

Fee Transparency in the Mutual Fund Industry



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Introduction

Mutual funds, noted for their ease-of-use, liquidity, investment diversification and professional management, have long been a common fixture in the retirement and investment communities. Mutual funds receive significant inflows from employer-defined contribution retirement plans (401k), Individual Retirement Accounts (IRAs) and Roth IRAs. They invest in an array of financial instruments that vary substantially in the types of securities bought and sold for each fund's portfolio based on the fund's investment objectives, the types of securities eligible for investment, and their availability in the marketplace. The mutual fund industry offers a wide range of fund products with a variety of different fee structures. It is estimated that investors pay over \$70 billion in mutual fund fees annually. Although fees have actually increased over the past 20 years, so have the level of services offered to investors through the use of enhanced technology.

Due to the wide variety of relationships and agreements between the fund and financial intermediaries it has become increasingly more difficult to fully disclose to shareholders the intricate details of all these relationships and agreements, the services provided, and how fees or commissions are distributed. The lack of fee transparency within the mutual fund industry continues to cause some contention between fund companies, financial intermediaries and more importantly, investors. Rarely, if ever, are the cost and benefits related to these enhanced levels of service clearly disclosed on financial statements or explained in the footnotes. To add complexity to this disclosure issue, enhanced services (such as tax reporting, statement processing, trade processing, and electronic reconciliations) to investors are often provided by third party financial intermediaries who have invested time and resources in developing technology to better service their underlying clients / investors. Regulatory agencies and the media have been questioning revenue sharing arrangements between fund companies and intermediaries and how underlying shareholders are receiving actual benefits for the services performed. So the mutual funds industry, although highly regulated, is constantly reviewing and evaluating more effective ways to provide appropriate disclosure to the public.

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Structure and Flow of Revenue Sharing within the Mutual Fund Complex

Congress, through the U.S. Securities and Exchange Commission (SEC), passed the Investment Company Act of 1940 which set forth guidelines for all mutual funds and fund companies to follow. The Sarbanes-Oxley Act, the most far-reaching change in American securities law since the Depression was passed in the wake of corporate scandals that shook the stock market in 2002. Following a tip on improper trading, New York's attorney general initiated sweeping investigations of the mutual fund industry, in conjunction with the Securities and Exchange Commission and other regulators. Numerous agreements and settlements with executives and companies have been reached after the investigation of abuses in financial services such as late trading and market timing. Currently, the industry continues to face Department of Labor inquiries, state litigation, pending S.E.C. enforcement actions, steep fines and a huge increase in the number of class action law suits.

Several entities play a role within the mutual fund complex.

In most cases there is a Mutual Fund Holding Company that serves as the parent for a number of related entities that provide separate and distinct services to a fund or group of funds. The entities are as follows:

- The **Fund** which is a separate legal entity comprised of securities that are bought and sold in accordance with stated investment objectives. Each investor owns a prorated share of the fund's portfolio rather than specific shares of any of the underlying securities.
- The **Investment Advisor** who determines what securities will be bought and sold for the Fund's portfolio. The investment advisor is usually related to the Fund Company but their role can also be outsourced to a third party. The advisor must buy only those types of securities that coincide with the stated investment objectives disclosed in the fund's prospectus.
- The **Distributor**, a member firm of the National Association of Securities Dealers (NASD), responsible for marketing and distributing shares to the public by going directly to individual investors or through other financial intermediaries. The distributor, who interacts with all financial intermediaries, is usually a subsidiary of the Fund Company but can also be an outsourced third party. Most revenue sharing arrangements are made with the fund's distributor.
- The **Transfer Agent** is responsible for handling shareholder record-keeping functions and processing shareholder transactions. The Transfer Agent services the underlying investors in the fund. The transfer agent may be a subsidiary or an outsourced third party.
- The **Custodian** manages the safe keeping of all the assets within the fund's portfolio. The custodian may also perform fund accounting services to calculate daily share prices (NAV's), dividend factors/rates and capital gain rates. The custodian may be a subsidiary or an outsourced third party.

