

NAVIGATING INTERMEDIARY RELATIONSHIPS

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INTRODUCTION

PURPOSE

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

As the mutual fund industry has evolved, the role of intermediary distribution partners in that development has grown more prominent. Understanding this role is essential to understanding the linkage between a fund complex and an intermediary. The purpose of this paper is to describe the participation and impact of intermediaries in the mutual fund industry. To achieve this goal, the paper addresses a number of 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

Although this paper was developed primarily to provide fund directors with background information about intermediaries and funds' relationships with them, it should be helpful to anyone interested in better understanding intermediary relationships.

In general, a fund board's role with respect to intermediaries is one of oversight (although there are specific statutory and regulatory requirements that govern various intermediary relationships). As part of this oversight function, 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.

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

OVERVIEW OF THE INTERMEDIARY ROLE

Intermediaries have played a significant part in the exponential growth of the fund industry since 1980.

From 1980 through 2008, the total net assets invested in mutual funds grew from \$134 billion to over \$9 trillion,¹ while the number of U.S. households owning mutual funds grew from 4.6 million to 52.5 million.² During that period, the number of investor accounts grew from slightly over 12 million to over 260 million.³

Among households owning mutual fund shares, 86 percent hold the fund shares through an intermediary⁴ such as a broker-dealer, bank,⁵ fund supermarket or platform,⁶ insurance company, investment adviser, or retirement plan recordkeeper (see Appendix A). Investors choose which intermediary best suits their needs.

Investors use intermediaries to obtain a number of benefits. First, through the intermediary, investors obtain the convenience of a single point of contact for financial planning expertise and other services for all of their investments. Second, intermediaries provide an array of investment choices such as stocks, bonds, options, and mutual funds. Third, intermediaries manage investor accounts through automation tools that provide to the investor cost-effective trade, account maintenance, and communications support, regardless of the type of security owned. Fourth, the investor can build a one-on-one relationship with the intermediary to obtain a personalized level of service. And finally, intermediaries compete for investors' assets by offering a variety of service models, leaving the investors 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. With the help of the intermediary, the investor may decide to include mutual funds as part of a portfolio of investments. Regardless of how assets are allocated between types of securities, with the choice to purchase mutual funds, an investor becomes a mutual fund shareholder.

Due to the large number of shareholders who prefer to use 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

For the shareholder, having the intermediary deliver these services, instead of the fund complex or its transfer agent, provides the shareholder a simple method to manage his or her mutual fund investments, regardless of how many different fund complexes the shareholder has invested with.

1 Investment Company Institute. 2009. *2009 Investment Company Fact Book: A Review of Trends and Activity in the Investment Company Industry*, 110. Washington, DC: Investment Company Institute.

2 *Ibid.*, 72.

3 *Ibid.*, 110.

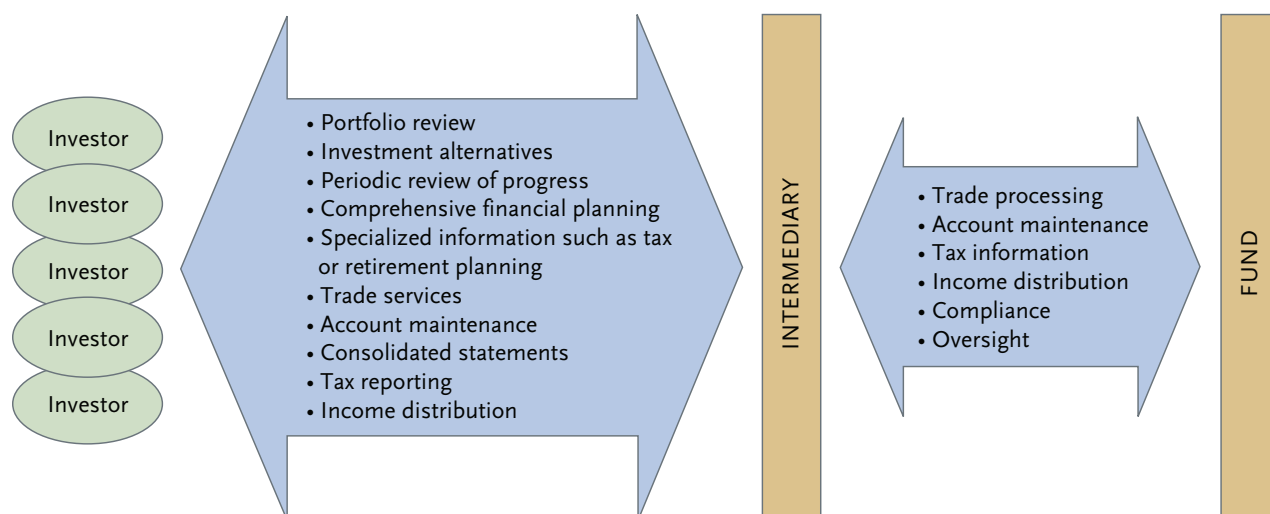
4 *Ibid.*, 75.

