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Evolution of the mutual fund transfer agent: Embracing the challenges and opportunities

How the mutual fund transfer agent can take stock of the changed environment.

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The heart of the matter

Over the past 30 years, the landscape of the mutual fund industry has continuously reshaped itself to accommodate the move investors have made toward using intermediaries. Along with that shift have come changes in the relationships among mutual funds, their transfer agents, and intermediaries. In a process that offers investors a more efficient way to access a wider choice of mutual funds, the industry has evolved toward the use of omnibus subaccounting.

The change in the landscape of the mutual fund industry has particularly affected the roles and responsibilities of shareholder servicing. Under an omnibus system, intermediaries maintain and keep records for individual shareholder accounts almost exclusively on their own books, aggregating records into a single account on the transfer agent system. With a much smaller number of aggregated accounts passing to transfer agent systems for trade settlement, this evolution has drastically reduced the volume of fund transactions transfer agents handle directly.

The shift to omnibus subaccounting has also reduced transparency for transfer agents and the mutual fund companies they serve. Shareholder accounts are now spread across a number of intermediaries, each of whom provides varying levels of information reporting with detailed shareholder account activity, back to transfer agents and mutual fund managers. This makes it more difficult for transfer agents and funds to oversee regulatory and prospectus compliance.

While mutual funds retain ultimate responsibility, most transfer agents assume the compliance responsibility on behalf of the mutual fund through a web of dated regulations, no-action letters, and issue-specific guidance—even though they may have minimal visibility into the underlying shareholder accounts. Because mutual fund managers and transfer agents are not directly involved in maintaining all sensitive data, this shift also makes it harder for them to enforce appropriate cybersecurity and data-protection controls.

These developments have amplified the oversight challenges for both transfer agents and mutual funds, but they have also created an opportunity for transfer agents to enhance their offerings to mutual funds by centrally monitoring key areas such as compliance and information security. While intermediaries are, at times, reluctant (or unable) to supply detailed information to transfer agents, the mutual fund industry has been moving toward a common framework for sharing this data—one that would allow transfer agents to provide comprehensive oversight to mutual fund boards.

Considering most transfer agents have seen the number of accounts on their systems decline dramatically, a common framework for data sharing could be a helpful development. This decline in the number of accounts has been a big adjustment for transfer agents, who previously focused on the efficient processing of high transaction and call center volumes that are now handled primarily by intermediaries.

At the same time, although the fall in transaction volumes means many transfer agents no longer benefit from past economies of scale, their costs have not dropped commensurately. Cost drivers include working with multiple intermediaries and fulfilling increasingly complex regulatory requirements. This environment has driven transfer agents to continue to focus on cost reduction, including the evaluation of outsourcing and offshoring activities.

For the future, it is important for both transfer agents and the mutual fund companies they serve to take stock of the changed environment for the benefit of shareholders and continue to assess the functions of the transfer agent. As they have done in the past, transfer agents need to reconsider existing billing practices, organizational structures, and staffing models in light of the role they should continue to play in the mutual fund industry.

Based on our experience and extensive discussions with industry stakeholders, we have developed the following five recommendations for mutual fund companies and transfer agents to consider in fulfillment of their responsibilities:

- Assess the current and likely future operating environment, including clear delineation of services and who is performing key functions such as shareholder servicing and recordkeeping, external reporting, compliance, and oversight.
- Rethink the transfer agent resource model. This should include a talent management review of current resources and capabilities, as well as an assessment and analysis of possible future core competencies.
- Continue to evolve the intermediary oversight model to monitor and provide greater assurance that intermediaries perform contractually agreed upon services for a reasonable fee. This may include a larger oversight role for transfer agents to help boards effectively achieve their oversight responsibilities.
- Design and implement programs to combat emerging threats to data protection and cybersecurity, including assessing the controls in place at intermediaries (and transfer agents) over shareholder information.
- Collaborate with regulators to modernize the rules to better address the risks across the full spectrum of the recordkeeping and shareholder servicing environment.