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Financial intermediaries interacting with any of the above entities include:

- **Clearing Firms** – NASD member firms that process mutual fund transactions for individual investors or other financial intermediaries such as other broker dealers, banks, record keepers or any combination listed. Clearing firms establish trading and revenue sharing agreements with many fund companies. The underlying clients of the clearing firm need only one set of agreements with the clearing firm to gain access to multiple fund companies. Clearing Firms receive compensation for their services by invoicing their underlying clients or by retaining a portion of their revenue sharing earnings, or by some combination of the two methods.
- **Banks** – Although banks are not NASD members, they are permitted to process mutual fund transactions on behalf of their underlying clients. Trust departments of banks who service traditional clients such as personal trusts, charitable trusts, and foundations etc. may also serve as custodians for retirement plans and pension plans. Banks that serve as custodians for retirement plans are responsible for sending and receiving money for settling trades placed by the plan at the fund. In some instances, the trust department may serve as an intermediary on behalf of a record keeper and execute trades on its behalf. When imposed, the Gramm-Leach-Bliley Act would require that bank trusts meet the chiefly compensated test when collecting outside revenue from mutual fund companies. The test will require banks to ensure that outside revenue received for marketing and distribution services is less than 50 percent of the total revenue earned on the assets. It has not been determined whether the test must be performed based on all assets held in trust or for each individual trust client.
- **Record keepers** – Record keepers provide participant level record keeping services on behalf of a variety of retirement plans. The most common forms of record keepers are firms that specialize in the administration of retirement plans or insurance companies that also provide services for administering retirement plan services.
- **Broker Dealers** – Broker dealers are NASD members who provide investment advice to their underlying clients. Broker dealers process transactions and provide account statements on behalf of their underlying clients. It is important to note that some broker dealer firms also act as clearing firms.

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The flow of revenue sharing is initiated when mutual funds make payments to the fund's distributor based on what is disclosed in the prospectus of the fund. The fund's distributor has signed agreements with financial intermediaries and will pass through all or a portion of those payments based on the agreements. Financial intermediaries that operate as clearing firms may pass through all or a portion of the received payments to their clients, who themselves are also financial intermediaries. Other financial intermediaries that deal directly with the fund companies receive payment from the fund's distributor in accordance the signed agreement. Upon receipt of revenue by an intermediary, processes are put in place to record the revenue at various levels within the organization. Some methods may be very simple while other firms may require sophisticated allocation methods. Examples of some of these more sophisticated methods may include crediting revenue to the primary accounts on their record keeping system, offsetting service fees charged to clients, or crediting fees to cost centers, or to departments, or to lines of business. Some intermediaries may even adopt multiple allocation methods within the same organization.

Fees in the Mutual Fund Complex

Lack of fee transparency is most prevalent between clearing firms and their underlying clients. This is primarily attributed to the fact that the level of services may be redefined each time revenue is passed through from one intermediary to another. For example, a clearing firm may receive trades from a record keeper, then roll the trades into orders and send orders to the fund company. The clearing firm may accept fees from the fund company based on invested assets created from the orders processed on behalf of another underlying financial intermediary. The clearing firm may then pass through all or part of these collected fees to the underlying financial intermediary as compensation for performing various shareholder services such as issuing statements to underlying investors, performing year end tax reporting etc. As these fees continue to be passed on down through the chain of intermediaries, the services take on different forms for which these firms receive compensation.

Establishing guidelines and regulations for defining allowable revenue sharing arrangements and disclosing all the unique services provided to investors is no easy task for the industry. Regulatory bodies within the industry must perform ongoing analysis of the impact these arrangements have on the normal investor and define this impact in terms that would be understood by the general public. So far, the industry has been partially successful at disclosing these expenses at a high level through the fund's financial statements and statements of additional information sent out to shareholders. The most common types of fees or commissions paid to financial intermediaries by the mutual fund include distributions under Rule 12b-1, Sub Transfer Agent or Sub TA fees, Administrative Fees and Finder's Fees (see Appendix 1).

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Revenue Management – Existing Solutions

The complexity of relationships amongst the various entities that play a role in the mutual fund industry, the myriad of services that are performed by these players and the many different types of fees paid and allocated for these services make tracking and highlighting these fees an especially difficult problem.

The principal challenge for fund companies is making certain that accounts are properly linked for inclusion in the distribution process. These links must be maintained when financial intermediaries complete acquisitions of other firms or create new accounts / positions at the funds. The functionality for linking accounts for trade processing are autonomous from account linkage functionality for processing fees. Consequently, fund companies often overlook the second part of the setup, resulting in the under payment of fees by the distributor. Over time, accumulated unpaid fees can add up to a significant amount of unrealized revenue for a financial intermediary.

The principal challenge confronting financial intermediaries is to efficiently track and monitor incoming fees or commissions earned and identify unpaid amounts on a timely basis. As the number of positions at the fund company grow along with the number of funds with varying fee rates and payment frequency, so does the challenge of monitoring and tracking of fees by the intermediary.