5 For brevity, any reference to "bank" includes bank, bank trust, and/or independent trust intermediaries. From an operational viewpoint, a fund's interaction with each of these is generally the same.

6 Both mutual fund platforms and supermarkets 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.

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. To effect that relationship, the fund complex and the intermediary execute a contract that spells out the obligations of each party. 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 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 legal, regulatory, and contractual requirements, as well as competitive market forces.

Two of the most prominent intermediary trends today are (1) defined contribution plans becoming the fastest growing account base, and (2) broker-dealers beginning to shift away from individual accounts held on the books of the fund complex toward aggregated ("omnibus") accounts. Both of these movements reduce the number of individual accounts on the fund complexes' books relative to all shareholder accounts and leave fund complexes with less information about the accounts and activities of beneficial shareholders of the fund. To address these trends, fund management and intermediaries continue to work together to seek alternatives for data exchange to meet shareholder servicing, fund administration, and compliance needs and requirements. Cooperative efforts are critical to creating an appropriate and cost-effective control environment for the protection of shareholder interests.

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

OVERVIEW OF THE FUND TRANSFER AGENT ROLE

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

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

In many cases, the transfer agent maintains teams of staff trained specifically to deal with the needs of the intermediary client.

Funds 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 (see Figure 1).

INTERACTING WITH INTERMEDIARIES

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 non-financial (such as account maintenance). Within these categories are many touch points between fund complexes and intermediaries, and a number of alternatives exist 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. Beyond trade activity, disbursement of dividends and capital gains are the most prevalent financial transactions.
- » *Non-financial transactions* are those actions that establish or change account details. For example, as the trade and dividend transactions occur (financial transactions), the share balance in an account increases or decreases. Transmitting that new share balance to the intermediary is the most common non-financial transaction for a shareholder account. Other examples of non-financial transactions 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 reinvestment options for dividends and capital gains for the account.

As with other activities between funds and intermediaries, there are a variety of methods for completing the bidirectional exchange of information for both financial and non-financial transactions. An overwhelming majority of these transactions occur through two automated utilities: Fund/SERV (for financial transactions) and Networking (for non-financial transactions). With this automation, shareholders are largely insulated from the kinds of errors and delays endemic to a manual process. There remains, however, a sizeable volume of activity that is processed outside of the Fund/SERV and Networking systems, most commonly via the Internet, telephone, or fax machine.

DEVELOPMENT OF FUND PROCESSING AUTOMATION

Prior to the mid-1970s, most securities transactions, including mutual funds, were cleared and settled via some type of manual process. Telephone calls, faxes, or wire order transmissions were the common trading tools in use at the time. Paper certificates were provided to evidence 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 first of the Depository Trust Company (DTC) and later the National Securities Clearing Corporation (NSCC),⁷ the securities industry undertook concerted efforts to streamline transaction settlement processing. These initial efforts, targeting 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. Over the years, these services have been enhanced to meet the changing needs of broker-dealers and augmented to address the bank and retirement markets.

The combination of Fund/SERV and Networking created an efficient operational platform that would cost-effectively support the dramatic growth of the mutual fund industry to the levels attained today.

ACCOUNT STRUCTURES

Intermediaries typically use two basic account structures when opening and maintaining accounts with fund complexes for their clients' fund investments: individual accounts and omnibus accounts.

Individual Networked Accounts⁸

Individual Networked accounts, the most common type of individual account,⁹ are used by many broker-dealer firms in the industry. The most common type of Networked account is opened and controlled exclusively by the broker-dealer, meaning the broker-dealer generally provides all shareholder service. Individual Networked accounts are typically registered on the fund transfer agent's books in the broker-dealer firm's name "for the benefit of" ("FBO") the individual broker-dealer client. While the registered representative at the brokerage firm associated with the investor's account is identified on the account registration, information identifying the underlying investor ("beneficial owner") may or may not be included.¹⁰

7 In 1999, DTC and NSCC were consolidated under a single parent company, the Depository Trust and Clearing Corporation (DTCC). Today, as independent subsidiaries of DTCC, DTC and NSCC continue to closely collaborate on efficient securities processing.

8 "Networked" refers to the NSCC Networking service, which supports the exchange and reconciliation of investor account activity data. The Networking service is segmented into five levels with Level 3 (broker-dealer-controlled accounts) being the most common. See Appendix B for more information.