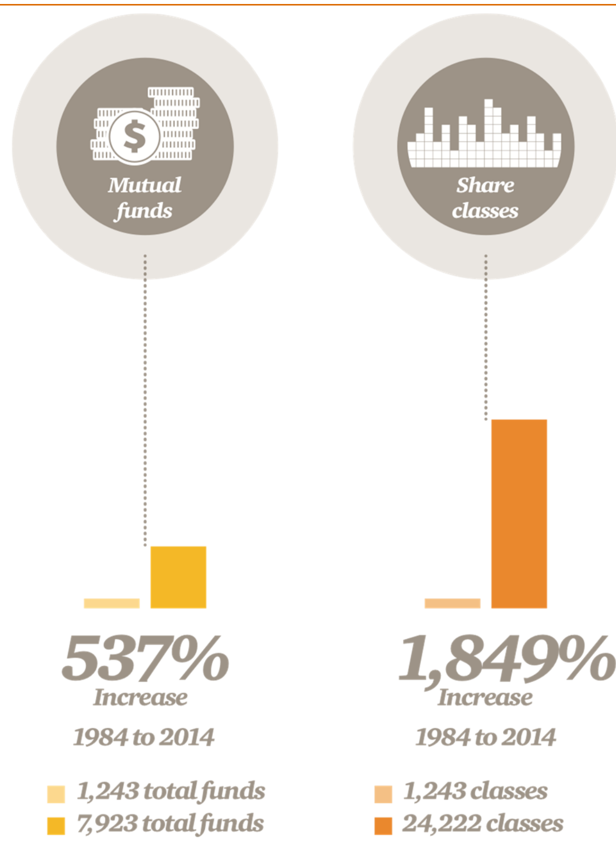
In our view, addressing these key areas will enable mutual funds and transfer agents to remain out in front of compliance and security risks, as well as increase efficiencies and reduce the costs associated with performing critical functions for shareholders. Although these steps are not always sequential or distinct, the successful implementation of each one increases a program's overall odds of success.

An in-depth discussion

The mutual fund industry has grown tremendously in both size and complexity during the past 30 years. The variety of mutual fund structures and products has expanded, along with the diversity of investors. According to the 2015 Investment Company Fact Book published by the Investment Company Institute (ICI), from 1984 to 2014 the number of mutual funds offered increased 537%.

Meanwhile, as investors and intermediaries looked for more targeted product offerings to meet their changing investment needs, the total number of mutual fund share classes increased 1,849%, to more than 24,000 (see Figure 1). This growth led to changes in the way the industry operated and, consequently, in shareholder services and the role of transfer agents. Most notably, the growth of "intermediated" accounts, with providers offering a range of mutual funds from different managers, dramatically outpaced that of "direct" accounts. This was a significant shift from the way things had previously worked.

Figure 1: The increase of mutual funds and share classes from 1984 to 2014.



Source: PwC analysis based on data provided by Investment Company Institute.

While intermediary relationships existed in the early 1980s, at that time the majority of investors opened mutual fund accounts directly with the fund's transfer agent, who would then handle their fund share purchases and sales. Transfer agents have played a critical part in recording share registration and tracking shareholders for both stocks and mutual funds since 1934, when the Securities and Exchange Act defined their role in the industry. Over the years, transfer agents have provided a wide array of services to mutual funds, including maintaining ownership records, facilitating issuance of dividends, preparing and mailing statements, and ensuring compliance with the prospectus.

Under the old model, shareholders looking for diversification or to meet particular investment objectives might need to find a mutual fund company with a broad lineup of funds. Or they could set up accounts at many different mutual fund companies, and then pick the relevant funds distributed by each company.

As servicers for a huge number of shareholder accounts, transfer agents dealt with large volumes of often manual transactions, as well as customer calls and correspondence. Transaction processing quality and customer service capabilities were the primary differentiators in the transfer agent industry. These activities led to the establishment of large call centers and back-office operations, and the addition of significant numbers of employees.