Solutions currently used in transaction processing of mutual fund trades vary by size of the financial intermediary in question and include the following:

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- **Desktop solutions** like Excel and Access are the most common solutions used by large bank trusts and many medium sized retirement service providers, retirement plan administrators, and mutual fund clearing and settlement firms. However, these desktop solutions are **not usually powerful enough** to handle the growing needs of the business such as adding new accounts, new fund families and funds, and the volume increases of such additional transactions. This type of solution is also uneconomical as it usually requires extensive manual intervention to update databases and / or spreadsheets.
- **Customized in-house systems** are less common and used primarily by large retirement service providers and retirement plan administrators and large mutual fund clearing and settlement firms. These customized systems, once developed and installed, **may not be flexible enough** to keep up with the ever changing provisions mandated by government legislation and industry regulation including Sarbanes-Oxley (SOX), Gramm-Leach-Bliley (GLB), etc.

- **Manual or paper-based systems** are typically used by the smaller mutual fund clearing and settlement firms, bank trusts, and retirement service companies or third party administrators. These non-automated processes utilize the paper statements provided by fund families and are **highly inefficient** as they are manually intensive and assume that the fund companies are able to identify all revenue earned. Emphasis in processing is usually concentrated on where to allocate or book the revenue paid as opposed to identifying all positions for which fees are due.

Revenue Management – A New Approach

In the mutual funds industry efficient revenue management is as much a matter of linking earned commissions (sometimes described as fees) on a very detailed level, as it is of controlling costs, also usually described as fees. Special revenue management software now exists that is powerful and flexible enough to address the complexity, advancement and impact of fee transparency (or the lack thereof) between all parties within the mutual fund industry. Such software's highly efficient intermediary-friendly features enable users to create internal bench marks for matching anticipated fees against actual payments. This software's matching process is automated when fund companies provide electronic payment details through the NSCC Commission Settlement Service or some other electronic data file. Also, the software's ability to identify missing payments and submit back fee requests in a timely manner represents only half of the process as there is also the need to allocate revenue within the organization to specific lines of business, underlying accounts, etc.

With the introduction of Revenue Manager™, Delta Data Software clients are discovering numerous cost saving benefits, which include identifying unpaid fees, easy electronic matching of fees earned versus fees paid, timely processing of back fee requests as well as the ability to clearly allocate pass through of fee revenue at any level such as cost centers, departments, lines of business, retirement plans, etc. In addition, Revenue Manager allows users optional set up of standard journal entries to record economic events at the time of processing and interface with other financial systems, an added dimension rarely found in existing software packages.

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Looking Ahead

When fund companies and financial intermediaries are found to be in violation of securities law, they risk being penalized by regulatory bodies and may open themselves up to class action law suits. More importantly, they run the risk of losing investor confidence which can result in material decreases in assets and revenues as investors seek alternative firms who have not been tarnished by such improprieties. As an example, outflows from one mutual fund company found to be in violation reached \$4.4 billion in the week ending November 5, 2003.

In today's sensitive regulatory environment therefore, financial intermediaries are not only looking for efficient processing, but want to ensure that there are sufficient audit trails which will satisfy SOX and GLB requirements. Smart intermediaries are already staying ahead of the curve with highly efficient solutions such as Revenue Manager that are flexible and powerful enough to promptly deal with changes in the regulatory environment and proactively address the intricate complexities of fee transparency without having to go through major system overhauls.

About Delta Data Software

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With a 20-year legacy of building, implementing, supporting and maintaining sophisticated software systems, Delta Data Software (www.deltadatasoft.com) is uniquely skilled in the delivery of transaction-based applications specifically tailored to meet the technology needs of the retirement and investment services industry. Delta Data's FUNDLinx is the industry's most advanced and comprehensive mutual fund and securities processing system - driving profitability for our clients with better edits and audit controls, less risk and dramatic cost reductions from straight-through processing.

APPENDIX 1

12b-1 fees:

Under rule 12b-1 of the Securities Act, and with the approval of the board of directors of the fund, payments may be made by the fund to the distributor. The distributor may then make payments to third party financial intermediaries in accordance with signed agreements. The maximum payout allowed under the rule is 100 basis points annually (limited in form to 25 basis points in a shareholder serving fee and 75 basis points in marketing/distribution fees). The expression 12b-1 fee is generically used within the industry to describe both shareholder serving and marketing / distribution portions of the fee. When presented within a specific context, the expression 12b-1 fee refers specifically to the marketing/distribution portion of the fee. These fees may also be referred to generically as trailer fees or asset based fees.

Fund Companies prorate annual fees and perform monthly or quarterly fee calculations. The calculations are usually based on the average assets an intermediary may have invested in the fund during the payment cycle. Payment cycles may vary with some funds paying monthly, some quarterly, some semi annually and some may only make annual payments. In most instances, average assets are calculated on invested positions throughout the payment cycle.