According to the Depository Trust & Clearing Corporation's (DTCC) 2008 annual report, as of December 2008, there were about 94 million Networked accounts, the vast majority of which are individual Networked accounts. See Appendix C for more information about DTCC.

9 There are two other types of individual accounts: non-Networked accounts and retail accounts. See Appendix B for a detailed discussion of these account types.

10 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 more fully described in Appendices B and E.

Omnibus Accounts

An omnibus account is a master account representing subaccounts of multiple investors. 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).

FIGURE 2

Account Structures

Account Type	Contains
Individual Networked account	Single investor account
Omnibus	Subaccounts of multiple investors

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. These omnibus accounts are sometimes referred to as “super” omnibus accounts. An omnibus account is opened on the 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 trade (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 to the beneficial owners of the subaccounts.

An intermediary determines which account structure or structures it will use to support its mutual fund business. Generally, individual Networked accounts are used by broker-dealers and some investment advisers. Omnibus accounts are used by all types of intermediaries. Because most fund complexes work with a variety of intermediaries, they need to be prepared to support whichever account types their intermediary partners choose to use (see Appendix B).

SERVICE ARRANGEMENTS

Through contractual agreements, fund companies 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
- » Tax reporting and distribution of other information

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

Some broker-dealers support all of the 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 or the fund complex, or both.

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

Financial advisers generally use other intermediaries (e.g., broker-dealers, banks, platforms, supermarkets) to access funds. The adviser controls the interaction with the shareholder, but the support services are provided in a variety of ways, ranging from entirely provided by the adviser's intermediary to mostly provided by the fund complex.

Funds and intermediaries take various approaches to facilitate the servicing of investor accounts. The most common, and most automated, is the use of the NSCC's services.

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 redemption 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.

Although intermediary oversight has always been a significant focus of the mutual fund industry, certain recent regulatory initiatives have elevated the concern for oversight to a higher level. (See Appendices D and G for summaries of the obligations.) With the establishment of these new or expanded compliance requirements, fund complexes have needed to amend 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 managers employ a number of 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. This complexity and variability also makes intermediary oversight an increasingly expensive undertaking for fund complexes.

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 supports various business models (including omnibus and Networked accounts) and is operationally efficient. However, it leaves fund management with little control of transaction processing and less detail regarding the investor or beneficial owner 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 a number of tools to automate information flow and enhance independent review for specific compliance purposes. These devices are designed to employ standard formats and transmission processes and industry-endorsed procedures so fund complexes can more efficiently manage the associated resource requirements. 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 employ a variety of solutions to achieve oversight of the intermediary's compliance with its contractual obligations and with the fund's prospectus.

Omnibus Attestation

ICI and an industry working group—including fund managers, intermediaries, and representatives from the major auditing firms—developed a compliance framework intended to provide fund sponsors with assurance that their distribution partners have appropriate compliance controls. This framework provides funds with a higher level of assurance from an independent third party that investor transactions are properly executed and that shareholder accounts are properly maintained.

Under the review framework, an omnibus account recordkeeper would hire an independent accounting firm to assess its compliance controls related to specified activities it performs for shareholder accounts. The auditor would issue an opinion on the design and operating effectiveness of the intermediary’s compliance controls. The recordkeeper could provide this opinion to all of the fund complexes it represents. The engagement would be performed under attestation standards issued by the American Institute of Certified Public Accountants.

Funds, fund boards, and fund chief compliance officers may choose to rely upon the auditor’s opinion for reasonable assurance that their intermediaries have an adequate compliance control environment. Widespread acceptance and use of the engagement may reduce costs, for both fund complexes and intermediaries, and may also reduce the number or frequency of on-site visits conducted with their intermediaries.

This is a recent initiative, announced in November 2008. Thus, fund complexes, internally and with intermediaries, continue to discuss and consider its acceptance.

Client Data Share (CDS)

CDS is designed to address a number of 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*¹¹ 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. 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 meet breakpoint and books and records compliance.
CDS II	Supports Level 3 Networking (broker-dealer-controlled). Broker-dealers disclose and transmit all investor data to the funds.	Helps meet the needs for both breakpoint and frequent trading/market timing monitoring.
CDS III	Supports data exchange for omnibus accounts. Data exchange occurs outside of the NSCC, but uses industry standards. Broker-dealers originate investor account data for omnibus accounts and transmit them to the funds’ repositories.	Helps meet the needs for both breakpoint and frequent trading/market timing monitoring requirements for omnibus positions.

¹¹ For additional information, see NASD, “Report of the Joint NASD/Industry Task Force on Breakpoints” (July 2003). Available at www.finra.org/Industry/Regulation/Guidance/ReportsStudies/p085415.

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 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, recordkeepers, and insurance companies.