As the industry grew, the changing environment pushed transfer agents to look for additional ways to improve efficiency. Among the options were offshoring and/or outsourcing some core functions, such as transaction processing, reconciliation, and information technology.

Automation

Information technology began taking on more importance as the mutual fund industry looked to automation. Prior to the 1970s, both the equity and mutual fund industries cleared and settled transactions manually. Automation began to replace many of these manual processes in the equities industry with the formation of the Depository Trust Company (DTC) and, later, the National Securities Clearing Corporation (NSCC). Meanwhile, the mutual fund industry remained highly manual until the mid-1980s, when it saw the advantages that equities trading gained from technology.

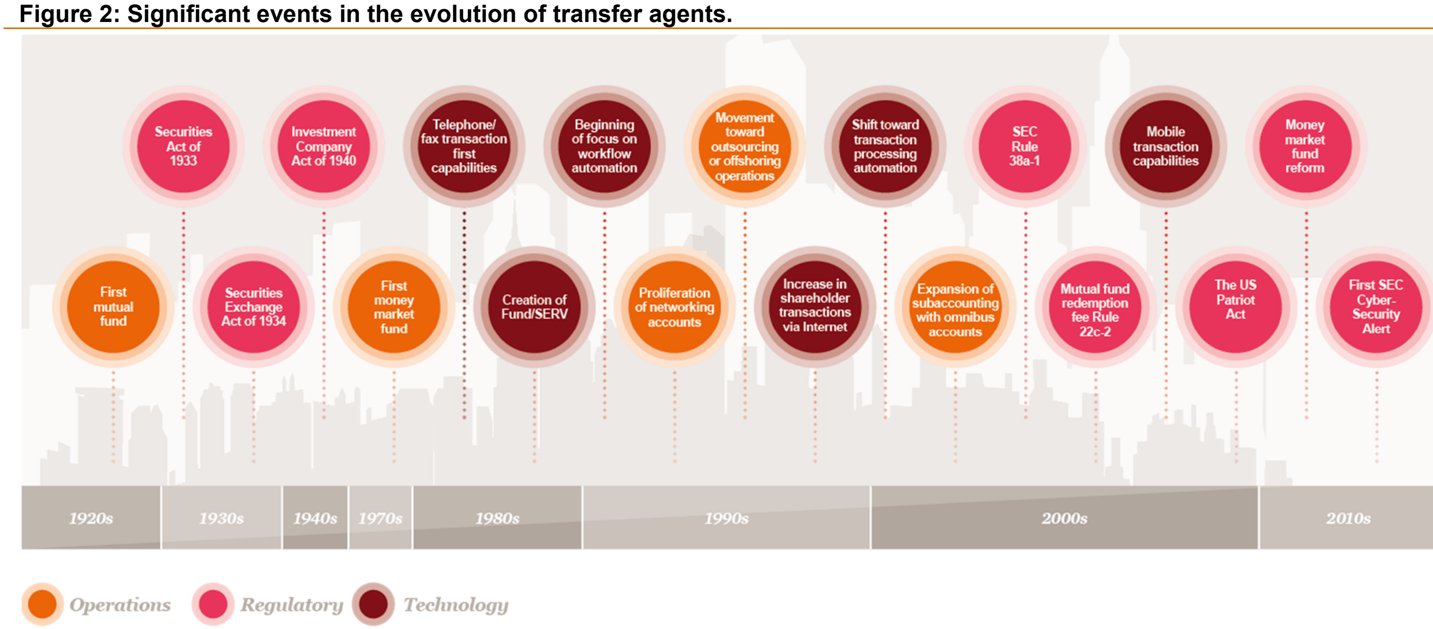
In cooperation with the DTC, now the Depository Trust and Clearing Corporation (DTCC), the mutual fund industry came together to create the Fund/SERV platform for processing and settling mutual funds and other pooled investment product trades. They also created Networking, an industry standard for exchanging shareholder account information, as well as for account reconciliation and dividend processing.