Disclosure of 12b-1 payments to shareholders is limited to amounts paid by the fund to the distributor. However, it is common for the fund to disclose more detailed information of third party payouts to its board of directors. In addition, this level of detail may also be provided to internal and external auditors as well as outside regulators upon request.

Fund Companies and directors of the funds are obligated to ensure that funds do not pay out commissions / sales loads to third parties in excess of amounts set forth by the NASD. The marketing / distribution portion of the fee must always be included in the calculation for determining whether a fund has exceeded its maximum sales load. Funds that exceed the maximum load must discontinue paying the marketing / distribution portion of the fees.

Subtransfer or TA fees:

Transfer Agent Fees are paid by the fund to the Transfer Agent for performing record keeping services for shareholders invested in the funds. When some or most of these responsibilities are passed on or assumed by a financial intermediary, compensation for those services may be passed on accordingly. These fees are common when a financial intermediary groups or rolls up multiple positions from their record keeping system into single omnibus accounts at the fund. Large intermediaries may have thousands of sub omnibus positions rolling up to one omnibus account at the fund. It is far less expensive for the fund to maintain an omnibus account than thousands of individual accounts at the fund. Consequently, the funds are willing to provide some compensation to financial intermediaries that maintain omnibus positions.

Sub TA Fees may be asset based and calculated in the same way as 12b-1 fees. They may also be calculated for a set dollar amount per head count. Head counts represent the number of individual (sub omnibus) positions that roll up into an omnibus account at the fund. Head counts can only be determined by the financial intermediary.

When fee calculations are based on head counts, the financial intermediary is required to invoice the fund company for the amount due. Some fund companies still require invoices from the intermediaries for asset based sub TA fees while others do not. Some fund companies require financial intermediaries to perform both methods of calculation, compare the results and bill the lower amount of the two outcomes.

Administrative fees:

Administrative fees are similar to 12b-1 fees except that the source of payment usually comes from the investment advisor company within the fund complex, and not from the fund. Contract agreements are service oriented and exclude marketing and distribution type services. Banks and investment advisors are more inclined to accept revenue sharing under these types of agreements.

Finder's fees:

Finder's fees are transaction based fees that are usually limited to financial intermediaries that process transactions for retirement plans. Finder's fees are normally paid on new money (money coming from outside the fund complex) at a stated rate. Shares created by transactions subject to finder's fees are usually excluded from 12b-1 calculations for a specified period of time such as a year. When finder's fee agreements require shares to be exempt from 12b-1 fees for a period of time, procedures used by financial intermediaries for verifying 12b-1 payments become exponentially more difficult. Some fund companies charge different finder's fee rates throughout the year as volume of new money reaches predefined breakpoints. These same fund companies usually have policies where the finder's fee schedules and tracking mechanisms are reset annually.

APPENDIX 2

Regulatory developments in the mutual fund industry include:

SEC – Securities and Exchange Commission:

- SEC enforcement actions against brokers that do not fully disclose revenue sharing by funds or give preferential treatment to some funds without disclosure.
- SEC Point of Sale / Confirmation Disclosure Proposal from March 2005 requires brokers to provide more specific disclosure about commissions and other fees received on fund sales, using standardized disclosure forms.

Department Of Labor (DOL): ERISA – Employment Retirement Income Security Act 404(c)

- Under current DOL 404(c) Participant Disclosure Requirements a summary plan description (SPD) must describe circumstances that could result in a fee or charge imposed on a participant's account.
- Section 404(c) also requires automatic disclosure of transaction fees and expenses that affect the value of the participant's account and disclosure on request, of annual operating expenses of investment options (as a percent of net assets) and performance net of expenses.
- Amendments to 404(c) will seek to clarify and improve information provided to participants, e.g. disclosure of plan fees and expenses (70 Fed. reg. 27185-86, May 16, 2005).

Department Of Labor (DOL): Form 5500 Reporting Requirements

- The DOL seeks to amend Form 5500 Schedule C – Service Provider Information, to require reporting of “indirect” compensation, including “finder's fees” or other fees and commissions received in a transaction involving a plan.
- In addition, for fiduciaries:
 - i. The DOL requires that “fiduciaries” must disclose actual amounts received, using a dollar for dollar offset [DOL Adv. Op. 2005-10A (May 11, 2005)].
 - ii. The DOL's Prohibited Transaction Exemptions, PTE 77-04 on purchases of mutual funds managed by a fiduciary require full and detailed written disclosure of plan and fund-level investment advisory and other fees, including the nature and extent of any differential between rates.
- For non-fiduciaries:
 - i. The DOL requires that a non-fiduciary service provider should disclose:
 - Any fees and other compensation it receives, directly or indirectly, with respect to the plan.
 - The basis for determining amounts received, including a rate or range of rates. The plan fiduciary may also request additional information.

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