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, "subaccounting" or "sub-transfer agent" 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 Fees¹²

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-1 to compensate intermediaries for those same activities.¹³ No-load funds,¹⁴ retirement share classes, load-waived Class A shares,¹⁵ 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 used for advertising, as well as for printing and distribution of prospectuses and sales literature. Over time, however, 12b-1 fees have been used as a substitute for the sales charge and to compensate intermediaries for providing ongoing shareholder advice and a variety of other ongoing shareholder services that the fund complex would otherwise perform.¹⁶ ICI research shows that in 2004 about 92 percent of

¹² 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/pdf/rpt_07_12b-1.pdf.

¹³ A 12b-1 plan that provides for the use of an annual 12b-1 fee in lieu of a front-end sales charge is commonly referred to as a "spread load." Generally, this arrangement is used in combination with a CDSC.

¹⁴ No-load funds are funds sold without a front-end sales charge or contingent deferred sales charge (see Appendix E), and 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 to the fund transfer agent.

¹⁵ 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 load will be waived. Commonly, one of the waivers occurs when the fund is used as an investment option for retirement plans.

¹⁶ 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.

12b-1 fees were used to compensate intermediaries for investor services provided before and after the purchase of fund shares.¹⁷

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 agreements with broker-dealers, sub-transfer agent agreements with banks and recordkeepers, and third-party mutual fund supermarket arrangements—intermediaries may assume the responsibility to complete some or all of these activities for their customers on behalf of a fund. 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 as a sub-transfer agent fee (often referred to as a “sub-TA,” “sub-agent,” or “shareholder servicing” fee), as Networking fees paid to broker-dealers, 12b-1 fees, or as other types of fees under a separate agreement with the fund and/or its affiliates.

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 (CDSC) 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.

¹⁷ Investment Company Institute. 2009. *2009 Investment Company Fact Book: A Review of Trends and Activity in the Investment Company Industry*, 68. Washington, DC: Investment Company Institute.

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.

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 F for more information).

CONCLUSION

Intermediary relationships are complicated arrangements, demanding significant commitment from the fund complex for management and oversight. These relationships, which provide investors alternative means 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 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 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). In general, broker-dealers fall into two categories: (1) "clearing" (or "self-clearing") broker-dealers and (2) "introducing" broker-dealers. Clearing broker-dealers include firms that maintain the infrastructure and required capital to complete trade processing and settlement in-house.¹⁸ Typically, clearing broker-dealers are large- to mid-sized 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. Some clearing broker-dealers also complete trade processing and settlement for other nonaffiliated broker-dealers.

Introducing broker-dealers are firms that choose to outsource trade and settlement to a clearing broker-dealer. By outsourcing trade settlement to a clearing broker-dealer, introducing broker-dealers can focus capital and other resources on serving the ultimate investor. Introducing broker-dealers tend to be mid-sized to smaller firms.

Clearing broker-dealers that provide services to introducing broker-dealers offer a wide variety of options, 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 with the fund complex either a Networking Level 3¹⁹ account for each beneficial shareholder of the introducing broker-dealer, or an omnibus account aggregating all beneficial shareholder transactions for an introducing broker-dealer.

BANKS

Banks may interact directly with the fund complex or use a mutual fund supermarket or platform to support their clients. Large money-center banks 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.

¹⁸ 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 who is not allowed to settle transactions or hold client funds or securities.

¹⁹ See page 6 and Appendix B for more information regarding Networking.

MUTUAL FUND SUPERMARKETS AND PLATFORMS

Mutual fund supermarkets offer thousands of funds to retail investors, institutional investors (including investment advisory firms), or both. Many times the fund supermarket 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 similar to supermarkets in that they offer a large number 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 a contract with the fund complexes that authorize the sale of fund shares through these intermediaries.

INSURANCE COMPANIES

Insurance companies 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.

REGISTERED INVESTMENT ADVISERS (RIA)

Registered investment advisers may use a broker-dealer, supermarket, platform, or bank to access mutual funds. In more limited instances, they may interact directly with the mutual fund transfer agent to support their client base. 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.

RETIREMENT PLAN RECORDKEEPERS

Retirement plan recordkeepers typically use a conduit (broker-dealer, supermarket, platform, or bank) to access mutual funds, or, 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 they will be structured to clear and settle mutual fund trades, and consequently will use a conduit for clearance and settlement activities.

