

## Financial Foresight

A look at topics affecting private equity, hedge funds, mutual funds, banking, securities, and insurance

### Managing Risk Among Financial Intermediaries

Shareholder servicing in the mutual fund industry has evolved from a relatively simple model involving a single vendor to a much more complex “omnibus” model reflecting the industry’s substantial expansion, increased reliance on technology, and increased reliance on multiple service providers.

“With the growth of omnibus accounting, it really has become difficult for the fund companies to manage the risks associated with extended distribution and servicing models,” says Krissy Davis, a partner with Deloitte & Touche LLP’s Audit and Enterprise Risk Services practice. “To help address these issues, fund companies need to create risk management programs that align internal controls with oversight functions.”

Under the traditional servicing model, mutual fund companies engaged transfer agents to maintain shareholder books and records. As the industry grew and fund companies expanded their distribution channels to include banks, insurance companies, and other financial intermediaries, accounting and recordkeeping became more complex. Transfer agents worked with institutional clients and broker-dealers to perform these services on behalf of fund companies, creating an extended servicing model.

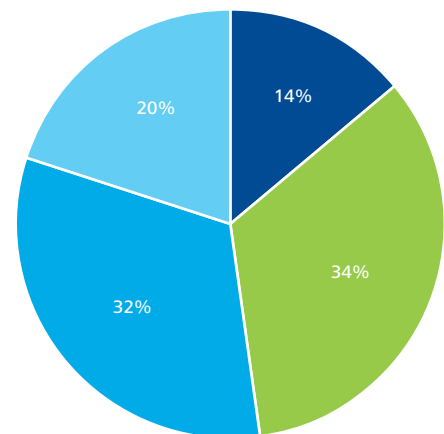
In the 1990s, various distribution channels, such as insurance and variable annuities, began offering fund products on their own processing platforms. They held these underlying positions in omnibus accounts, where the sub-accounting was done at the insurance provider. A similar structure developed at retirement plans, where participants demanded an open architecture that could provide more retirement plan investment options. This led to the need for omnibus accounting by third-party administrators.

Soon, fund supermarkets and broker/dealers adopted the omnibus model. While the omnibus model simplifies some of the processing that transfer agents previously provided, it is more complex because it requires multiple layers of servicing.

This complexity also makes it more difficult to manage. “If you think about trying to execute a corporate action or a prospectus change, or really dealing with an issue or an event, such as a bad price, you no longer just need to deal with a single transfer agent,” says Tim O’Sullivan, a director with Deloitte & Touche LLP. “You need to now execute that across an array of service providers.”

According to a recent online poll that Deloitte conducted among more than 900 financial professionals, the growth of omnibus sub-accounting has had a mixed effect on the manner in which fund companies do business. Approximately half of the executives surveyed say the growth of omnibus sub-accounting has had a significant (14%) or moderate (34%) impact. At the same time, 32% say it has had only a minor impact and 20% have discerned no impact.

**To what degree has the growth of omnibus sub-accounting impacted the manner in which your company does business?**



- Significant Impact
- Moderate Impact
- Minor Impact
- No Impact

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## An Evolving Perspective of Intermediary Risk

The risk equation surrounding intermediary distribution began to shift in the 1990s, as the mutual fund industry sought to gather more assets by increasing the number of distribution channels that they were using. During this period, the industry saw the National Securities Clearing Corporation emerge as a central counterparty for mutual fund transactions, fund supermarkets offer multiple fund families, retirement plan record-keepers adopt open architecture, and brokerage platforms begin to move to an omnibus structure.

The industry next moved to a phase of risk realization in the early part of this decade. Market timing, late-trading issues, and breakpoints were coming out of the market activities. This drew more attention back to how relationships were being managed and the lack of transparency in the omnibus model.

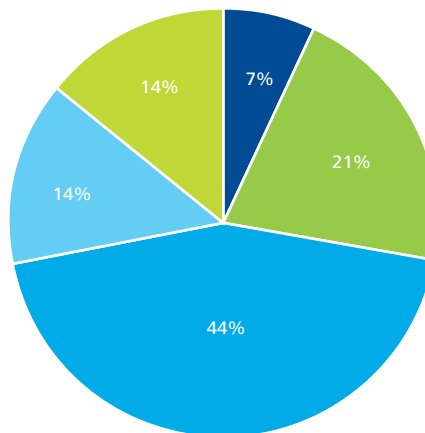
With the introduction of SEC Rule 22c-2 in 2005, fund companies needed to re-paper agreements with each of their intermediaries to provide for information sharing. This led many fund companies to realize the risks that were inherent in their new business models. Fund companies started looking more critically at their overall relationships.

