the underlying shareholders in an omnibus account do not directly interact with the fund organization; the mutual fund organization may have limited to no knowledge or transparency about the underlying shareholders.

² See Appendix E.19 for more information.

³ An example of this trend is the advisory distribution model that is often used by independent registered investment advisers (RIAs) or within a fee-based advisory program offered through investment advisers affiliated with a broker-dealer.

The role of technology in intermediated fund distribution is discussed throughout this paper. Intermediaries have increasingly turned to technology to help them meet changing market and regulatory demands, provide value-added services to investors, and expand their ability to efficiently provide investment recommendations. Technology, along with increasing cost pressures, has fueled three intermediary trends. First, there is a wave of consolidation occurring among intermediaries in many channels, with acquiring organizations seeking economies of scale. Second, some intermediaries have embraced an increased use of third-party service providers to supply recordkeeping technology for fund investor accounts—and sometimes the shareholder servicing of fund investors. Finally, technology has been critical in the emergence of “robo-advice.” This capability, used in both stand-alone and hybrid advice models,⁴ relies on a variety of investor-specific data points as inputs to the intermediary’s automated and algorithmically driven investment models to cost-effectively provide investment recommendations for all levels of investable assets.

What has not changed in the paper is the development and application of processing efficiencies that has continued over 35-plus years of industry operational collaboration between intermediaries and funds. Flexible systems have developed, primarily in partnership with DTCC,⁵ to provide trading and settlement of mutual fund shares and reconciliation of shareholder activity in an efficient and cost-effective manner. Over the same period, other existing services have matured, and new services introduced to meet the needs incumbent with increasingly intermediated distribution of fund shares. The paper reflects this updated technology footprint for back-office operations and the distribution of mutual fund shares.

⁴ Hybrid robo-advice models typically use technology to determine the base investment strategy, augmented with personal contact by the intermediary organization. Stand-alone robo-advice models deliver advice and services almost exclusively through technology.

⁵ The Depository Trust and Clearance Corporation (DTCC), through the Mutual Fund Services division of its Wealth Management Services organization, serves as a member-owned industry utility that provides critical technology solutions in support of the distribution of mutual fund shares. Learn more at www.dtcc.com/wealth-management-services/mutual-fund-services. Solutions offered to the mutual fund industry often are provided by the National Securities Clearing Corporation, a DTCC subsidiary. See Appendix D for more information.

Introduction

Purpose

Intermediaries—such as broker-dealers, fund supermarkets, and investment advisers—are integral to the distribution of mutual funds. Most funds distribute their shares through intermediaries; most investors buy and sell fund shares through intermediaries; and many investors rely on intermediaries for ongoing fund shareholder services, such as investment advice, investment information, and account information.

As the mutual fund industry continues to evolve, the prominent role of intermediary distribution in that evolution has not abated. Exploring this role is essential to understanding the linkage between a fund complex and an intermediary. The purpose of this paper is to describe intermediary participation in and effect on the mutual fund industry today. The paper addresses several themes, including:

- » The types of intermediaries that participate in the mutual fund industry
- » Processing efficiencies developed by fund complexes and intermediaries
- » The interaction points between fund complexes and intermediaries
- » Tools used by fund management to oversee intermediary activities
- » Methods by which intermediaries are compensated for servicing mutual fund shareholders

The significant adoption of omnibus subaccounting by intermediaries elevates the importance for fund management, fund directors, and other industry participants to understand the different intermediary types and their interactions with the fund. In general, fund management is responsible for selecting intermediaries, conducting due diligence, and ongoing management of a fund's intermediary relationships. Fund boards, consistent with their general duty to oversee the reasonableness of fees paid out of fund assets and the relationship between funds and their service providers, provide oversight of intermediary relationships (although there are specific statutory and regulatory requirements that govern various intermediary relationships). To carry out their oversight responsibilities, fund directors should have a general understanding of the fund's methods for distribution and shareholder servicing; the various intermediaries involved in distributing the fund's shares and in servicing the fund's shareholders; and the compensation structure associated with those distribution and servicing activities.⁶

Additional information may be found in appendices to the paper, including potential discussion topics for boards (Appendix H).

⁶ An example of areas where fund management and directors may require this understanding is reflected in "Mutual Fund Distribution and Subaccounting Fees," *SEC Division of Investment Management Guidance Update 2016-01* (January 2016). See Appendix E.19 for more information.

Overview of the Intermediary Role

Intermediaries have played a significant part in the exponential growth of the fund industry—from 1980 to 2021, total net assets invested in mutual funds grew from \$134 billion to nearly \$27 trillion,⁷ while the number of US households owning mutual funds grew from 4.6 million to 59 million.⁸

Among households owning mutual fund shares in 2021, 79 percent purchase and hold their fund shares through an intermediary⁹ such as a broker-dealer, bank,¹⁰ fund supermarket or platform,¹¹ insurance company, investment adviser, or retirement plan recordkeeper (see Appendix A). Investors choose which intermediary best suits their needs.

Investors use intermediaries to obtain several benefits. First, the intermediary provides investors with a convenient single point of contact for financial planning expertise and other services for all their investments. This allows the investor to build a one-on-one relationship with the intermediary to obtain personalized service. Second, intermediaries typically provide an array of investment choices such as stocks, bonds, options, exchange-traded funds (ETFs) and mutual funds. Third, intermediaries deploy technology to enhance the investor experience, providing cost-effective trade, account maintenance, and communications support for all securities owned. And finally, intermediaries offer a variety of service models, providing investors with many choices among types and levels of service in line with their individual needs.

Investors typically look to the intermediary for recommendations on how to invest their money. Such recommendations may come through traditional, face-to-face meetings with a representative of the intermediary. In recent years, an increasing number of investors have leveraged technology offered by intermediaries to receive recommendations. With the help of the intermediary, the investor becomes a mutual fund shareholder when they include mutual funds as part of a portfolio of investments.

Due to the large number of shareholders who choose to work with intermediaries, intermediaries have become a bridge between mutual funds and fund shareholders (Figure 1). Among other things, intermediaries:

- » Provide financial advice and counseling to shareholders
- » Maintain the financial records and account information of shareholders
- » Disburse dividend and capital gains distributions
- » Mail trade confirmations, shareholder reports, and prospectus updates
- » Complete year-end tax reporting

⁷ Investment Company Institute, *2022 Investment Company Fact Book: A Review of Trends and Activities in the Investment Company Industry* (Washington, DC: Investment Company Institute, 2022). Available at www.ici.org/fact-book.

⁸ Investment Company Institute, *Fact Book*, 118

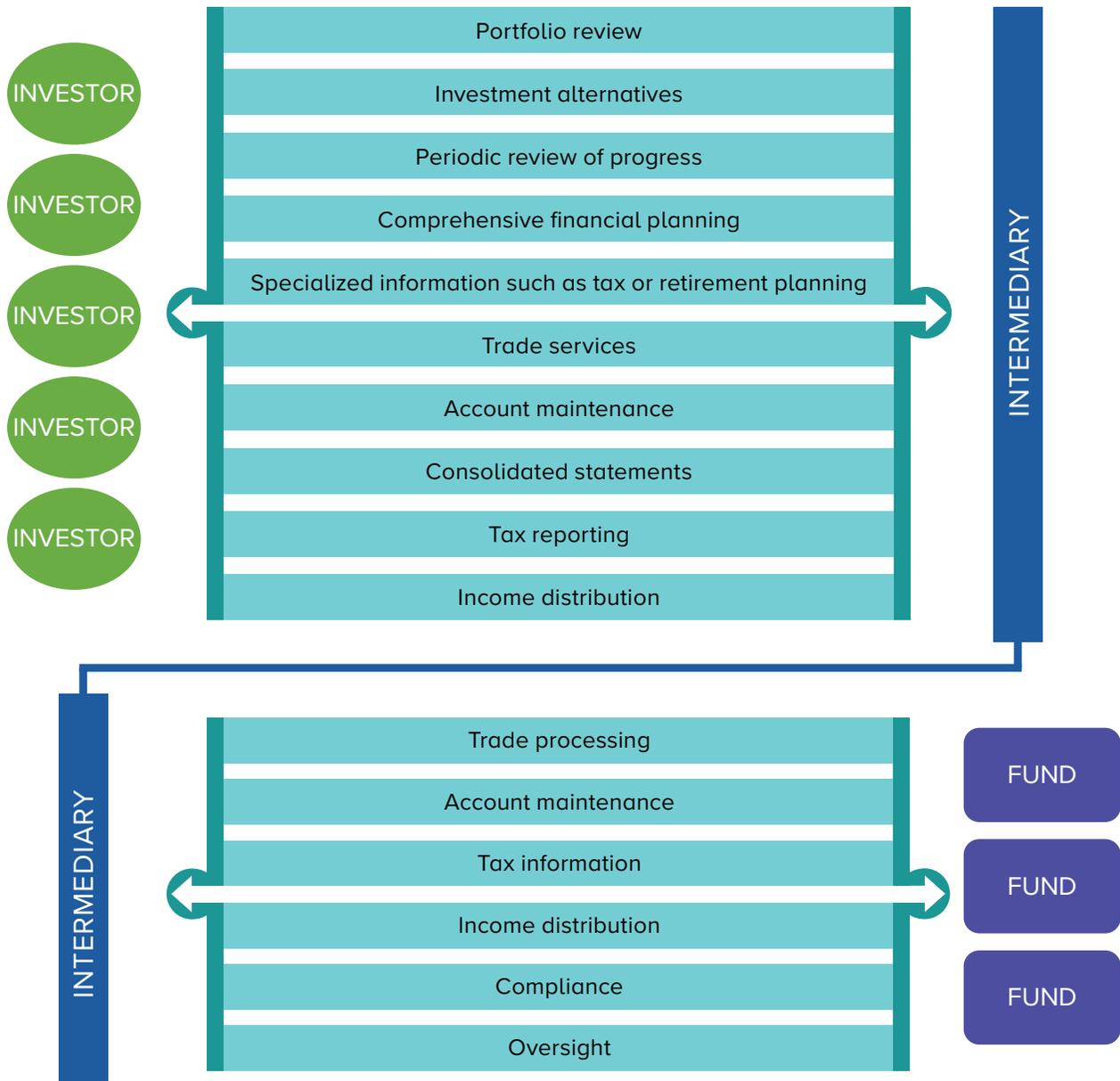
⁹ Investment Company Institute, *Fact Book*, 124

¹⁰ Any reference to bank includes bank, bank trust, and/or independent trust intermediaries. From an operational perspective, a fund's interaction with each of these is generally the same.

¹¹ Both mutual fund supermarkets and platforms offer a wide array of mutual fund investments. The difference between them is that typically fund supermarkets serve retail investors, institutional investors, or both, while platforms generally serve only other institutions.

The intermediary's delivery of these services, instead of the fund complex or its transfer agent, provides the shareholder with a consolidated point of contact to manage his or her mutual fund investments, regardless of how many different fund complexes in which the shareholder has invested.

FIGURE 1
Overview of the Intermediary Role



Each fund complex decides which intermediaries, if any, to do business with to reach potential investors. The type of intermediary, its business model, and the types of services offered by an intermediary are all factors influencing the relationship between the fund complex and the intermediary. The fund complex and the intermediary enter into one or more contractual agreements that outline the obligations of each party in the business relationship.¹² As governed by the scope of the agreement, the fund complex is accepting the business choices of the intermediary.

Most intermediaries are independent from the fund complexes they sell. Because of this independence, the fund complex has limited input on how the intermediary's client is serviced. Aside from any contractual or prospectus obligations related to selling and servicing fund shares, the intermediary chooses its own business model, processing and procedural routines, computer systems, vendors, and target market. The constraints for the intermediary are primarily legal, regulatory, and contractual requirements, as well as competitive market forces that benefit shareholders. One area in which these constraints do not operate effectively, however, is processing fees for the delivery of fund documents to investors who hold their shares through intermediaries.¹³

ICI's 2009 paper cited the growth of defined contribution (DC) retirement plans¹⁴ and the shift toward omnibus recordkeeping as two prominent industry trends. With DC plans' reliance upon omnibus recordkeeping, and with other intermediaries adopting omnibus recordkeeping for nonretirement accounts, these trends have been recognized. Assets held in DC retirement plans increased from \$3.5 trillion at the end of 2008 to almost \$11.0 trillion at the end of 2021, an increase of 214 percent, while total mutual fund net assets (including DC plan assets) increased 180 percent over the same period.¹⁵

Overview of the Fund Transfer Agent Role

The fund transfer agent is the primary point of operational support for the intermediary. Support activity includes:

- » Executing trade and settlement activities, including handling adjustments and corrections
- » Managing account maintenance needs such as mass transfers and conversions
- » Administering account reconciliation and fee payment matters
- » Supporting fund compliance needs, such as monitoring adherence to prospectus and fund policies

¹² In some instances, a selling group agreement includes the terms and conditions of the intermediary offering mutual fund shares to investors, while a shareholder servicing agreement is used for the terms and conditions of servicing investor accounts. In other instances, one document addressing both sales and servicing arrangements may be used. Decisions about legal documents used are mutually reached between the fund complex and intermediary.

¹³ Funds pay three to five times more to deliver materials through broker-dealers and their vendors than they pay to deliver the same materials directly. ICI has urged the SEC to fix the outdated, broken processing fee framework by permitting funds to choose their own vendors and directly negotiate the rates they pay. Refer to ICI's comment letter to Vanessa A. Countryman, Secretary, Securities and Exchange Commission dated May 13, 2021, for additional details. Available at www.ici.org/system/files/2021-05/33531a.pdf.

¹⁴ Examples of DC retirement plans include 401(k) plans used by for-profit businesses, 403(b) plans used by nonprofit organizations and public schools, 457 plans used by state and local governments, and the federal Thrift Savings Plan (TSP).

¹⁵ Investment Company Institute, Quarterly Retirement Market Data, Table 6; and Investment Company Institute, *Fact Book*, 225.

In many cases, the transfer agent maintains teams of staff trained and dedicated specifically to assist the intermediary client.

Funds often compensate intermediaries directly, or indirectly through the fund's transfer agent, for managing the relationship with the beneficial shareholder. Funds must also compensate transfer agents directly for servicing intermediaries. This is because intermediaries, in addition to being service providers to funds, are also fund clients (Figure 1). Compensation is negotiated between the counterparties and is subject to regulatory provisions, such as SEC Rule 12b-1.¹⁶

Overview of Oversight Responsibilities

Over the past decade, the mutual fund industry's shift to omnibus recordkeeping has greatly shaped the industry's operational changes and has redefined the interaction between omnibus intermediaries and the fund complex.

Fund complexes have less information about the accounts and activities of beneficial shareholders of the fund that are directly serviced by and exclusively known to the intermediary. Funds often need this information to carry out required oversight activities as outlined by regulation, such as SEC Rule 38-a1¹⁷ or by contract, protecting shareholder interest by creating an appropriate and cost-effective control environment. To address these needs, fund management and intermediaries continue to work together to facilitate and streamline data exchange to meet shareholder servicing, fund administration, and compliance needs and requirements. For example, cooperative efforts have led to several successes in intermediaries' daily transfer of key transaction and position data through the DTCC's Networking Omni/SERV® service,¹⁸ as well as in intermediaries' adoption of standardized frameworks for compliance assessment and reporting, such as ICI's Financial Intermediary Controls and Compliance Assessment (FICCA) framework.¹⁹

For the fund, managing complex intermediary relationships is a team effort. Senior personnel from several areas—often including compliance, fund management, fund distribution, the transfer agent, and other operational areas—interact with intermediary counterparts to oversee adherence to regulatory, prospectus, contractual, and other fund-mandated obligations. Because oversight activities are not static and must evolve with regulatory and business environment changes, these parties decide the best way to monitor the activities of the intermediary and determine which oversight tools are most appropriate based on their funds' circumstances.