APPENDIX B: PROCESSING AND ACCOUNT STRUCTURES

PROCESSING

Regardless of the type of account, the processing of the majority of 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 (see Figure 4 below). Access to Fund/SERV is available to any NSCC Wealth Management Services²⁰ member agreeing to abide by the rules pertaining to the use of the system. As of the end of 2008, there were over 1,000 participants (700 fund companies and 350 intermediaries) using the system to facilitate automated trading and settlement.²¹ In 2008, transaction activity through Fund/SERV totaled 193 million transactions for a value of \$2.9 trillion. These amounts represent a double-digit percent increase from 2007 to 2008.²²

Through Fund/SERV, trade orders are electronically transmitted from the intermediary to the fund through NSCC. NSCC collects all the trades from intermediaries for a particular fund complex for the day and on a regular schedule 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 for the fund shares, the transfer agent values the trades, creates acknowledgments, and transmits them to NSCC. The latter then forwards the acknowledgments 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 generally 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 those accounts which 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 dividend activity executed through NSCC. This net

²⁰ Wealth Management Services is the NSCC business group supporting mutual fund activity.

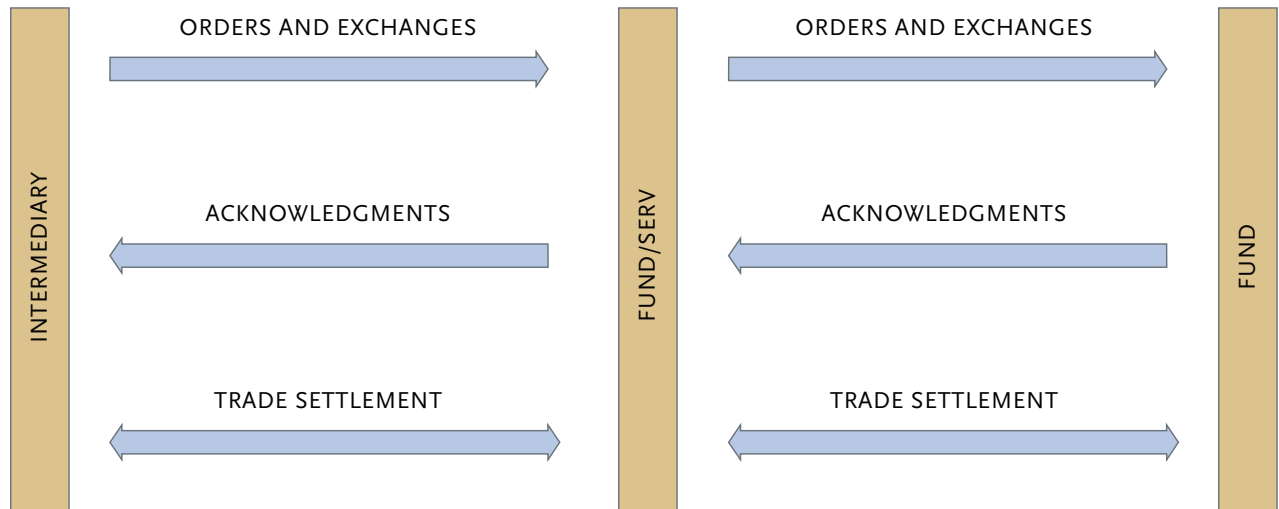
²¹ The Depository Trust & Clearing Corporation. 2009. *Annual Report 2008*, 39. New York, NY: The Depository Trust & Clearing Corporation.

²² *Ibid.*

settlement process is the most efficient and cost-effective method for fund complexes and intermediaries to complete daily money movement.