More recently, the perception of risk has evolved into a maturity level of oversight integration. After implementing SEC Rule 22c-2, SEC Rule 38a-1, and other regulatory requirements, fund companies are starting to look for greater, more strategic benefits from their compliance efforts.

In order to start moving away from replication of the activity that funds pay third-party service providers to perform, more fund companies are adopting more of a risk-based approach to performing oversight of financial intermediaries. Some fund companies have looked at different ways of categorizing risk, but they are trying to understand the overall set of dependencies that go into the service model. Fund companies are moving to a holistic approach that harmonizes compliance, distribution, and operations.

Concerns related to intermediary services are growing among most fund companies. According to Deloitte's recent online poll, more than one-quarter of the executives surveyed believe that concern has increased either very significantly (7%) or significantly (21%) over the past two years. Another 44% reported that concern has increased to some extent and 14% say it has increased to a moderate extent. Only 14% reported no increase in their level of concern related to intermediary services.

Has the level of concern related to intermediary services increased at your organization (or at your clients) over the last two years?



- Yes, to a very significant extent
- Yes, to a significant extent
- Yes, to some extent
- Yes, but to a very moderate extent
- No

## Intermediary Oversight and Risk Management

The growth of the omnibus model has increased firms reliance upon an extended service network to deliver services and maintain compliance to the shareholders. This has created a more complex environment to manage.

"A critical question becomes, how do you sleep at night, knowing these activities are being performed in a controlled environment?" says Peter Marsiglia, Jr., a senior manager with Deloitte & Touche LLP. "As a fund company board member, how do you know that the dividend was calculated and distributed to the shareholders correctly? How do you know that confirmation statements were produced and distributed to shareholders?"

While contractual responsibility may be specific to the intermediary, the overriding fiduciary responsibility of the fund may create exposure which may include reputational, financial or regulatory harm given the nature of the outsource service contract."

A structured approach to risk intelligence can help fund companies manage risk by focusing on three principal elements:

**Oversight** – The control environment is a key variable in setting the tone of an organization. Control environment factors include, but are not limited to, integrity, ethical

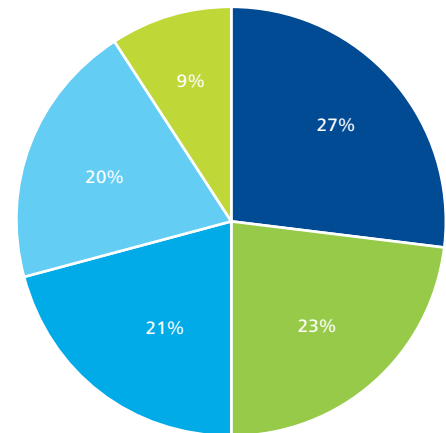
values, and management’s operating style. As fund companies extend their risk framework to the extended service partner model, they may want to see whether their partners’ organizations have a sufficient tone at the top. Are intermediaries open to discussing risk? Are they truthful and honest when mistakes occur? Do they contact the fund companies, or do the fund companies find out about errors from their customers?

**Common risk infrastructure** – When it comes to risk activities, do intermediaries have the right mix of people, process, and technology support to manage their responsibilities and overall risk? Take the example of managing late trading under SEC Rule 22c-1. Does the intermediary have the sufficient technology, such as hard cut-offs, within its system to manage the risk? Are there policies and procedures around the process and are they willing to share them with the fund companies? Do intermediaries have procedures to manage exceptions, and, if so, are they properly controlled, including escalation, authorization, and reconciliation? Do employees have a clear understanding of the regulations to be able to make the proper decision?.

**Risk process** – Intermediaries should have a process to identify and evaluate risks. Do they integrate the risks identified into the day-to-day process? Have they designed controls and measurements? Are they testing those controls, either internally or through the use of a third-party? Do they own the process and are they willing to share it with the fund companies?

According to Deloitte’s recent online poll, relatively few fund companies have all these elements in place. Only 27% of the executives surveyed say they have a formally staffed and integrated program. Fund companies are more likely to say the components of such a program exist, but are performed in silos (23%), are in the design or implementation process (21%), or are under consideration (20%). In addition, 9% do not consider the structure of their oversight practices to be a material risk.