¹⁶ See Appendix E.2 for more information.

¹⁷ See Appendix E.10 for more information.

¹⁸ See page 16 for more information on Networking Omni/SERV.

¹⁹ See page 15 for more information on the FICCA framework.

Interacting with Intermediaries

Funds and intermediaries interact on multiple levels. Their engagement begins with executing contracts and often includes reciprocal integration with long-standing fund processing automation tools that have helped the mutual fund industry efficiently and effectively support fund investors for decades. Those tools often shape the types of accounts and transactions that intermediaries use when engaging with funds.

Service Arrangements

Before an intermediary can distribute or service mutual fund shares, it must enter into a contractual agreement with the fund complex—often through the fund’s distributor for distribution agreements (also known as selling or selling group agreements) and with the fund’s service company or transfer agent for servicing agreements. Distribution agreements define the terms and conditions regarding the intermediary’s sale of the fund complex’s products, including eligible share classes and compensation frequency.

Service agreements allow fund companies to engage intermediaries to provide a variety of services to fund shareholders that would otherwise be provided by the fund complex, including its transfer agent. These services may include:

- » Trade processing
- » Accounting of investor positions
- » Receipt and processing of investor trade orders
- » Servicing of investor accounts
- » Providing trade confirmations and statement mailings
- » Tax reporting and distribution of other information, including regulatory mailings

Depending upon the arrangement with the fund complex, intermediaries perform some or all these functions.

Broker-Dealers

Many broker-dealers support all functions necessary to maintain the most comprehensive relationship with their shareholder client. Under this arrangement, the shareholder has no interaction with the fund complex. The shareholder only interacts with the broker-dealer, and the registered representative of the broker-dealer serves as the primary point of contact with the shareholder.

Other broker-dealers provide one or more of the services, such as processing trades or providing statements, while the fund complex provides shareholder accounting and tax reporting. In these instances, the shareholder may interact with either the registered representative of the broker-dealer, the fund complex, or both.

Banks and Retirement Recordkeepers

In the bank, retirement, and insurance distribution channels, the intermediary generally manages the interaction with the shareholder and provides most or all related support services.

Investment Advisers

Investment advisers generally use other intermediaries (e.g., broker-dealers, banks, platforms, supermarkets) to access funds. The adviser controls the interaction with the shareholder, while the support services are typically provided in entirety by the adviser's intermediary.

Funds and intermediaries take various approaches to facilitate the servicing of investor accounts. The most common, and most automated, is to use the services of the National Securities Clearing Corporation (NSCC).

Fund Processing Automation

Prior to the mid-1970s, most securities transactions, including those of mutual funds, were cleared and settled manually. Telephone calls, faxes, or wire order transmissions were the common trading tools in use at the time. Paper certificates were provided as evidence of ownership positions. This primarily manual environment often gave rise to problems, such as errors in transactions and account details, delays in processing, and reconciliation challenges.

Beginning in the 1970s, with the formation of the Depository Trust Company (DTC) and later, the NSCC,²⁰ the securities industry undertook concerted efforts to streamline transaction settlement processing. These initial efforts, which targeted stocks and bonds, were successful in the immobilization, and eventual elimination, of paper certificates and the automation of trade and payment processing. With these successes in hand, and with the continuing growth of mutual fund ownership and transaction volume, the securities industry turned its focus to mutual fund processing.

In the mid-1980s, an ICI task force of fund complexes and broker-dealers helped develop efficient mutual fund processing systems. Based on the DTC-NSCC framework in place for other securities, two NSCC automated services were established for mutual funds: Fund/SERV® for trade processing and Networking for account information exchange.²¹ Over the years, these services have been enhanced to meet the changing needs of broker-dealers and expanded to address the bank and retirement markets.

Following a recommendation of the “Report of the Joint NASD/Industry Task Force on Breakpoints” (July 2003),²² an ICI task force of fund complexes and broker-dealers partnered with DTCC to enhance the Mutual Fund Profile Service II—Security Issue Database²³ to serve as a common repository for breakpoint schedules and other operational processing rules. With most rules updated concurrently with prospectus filings, this information and level of automation has been especially beneficial to omnibus intermediaries in keeping their system rules synchronized with fund updates, an important compliance concern for both intermediaries and fund complexes.

²⁰ In 1999, DTC and NSCC were consolidated under a single parent company, the DTCC. Today, as independent subsidiaries of DTCC, DTC and NSCC continue to closely collaborate on efficient securities processing. See www.dtcc.com and Appendix D for more information about DTCC.

²¹ See Appendix B for more information about Fund/SERV and Networking.

²² See Appendix E.22 for more information.

²³ See Appendix C for more information.

The combination of Fund/SERV and Networking created an efficient operational platform that cost-effectively has supported the dramatic growth of the mutual fund industry to the levels attained today. Enhancements to services such as the Mutual Fund Profile Security Issue Database provide the information and flexibility needed to meet the industry's recordkeeping needs today and into the future.

Account Structures

Accounts opened by intermediaries through Fund/SERV or Networking are, collectively, known as Networked accounts.²⁴ An account's Networked status affects how intermediaries interact with fund complexes, primarily through the fund's transfer agent. Regardless of Networked status, intermediaries typically use two basic account structures for their clients' fund investments: omnibus and individual accounts.

Networked vs non-Networked Account Status

The fund's transfer agent receives Networked account details from Fund/SERV or Networking services and uses it to open an account on its recordkeeping system. The most common type of Networked account is opened and controlled exclusively by the intermediary, with different indicators for broker-dealers and banks, and where the intermediary provides all shareholder service. Another Networked account type allows the intermediary and transfer agent to share account servicing responsibilities and is typically used when intermediary system limitations or product regulatory requirements²⁵ require shared responsibility.²⁶ Networked accounts feature the use of technology to streamline the interaction between intermediary and fund transfer agent, thereby encouraging efficient, cost-effective servicing of shareholder accounts and allowing a focus of intermediary and fund personnel on exception processing or providing value-added customer services.

Non-Networked accounts, also referred to as "direct-at-fund" accounts, are typically opened by application sent to the fund's transfer agent.²⁷ The shareholder or their intermediary indicates any intermediary relationship on the application, and, assuming a selling group agreement exists between the intermediary and fund complex, the transfer agent records the details on the shareholder's account. The fund's transfer agent provides all shareholder servicing directly to the shareholder; any named intermediary may have certain transaction and inquiry privileges on the account based on their agreement with the fund. Most interactions occur by phone, fax, postal mail, or through the fund's website.

²⁴ Networked refers to the NSCC Networking service, which supports the exchange and reconciliation of investor account activity data. See Appendix B for more information.

²⁵ Common examples include support for 529 education savings plans or certain IRA products, such as SIMPLE, SEP, or SAR-SEP IRAs that may be registered in Networking Level 4. See Appendix B for more information.

²⁶ The various types of Networking arrangements and related compensation paid to the firm for servicing these types of accounts (in lieu of the fund transfer agent performing such duties) are described in Appendices B and F.

²⁷ Some fund complexes may support new account opening electronically through a secure website.

Omnibus Accounts

An omnibus account is a master account held on the fund’s transfer agent system that represents subaccounts of multiple investors held on the intermediary’s recordkeeping system. Some omnibus accounts may contain only a specific type of subaccount. For example, banks may open an omnibus account to aggregate all individual investor accounts that choose the same dividend reinvestment option, or an omnibus account may be opened for a single retirement plan (also known as a “plan level” omnibus account). In other circumstances, an omnibus account may represent the subaccounts of a mix of investor account types, including individual investors, retirement plans, and other pooled accounts. This type of omnibus account is referred to as a super-omnibus account.

Omnibus accounts are opened and held on the books and records of the mutual fund in the name of the intermediary. The intermediary aggregates trade activity for the subaccounts in the omnibus account and typically sends one or a few trades (representing the net of all purchases and redemptions of the subaccounts) to the fund transfer agent each day. The fund complex typically does not have any information identifying or otherwise relating trades to the beneficial owners of the subaccounts.

Omnibus accounts may be Networked or non-Networked. Anecdotally, it appears that non-Networked omnibus accounts are long-standing accounts established prior to widespread adoption of fund processing automation by the industry. Input from industry participants indicate most omnibus accounts opened and supported today are now Networked.

FIGURE 2
Account Structures

ACCOUNT TYPE	CONTAINS
Omnibus	Subaccounts of multiple investors
Individual	Single investor

Individual Accounts

Prior to the widespread adoption of omnibus accounts, intermediaries primarily interacted with fund complexes through individual accounts that pertained to a single investor. The type of interaction was shaped by how the individual account was opened, and by whom.

Networked Accounts

Individual Networked accounts are the most common type of individual account for intermediaries. These accounts are typically registered on the fund transfer agent's books in the intermediary firm's name "for the benefit of" (FBO) the individual intermediary client. While the registered representative at the intermediary associated with the investor's account is identified on the account registration, information identifying the underlying investor (the beneficial owner) may or may not be included—often the investor's account number with the intermediary or some other identifier, instead of the investor's name, is provided. Most individual Networked accounts are controlled exclusively by the intermediary, and the intermediary provides all shareholder service.

Since the original publication of this paper, the prominence of individual Networked accounts has declined from 94 million in December 2008 to 28.9 million in December 2021.²⁸ This is primarily due to the intermediary's shift from individual to omnibus accounts.

Non-Networked Accounts

Many fund complexes, including those that encourage intermediary-based distribution of fund shares, have significant numbers of individual non-Networked accounts on their books and records held by the fund's transfer agent. Intermediaries are most concerned about the non-Networked accounts that are associated with that intermediary, as previously described. Some intermediaries find these accounts challenging to incorporate into their systems used to holistically service investors²⁹ and comply with regulations.³⁰

In response, some intermediaries have updated their business practices to disassociate from individual non-Networked accounts. These intermediaries either have (1) arranged with the investor to transfer their account shares into the intermediary's omnibus account with the fund, with the investor becoming a beneficial owner of the omnibus account, or (2) contacted the fund to resign as intermediary from the individual account. The latter circumstance often occurs if the intermediary no longer has an active relationship with the individual non-Networked account shareholder.

²⁸ DTCC Annual Report from 2008 and fourth quarter 2021 statistical reporting to ICI Broker-Dealer and Bank, Trust, and Retirement Advisory Committees.

²⁹ Intermediaries may use CDS I files, available through NSCC Networking, to assist with monitoring non-Networked accounts held at fund complexes. See the section titled, "Client Data Share (CDS)" on page 17 for more information.

³⁰ For example, the 2016 DOL fiduciary rule (subsequently overturned in 2018) and the SEC's Regulation Best Interest. See Appendix E.17 and 20 for more information.

Completing the request to resign means the underlying investor will no longer receive services from the intermediary related to that mutual fund account, while the intermediary no longer receives any compensation for their relationship to the account, if applicable. Operationally and legally, intermediary resignations have numerous implications and considerations for both intermediaries and funds, especially when involving retirement accounts with a designated custodian. Resignations due to lack of active relationship with the investor could also have implications under Rule 17Ad-17 of the Securities Exchange Act of 1934 and require the intermediary to treat the investor as “lost” or “missing.”³¹ Resignations must be carefully considered for overall effect and, if pursued, require close collaboration between the intermediary and the fund complex.³²

An intermediary determines which account structure or structures it will use to support its mutual fund business—individual or omnibus, Networked or non-Networked. Because most fund complexes work with a variety of intermediaries, they need to be prepared to support whichever account types and methods of interaction their intermediary partners choose to use (see Appendix B).

³¹ See Appendix E.12 for more information.

³² An ICI task force of intermediaries and fund complex representatives created the white paper “Operational Process Flows and Considerations Related to Dealer/Custodian Resignations,” which provides suggested practices to follow and steps to consider. Available at www.ici.org/system/files/attachments/ppr_19_operational_process.pdf.

Types of Transactions

Fund complexes and intermediaries engage in a variety of transactions, which can be separated into two categories: financial (such as trading) and nonfinancial (such as account maintenance or clerical). Within these categories are many touch points between fund complexes and intermediaries, and there are several alternatives for processing these transactions.

- » *Financial transactions* are those that ultimately require money to move between fund complexes and intermediaries. The most common is the clearance and settlement of purchase and redemption activity.
- » *Nonfinancial transactions* are those that establish or change account details. For example, as financial transactions occur, the share balance in an account increases or decreases. Transmitting that new share balance to the intermediary is the most common nonfinancial transaction for a shareholder account. Other examples of nonfinancial transactions³³ include changes to names, addresses, telephone numbers, or bank accounts of record; changes to the designated broker-dealer or firm on an account; and investor decisions to change the dividend and capital gain reinvestment options for the account.

As with other activities between funds and intermediaries, there are a variety of approaches to achieve the bidirectional exchange of information for both financial and nonfinancial transactions. An overwhelming majority of these transactions occur through Fund/SERV (for financial transactions) and Networking (for nonfinancial transactions).³⁴ With this automation, shareholders are largely insulated from the kinds of errors and delays endemic to a manual process. There remains, however, some volume of activity that is processed outside of the Fund/SERV and Networking systems, most commonly via the internet, telephone, or fax.

³³ The other nonfinancial transactions described primarily pertain to individual accounts. Nonfinancial changes pertaining to a specific beneficial owner within an omnibus account are processed by the intermediary on its recordkeeping system; the fund is not aware of these changes.

³⁴ Networking new account, activity, position, and distribution reporting applies to funds reporting to intermediaries on intermediary accounts recorded on the fund's books and records. Networking Omni/SERV activity and position reporting allows intermediaries to communicate details to funds for the beneficial owners whose positions own the shares constituting the intermediary's omnibus account held on the fund's transfer agent system.

Intermediary Oversight and Compliance

General Intermediary Oversight

Intermediaries perform a range of vital compliance functions for funds, such as enforcing fund policies; providing disclosures, confirmations, and account statements to fund shareholders; collecting fund fees; calculating shareholder breakpoint discounts; and monitoring for frequent trading. Oversight of these activities on behalf of the fund is necessary and may include a review of the adequacy and effectiveness of an intermediary's compliance controls in these areas.

Although intermediary oversight has always been a significant focus of the mutual fund industry, certain recent regulatory initiatives have elevated the concern for oversight (see Appendices E and H for summaries of the obligations). With the establishment of these new or expanded compliance requirements, fund complexes have amended oversight procedures to ensure that intermediaries are meeting their obligations. Accordingly, all parties have generally sought to achieve greater levels of transparency across the industry.

Ongoing monitoring of intermediary activity is a complex process because of the variety of intermediaries, their different business models, growing compliance demands, and the labor-intensive nature of assuring compliance with regulations and adherence to prospectus and contract provisions. To address these intricacies, fund complexes employ several mechanisms that may include internal analysis of trade activity, compliance questionnaires, intermediary self-certification, review of available reports such as third-party audit and regulatory reports, and intermediary site visits.