FIGURE 4

Fund/SERV

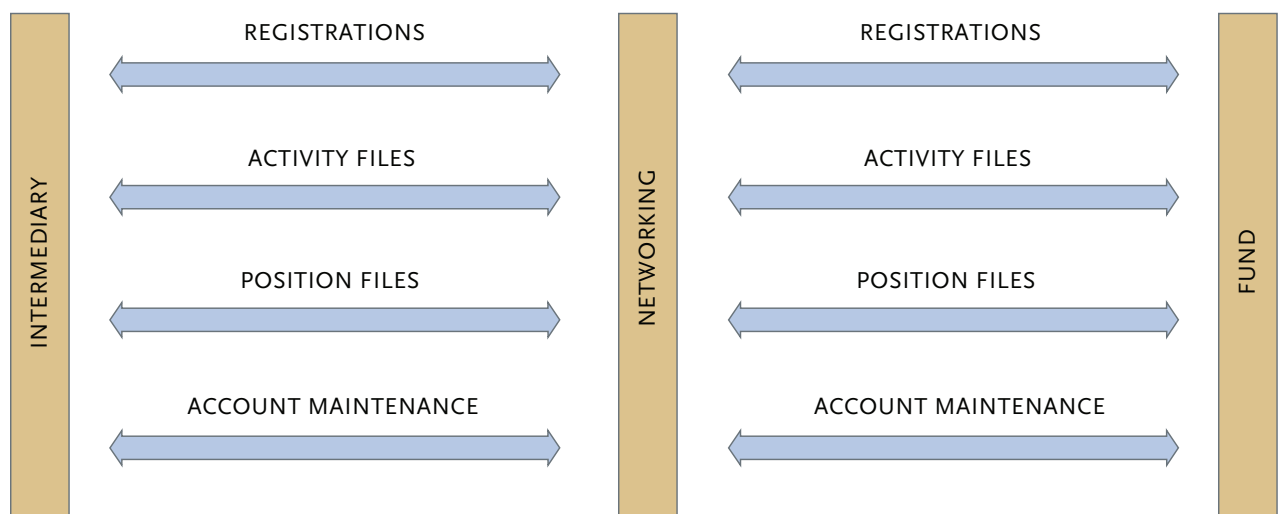


NSCC Networking System

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 (see Figure 5). Implemented in 1988, intermediaries have connected (“Networked”) large numbers of accounts into the system to take advantage of its automation and efficiency. At the end of 2008, Networking had grown to support approximately 94 million accounts.²³

FIGURE 5

Networking



²³ Ibid.

Networking is segmented into five levels. 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. The five Networking levels are defined as shown in Figure 6.

FIGURE 6

The Five Networking Levels

Level	Description
Level 0	Non-Networked Account or a Trust Networked Account
Level 1	Firm-Controlled Margin/IRA Account
Level 2	Customer Name Account
Level 3	Broker-Dealer Controlled Account
Level 4	Fund-Controlled Account

Level 0

There are two categories of Level 0 accounts.

1. When a broker-dealer sends an application and a check to the fund transfer agent to open an account, the transfer agent sets up the account and the broker-dealer of record on the transfer agent system. 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 their books and records requirements, broker-dealers may receive account information from the fund complex through Client Data Share (CDS) I.²⁴
2. When a bank 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 generally provides all of the investor servicing and reporting.

Level 1

For Level 1, the intermediary is responsible for most of the interaction with the shareholder. The fund complex, however, provides the dividend and capital gain tax reporting to the investor. This level is rarely used.

Level 2

For Level 2, the shareholder generally places trades with the intermediary, but may also place trades directly with the fund. The intermediary provides trade confirmations and account statements to the investor, and the fund complex provides dividend and capital gain tax reporting. This level is rarely used.

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. All trading is done through the broker-dealer; all beneficial

²⁴ Client Data Share is automated functionality between funds and intermediaries that supports exchange of information for compliance needs. See the section titled “Client Data Share (CDS)” on page 10 for more information.

investor confirmations and statements are provided by the broker-dealer; all required shareholder information is distributed through the broker-dealer; and all shareholder tax reporting is provided by the broker-dealer. 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. Under Level 4, the shareholder generally places trades through the intermediary, but may also place trades directly with the fund. 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 is 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 is managed through manual means, partly automated means, or both. Some intermediaries (typically small) may call or send a fax to 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 transfer to settle the account-opening trade. Subsequent purchases and redemptions may then be transacted via telephone, fax machine, or the website with settlement via check or wire 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 fund repositories, via telephone contact or fax transmission, or on hard copy documentation. Because the exchange is 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.

ACCOUNT STRUCTURES

Individual Account

There are various means for opening individual accounts with a fund. The simplest method 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.²⁵ These accounts are opened as Level 0, Non-Networked accounts and are known as “direct-at-funds.” The practice is known as “check and app” or “subscription way” business. In this situation, the account is opened in the name and tax identification number of the investor, and the fund is the primary point of contact for the investor. The broker-dealer firm and the registered representative shown on the application are also included in the account registration.

²⁵ Some mutual funds accept unsolicited purchase orders directly from investors without the involvement of an intermediary. These funds do not charge a sales load, so the funds are commonly known as “no load” funds. The accounts opened are individual accounts on the records of the fund transfer agent and are generally known as “retail accounts.” These purchases are not processed through the NSCC. The fund provides all shareholder servicing for retail accounts. Since there is no intermediary involved with a retail account, it is not further addressed in this paper.

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

The majority of individual accounts are opened through the NSCC as Networked Level 3 accounts, mainly by broker-dealers. Accounts are opened in the name of the broker-dealer, on behalf of its customer, or in the name of the investor. For Networked Level 3 accounts, the broker-dealer is the sole point of contact for the investor.

Financial advisers and some broker-dealers 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.

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. To achieve account transparency, 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). One of the investments John Doe decides to make is to buy 100 shares of a mutual fund. To effect the mutual fund investment, 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 7.

FIGURE 7
Individual Account
Networked Level 3 Account Opened by a Broker-Dealer



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 daily into a single net purchase or redemption for all investors in that fund.