As a result, transfer agents, fund companies, broker-dealers, and other distribution firms were able to exchange and reconcile all customer information, whether held in direct accounts or omnibus accounts. These developments helped to support the growth of the industry through better communication, greater economies of scale, and increased efficiency.

In line with the general trend in the industry, transfer agents also made significant investments in technology advancements, focusing first on workflow tools to manage the volume of manual transaction requests and later on automation to permit more efficient processing. Meanwhile, the role of the transfer agent was becoming increasingly complex. They began to manage more frequent transaction processing and shareholder communications through many different channels from a variety of intermediaries.

They also expanded tasks, such as compliance with and monitoring of intermediary adherence to certain regulatory requirements (see Figure 2).[1] This expansion was partly a result of an increase in the regulation of mutual funds, but also occurred in part because compliance oversight of shareholder transactions had traditionally been part of the transfer agent's role. Oversight became increasingly difficult as the industry shifted from direct accounts to "networking" accounts, and then finally to omnibus accounts—moves that the creation of Fund/SERV and the Networking standard enabled.

Figure 2: Significant events in the evolution of transfer agents.



[1] These include the Customer Identification Program under the USA Patriot Act, SEC Rule 22c-2, and the Bank Secrecy Act.

Networking and omnibus accounts

The network "Level 3" individual account, owned and maintained by a broker-dealer and registered on the transfer agent's books in the broker-dealer's name, predominated the industry during the 1990s and 2000s. Under this model, the transfer agent maintained an account for each individual shareholder to facilitate the transfer of transactional information to and from the broker-dealer. But transparency was sometimes limited, as the transfer agent might or might not have access to complete information for that investor.

As network "Level 3" accounts grew in popularity, intermediaries increasingly took over functions that transfer agents had historically performed. Depending on the agreed-upon service level in their contracts with the mutual fund company, these functions included account management, customer service, and information reporting.

However, with the development of more sophisticated technology, networked accounts became less prevalent as intermediaries found investor and efficiency advantages in omnibus arrangements. These arrangements aggregated multiple underlying individual investor subaccounts into a single account on the transfer agent's books in the name of the intermediary.

This shift began with retirement plan recordkeepers, which generally already had the necessary infrastructure to support the omnibus subaccounting model. Most broker-dealers stayed with network "Level 3" accounts longer, because they did not have the related technology in place. Over time, however, many broker-dealers began updating the capabilities of their back-office systems in an effort to develop omnibus subaccounting functions.

Transfer agent fees and alternative servicing arrangements

Omnibus accounts now prevail in the industry, and intermediaries are performing some or all of the investor servicing and recordkeeping functions that transfer agents would have previously handled under the direct model. As a result, a broker-dealer intermediary may seek, and receive, a portion of the shareholder servicing fees (that were traditionally paid to the transfer agent), either directly from the mutual fund or through its transfer agent, to offset the additional costs.

While such subaccounting payments have existed for a long time—starting with the 401(k) plan recordkeeping platforms and a few early broker-dealers—the shift in those payments from the transfer agent to the intermediary grew with the use of networked accounts, due to the high volume of transactions. However, the real increase in intermediary payments began with the jump in omnibus arrangements in 2009. Since then, the percentage of overall transfer agent fees that funds pay to intermediaries for subaccounting has risen from 26% to 57%, although not all intermediaries receive them (most notably, trust companies).[2]

Fee structures generally follow what was previously established for transfer agents, including fixed-dollar per-account fees, basis point fees (a percentage of assets applied to account balances), or a combination of the two. However, on the whole, the industry has migrated away from the once predominate per-account fee arrangements. In a recent study published by the ICI, 86% of survey respondents now use two or more billing methodologies, such as per-account fees, out-of-pocket fees, basis point fees, or transaction fees.[3,4]

[2] PwC compiled data from the Investment Company Institute, "Mutual Fund Transfer Agents, Trends, and Billing Practices," 2009, 2011, 2013. This study is available only to those ICI members who agree to participate.
[3] *Ibid.*
[4] 97 fund families surveyed.