Use of these mechanisms, singularly or in combination, varies depending upon the policies and procedures that best fit the monitoring needs as determined by the fund complex. The variability makes intermediary oversight an increasingly complex and expensive undertaking for fund complexes and requires considerable investment by intermediaries, as well.

Oversight of Controls and Attaining Transparency

As discussed earlier, many accounts on the books of the transfer agent are not opened in the name of the investor, but rather, in the name of the intermediary. This approach is used by various business models (including omnibus and Networked accounts) and is operationally efficient. However, it leaves fund management with little control of transaction processing and little information regarding the investor or beneficial owner(s) of the fund.

To increase account transparency, provide assurances regarding the intermediary's controls, and help mitigate some of the cost and uncertainty, the industry has developed several tools to automate information flow and enhance independent review for specific compliance purposes. These mechanisms employ standard formats and transmission processes and industry-endorsed procedures so fund complexes can more efficiently manage the associated resource requirements, and intermediaries can more efficiently and readily provide important information. As with other alternatives, however, use of these tools is voluntary and may not be appropriate for every circumstance. Fund management consequently still needs to implement a variety of solutions to achieve oversight of the intermediary's compliance with its contractual obligations and with the fund's prospectus.

Financial Intermediary Controls and Compliance Assessment (FICCA)

ICI and an industry working group—including fund managers, intermediaries, representatives from the four national accounting firms, and the American Institute of Certified Public Accountants (AICPA)—developed the Financial Intermediary Controls and Compliance Assessment (FICCA)³⁵ framework to provide criteria for assessing controls at intermediaries to address key areas for which mutual fund complexes typically seek assurance. In addition, the framework includes additional information on the intermediary's key policies and procedures as well as certain areas that are not subject to controls testing. This framework and the resulting report(s) provide funds with a higher level of assurance that investor transactions are properly executed and that shareholder accounts are properly maintained.

Under the review framework, an omnibus intermediary hires an independent accounting firm to assess its compliance controls related to specified activities it performs for shareholder accounts. The auditor issues an opinion on management's assertion about whether the intermediary's controls were suitably designed and operating effectively to achieve the control objectives. The intermediary may provide this opinion to all fund complexes for which it provides shareholder servicing. The engagement is performed under attestation standards issued by the AICPA.

Funds, fund boards, and fund chief compliance officers may choose to rely upon the auditor's opinion as one data point for reasonable assurance that their intermediaries have an adequate compliance control environment. Many of the larger omnibus broker-dealers have completed numerous years of FICCA engagements. Most have reported positive outcomes regarding the number and frequency of on-site visits and a reduction in requests for customized, yet repetitive questionnaires. Fund complexes receiving reports from FICCA engagements benefit by reduced need for intermediaries to complete customized questionnaires and an increased ability to focus information requests to address the fund complex's unique processing or informational needs.

Since initially launched in 2008, FICCA has been revised three times, most recently in August 2020. ICI and the Omnibus Task Force of its Operations Committee are committed to keeping the FICCA framework relevant to the needs of an evolving mutual fund industry.

³⁵ Investment Company Institute, *Financial Intermediary Controls and Compliance Assessment Engagements* (Washington, DC: Investment Company Institute, 2020). Available at www.ici.org/system/files/attachments/20_ppr_ficca.pdf.

Client Data Share (CDS)

Client Data Share (CDS) is designed to address several compliance obligations between fund complexes and broker-dealers. CDS began as an initiative to address some of the recommendations contained in the *Report of the Joint NASD/Industry Task Force on Breakpoints*³⁶ and has since evolved to help address not only breakpoints, but also SEC broker-dealer books and records requirements, as well as compliance with the SEC redemption fee rule, Rule 22c-2, and SEC Regulation Best Interest. Through CDS, fund complexes and broker-dealers exchange information that provides each side a more complete view of account and investor data residing on the other's records.

FIGURE 3

Client Data Share

TIER	DESCRIPTION	COMPLIANCE OBLIGATIONS
CDS I	Supports Level 0 Networking (accounts held directly by the fund). Funds originate data and transmit it to the intermediary listed on the account. Also known as "direct account networking."	Designed to help intermediaries meet breakpoint, books and records compliance, and monitoring for compliance with SEC Regulation Best Interest.
CDS II	Supports Level 3 Networking (controlled by broker-dealers) individual accounts. Broker-dealers disclose and transmit key investor data to the funds.	Helps fund complexes meet the needs for both breakpoint and frequent trading/market timing monitoring.
CDS III	Supports data exchange for omnibus accounts via DTCC Networking Omni/SERV. Broker-dealers originate investor (beneficial owner) account data for omnibus accounts and transmit them to the funds' repositories.	Helps fund complexes meet the needs for both breakpoint and frequent trading/market timing monitoring requirements for omnibus positions.

³⁶ See Appendix E.22 for more information.

DTCC Networking Omni/SERV®

Since the last publication of this paper, the focus of CDS-related work has been on CDS III and the introduction and subsequent adoption of DTCC Networking Omni/SERV (Omni/SERV).³⁷ An initiative sponsored by ICI's Broker-Dealer Advisory Committee, Omni/SERV was delivered in 2010.³⁸ The service uses DTCC's secure transmission network to allow omnibus intermediaries to use common layouts to securely transmit to fund complexes the activity and share balances of the beneficial owner accounts held on the intermediary's subaccounting recordkeeping system.

Omni/SERV was further enhanced to include a 529 education savings plan aggregation file. The aggregate data are necessary to monitor for and enforce various limits that apply to a beneficiary or owner/beneficiary combination across all accounts held in a state's various 529 plan programs.³⁹

Standardized Data Reporting (SDR)

In response to the SEC's adoption of Rule 22c-2, ICI organized a task force to design functional processing and industry practices to meet the rule's transparency requirements. The results of that project are NSCC's Networking Standardized Data Reporting (SDR) system and related best practices to facilitate the exchange of data between fund complexes and intermediaries in a standard, uniform format. This capability was developed to aid fund complexes in achieving transparency by obtaining underlying transaction data for omnibus accounts, primarily from banks, retirement recordkeepers, and insurance companies. Fund complexes often use Omni/SERV activity files as the source of underlying transaction data for broker-dealer omnibus accounts.

³⁷ Omni/SERV® provides a streamlined communication platform for the transmission of activity and position files for fund accounts held in omnibus, enabling participating trading partners to share subaccount information and creating transparency for omnibus relationships. Available at www.dtcc.com/wealth-management-services/mutual-fund-services/omni-serv.

³⁸ Prior to the introduction of Omni/SERV, intermediaries and fund complexes created and managed point-to-point computer connections to effect the exchange of activity and position data. In addition to the transmission complexity this created, these connections often were less secure, subjecting the security of nonpublic personal information (NPPI) they contain (to identify the underlying shareholder) to greater risk of being breached. Intermediaries and fund complexes constantly manage NPPI exchange, allowing fund complexes to complete the oversight and compliance activities that are based on shareholder data while protecting these data. All fund and intermediary activities are subject to regulatory restrictions, under SEC Regulation S-P, regarding the use and protection of investors' NPPI.

³⁹ Examples include maximum contribution amounts by beneficiary, basis and earnings reporting on distributions, and investment election changes by owner/beneficiary.

Fund Oversight Program Considerations

As previously discussed, use of the FICCA and other data transparency tools are voluntary and may not be appropriate for every intermediary relationship or circumstance. Fund management consequently still must employ a variety of solutions to achieve oversight of the intermediary's compliance with its contractual obligations and with the fund's prospectus. To fully oversee its intermediary relationships, fund complexes must develop a comprehensive oversight program. When developing an oversight program, fund complexes should consider both the type of intermediary and its corresponding business model.

Oversight programs are typically divided into two areas: 1) onboarding of new intermediaries, and 2) ongoing monitoring of existing relationships.

Onboarding Due Diligence

Prior to entering a contractual arrangement with an intermediary, fund complexes generally undertake a comprehensive due diligence effort. Factors that fund complexes may consider prior to execution of an agreement and during the onboarding process include the following:

- » Receiving a comprehensive questionnaire covering the intermediary's general information, the firm's compliance history and structure as well as operational and trading practices
- » Completing a background check of the intermediary's named officers based on "know-your-customer" (KYC) or other applicable customer identification regulations
- » Conducting a negative news search of various regulatory and media websites
- » Ensuring detailed contract negotiations outline and address all obligations, expectations, and responsibilities within the appropriate agreements

Ongoing Monitoring

A fund complex's ongoing oversight monitoring program will vary in frequency and content based on the type of intermediary, its business model, and the information being reviewed. It must satisfy the requirements of SEC Rule 38a-1, which requires that the fund have policies and procedures to oversee the compliance of its intermediaries, including investment advisers, principal underwriters, administrators, and transfer agents. Intermediary relationships are complex arrangements and do not lend themselves to one standardized oversight program. As a result, a fund complex will need to develop a nuanced oversight program that uniquely addresses its array of intermediary relationships. Often fund complexes will use some combination of the following methods to achieve their oversight objectives:

- » Employing a risk-based assessment of each intermediary
- » Circulating periodic questionnaires regarding operational and compliance practices
- » Requiring periodic certifications from intermediaries regarding compliance and operational obligations outlined in the relationship's selling and (or) servicing agreements
- » Reviewing third-party compliance reports submitted by the intermediary, including the following:
 - » FICCA, or other reporting issued under AICPA AT-C 205
 - » Systems and Organization Control (SOC) 1 report issued under AICPA AT-C 320⁴⁰
 - » Other available third-party reports
- » Evaluating the quality of data transparency files
 - » Networking Omni/SERV
 - » Networking SDR
- » Conducting virtual and/or in-person site visits to the intermediary's offices
- » Discussing compliance controls with the intermediary via conference call
- » Validating and reviewing invoices that the intermediary submits
- » Assessing the general status of the day-to-day relationship with the intermediary
- » Updating review of negative news from regulatory and media sources

Organizational Structure of Oversight Program

Fund complexes may structure their oversight program in numerous ways. However, the most common model is for the daily operational components of the program to reside within the fund's transfer agent. With this approach, the transfer agent administers the oversight program's daily and periodic functions based on policies and procedures developed in conjunction with the fund complex's compliance and legal departments. Various reporting and escalation mechanisms between the transfer agent, the fund complex's compliance and legal departments, and the board of directors should be considered as part of an effective program.

⁴⁰ This is based on AICPA Statement on Standards for Attestation Engagements (SSAE), most recently published in 2021. At various times, the AICPA has referred to these reports as Statement and Auditing Standards (SAS) 70 or AT-801 reports (under SSAE-16 standards).

Intermediary Compensation

Intermediaries are compensated for distribution and shareholder servicing through a variety of arrangements. Generally, fees for these activities are billed by intermediaries to the fund, the fund's transfer agent, or an affiliate of the fund. Some forms of compensation are paid directly by investors. Each fund complex tailors the structure of intermediary arrangements and related compensation to its unique business model and the competitive forces within the industry. 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.

Intermediaries are compensated for performing services that would otherwise need to be provided by the fund complex. For example, subaccounting⁴¹ fees are paid to intermediaries for maintaining the financial records of the individual investor, providing investor statements, and producing tax reporting to the investors. Often these fees are evaluated in the context of the fund's cost of providing the same services to an account directly held and serviced by the fund's transfer agent.

Compensation Paid by Funds and/or Fund Affiliates

Rule 12b-1 Fees

Some fund investors pay a front-end sales charge to compensate intermediaries for activities conducted in connection with an investment. As an alternative, many funds use Rule 12b-1⁴² to compensate intermediaries for those same activities. No-load funds,⁴³ retirement share classes, load-waived Class A shares,⁴⁴ Class B shares, and Class C shares may all compensate intermediaries for initial investment activities through 12b-1 fees instead of the investor paying a front-end sales charge.

Initially, 12b-1 fees were primarily used for advertising, as well as for printing and distribution of prospectuses and sales literature. Over time, 12b-1 fees have been used as a substitute for the sales charge and to compensate intermediaries for providing ongoing shareholder assistance, including a variety of shareholder services that the fund complex would otherwise perform.⁴⁵

The role of 12b-1 fees as a source of intermediary compensation, when viewed at a macro level within the industry, has changed over time. ICI research reports that, in 2021, no-load mutual funds without 12b-1 fees received 89 percent of total gross sales, compared to 46 percent in 2000 and 68 percent in 2010.⁴⁶ This trend can be attributed to several factors; however, there are two that likely explain most of the shift. First, sales of no-load share classes through sales channels that compensate intermediaries

⁴¹ Subaccounting fees may also be referred to as sub-TA (transfer agent), sub-agent, or shareholder servicing fees.

⁴² See Appendix E.2 for more information.

⁴³ No-load funds are funds sold without a front-end sales charge or contingent deferred sales charge (see Appendix F) and that have a 12b-1 fee of no more than 0.25 percent. Typically, no-load fund purchases and redemptions are initiated by retail investors directly with the fund transfer agent.

⁴⁴ Load-waived Class A shares are funds that normally assess a sales charge, but the fund has included in its prospectus certain circumstances when the sales charge (sales load) will be waived. Commonly, one of the waivers occurs when the fund is used as an investment option for retirement plans.

⁴⁵ By regulation, no more than 0.75 percent (75 basis points) of the 12b-1 fee is used for distribution-related activities, and no more than 0.25 percent (25 basis points) of the fee is used for investor servicing activities.

⁴⁶ James Duvall and Alex Johnson, "Trends in the Expense and Fees of Funds, 2021," *ICI Research Perspective* 28, no. 2 (March 2022): 6. Available at www.ici.org/system/files/2022-03/per28-02_2.pdf.

through asset-based fees calculated and collected outside the mutual fund (e.g., advisory) have increased. Second, assets and flows to institutional no-load share classes have been bolstered by 401(k) plans and other retirement accounts, where growth in fund assets held by DC plans is outpacing the growth in the broader industry. Regardless of gross sales level, fund boards still must approve, on an annual basis, any 12b-1 fee associated with a fund and share class.

Alternative Shareholder Servicing Arrangements

Mutual fund transfer agents manage the servicing aspects of a shareholder's account. This role encompasses responsibilities such as:

- » Processing purchase, redemption, or exchange orders
- » Managing account maintenance tasks
- » Responding to investor telephone calls and correspondence
- » Providing investor statements and tax reporting
- » Delivering all required mailings

Through alternative shareholder servicing arrangements—including Networking or omnibus subaccounting agreements with broker-dealers and banks as well as third-party mutual fund supermarket arrangements—intermediaries may assume the responsibility to complete some or all these activities for their customers on behalf of a fund.⁴⁷ For such arrangements, the books of the intermediary are the official record of all underlying investor transactions and reflect the related share position in the fund.

These same shareholder servicing activities are necessary for retirement plan participants. In the retirement plan context, plan recordkeepers provide the participant level accounting of activity and positions, and they conduct the account processing, maintenance, and servicing activities. Effectively, these are the same services that other intermediaries provide for non-retirement plan accounts on behalf of the transfer agent.

To the extent an intermediary assumes these servicing obligations, compensation may be paid in the following ways:

- » Subaccounting fees
- » Networking fees
- » 12b-1 fees (shareholder servicing component)

There can be other types of fees paid to intermediaries for alternative shareholder servicing arrangements, as stipulated by a separate agreement with the fund and/or its affiliates.

⁴⁷ Subaccounting fees are typically paid to compensate omnibus intermediaries for servicing the beneficial owners that make up the omnibus account at the fund's transfer agency. Networking fees are typically paid to compensate intermediaries for servicing individual Networked accounts reflected on the fund transfer agent's books and records.