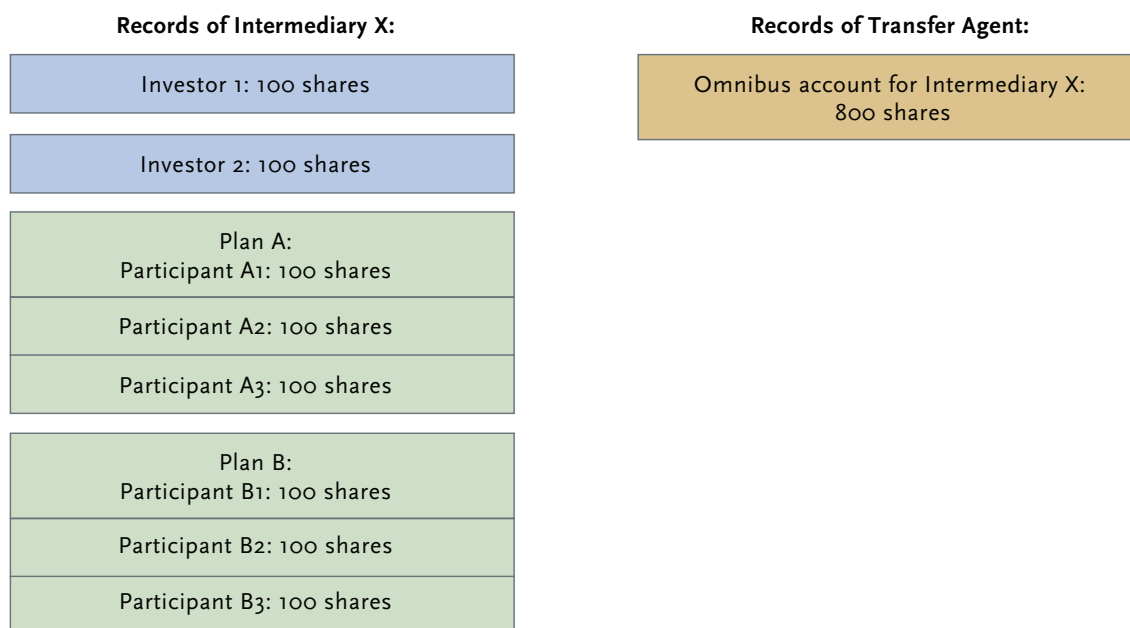
Broker-dealer omnibus accounts generally are opened as Networked Level 3 accounts, and the broker-dealer is known as an “omnibus broker.” The fund recognizes these Networked Level 3 accounts as omnibus (as opposed to the individual Networked Level 3 accounts discussed above), typically because of the agreement that the fund requires the omnibus broker to execute to use Networked Level 3 omnibus accounts. Bank omnibus accounts are usually opened as Level 0-Trust Networked Accounts.

For omnibus accounts, the intermediary provides to the investor the following: trade confirmations, statements, and investment information; any tax reporting; and required shareholder communication.

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 8.

FIGURE 8

Omnibus Account



Omnibus Account Transparency

Transparency for omnibus accounts is achieved in two ways. For the 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. For the bank and retirement channels, NSCC’s Standardized Data Reporting (SDR) system is used by the intermediary to supply subaccount details in response to a request for information from the fund complex. See page 11 for more on SDR.

APPENDIX C: 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,²⁶ 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 five levels, 0 through 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, including improved reconciliation functionality, many broker-dealer firms moved positions from omnibus registrations to Level 3 registrations.

²⁶ This task force evolved into the ICI Broker-Dealer Advisory Committee.

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 functionality known as “Trust Networking” was implemented, allowing banks and fund complexes to more accurately manage bank trading account details. For the growing defined contribution plan market, Fund/SERV and Networking enhancements were packaged together as the Defined Contribution Clearance and Settlement services (DCC&S), which support the specialized demands surrounding the evolution of participant-directed retirement plans.

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 over the past 30 years will continue to advance to meet those needs.