#### How would you characterize the structure of your firm’s (or your clients’) oversight practices?



- Formally staffed and integrated program
- Components are built but performed in silos
- In the design or implementation process
- Under Consideration
- Do not consider it a material risk

#### An Industry Search for a Common Solution

In response to the challenges that mutual fund companies face in managing risk through their extended service models, the Investment Company Institute (ICI) assembled a working group, including representative mutual fund companies and the national accounting firms, to evaluate a list of key areas of interest pertaining to intermediary services as identified by the representative fund companies and to develop a framework including suggested key control objectives for inclusion in an attest examination. The resulting framework, known as the Financial Intermediary Controls and Compliance Assessment, was introduced by the ICI in November 2008.

The framework supports an industry standard attest examination for fund intermediaries performed by an independent accounting firm. A financial intermediary attestation has a compliance focus, the differentiator from a SAS 70 report, which generally focuses on operational controls and issues relevant to a financial statement audit.

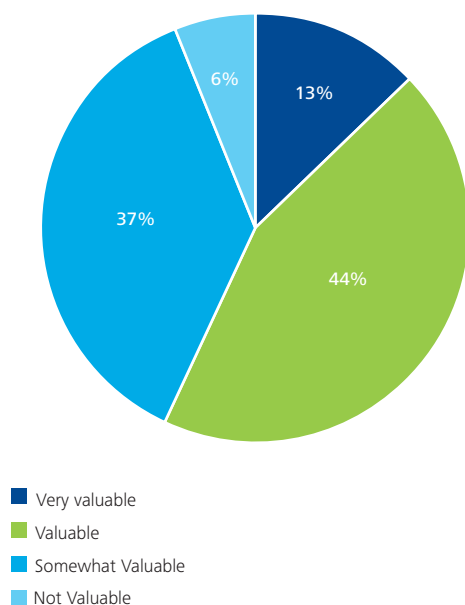
The framework provides suggestions on control areas that a fund company would be interested in examining

at their intermediaries. These areas include ethics, privacy protection, anti-money laundering, document retention, and many other essential functions and disciplines. While the framework is designed to establish areas of interest to the fund companies, it is not intended to be prescriptive or exhaustive. Intermediaries would determine the scope of these examinations by considering the services they provide to fund companies.

Financial intermediaries would hire an independent accounting firm to perform these examinations. They would be structured as management assertion engagements and the auditor performing the attestation would be giving an opinion, both on the design of controls as well as on the operating effectiveness of those controls over a period of time.

According to Deloitte's recent online poll, most fund executives would find intermediary attestation reports valuable as a means of streamlining the risk management challenges presented through omnibus distribution. More than half would find the report very valuable (13%) or valuable (44%). Another 37% would find it somewhat valuable. Only 6% would not find the report valuable.

#### How would you rate the value of intermediary attestation reports as a means of streamlining the risk management challenges presented through omnibus distribution?



#### Leveraging Existing Reports

Properly designed, financial intermediary attestations should allow intermediaries to reduce the time spent responding to information requests from fund companies.

Intermediaries that already have SAS 70 reports, compliance program examination reports, and/or agreed-upon procedures may be able to leverage the information gathered for these attestations when structuring financial intermediary attestations. In some cases, financial intermediary attestations might even replace some of these other reports. By effectively leveraging any overlapping control attestation efforts that may currently exist, intermediaries may be able to find efficiencies in producing a targeted report that is specifically structured to satisfy the growing demand by the fund companies they are providing services to.

It is important for financial intermediaries to consider the control functions they are performing and how they can most effectively and efficiently leverage these third-party reports. These reports could give assurance to management, customers, and any other interested parties that their control environment is well-functioning.

#### Looking Ahead

The financial services industry has experienced a paradigm shift in its model for business partners. For years, mutual funds were sold through affiliated distributors and serviced through a transfer agent. This traditional service model has shifted to an extended enterprise, including broker/dealers, banks, insurance companies, and other third parties.

Mutual fund companies now need to manage the risks associated with this extended distribution and servicing model, and the intermediaries need to manage the expectations of the fund companies, all of which have unique policies and requirements.

For the intermediaries, it is important to have a robust and cohesive program in place that can manage the expectations and requirements of the fund companies. Building a scalable approach that addresses the concerns of the fund companies and leveraging an independent third party assurance report to help demonstrate the organization's focus and approach should help provide more transparency and stability to the extended enterprise model, while positioning it for continued growth.

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