Finder's Fees

As described in a fund's prospectus, a very large order may have all sales charges waived since the dollar value meets or exceeds the fund's highest amount for reducing sales charges. In this circumstance, as disclosed in the prospectus, the fund distributor pays the intermediary an upfront fee known as a finder's fee. Since there is no sales charge paid by the shareholder, the finder's fee is paid to compensate the intermediary for producing the large value trade. This type of purchase, however, is usually subject to contingent deferred sales charges (CDSCs) where, in the first year of the investment, any redemption will be net of the amount of the CDSC.

Other Compensation

In certain circumstances, other payments may be made to intermediaries. Some fund distributors may have incentive programs for some of their distribution partners to compensate them for providing additional education to registered representatives and additional marketing to potential investors. These payments are made from the revenue of the distributor or adviser and are commonly known as "revenue sharing."

As is typical in other industries, payments may be made so that sellers (i.e., intermediaries) will include the product (i.e., mutual funds) as part of the array of offerings the sellers will carry for their customers. In the mutual fund context, these payments are variously referred to as "shelf space" or "access" fees and are generally arrangements established between fund affiliates and their more significant business partners.

Compensation Paid by the Investor

Sales Charges

Sales charges are one-time fees paid directly by investors either at the time of purchase (known as front-end loads) or, in certain cases, at the time of a redemption (known as back-end loads). The traditional sales charge is paid to intermediaries, primarily broker-dealers, as part of the purchase of fund shares. Typically, front-end sales charges include breakpoint provisions where the load declines based on the dollar value of the purchase. At the highest end of the breakpoint schedule, the sales charge is eliminated completely.

Generally, the option for investors to pay sales charges over time through 12b-1 fees includes a back-end fee repayment mechanism—the CDSC fee—if the shares are held for only a short time. CDSC fees typically decrease over a specified number of years, eventually falling to 0. In 2021, funds that feature a CDSC as a key part of their compensation structure (e.g., back-end and level load funds) were responsible for less than 1 percent of industry gross sales and held less than 1 percent of total net assets for long-term mutual funds.⁴⁸

⁴⁸ For a comparison of back-end and level load share classes, see Investment Company Institute, *Fact Book, Figures 6.11 and 6.12, 114–115*.

Historically, the same front-end or back-end sales charge rules have applied to all shareholders of a given share class, regardless of the way the shareholder acquired shares (e.g., through an intermediary, directly from the fund). More recently, funds have applied variations in sales charges that apply uniformly to investors who purchase fund shares through a particular intermediary (or category of intermediaries). The SEC Division of Investment Management, in *IM Guidance Update 2016-06*, permitted funds, subject to certain conditions including approval by the fund board, to disclose these intermediary-specific variations in sales loads in a prospectus appendix.⁴⁹ Intermediaries pursuing variations in sales loads typically do so to achieve levelized sales charge-based compensation and to remove compensation-based conflicts of interest among the mutual funds and share classes offered to the intermediary's customers.

Front-end and back-end sales charges, when applicable, are inherently part of the fund's product construction. A third sales charge alternative emerged while intermediaries were considering ways to manage compensation when implementing the 2016 DOL fiduciary rule (vacated in 2018). A 2017 SEC staff no-action letter provides that a broker, acting as agent on behalf of its customers, with respect to a class of shares that does not have a front-end load, deferred (back-end) sales charge, or other asset-based fee for sales or distribution, may charge its customers commissions for transactions in such shares.⁵⁰ The broker's commissions must be independently determined, assessed, and retained by the broker.

Externalized Asset-Based Fees

Over the past decade, investors have moved increasingly toward adopting a fee-based model for receiving investment advice from intermediaries. Fees are typically based on a percentage of assets managed by the intermediary on behalf of the investor,⁵¹ are agnostic to the investment products used, and may vary based on the level of services provided and service delivery model used by the intermediary. For instance, asset-based fees charged by a robo-adviser, where investment advice is computer-generated based on investor inputs and the intermediary's algorithm, and where trading occurs systematically, may differ from those charged by a personal financial adviser who may provide additional financial planning services in addition to advice and account servicing activities.

Intermediaries are independently responsible for determining and administering asset-based fees. In turn, funds independently decide to make available the various share classes that support intermediaries that want to adopt the business model.

⁴⁹ See Appendix E.20 for more information.

⁵⁰ See Appendix E.21 for more information.

⁵¹ In other instances, a flat fee covering a time (e.g., monthly, quarterly), or an hourly fee for advice only (with limited to no services provided) may instead be used.

Calculation Methods and Processing

Within the confines of regulation and prospectus provisions, the method and frequency for compensating intermediaries must be determined. The methods will vary from asset-based calculations to fixed amounts. Payment processing may be automated through NSCC or manual based on an intermediary's invoice. Payment frequency will also vary, based in part on the processing method used between the fund complex and the intermediary (see Appendix G for more information).

Conclusion

Intermediary relationships are complicated arrangements, demanding significant commitment from the fund complex for management and oversight. These relationships, which allow investors to choose from a variety of arrangements to purchase fund shares and to pay for advice and shareholder servicing, have been highly successful and, as such, are a key driver in the dynamic growth of the mutual fund industry. As the industry continues to evolve with the development of new fund products, growing investor sophistication, additional regulatory and legislative demands, and increased competition from other financial sectors, the need for collaboration between fund complexes and intermediaries will remain critical in continuing the successes of the mutual fund industry.

Appendix A: Intermediary Partners

Broker-Dealers

Broker-dealers are one of the entities through which mutual funds offer their shares for sale to investors. A broker-dealer usually enters into a selling agreement with the fund's principal underwriter, which authorizes the broker-dealer to sell the fund's shares. Broker-dealers must be registered under the Securities Exchange Act of 1934 and be a member of a self-regulatory organization, such as the Financial Industry Regulatory Authority (FINRA). Broker-dealers are also required, with respect to retail investors, to comply with the SEC's Regulation Best Interest (Reg BI) and to provide Form CRS, describing their relationship to customers.⁵²

In general, broker-dealers fall into two categories: (1) clearing (or self-clearing) broker-dealers and (2) introducing broker-dealers.

Clearing Broker-Dealers

Clearing broker-dealers include firms that maintain the infrastructure and required capital to complete trade processing and settlement in-house.⁵³ Typically, clearing broker-dealers are large- to midsize national, regional, and independent firms. Most clearing broker-dealers offer clients a selection of mutual funds based on the broker-dealers' research on the most appropriate mutual funds for its target client base. In addition to its own trading activity (self-clearing), some clearing broker-dealers complete trade processing and settlement for other nonaffiliated broker-dealers.

Introducing Broker-Dealers

Introducing broker-dealers are firms that outsource trade and settlement to a clearing broker-dealer. By outsourcing these activities to a clearing broker-dealer, introducing broker-dealers can focus capital and other resources on serving investors. Introducing broker-dealers tend to be midsize or smaller firms.

Introducing broker-dealers benefit from a variety of product and service options from their clearing broker-dealer, including access to an array of mutual funds. The clearing broker-dealer negotiates the operational arrangements with the fund complexes that allow introducing broker-dealers to trade with those fund complexes through the clearing broker-dealer. To process trades, clearing broker-dealers typically open an omnibus account with the fund complex. The clearing broker-dealer may use one omnibus account to aggregate all beneficial shareholder activity for a single introducing broker-dealer. Alternatively, it may adopt super-omnibus processing and aggregate all beneficial shareholder activity into a single omnibus account for all introducing broker-dealers that use the clearing broker-dealer's services. Less commonly, the clearing broker-dealer will establish individual Networking Level 3⁵⁴ accounts for each beneficial shareholder of the introducing broker-dealer.

⁵² See Appendix E.18 for more information.

⁵³ Under SEC Rule 15c3-1, a broker-dealer is required to maintain sufficient liquid assets to pay any investor claims that may arise if the broker-dealer goes out of business. The level of capital required is tiered based upon the type of activities the broker-dealer provides to clients. Since clearing broker-dealers settle transactions and hold client funds and securities, they are required to maintain a much higher capital base as compared to an introducing broker-dealer that is not allowed to settle transactions or hold client funds or securities.

⁵⁴ See Appendix B for additional information about Networking.

Banks

Banks may interact directly with the fund complex or use a mutual fund supermarket or platform to support their clients. Large money center banks⁵⁵ most often interact directly with fund complexes to serve their client base. Regional and community banks most often contract with a supermarket or platform to access fund complexes. Money center banks and many regional banks have a broker-dealer, trust subsidiary, or trust department to serve the mutual fund needs of their retail clients. Generally, community banks provide investor services only through a trust department, although some create a referral arrangement with a local broker-dealer to execute retail investor trades.

Mutual Fund Supermarkets and Platforms

Mutual fund supermarkets offer thousands of funds to retail investors and institutional investors (including investment advisory firms). The fund supermarket often is part of a larger array of services offered by diverse financial services firms. These firms may provide not only mutual fund investments, but also brokerage services, retirement services, and services for the investment adviser market.

Platforms are like supermarkets in that they offer a wide array of funds. In general, however, platforms only serve other institutions. Many banks and retirement plan recordkeepers use platforms to access funds for their clients because, like supermarkets, platforms provide the administrative and transaction infrastructure needed to support fund trading activities. Thanks to the platform completing these back-office functions, the bank or recordkeeper can devote more resources to serving its client base.

Mutual fund supermarkets and platforms sign contracts with the fund complex that authorize them to sell fund shares.

Insurance Companies

Insurance companies often use mutual funds as the underlying investment for variable insurance products. With a variable insurance product investment, the insurer chooses the mutual funds underlying the variable insurance product contract and sells a contract interest in the variable insurance product (e.g., a variable annuity contract) to the investor. Because of tax considerations, variable insurance products typically invest in funds that are available only to such products. Generally, insurance companies choose a limited number of fund family partners to use as funding vehicles for their insurance products.

Some insurance companies also offer retirement plan recordkeeping services (see below), offering an array of funds for the plan sponsor to select as investment alternatives for the retirement plan.

⁵⁵ The Corporate Finance Institute describes money center banks as typically located in large financial centers and providing a wide range of financial services to large corporations, other retail banks, and governments. See <https://corporatefinanceinstitute.com/resources/knowledge/finance/money-center-bank/> for additional details.

Registered Investment Advisers (RIAs)

Registered investment advisers (RIAs) typically use a broker-dealer, supermarket, platform, or bank to access mutual funds. Many factors influence this business model. For example, most advisers are not part of a banking or brokerage system, so they need a service provider to clear and settle mutual fund trades. In addition, advisers seek to leverage the scale of a larger organization to gain access to a wider array of funds than they reasonably could arrange on their own.

The National Securities Markets Improvement Act of 1996 generally divided oversight of advisers between the SEC (larger advisers) and the states (smaller advisers). The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 provided additional clarification regarding midsize advisers. In general, oversight is determined by assets under management and the advisory role, although there are exceptions.⁵⁶

RIAs are subject to a fiduciary duty when providing investment advice to their clients. In some instances, an RIA may also be registered and function as a broker-dealer that is subject to Reg BI and applicable FINRA rules when acting as a broker-dealer. This is referred to as dual registration. SEC-registered RIAs are required to describe their relationship with investors in Form CRS and to clearly identify to investors in which capacity (RIA, broker-dealer) they are acting in relation to the investor.⁵⁷

Retirement Plan Recordkeepers

Retirement plan recordkeepers typically use a conduit (broker-dealer, supermarket, platform, or bank) to access mutual funds. Sometimes, they may interact directly with the mutual fund transfer agent to support their client base. Like RIAs, many factors influence this arrangement. Unless the recordkeeper is part of a diverse financial services organization, it is unlikely that it will be structured to clear and settle mutual fund trades; consequently, it will use a conduit for clearance and settlement activities. Recordkeepers provide the account servicing, recordkeeping, and support for plan participants.

Unlike broker-dealers and RIAs, retirement plan recordkeepers typically do not have requirements to register with state or federal regulators. Instead, they are indirectly regulated through their relationship with their retirement plan clients. Recordkeepers work with plan trustees directly or indirectly through a third-party administrator (TPA) that typically manages plan design and ensures plan compliance with the DOL, Internal Revenue Service (IRS), or other governmental agencies and regulations governing retirement plans, such as the those under the Employee Retirement Income Security Act of 1974 (ERISA). Because ERISA requires plan trustees and administrators to act as fiduciaries⁵⁸ on behalf of the plan, retirement plan recordkeepers, by extension, are subject to conduct standards that are consistent with ERISA expectations. Recordkeepers must understand regulatory requirements and have developed tools that help plan trustees and TPAs carry out their compliance responsibilities.

⁵⁶ The registration requirements for registered investment advisers are summarized at www.sec.gov/divisions/investment/iaregulation/memoia.htm.

⁵⁷ Refer to Appendix E.18 for more information. A dual registrant would be required to address Form CRS as a broker-dealer and RIA, and when undertaking covered activities, must ensure that investors understand in which capacity the intermediary is acting.

⁵⁸ The fiduciary responsibilities associated with plan sponsors are summarized at www.dol.gov/general/topic/retirement/fiduciaryresp.

Appendix B: Processing and Account Structures

Processing

Regardless of the type of account, the processing of most of the trade and account information between intermediaries and funds occurs through NSCC's Fund/SERV® and Networking systems (discussed below). These services provide the most automated, efficient, and cost-effective means for fund complexes and intermediaries to exchange trade and account data.

NSCC Fund/SERV System

Fund/SERV provides a standardized and fully automated platform to process purchase, exchange, and redemption orders, and to settle those orders (Figure 4). Access to Fund/SERV is available to any NSCC Wealth Management Services⁵⁹ member agreeing to abide by the rules pertaining to the use of the system. As of March 2022, there were more than 1,250 participants (more than 930 fund companies and 320 intermediaries, as determined by NSCC participant number) using the system to facilitate automated trading and settlement.⁶⁰ In 2021, transaction activity through Fund/SERV totaled 261 million transactions with an absolute value of \$8.5 trillion.⁶¹

Through Fund/SERV, trade orders are electronically transmitted from the intermediary to the fund through NSCC. NSCC receives all the trades from participating intermediaries for a particular fund complex for the day and on a regular schedule⁶² transmits those collected orders to the fund's transfer agent for processing. After the fund accountant provides to the transfer agent that day's net asset value (NAV) for the fund shares, the transfer agent values the orders, creates trade confirmations, and transmits them to NSCC. The latter then forwards the confirmations to each of the intermediaries. This routine supports account-opening trades, as well as subsequent purchases, redemptions, and exchanges for existing accounts.

Fund/SERV facilitates settlement of trades so that funds and intermediaries are managing only a single net settlement each day. Under this arrangement, NSCC calculates the monetary impact of all trade activity for each day for any particular fund, as well as any particular intermediary, and provides a net settlement report to each. As part of service membership, fund complexes and intermediaries agree to allow NSCC to either credit or debit a designated bank account daily to complete the money movement for all amounts owed or expected that day.

In addition to determining the monetary result of trade activity, Fund/SERV's net settlement capabilities include cash dividend or capital gain distributions. For accounts that have chosen to receive dividends or capital gains in cash, the fund includes the total amount of any cash disbursement in the daily settlement computation. As a result of the net settlement process, the daily debit or credit to the fund or intermediary bank account includes the outcome of trade activity and distribution activity executed through NSCC. This net settlement process is the most efficient and cost-effective method for fund complexes and intermediaries to complete daily money movement.