APPENDIX D: RELEVANT REGULATORY AND COMPLIANCE INITIATIVES

- » The USA PATRIOT Act (PATRIOT Act) legislation enacted in 2001 requires that the investor and the source of funding be known and understood. The PATRIOT Act includes a number of compliance obligations such as:
 - » Anti–Money Laundering (AML) programs
 - » Customer Identification Programs (CIP)
 - » Suspicious Activity Reporting (SAR)
 - » Due diligence programs for foreign correspondent accounts and private bank accounts
- » Rule 38a-1, the Compliance Program Rule (see Appendix G for details).
- » SEC Rules 17a-3 and 17a-4 under the Securities Exchange Act of 1934 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 impact broker-dealers, fund complexes—through the CDS structure—may be a primary source of information for the broker-dealers’ compliance efforts.
- » *Report of the Joint NASD/Industry Task Force on Breakpoints*, issued July 2003, includes 13 recommendations for the proper application of break point discounts to achieve the best pricing for the investor.
- » SEC Rule 22c-2 under the Investment Company Act of 1940 (adopted April 2006), 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 or to determine that a redemption fee is either not necessary or not appropriate to address market timing 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 market timing policies.
- » New regulations issued under Internal Revenue Code section 403(b) governing retirement plans for public schools and tax-exempt organizations, issued July 2007, require new reporting and disclosure obligations for mutual funds providing 403(b) plan investment options.
- » The U.S. Department of Labor has issued new service provider disclosure requirements on Form 5500 for retirement plans. The most noteworthy change to Form 5500 requires disclosure, on Schedule C, of significantly more 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).

APPENDIX E: 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”²⁷
- » *Statements of Intention* or *Letters of Intent* that allow 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 charge²⁸

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 period of time without any sales charge

²⁷ Also, some funds, as part of their combined purchase programs, 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.

²⁸ A statement of intention allows the shareholder to take immediate advantage of the maximum quantity discount available.

CONTINGENT DEFERRED SALES CHARGE²⁹

To facilitate the use of a Rule 12b-1 plan,³⁰ the fund's principal underwriter (sometimes 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 contingent deferred sales charges (CDSC) 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. Typically the CDSC recovery period for Class C shares is one year. In contrast to Class B shares, Class C shares generally do not convert to Class A shares, so the investor continues to pay the full 100 basis point 12b-1 fee as part of the Class C fund expense ratio.³¹ Again, the 12b-1 fee is paid to the intermediary for its ongoing advice and servicing of the investor account.

²⁹ These fees are also referred to as Contingent Deferred Sales Loads, or CDSLs.

³⁰ 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 12 and Appendix G for further discussion on Rule 12b-1.

³¹ Under this arrangement, the fund is termed a "level load" share class.

APPENDIX F: FEE CALCULATION METHODS AND PROCESSING

CALCULATION METHODS

Asset-Based Fees

Rule 12b-1 fees and many sub-transfer agent 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 on a daily basis. 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 sub-transfer agency 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 non-retirement market, on a “per account” charge of \$X per investor account being serviced by the intermediary. Typically, in the retirement market, the basis is a “per participant” charge of \$X per participant 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 have begun to 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; they are not paid by the fund, but rather, from one of its 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.

COMPENSATION PROCESS

As with other fund processing, compensation (such as commissions, 12b-1 fees, subaccounting 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. Those intermediaries who are not participants of NSCC are likely to be paid either by wire transfer or by 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.

NSCC Commission Settlement

Commission Settlement can be used for any type of compensation payment, including front-end sales charges, contingent deferred sales charges, 12b-1 fees, and other payments. This service for NSCC participants provides an automated process for fund complexes to 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.

Manual Payments

In contrast to the automated approach provided by Commission Settlement, 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 number of times before both sides are satisfied with the amount and detail for the payment to occur.

APPENDIX G: STATUTORY AND RULE REQUIREMENTS UNDER THE INVESTMENT COMPANY ACT OF 1940 RELATING TO DISTRIBUTION AS APPLICABLE TO FUND BOARDS

- » Rule 12b-1 requires the board, including a majority of its independent directors, of any fund that has a 12b-1 plan to approve the plan. 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.
- » Rule 12b-1(h)(2)(ii) also requires the board, including a majority of its independent directors, to approve policies and procedures reasonably designed to prevent (a) the persons responsible for selecting brokers and dealers to effect portfolio transactions from taking into account 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.
- » Section 15(c) requires that a majority of the board's independent directors approve a fund's principal underwriting contracts.
- » Section 17(d) addresses 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 position requires that the 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.
- » 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.
- » Rule 18f-3 requires the 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.
- » Rule 22c-2, the Redemption Fee Rule (see Appendix D for details).
- » SEC Rule 38a-1 under the Investment Company Act of 1940, "the Compliance Program Rule" (adopted February 2003), requires the 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 fund share transactions; (c) identification of affiliated persons; (d) protection of nonpublic information; and (e) market timing.
- » Sections 326 and 352 of the USA PATRIOT Act require the board to approve a fund's Anti-Money Laundering Program and Customer Identification Programs.

APPENDIX H: POTENTIAL BOARD QUESTIONS

In addition to the specific statutory and regulatory requirements listed in Appendix G, 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.)

- » Do the distributor, adviser, and/or any other party pay any of the intermediaries 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.)



1401 H Street, NW
Washington, DC 20005
202/326-5800
www.ici.org

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