⁵⁹ Wealth Management Services is the area of DTCC that supports Mutual Fund Services.

⁶⁰ Second quarter 2022 statistical reporting to ICI Broker-Dealer and Bank, Trust, and Retirement Advisory Committees.

⁶¹ The Depository Trust and Clearing Corporation, 2021 Annual Report, 57. Available at www.dtcc.com/~media/files/downloads/about/annual-reports/DTCC-2021-Annual-Report.

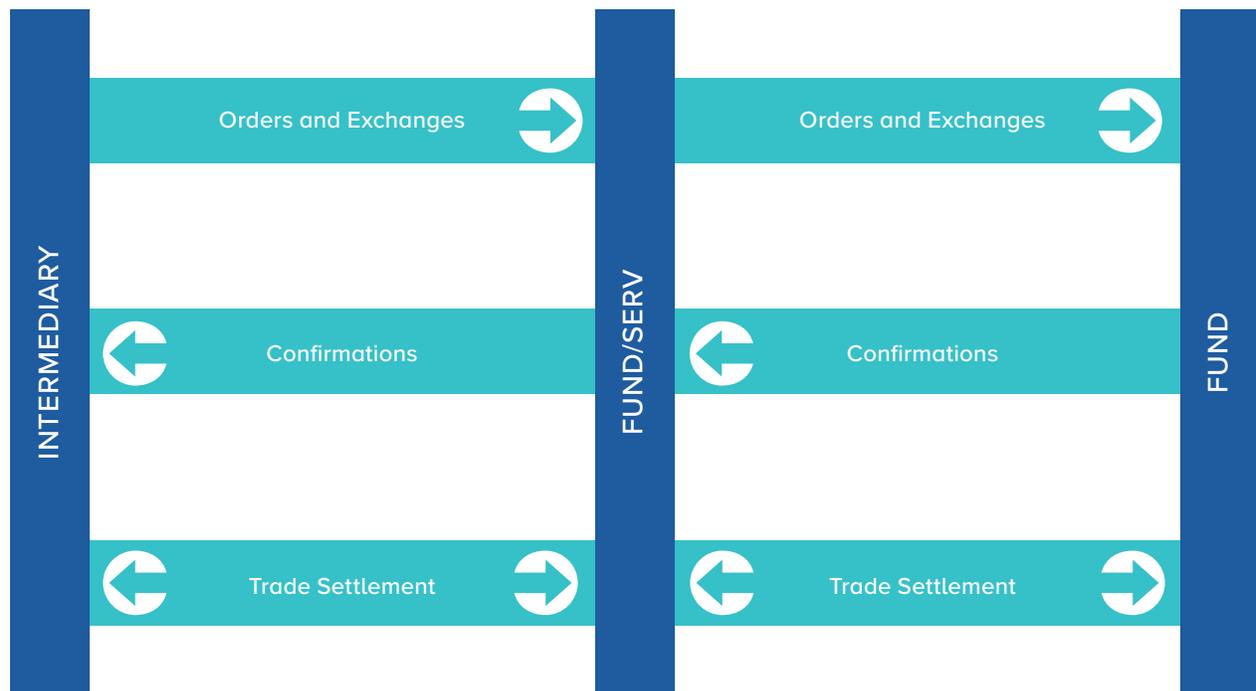
⁶² Fund/SERV users may choose to interact with DTCC by data file or by IBM® MQ messages. Less commonly and more for exception processing or use by smaller entities, DTCC also provides a web portal for manual entry. Counterparties to activity are not required to use the same method.

Defined Contribution Clearance and Settlement (DCC&S)

An ICI-led task force partnered with DTCC to address the growing need of omnibus intermediaries to systematically deliver on the morning of trade date plus one day, trades reflecting the intermediary's processing of yesterday's (trade date) activity.⁶³ The solution was to leverage Fund/SERV trade files, with cycles occurring early each morning that allow funds to merge the intermediary's trades, representing yesterday's activity, with the fund's activity for yesterday. The result is an efficient, accurate reflection of the fund's books and records and shares outstanding. Trades received through DCC&S are also incorporated into the daily NSCC settlement computation.

When originally conceived, many omnibus intermediaries were supporting participant-directed retirement plans, hence the name of the service. However, DCC&S has evolved and expanded its scope to support all types of omnibus intermediaries. The success of DCC&S has contributed to the growth and scalability of the omnibus model, reducing operating risk and increasing operating efficiencies. In 2021, nearly 59 percent of all Fund/SERV activity was generated through the DCC&S service.⁶⁴

FIGURE 4
Fund/SERV



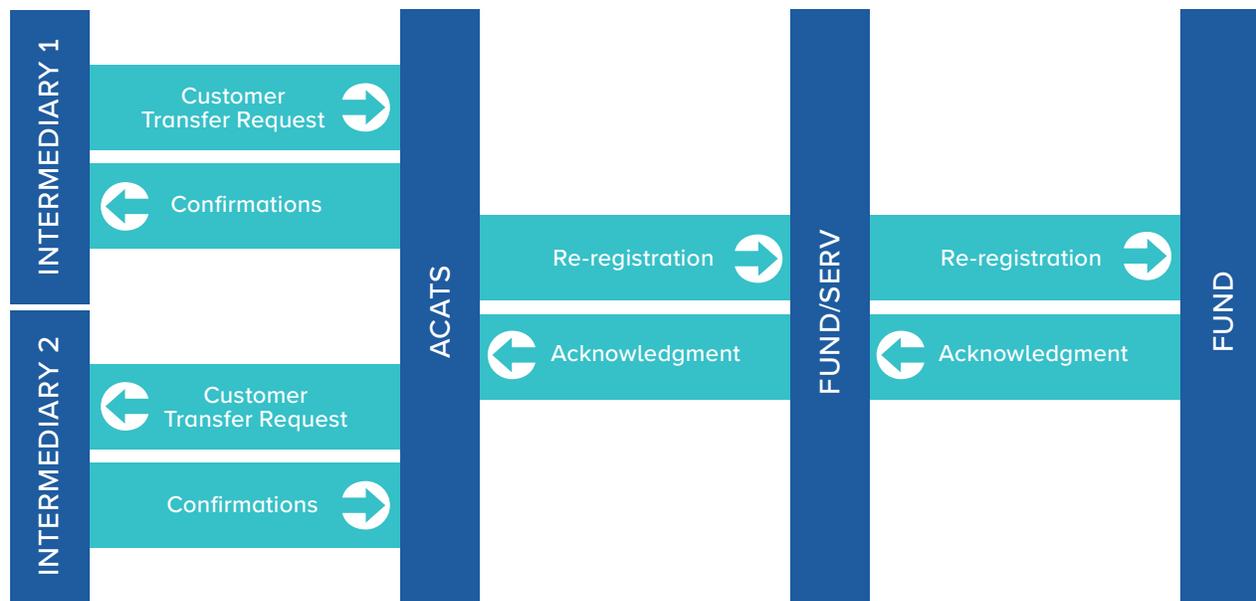
⁶³ See www.dtcc.com/wealth-management-services/mutual-fund-services/defined-contribution-clearance-and-settlement for additional information about DCC&S.

⁶⁴ The Depository Trust and Clearing Corporation, 2021 Annual Report, 57. Available at www.dtcc.com/~media/files/downloads/about/annual-reports/DTCC-2021-Annual-Report.

Automated Customer Account Transfer Service (ACATS)

Integration between Fund/SERV and DTCC's Automated Customer Account Transfer Service (ACATS)⁶⁵ allows intermediaries to include mutual fund assets when systematically transferring a customer's portfolio (including stocks, bonds, options, and other securities in addition to funds) to another intermediary (commonly referred to as "broker-to-broker" transfer). Transfers outside of ACATS require investors' fund holdings to be liquidated prior to transfer, which takes the investor out of the market while the transfer transaction occurs over three to four business days. Depending on the type of account, this can also create tax consequences for the investor. Instead, the fund can transfer the investor's shares—either from the intermediary's omnibus account or an individual Networked account controlled by the intermediary—to the receiving intermediary and leave the shareholder invested the entire time.

FIGURE 5
ACATS Fund/SERV



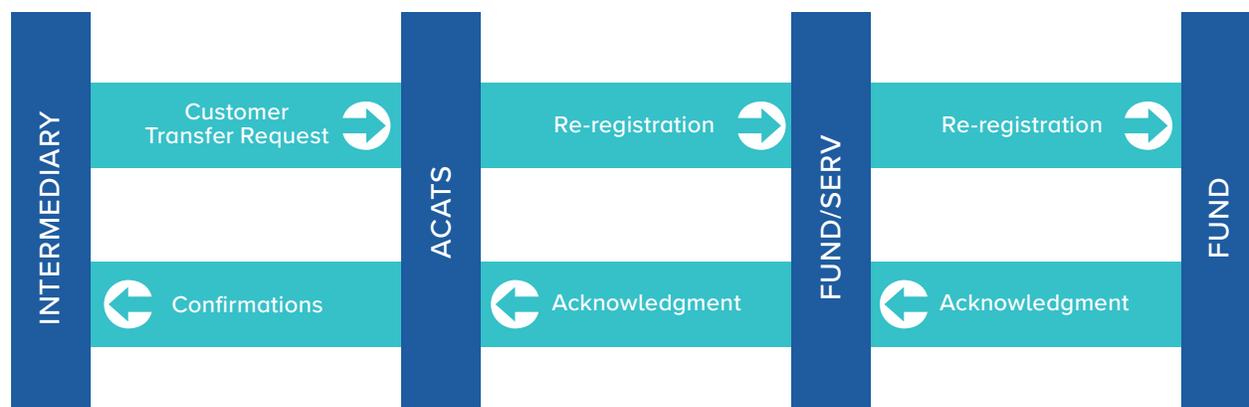
Intermediary 1 initiates the customer transfer request through ACATS for routing to Intermediary 2. If confirmed by Intermediary 2, ACATS also initiates a reregistration request through Fund/SERV to the fund to transfer shares between Intermediary 1 and 2's accounts at the fund.

⁶⁵ See www.dtcc.com/clearing-services/equities-clearing-services/acats for an overview of ACATS.

In 2008, ACATS-Fund/SERV was further enhanced to transfer like account types (e.g., IRA, Roth IRA, joint tenant) between an intermediary and fund. Intermediaries initiate, and funds either accept or reject the transactions. Transactions that are accepted by the fund either deliver shares to an account at the fund, or request that the fund transfer shares into an account at the fund that is controlled by the intermediary.⁶⁶ Industry members have indicated the functionality has contributed to a decline in the number of manual requests to transfer customer positions to and from funds.

FIGURE 6

ACATS Fund/SERV Fund Firm (PTF) Transfer



NSCC Networking System

Networking is the automated NSCC service that supports the reconciliation and exchange of account information contained on the books of the transfer agent and intermediaries (Figure 7). Implemented in 1988, intermediaries have connected, or Networked, large numbers of accounts into the system to take advantage of its automation and efficiency.

In addition to the original Networking service, DTCC has incorporated into Networking the many account-level data exchange solutions developed for funds and intermediaries, including the following:

- » Omni/SERV® is used by intermediaries to transmit the beneficial owner activity and position records to funds for each omnibus account held on the fund's books and records at the transfer agent.
- » Standardized Data Reporting (SDR) is used by funds to request, and intermediaries to remit, transaction information from beneficial owner accounts related to compliance with SEC Rule 22c-2 addressing frequent trading activities.
- » Retirement Plan Reporting (RPR) is used to exchange important retirement plan information between intermediaries and retirement plan recordkeepers. The information supports DOL Form 5500, Internal Revenue Code 408b-2 and 404a-5, general supervision, and sales reporting needs.

⁶⁶ DTCC members can learn more about the ACATS-Fund/SERV Fund Firm (PTF) Transfer Capability and recommended use at <https://dtcclearing.com/documents/mutual-fund-services/fundserv/fund-serve-guides/1533-fund-firm-transfer-capability-best-practices.html>.

FIGURE 7
Networking



The original Networking service requires investor accounts to be coded into one of three levels.⁶⁷ Each level defines a different set of responsibilities for fund complexes and intermediaries and prescribes how, and by whom, shareholder servicing is completed. The levels are designed to provide the intermediary with flexibility in selecting operational options that meet its business needs (Figure 8).

FIGURE 8
The Three Networking Levels

LEVEL	DESCRIPTION
Level 0	Non-Networked account or a Trust Networked account
Level 3	Broker-dealer controlled account
Level 4	Shared control account between broker-dealer and fund

Level 0

There are two categories of Level 0 accounts.

1. When an investor or intermediary sends an application and a check to the fund transfer agent to open an account, the transfer agent sets up the account on the transfer agent system. If a selling agreement exists between the intermediary and fund, the transfer agent will also associate the intermediary with the account. The account is termed “Level 0, non-Networked.” The fund complex provides all investor reporting, including trade confirmations and statements, information distribution, and tax reporting. To fulfill various regulatory requirements regarding books and records and Regulation Best Interest, intermediaries may receive account information from the fund complex for their associated accounts through Client Data Share (CDS).⁶⁸
2. When a bank, retirement recordkeeper, or related platform that participates in Networking sets up an account through NSCC, typically the account carries a marker designating it as a trust account. When designated with the trust account marker, the account is termed Level 0, but the marker indicates that the account is a Level 0 Trust Networked account. For Trust Networked accounts, the bank or recordkeeper provides all the investor servicing and reporting.

⁶⁷ Networking Levels 1 and 2 were retired in 2015. DTCC members may reference “Matrix Level Guidelines” at <https://dtcclearning.com/documents/mutual-fund-services/networking-1/matrix-levels/1643-matrix-level-guide/file.html> for more information.

⁶⁸ CDS is an automated functionality between funds and intermediaries that supports exchange of information for compliance needs. See “Client Data Share (CDS)” on page 17 for more information.

Level 3

Level 3 Networking is mainly used by broker-dealers and is the most prevalent arrangement between broker-dealers and fund complexes. Under Level 3 Networking, the broker-dealer maintains complete control of all interaction with the investor. This includes all trading activities; creating and delivering all beneficial investor confirmations, statements, and tax reporting; and producing and distributing all required shareholder information. Should the shareholder contact the fund complex, it will refer the shareholder to the broker-dealer for a response.

Level 4

Level 4 is used mainly by investment advisers and for certain special products such as 529 education savings plan accounts, where a state regulator may require the fund to retain a locus of control over the account. Under Level 4, the shareholder generally places purchase trades through the intermediary but may also place trades to purchase or redeem fund shares directly with the fund.⁶⁹ The fund complex provides all other servicing, including sending trade confirmations and statements, information distribution, and tax reporting to both the intermediary and the shareholder.

Because Networking is an automated system using standard formats defined by the NSCC, data are transmitted between fund complexes and intermediaries as regular, automated activity. Use of Networking creates a central transit point between fund complexes and intermediaries that allows for the exchange of data to ensure shareholder accounts are reconciled between the fund complex and the intermediary.

Trading Outside of Fund/SERV

Outside of Fund/SERV, trade and dividend activity may be managed through manual means, partly automated means, or both. Some intermediaries (typically small) may call or fax the fund company's customer service area to open accounts and fund them by mailing a check. Others may transact through the fund complex's website to open accounts, and then either send a check through the mail, or arrange a bank wire or Automated Clearing House (ACH) transfer to settle the account-opening trade. Subsequent purchases and redemptions may then be transacted via telephone, fax, or the website with settlement via check or bank transfer.

Exchange of Account Information Outside of Networking

Not surprisingly, managing the exchange of account data outside of the Networking system is a labor-intensive, time-consuming process. Information may be provided through secure internet portals to data repositories, via proprietary information exchanges, telephone contact or fax, or even on hard copy documentation. Because the exchange is typically not standardized or fully automated, many inquiries between funds and intermediaries need follow-up to clarify the request or the response. Often this necessitates multiple contacts between fund complexes and intermediaries to resolve questions or issues.

⁶⁹ Most industry participants adopted an ICI-recommended practice, effective January 1, 2012, with the introduction of mandatory cost-basis reporting for mutual funds, to disallow intermediary-originated redemptions on taxable (nonretirement) Level 4 accounts. The recommended practice consolidates all redemption activity with the fund, which has tax reporting responsibilities including cost basis reporting, for all accounts under Level 4.

Account Structures

Omnibus Account

This is an account where the share balance on the books of the fund transfer agent is the aggregate share balance of all the subaccounts of multiple investors in that fund on the books of the intermediary. For trading, the intermediary generally aggregates orders for all investors in that fund. Aggregation may occur once or a few times during the day, and it may occur within category (e.g., aggregated purchases separate from aggregated redemptions) or across category (e.g., purchases minus redemptions equal a single net purchase or redemption). Differences in aggregation practices are based on intermediary business decision, system capabilities, and contractual arrangements with fund complexes.

Broker-dealer omnibus accounts generally are opened as Networked Level 3 accounts. Bank and retirement recordkeeper omnibus accounts are usually opened as Level 0 Trust Networked accounts.⁷⁰ Most fund transfer agent systems place indicators on accounts to identify them as omnibus. As with other broker-controlled accounts, the intermediary provides to the investor the following: trade confirmations and statements; investment information; tax reporting; and required shareholder communications.

To illustrate an omnibus account, consider this example. Intermediary X has two individual investors and two retirement plans (each with three participants), all of whom are purchasing 100 shares of the same fund. The total number of shares to be purchased is 800 shares—100 shares for each individual investor and 100 shares for each of the three participants in the two retirement plans. The intermediary enters the individuals' and participants' orders on its system but sends only a single trade for 800 shares to the mutual fund. As a result, the records of the intermediary and the fund transfer agent will appear as shown in Figure 9.⁷¹

⁷⁰ There are certain legacy omnibus accounts that are non-Networked Level 0. These often are in bank nominee name and follow established policies adopted before widespread automation of trading and reconciliation activities. Anecdotally, industry participants report that virtually all omnibus accounts opened today are Networked.

⁷¹ The practice of combining multiple account types into one omnibus account at the fund creates a super-omnibus account. In some instances, an intermediary in this same example may choose to create three omnibus accounts—one corresponding to all individual investors, and accounts for each retirement plan.

FIGURE 9

Omnibus Account



Omnibus Account Transparency

Transparency for omnibus accounts is achieved in two ways. For broker-dealer accounts, CDS III provides the structure for broker-dealers to transmit to the transfer agent the detail of the subaccounts contained in the omnibus account. As previously described, CDS III has been operationalized as Networking Omni/SERV.⁷²

For the bank and retirement channels, NSCC's Networking Standardized Data Reporting (SDR) system is often used by the intermediary to supply subaccount details in response to a request for information from the fund complex, primarily in support of compliance with SEC Rule 22c-2.⁷³ Increasingly, intermediaries in this channel are also considering the use of Networking Omni/SERV to provide funds with subaccount details.

Individual Account

There are various means for opening individual accounts with a fund. Most individual accounts are opened through the NSCC as Networked Level 3 accounts, mainly by broker-dealers, or Trust Networked Level 0 accounts with bank trust companies, retirement recordkeepers, and their platforms. Individual accounts are typically opened in the name of the broker-dealer, on behalf of its customer, who is often identified by their broker identification number (BIN). For Networked Level 3 and Trust Networked Level 0 accounts, the intermediary is the sole point of contact for the investor.

Financial advisers and some broker-dealers may open accounts through the NSCC as Networked Level 4. Depending upon the arrangement between the intermediary and the fund complex, the intermediary may be the sole point of contact for the investor, or the intermediary and the fund complex may each provide specific client services. The use of Level 4 account structures is declining over time.

For individual accounts Networked through NSCC, the share balance is the same on the books of the fund transfer agent and the intermediary. Commonly for Networked accounts, shareholder information—such as name, address, or social security number—is not included directly in the account registration information held at the fund (this is also referred to as “not fully disclosed”). To achieve account transparency, and to help fund complexes complete oversight activities and comply with regulations for not fully disclosed individual accounts, fund complexes typically receive shareholder information from the broker-dealer through CDS II.

To illustrate the most common type of individual account (the Networked Level 3 account opened by a broker-dealer on behalf of the investor), consider the following example. John Doe opens a brokerage account with ABC Brokerage with a deposit into a money market fund (or some other short-term investment). John Doe decides to buy 100 shares of a mutual fund, so ABC Brokerage opens and networks an account with the mutual fund and sends a buy order for 100 shares. As a result, the records of the broker-dealer and the fund transfer agent will appear as shown in Figure 10.

⁷² See page 16 for more information on Networking Omni/SERV.

⁷³ See page 16 for more information on Networking SDR.

FIGURE 10

Individual Account

Networked Level 3 account opened by a broker-dealer



The simplest, yet least-efficient method to open an individual account is when either the broker-dealer (in conjunction with the investor) or an investor (using an application obtained from the broker-dealer) mails an account application and a check—typically to the fund transfer agent.⁷⁴ These accounts are opened as Level 0 non-Networked accounts and are known as “direct-at-fund” accounts. The practice is known as “check and app” or “subscription way” business. In this situation, the account is opened using the name and tax identification number of the investor, and the fund is the primary point of contact for the investor. If a selling agreement exists between the fund and the broker-dealer, any broker-dealer firm and the registered representative included on the application are also associated with the account record by the fund’s transfer agent.

Direct-at-fund accounts are typically not on the books of the broker-dealer. In recent years, through CDS I, fund complexes can regularly transmit account information to the broker-dealer associated with direct-at-fund accounts so that the broker-dealer can fulfill its books and records and other regulatory requirements.

⁷⁴ Some mutual funds accept unsolicited purchase orders directly from investors without the involvement of an intermediary. These accounts are generally known as retail accounts. Purchases are not processed through the NSCC, and the fund provides all shareholder servicing for these accounts. Since there is no intermediary involved with retail accounts, they are not further discussed in this paper.

Appendix C: Omnibus Intermediary System Considerations

In the omnibus recordkeeping model, the intermediary is required to follow the fund's prospectus, processing rules, and contract language specified in the shareholder servicing agreement with the fund. These requirements place great emphasis on the open, timely exchange of operating rules information between funds and intermediaries. Most intermediaries offer their investors a variety of fund products from multiple asset managers, making the management and application of the correct processing and prospectus rules a complex undertaking. Thankfully, the mutual fund industry has approached this challenge in innovative ways.

Over the past 20-plus years and with the guidance and support of ICI's Broker-Dealer and Bank, Trust, and Retirement Advisory Committees, DTCC has developed multiple services that efficiently help funds disseminate and intermediaries receive critical information in support of mutual fund operations. The result affords intermediaries every opportunity to operate their omnibus recordkeeping systems in both a timely and efficient manner.

Mutual Fund Profile Service

Broadly speaking, the DTCC's Mutual Fund Profile Service (MFPS) provides important information that assists intermediaries with establishing and maintaining their omnibus processing system rules to be in sync with those of the fund's transfer agent and transfer agent system. This coordination is critically important to facilitating the ability of the intermediary to satisfy its contractual obligations and may assist funds with their intermediary oversight and compliance activities through improved timely communication of key processing information and rules. MFPS is broken down as follows:

- » MFPS I Daily Price and Rate⁷⁵
- » MFPS II⁷⁶
 - » Security Issue Database
 - » Distribution Database

MFPS I Daily Price and Rate

Since 1996, DTCC's MFPS I Daily Price and Rate File has provided intermediaries with daily NAV and daily accrual factors for related fund products. Enhancements have added the communication of periodic factors (for declared dividends and capital gains), multi-currency capabilities, and support for both batch file and ISO/SWIFT messages. There are robust capabilities for communicating original as well as corrected information, as needed.

⁷⁵ See www.dtcc.com/wealth-management-services/mutual-fund-services/mutual-fund-profile-service-i for more information about MFPS I Daily Price and Rate.

⁷⁶ See www.dtcc.com/wealth-management-services/mutual-fund-services/mutual-fund-profile-service-ii for more information about MFPS II.

MFPS II Security Issue Database

The MFPS II Security Issue Database (often referred to as Profile) has supported intermediaries with providing comprehensive and timely information on fund processing rules, including when existing rules change and new rules take effect. Profile's data comparison tool receives information from the SEC EDGAR⁷⁷ database and automatically notes differences between what is in Profile and what has been filed with the SEC. Funds review their information and either accept the information in Profile or annotate why the Security Issue Database may be denoted differently than what was interpreted from EDGAR. Fund complexes may input details on operating rules that are necessary to operate systems but not specifically found in the prospectus.

Intermediaries may receive daily output files of participating security issue (e.g., CUSIP) information, including sales charge breakpoints, fees, transaction minimums and maximums, and sales eligibility by state. Alternatively, intermediaries may access a user-friendly web interface that displays rules by fund complex, share class, portfolio, or individual security issue. With robust output and ongoing development to provide customizable rules verification reports and files to intermediaries, Profile comprehensively supports intermediaries in maintaining and validating the accuracy of system processing rules for each of the funds offered to investors.

The review and maintenance of accurate Profile information by funds is vitally important to ensure intermediaries have timely, correct fund information when servicing their customers (fund shareholders). It takes a resource commitment, often from the fund personnel in addition to or instead of its transfer agent, to periodically review and update Profile. As such, some fund complexes may make the difficult business decision to not participate in Profile beyond the breakpoint schedules recommended by the Joint NASD/Industry Task Force.⁷⁸ Some intermediaries may seek to incorporate the fund's support of Profile into contractual shareholder servicing arrangements, to both manage costs as well as to ensure the intermediary has the most accurate, timely and consistent information from the fund for the best possible outcomes when servicing investor accounts.

MFPS II Distribution Database

A critical function for all fund recordkeepers is the accurate payment of income distributions, often in the form of dividends or capital gains. The MFPS II Distribution Database allows funds to provide intermediaries with projected and actual details regarding these distribution types—including amounts and applicable dates. Timely and accurate dissemination of this information to intermediaries helps to provide a positive investor experience regarding a highly visible transaction.

⁷⁷ The Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system is the primary system for companies and others submitting documents under the Securities Act of 1933, the Securities Exchange Act of 1934, the Trust Indenture Act of 1939, and the Investment Company Act of 1940.

⁷⁸ See page 9 for information about the task force.

MF Info Xchange

MF Info Xchange facilitates and centralizes the delivery and receipt of time-critical notifications from funds to intermediaries, including corporate actions, service disruptions, and other critical alerts. Intermediary to fund communication via MF Info Xchange includes large trade notifications. The service is integrated with MFPS II Security Issue Database and includes a web portal for organizing communications. The portal's daily calendar helps funds and intermediaries understand and coordinate their activities to align with any special events, such as announced corporate actions, fund mergers, fund name changes, or interval fund repurchase periods.⁷⁹

Initially implemented using Microsoft Excel®-based templates that were sent using email distribution lists managed by the sender or receiver, the service also supports inbound and outbound application programming interface (API) capabilities⁸⁰ for every notification type.

Other Non-DTCC Solutions

Commercial solutions help omnibus intermediaries support their operational needs, such as the desire for streamlined, timely information flows. Omnibus intermediaries—which make independent business decisions about the providers they use to support their recordkeeping activities—may decide that the benefits of these commercial solutions offset any cost incurred by their use.

⁷⁹ MF Info Xchange has more than 30 event types for which communications are supported. See www.dtcc.com/wealth-management-services/mutual-fund-services/mf-info-xchange for more information.

⁸⁰ An API leverages a documented interface to facilitate communication between disparate systems. Organizations may construct APIs to flexibly pull or push data between entities. Refer to www.ibm.com/cloud/learn/api for more on this definition.

Appendix D: History of Fund/SERV and Networking

In 1973, the Depository Trust Company (DTC) was formed to begin the process of immobilizing paper certificates and supporting “book entry” ownership positions, with the goal of eliminating paper certificates entirely. With book entry ownership, the investor does not receive a paper certificate. Rather, evidence of the investment is maintained on the intermediary’s records. The intermediary then regularly provides account information (e.g., customer account statements in addition to confirmations that may be received at the time of any transaction) so that the investor knows the holdings (and value) of the account. Reducing the management of paper certificates was an essential first step toward more efficient trade processing.

The National Securities Clearing Corporation (NSCC) was established in 1976 as an SEC-designated clearinghouse to provide clearing and settlement services for a wide variety of securities except mutual funds. In 1978, NSCC released the Continuous Net Settlement service, which provides uninterrupted details regarding the securities and money positions of NSCC participants. The combination of reducing the need for paper certificates and the continuous flow of financial information provided the foundation for efficient institutional trading.

In 1984, ICI initiated a project to develop automation for processing and settling mutual fund transactions. A task force,⁸¹ assembled to evaluate system offerings from various entities, determined that a proposal from NSCC best fit fund industry needs. The functionality that developed became the Fund/SERV mutual fund trading platform. Debuting in 1986, Fund/SERV is the dominant industry utility in use today for processing and settling mutual fund trades.

Once automated fund trading was established, the industry turned to the problem of sharing account data. At the time, broker-dealer systems struggled with reconciling the omnibus position on the mutual fund books with the investor positions on their books. This reconciliation process resulted in inconsistencies, for both the firms and the fund complexes, that had to be resolved manually. To remedy this costly and time-consuming problem, an ICI committee and NSCC sought an automated solution to seamlessly exchange data. The result is the Networking service used today.

Launched in 1988, Networking is the NSCC utility for the exchange of account-level data, such as share positions. As discussed in more detail in Appendix B, Networking is divided into three levels: 0, 3, and 4. Each level defines a different set of customer service responsibilities between the firm and the fund complex. The most common level is Networking Level 3, in which the broker-dealer controls all contact with the investor, and the share balance for the investor is the same on both the transfer agent and firm records. Since Level 3 provided numerous operational efficiencies such as improved reconciliation functionality when it was introduced, many broker-dealer firms moved positions from omnibus registrations to Level 3 registrations.⁸²

⁸¹ This task force evolved into the ICI Broker-Dealer Advisory Committee.

⁸² This trend has since reversed, as omnibus intermediary systems adopted the same efficiencies as mutual fund transfer agent systems. Positions have since shifted back into omnibus registrations.

As the automated services of Fund/SERV and Networking advanced, both were augmented for bank and retirement activity. Banks expanded their use of Fund/SERV for purchases and sales, and a functionality known as “Trust Networking” was implemented, allowing banks and fund complexes to manage bank trading account details more accurately. Level 0 Trust Networked accounts are afforded similar treatment as Networking Level 3 accounts, whereby the bank, trust company, or retirement plan recordkeeper controls all contact with the investor.

Both Fund/SERV and Networking were significantly enhanced to create the Defined Contribution Clearance and Settlement services (DCC&S). DCC&S permits early morning trading by omnibus brokers and banks that submit to funds the aggregate trades resulting from the intermediaries’ overnight processing cycle.⁸³ Funds can systematically incorporate this activity into their shares outstanding as if the trading activity was received the previous day.

Today, the mutual fund industry and NSCC continue to collaborate on improvements to these services. As the demands of intermediaries and their investors for higher quality, more efficient, and timelier service continue to grow, the systems and processes developed decades ago will continue to advance to meet those needs.

⁸³ As agents of the fund, omnibus intermediaries accept trades from their beneficial owners until the fund’s trading cutoff time as defined by the prospectus, or at an earlier time as defined by contractual arrangement with the fund. Once the fund provides the daily NAV, intermediaries process the day’s trading activity on their systems during the overnight hours, prior to delivering the aggregate activity via DCC&S to the fund early the next morning.

Appendix E: Relevant Regulatory and Compliance Initiatives

The following initiatives are relevant to fund and intermediary relationships. Items are drawn from congressional legislative and regulatory rulemaking activities, interpretive guidance issued by regulators, and recommendations received from regulators in partnership with industry participants. Fund board members and operations professionals can use this information to better understand obligations that must be met when navigating intermediary relationships.

The list of items is not presented in any order. Each identifier is used in footnotes to help the reader quickly identify where more information can be found.

Investment Company Act of 1940⁸⁴

1. Rule 2a-7 (the money market fund rule) was modified in July 2014. Modifications introduced a floating NAV for institutional prime and municipal money market funds, narrowed investment eligibility for constant NAV money market funds to retail investors, and provided fund boards with the ability to impose liquidity fees and redemption gates based on declines in a money market fund's weekly liquid assets.⁸⁵ The SEC is considering additional money market fund reforms, as of the publication of this paper.
2. Rule 12b-1 requires board of director approval of a 12b-1 plan, including approval by a majority of its independent directors. The board must also review quarterly the amounts expended under the plan and the purposes for which such expenditures were made. The board must reevaluate and reapprove distribution agreements annually.⁸⁶
3. Rule 12b-1(h)(2)(ii) provides that a mutual fund may not direct its portfolio securities transactions to a broker or dealer that promotes or sells the fund's shares unless the fund meets certain conditions, such as implementing policies and procedures that have been approved by the fund's board, including a majority of its independent directors. These policies must be reasonably designed to prevent (a) the persons responsible for selecting brokers and dealers to effect portfolio transactions from considering the brokers' and dealers' promotion of fund shares; and (b) the fund, adviser, and principal underwriter from entering into any agreement under which the fund's portfolio transactions are directed to a broker-dealer in consideration of the broker-dealer's promotion of the fund's shares.
4. Section 15(c) requires that a majority of a fund board's independent directors approve the terms of the fund's principal underwriting contract and any renewals.

⁸⁴ Refer to <https://ecfr.federalregister.gov/current/title-17/chapter-II/part-270> for the Code of Federal Regulations (CFR) version of the act.

⁸⁵ Refer to www.sec.gov/rules/final/2014/33-9616.pdf for the money market fund reform final rule.

⁸⁶ Rule 12b-1 under the Investment Company Act of 1940 was adopted by the SEC in 1980. For a comprehensive discussion of the development of Rule 12b-1 fees, see Investment Company Institute, "Report of the Working Group on Rule 12b-1" (May 2007). Available at www.ici.org/system/files/attachments/rpt_07_12b-1.pdf.

5. Section 17(d) and Rule 17d-1 address joint transactions involving funds and their affiliates. When a fund engages the adviser or its affiliates to perform services such as transfer agency services, SEC staff no-action positions require that the fund's board—including a majority of its independent directors—determine that (a) the service contract is in the best interests of the fund and its shareholders; (b) the services are required for the operation of the fund; (c) the services are of a nature and quality at least equal to the same or similar services provided by independent third parties; and (d) the fees for those services are fair and reasonable in light of the usual and customary fees charged by service providers for services of the same nature and quality.
6. Rule 17j-1 requires the board, including a majority of its independent directors, to approve the code of ethics of any principal underwriter before initially retaining its services. Any material change to the code of ethics must be approved by the board no later than six months after its adoption.
7. Rule 18f-3 requires a fund's board, including a majority of its independent directors, to approve any plan relating to multiple classes of shares, which have different arrangements for shareholder services or distribution of securities, as well as any material amendments to the plan.
8. Rule 22c-2 (the redemption fee rule) was enacted to combat frequent trading and market timing abuses. Rule 22c-2 requires the board, including a majority of its independent directors, to approve a redemption fee for the fund of up to 2 percent or to determine that a redemption fee is either not necessary or not appropriate to address frequent trading concerns. The rule also requires funds to enter into written agreements with intermediaries that hold shares on behalf of other investors, under which the intermediaries must agree to (a) provide funds with certain shareholder identity and transaction information if the fund requests it; and (b) implement any instruction from the fund to impose trading restrictions against shareholders the fund has identified as violating the fund's frequent trading policies. The 2006 SEC final rule states, "...a fund in appropriate circumstances could reasonably conclude that an intermediary's frequent trading policies sufficiently protect fund shareholders, and could therefore defer to the intermediary's policies, rather than seek to apply the fund's policies on frequent trading to shareholders who invest through that intermediary."⁸⁷
9. Rule 30e-3, adopted in 2018 and implemented in 2021, creates an optional "notice and access" method for a fund to satisfy its obligation to deliver shareholder reports. Under the rule, a fund may deliver its shareholder reports by making them publicly accessible on a website, free of charge; sending investors a paper notice of each report's availability by mail; and meeting certain other conditions. Investors who prefer to receive the full reports in paper may—at any time—choose that option free of charge. On October 26, 2022, the SEC reversed course and amended Rule 30e-3 to exclude investment companies registered on Form N-1A. As such, Funds will once again be required to deliver shareholder reports directly to shareholders by mail, or electronically if the shareholder has consented to electronic delivery.⁸⁸

⁸⁷ Refer to www.sec.gov/rules/final/2006/ic-27504.pdf for the final rule on mutual fund redemption fees. Quote from p. 16

⁸⁸ Refer to www.sec.gov/rules/final/2018/33-10506.pdf for the final rule on the optional internet availability of investment company shareholder reports, and www.sec.gov/rules/final/2022/33-11125.pdf for the final rule amending Rule 30e-3 to exclude investment companies registered on Form N-1A.

10. Rule 38a-1 (the compliance program rule), adopted February 2003, requires a fund's board, including a majority of its independent directors, to approve the compliance policies and procedures of the fund and each of its service providers. As defined in the rule, the term *service provider* means the fund's investment adviser, administrator, principal underwriter, and transfer agent. The approval must be based on a board finding that the policies and procedures are reasonably designed to prevent securities law violations by the fund and its service providers. Among other things, the compliance policies and procedures must address (a) pricing of fund portfolio securities and fund shares; (b) processing of fund share transactions; (c) identification of affiliated persons; (d) protection of nonpublic information; and (e) market timing.⁸⁹

Securities Exchange Act of 1934⁹⁰

11. SEC Rules 17a-3 and 17a-4 mandate what records broker-dealers must maintain, how they are to be maintained and made accessible to regulators, and the period for which they must be maintained. Although these rules primarily affect broker-dealers, fund complexes may be a primary source of information for the broker-dealers' compliance efforts for individual non-Networked accounts held with the fund's transfer agent.
12. SEC Rule 17Ad-17 requires mutual fund transfer agents and broker-dealers with custody of investors' accounts to conduct searches to locate "lost" securityholders. A securityholder, or shareholder, is generally defined as being lost when an item of correspondence sent by the transfer agent or broker-dealer to the securityholder's address of record is returned as undeliverable. When that happens, the transfer agent or broker-dealer may resend the correspondence within one month of the date it was first sent to the securityholder (to make sure it was not returned in error), and, if the item is again returned as undeliverable, the transfer agent must conduct searches of "national databases" as defined in the rule, to attempt to find a current address on the security holder. At the federal level, if a valid address cannot be found for the securityholder, the transfer agent or broker-dealer must consider the securityholder to be lost and include information on such securityholder in reports filed with the SEC. At the state level, deeming a securityholder as lost has more significant consequences. This is because the states' unclaimed property laws require the accounts of lost shareholders to be liquidated and escheated into state custody. It is because of these state laws that mutual funds and intermediaries use their best efforts to obtain valid addresses on their shareholders to avoid such shareholders' accounts being turned over to a state.

⁸⁹ Refer to www.sec.gov/rules/final/ia-2204.htm for the final rule on the compliance programs of investment companies and investment advisers.

⁹⁰ Refer to <https://ecfr.federalregister.gov/current/title-17/chapter-II/part-240> the CFR version of the act.

Other Legislative and Rulemaking Activities

13. The USA PATRIOT Act was enacted in 2001 in response to the September 11, 2001, terrorist attacks. The act, aimed at combating money laundering and terrorist financing, amended and strengthened the Bank Secrecy Act. The act and its implementing rules require financial institutions, including mutual funds and broker-dealers, to establish or conduct the following:

- » anti–money laundering (AML) programs,⁹¹
- » Customer Identification Programs (CIP),
- » suspicious activity reporting, and
- » due diligence programs for foreign correspondent accounts and private bank accounts.

These compliance obligations are aimed at ensuring that financial institutions know their customers, understand the customers' sources of funding, and report suspicious activity as appropriate. Sections 326 and 352 of the act require the fund board to approve a fund's AML program and CIPs.

14. IRC 403b, which is related to retirement plans for public schools and tax-exempt organizations, was modified in July 2007 to require new reporting and disclosure obligations for mutual funds providing plan investment options under the Internal Revenue Code Section 403(b).⁹²

15. Regulation S-ID (the identity theft red flags rules) was adopted in 2013 by the SEC to fulfill its responsibilities under Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The regulation requires federal regulators of financial institutions, including mutual funds, broker-dealers, transfer agents, and investment advisers, to adopt rules requiring such institutions to have programs designed to detect, prevent, and mitigate identity theft if they maintain “transaction accounts” for investors. Generally, a “transaction account” is one that enables the accountholder to make payments from the account to a third party.⁹³

⁹¹ Relevant AML statutes and rules are available at the Financial Crimes Enforcement Network (FinCEN) website, at www.fincen.gov/resources/fincens-mandate-congress. For a general overview of mutual funds' AML responsibilities, see Securities and Exchange Commission, Anti–Money Laundering (AML) Source Tool for Mutual Funds, available at www.sec.gov/about/offices/ocie/amlmfsourcetool.htm.

⁹² Refer to www.irs.gov/irb/2007-36_IRB#TD-9340 for the final rule on revised regulations concerning Section 403(b) tax-sheltered annuity contracts.

⁹³ Refer to www.sec.gov/rules/final/2013/34-69359.pdf for the final rule on identity theft red flags.

16. Customer Due Diligence (CDD) rules under the Bank Secrecy Act were adopted by FinCEN in 2016. The rules require financial institutions (including mutual funds and broker-dealers) to identify and verify beneficial owners of “legal entity customers.” Legal entity customers include entities such as corporations and LLCs. Beneficial owners of those entities are determined by either a minimum ownership stake (i.e., individuals owning, directly or indirectly, 25 percent or more of the equity interests of the entity) or significant control exerted over the legal entity by an individual. In related guidance, FinCEN stated, “To the extent that existing guidance provides that, for purposes of the CIP rules, a financial institution [e.g., a mutual fund] shall treat an intermediary (and not the intermediary’s customers) as its customer, the financial institution [e.g., a mutual fund] should treat the intermediary as its customer for purposes of this final rule.” Financial institutions serving as mutual fund intermediaries (e.g., broker-dealers) bear CDD responsibilities for their customers.⁹⁴
17. SEC Regulation Best Interest (Reg BI) was adopted in 2019. Reg BI imposes an enhanced standard of conduct on broker-dealers when they provide recommendations to retail customers regarding a securities transaction or an investment strategy involving securities. A broker-dealer must act in the retail customer’s best interest and cannot place its own interests ahead of the customer’s interests. A broker-dealer satisfies Reg BI by meeting its four component obligations: disclosure, care, conflict, and compliance. While Reg BI has limited direct effect on fund complexes, it has wide-ranging and varied effects on broker-dealers that, in turn, may affect fund products and distribution.⁹⁵
18. SEC Form CRS was adopted in 2019 as a companion to Reg BI. Investment advisers and broker-dealers are required to deliver a relationship summary to retail investors at the beginning of the relationship. The relationship summary, presented in a standardized question-and-answer format, provides investors with information about a firm’s services, fees and costs, conflicts of interest, applicable legal standard of conduct, and disciplinary history.⁹⁶

⁹⁴ Refer to www.govinfo.gov/content/pkg/FR-2016-05-11/pdf/2016-10567.pdf for the final rule on customer due diligence.

⁹⁵ Refer to www.sec.gov/rules/final/2019/34-86031.pdf for the final rule on Regulation Best Interest, the broker-dealer standard of conduct.

⁹⁶ Refer to www.sec.gov/rules/final/2019/34-86032.pdf for the final rule on the Form CRS relationship summary.

SEC Interpretive Guidance

19. The SEC's Division of Investment Management issued Guidance Update 2016-01: Mutual Fund Distribution and Subaccounting Fees following the SEC's "distribution-in-guise" examination sweep and included staff views and recommendations. The Guidance Update explains that fund boards "bear substantial responsibility for determining whether fees paid by a mutual fund are for distribution" and encourages boards to understand the overall distribution process. Boards may rely on others such as outside counsel, the fund's chief compliance officer, and relevant fund complex personnel to help in their understanding. Staff suggested focusing on both context and conflicts of intermediary arrangements and "the specific details of atypical or particularly significant arrangements." The Guidance Update explains that, in determining whether a payment may be used to pay for distribution, the fund's board should consider, among other things, compensation paid to intermediaries both within and outside a 12b-1 plan, lack of specificity or bundling of services, and certain tiered payment structures. Finally, the Guidance Update stressed that funds should have explicit policies and procedures as part of their Rule 38a-1 compliance programs designed to prevent violations of Section 12(b) and Rule 12b-1, taking into consideration whether the board has adopted a 12b-1 plan.⁹⁷
20. The Division of Investment Management issued Guidance Update 2016-06: Mutual Fund Fee Structures in response to the DOL fiduciary rule that was issued in 2016 (and subsequently vacated in 2018). At the time, funds and intermediaries were contemplating ways to level compensation paid to intermediaries on their sale of fund shares to facilitate intermediary compliance with the rule. The Guidance Update affirmed the ability for funds to be sold at prices that reflect schedule variations, including elimination, of sales loads consistent with Rule 22d-1 under the Investment Company Act of 1940, if each sales load variation is properly disclosed in the prospectus. Scheduled variations in sales loads may be included in an appendix to the statutory prospectus.⁹⁸
21. An SEC no-action letter clarifying applicability of Section 22(d) in the sale of certain mutual fund shares was issued in response to an inquiry by an asset manager. In this letter, the SEC provided a no-action response clarifying that a broker is not subject to the restrictions of Section 22(d) of the Investment Company Act of 1940 when it charges its customers commissions for transactions in fund shares that do not have a front-end load, deferred sales charge, or other asset-based fee for sales or distribution (clean shares). The letter includes several representations, including that the broker will represent in its selling agreement with the fund's underwriter that it is acting solely on an agency basis for the sale of clean shares.⁹⁹

⁹⁷ See Guidance Update Number 2016-01, regarding mutual fund distribution and subaccounting fees. Available at www.sec.gov/investment/im-guidance-2016-01.pdf.

⁹⁸ See Guidance Update Number 2016-06, regarding mutual fund fee structures. Available at www.sec.gov/investment/im-guidance-2016-06.pdf.

⁹⁹ Refer to www.sec.gov/divisions/investment/noaction/2017/capital-group-011117-22d.htm for information on the interpretive guidance.

Regulator/Industry Task Forces

22. The Report of the Joint NASD/Industry Task Force on Breakpoints was issued July 2003¹⁰⁰ and includes 13 recommendations for the proper application of breakpoint discounts to achieve the best pricing for the investor.

Employee Retirement Income Security Act of 1974 (ERISA)¹⁰¹

23. Labor Regulation § 2550.404a-5, issued in 2010, required retirement plan fiduciaries to ensure that plan participants and beneficiaries are made aware of their rights and responsibilities and are provided sufficient information regarding the plan's designated investment alternatives.¹⁰² Broadly, the required disclosure is divided into two parts:
- » plan-related information, such as general information about how to give investment directions, details on administrative expenses, and expenses for specific services, and
 - » investment-related information, such as historical performance and fee and expense information.
24. Labor Regulation §2550.408b-2 was amended in 2012 to require retirement plan service providers to disclose certain information to plan fiduciaries, so the latter may assess the reasonableness of compensation received by the service provider and to identify potential conflicts of interest.¹⁰³
25. The DOL amended the Form 5500, effective beginning in 2009, to require new reporting by retirement plans on the Schedule C to disclose fees paid to service providers. Updates require information on service provider compensation and payments received by service providers from others in connection with services provided to the plan (e.g., revenue sharing).¹⁰⁴

¹⁰⁰ Available at www.finra.org/Industry/Regulation/Guidance/ReportsStudies/p085415.

¹⁰¹ ERISA has numerous provisions that affect the type and attributes of products used in DC plans and the conduct of DC plan sponsors. Most notably, sponsors and other parties are to act as fiduciaries on behalf of plan participants. Intermediaries supporting ERISA plans, including retirement plan recordkeepers, are indirectly regulated by ERISA due to their relationship to the DC plan. Funds are most directly affected by ERISA when making product decisions and meeting the plan's needs to offer products that do not create a conflict of interest for plan sponsors. The fiduciary responsibilities associated with plan sponsors are summarized at www.dol.gov/general/topic/retirement/fiduciaryresp.

¹⁰² Refer to www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/our-activities/resource-center/fact-sheets/final-rule-improve-transparency-of-fees-and-expenses.pdf for a summary of the final rule.

¹⁰³ Refer to www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/our-activities/resource-center/fact-sheets/final-regulation-service-provider-disclosures-under-408b2.pdf for a summary of the final rule.

¹⁰⁴ Refer to www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/our-activities/resource-center/faqs/2009-form-5500-schedule-c.pdf for more information.

Appendix F: Sales Charges

A sales charge (also known as “sales load” or “load”) is paid by investors when purchasing certain share classes of a fund.

Front-End Sales Charge

The traditional sales charge is a front-end load fee paid by the investor to intermediaries (primarily broker-dealers) in connection with the purchase of fund shares. This fee is a component of the fund’s offering price and is assessed when an investor is purchasing Class A shares. Front-end sales charges compensate the intermediary for performing initial client servicing, such as analyzing existing investor holdings, assessing investor goals, determining appropriate investments to purchase, and establishing and maintaining the account.

To benefit investors making large purchases, Class A shares typically include breakpoint discounts where the load declines based on the dollar value of the purchase. At the highest end of the breakpoint schedule, the sales charge is eliminated completely. A variety of different sales charge reduction programs are available to investors in share classes with front-end loads. These types of programs offer investors the benefit of quantity discounts on sales charges that apply to front-end load purchases in certain circumstances. The types of accounts, eligible relationships, and discounts applied vary by fund and fund group.

Typical fund sales charge reduction programs may include:

- » **Rights of accumulation** programs that combine the value of existing investments in the fund group with the value of a new investment in the fund
- » **Combined purchase** programs that aggregate simultaneous or relatively concurrent purchases of shares of funds (within a fund group) into a single “purchase”¹⁰⁵
- » A **letter** or **statement of intent** that allows a shareholder to combine certain fund purchases for various share classes he or she intends to make over a certain period (e.g., 13 months) to determine the applicable (discounted) sales charge¹⁰⁶

Other programs offered include:

- » Reduced or eliminated sales charges for dividend reinvestment programs
- » Reinstatement or reinvestment privileges where an investor may reinvest proceeds from a redemption into the same account or fund at net asset value (NAV) within a certain time without any sales charge

In 2021, front-end load funds received approximately 6.5 percent of industry gross sales and held roughly 11.5 percent of total assets for long-term mutual funds. It is unknown what portion of those shares were acquired with waived front-end sales loads.¹⁰⁷

¹⁰⁵ Some funds, as part of their combined purchase programs, also permit the trades of various family members or affinity groups to be combined when determining the sales charge (or breakpoint discount) a purchaser is entitled to.

¹⁰⁶ A statement of intent allows the shareholder to take immediate advantage of the maximum quantity discount available.

¹⁰⁷ Investment Company Institute, *Fact Book, Figures 6.11 and 6.12, 114–115.*

Contingent Deferred Sales Charge¹⁰⁸

To facilitate the use of a Rule 12b-1 plan,¹⁰⁹ the fund's principal underwriter (often known as the distributor) initially advances to the intermediary an amount that would be equivalent to the commission normally paid by the investor. Under this process, the intermediary is compensated for its servicing, but the investor is 100 percent invested. The fund then reimburses the distributor for the advance payment through the 12b-1 expense paid by the investor as part of the fund expense ratio.

Generally, the option for investors to pay sales charges over time through 12b-1 fees includes a fee repayment mechanism if the shares are held for only a short time. These provisions are known as CDSCs or back-end loads. Back-end loads typically decrease over a specified number of years, eventually falling to 0. For example, when purchasing Class B shares, the investor does not pay a front-end sales charge; rather, the investor pays through a 12b-1 fee (typically 100 basis points) and a CDSC. Under specific prospectus provisions, the CDSC is triggered if the investor redeems fund shares before a given number of years of ownership (typically six to eight years for Class B shares). After the CDSC recovery period expires, the Class B shares convert to load-waived Class A shares. At that time, the expense ratio paid by the investor holding the load-waived Class A shares includes only the 25 basis point component of the 12b-1 fee paid to the intermediary for its ongoing servicing of the investor's account.

Class C shares are also subject to a CDSC, but for a much shorter window. The CDSC recovery period for Class C shares typically is one year. In contrast to Class B shares, most Class C shares historically did not convert to Class A shares, so the investor would continue to pay the full 100 basis point 12b-1 fee as part of the Class C fund expense ratio.¹¹⁰ The 12b-1 fee is paid to the intermediary for its ongoing advice and servicing of the investor account. Over time, many intermediaries have relied upon SEC interpretive guidance that allows for intermediary-specific variations in sales loads to introduce automatic Class C to Class A share conversions after a certain length of time.¹¹¹ Many funds have taken similar action.

In 2021, funds that feature a CDSC as a key part of their compensation structure (e.g., back-end and level load funds) were responsible for less than 1 percent of industry gross sales and hold less than 1 percent of total net assets for long-term mutual funds.¹¹²

¹⁰⁸ These fees are also referred to as contingent deferred sales loads, or CDSLs.

¹⁰⁹ Rule 12b-1 prohibits an open-end fund from using its own assets to pay for any distribution costs unless the distribution payments are made pursuant to a written plan approved by the fund's board, including its independent directors, and the fund's shareholders. See page 19 and Appendix E.2, 3, and 19 for further information on Rule 12b-1.

¹¹⁰ Under this arrangement, the fund is termed a "level load" share class.

¹¹¹ In the case of Class C share conversions, intermediaries have typically determined the length of time when the investor would have paid an equivalent amount of fees in Class C as in Class A and use that to determine the number of years before conversion. See Appendix E.20 for more information on variances in mutual fund fee structures.

¹¹² Investment Company Institute, Fact Book, Figures 6.11 and 6.12, 114–115.

Broker Commissions

A 2017 SEC staff no-action letter provides that a broker, acting as agent on behalf of its customers, with respect to a class of shares that does not have a front-end load, deferred sales charge, or other asset-based fee for sales or distribution, may charge its customers commissions for transactions in such shares.¹¹³

According to the no-action letter, funds must complete certain actions for an intermediary to receive broker commissions. The respective prospectus must disclose that an investor in the fund and share class may be required to pay a commission to a broker, and if applicable, that shares of the fund are available in other share classes that have different fees and expenses.

Unlike front-end sales charges and CDSCs, the application of broker commissions to a permissible share class is independently determined by the broker; the fund complex is not otherwise involved.

¹¹³ See Appendix E.21 for more information.

Appendix G: Fee Calculation Methods and Processing

Calculation Methods

Asset-Based Fees

Rule 12b-1 fees and many shareholder servicing fees are often structured as asset-based amounts, calculated as a percentage times the relevant average net assets of the fund. As the balance in an account grows from new purchases or market increases, the amount of the asset-based payment to an intermediary will grow. As balances decrease from redemptions or market declines, the amount paid will decrease. The factor used in the calculation generally is not changed.

As part of the calculation of fund expenses, asset-based fees are accrued daily. Frequency of the payment to intermediaries will vary depending on the disbursement method used between the fund complex and intermediary (see “Compensation Process” below).

Transaction-Based Fees

Front-end sales charges are assessed when fund shares are purchased. These fees are calculated as a component of the public offering price and are a predetermined percentage. This percentage will vary only to the extent that an investor may qualify for a breakpoint in the sales charge, as determined by the amount being invested.

CDSC fees are assessed only if the investor chooses to redeem shares before the CDSC recovery schedule expires. The amount the investor would pay is the CDSC percentage, as disclosed in the prospectus at the point in time when the investor redeems shares. For example, for Class B shares, the maximum CDSC may be 6 percent with six years being the maximum number of years the shares need to be held. Typically, the percentage declines 1 percent each year and is calculated against the lesser of the value of the shares at purchase or the value at redemption.

Fixed Amount Fee for Servicing

In lieu of an asset-based shareholder servicing fee, where the amount varies in relation to the value of the assets, the fund complex may use a fixed dollar amount payment. Generally, this alternative is based, for the nonretirement market, on a “per account” charge per investor account being serviced by the intermediary. Typically, in the retirement market, the basis is a “per participant” charge for each applicable fund position held in a retirement plan being serviced by an intermediary. In either case, the fixed amount does not fluctuate, only the basis (account or participant count) for the calculation.

Tiered Fee Calculation for Servicing

Some funds itemize payment for services provided and scale the fees based on the number and types of those services that an intermediary provides. Under this arrangement, the more services provided by the intermediary, the higher the payment up to a maximum. This approach matches the level of compensation to the activity. That way each intermediary can choose the extent to which it will assume transfer agency and investor servicing obligations and can understand the amount of compensation it will receive. This approach does create more administrative work for the fund affiliate managing the agreements and payments, in that it needs to accurately track the services being provided by the intermediary and any changes to them.

Negotiated Compensation

Additional compensation may be negotiated between a fund affiliate and an intermediary for a variety of reasons. These payments (commonly known as revenue sharing payments) are not fund expenses; rather, they are paid by one of the fund's affiliates. Subject to the discretion of the affiliate, this compensation may be increased or decreased, as the affiliate determines, based on market factors, competitive arrangements, or business strategies. For example, as market and investor preferences shift, shelf space payments may change or be eliminated to reflect volume movement either to or from an intermediary. Revenue sharing may not be a means for the fund to indirectly pay for distribution outside of a 12b-1 plan.

Compensation Process

As with other fund processing, compensation (such as commissions, 12b-1 fees, shareholder servicing fees) may be managed in a variety of methods. If the intermediary is a member of NSCC, the compensation calculation and processing may be wholly or partially automated. Intermediaries that do not participate with NSCC are likely to be paid by wire transfer, ACH, or manual check. The level of documentation needed from the intermediary to validate a payment and the time necessary for fund staff to review the documentation and process any payment is commensurate with the method; automated payments require little intervention and documentation, while manual payments require a substantial amount of both.

DTCC Payment aXis®

An ICI task force, working with DTCC, expanded upon NSCC Commission and Fee Settlement¹¹⁴ to incorporate an omnibus invoice and fee tracking, processing, and settlement process. The service for omnibus accounts was branded DTCC Payment aXis and introduced in 2012.

Since 1992, Commission and Fee Settlement has supported industry compensation payments, including front-end sales charges, contingent deferred sales charges, 12b-1 fees, and other payments. While all payment types apply to individual accounts, some may also apply to omnibus accounts. This service for NSCC participants allows fund complexes to systematically deliver compensation data and payments to intermediaries. Through this service, fund complexes typically transmit compensation information to intermediaries so that they may balance the payment information and resolve any differences with fund management before payments are completed. The ability to settle differences provides an efficient payment reconciliation method for both parties. The actual payment is included in NSCC net settlement activity between the fund complex and intermediary on the appropriate day.

¹¹⁴ Prior to 2014, "Commission and Fee Settlement" was branded "Mutual Fund Commission Settlement".

The omnibus invoice process, fully introduced in 2013 allows intermediaries to take advantage of similar capabilities related to their alternative shareholder servicing arrangements with the fund. The intermediary can transmit summary invoices only or can incorporate detailed beneficial owner account-level information that is relevant to the calculation of servicing fees owed to the intermediary. All the benefits of net settlement are afforded the invoice and fee workflow.

Manual Payments

In contrast to the automated approach provided by DTCC Payment aXis®, the manual process is a resource-intensive and time-consuming operation for both fund complexes and intermediaries. In the manual environment, intermediaries provide an invoice to the fund complex that indicates the amount of fees due, as calculated by the intermediary based on its contractual agreement with the fund complex. The fund complex validates the information provided and reconciles any differences between its records and the intermediary's prior to any payment being released. Once the payment is delivered, there may be follow-up contact with fund staff as the intermediary reconciles the payment and payment detail provided by the fund complex to its own records. This scenario may repeat itself a few times before both sides are satisfied with the amount and detail for the payment to occur.

Appendix H: Potential Board Questions

In addition to the specific statutory and regulatory requirements listed in Appendix E, the board's role with respect to intermediaries is generally one of oversight. Boards are not expected to navigate the complexities of the fund's arrangements with various intermediaries, but the following questions may help the board to have a general understanding of the fund's system for distribution and shareholder servicing; the various intermediaries involved in distributing the fund's shares and servicing the fund's shareholders; and the compensation structure associated with such distribution and servicing activities.

What types of intermediaries sell the fund's shares? (See pages 2–3 and Appendix A.)

- » Broker-dealers?
- » Banks?
- » Fund supermarkets?
- » Insurance companies?
- » Registered investment advisers?
- » Retirement plan recordkeepers?

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? (See page 7.)

How are the intermediaries compensated for their services? (See pages 12–14 and Appendices E and F.)

- » Does the distributor, adviser, and/or any other party pay any intermediary 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? (See pages 9–11.)

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