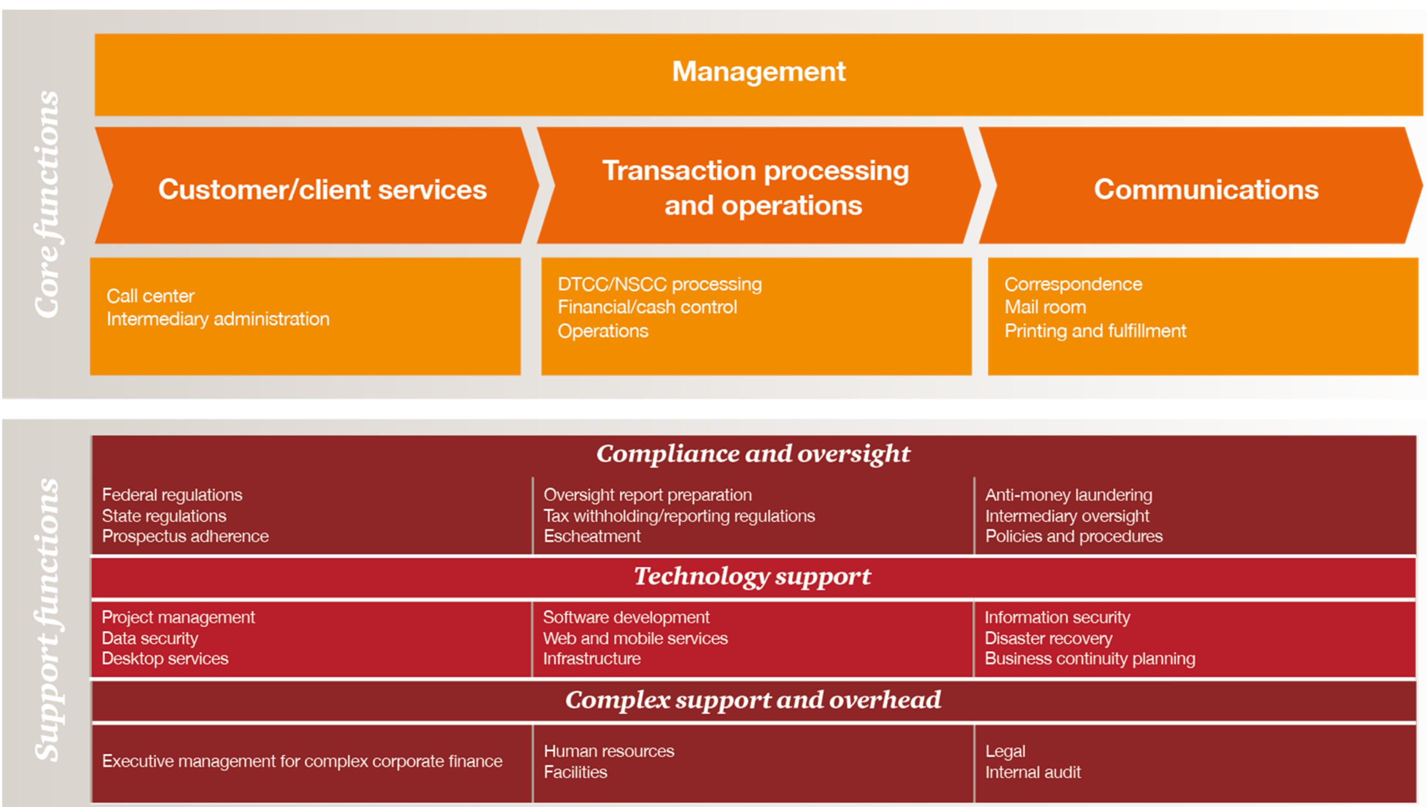
This shift in fee payments makes sense when you consider all the moving parts, including direct investors, omnibus subaccounting, intermediary oversight, regulations, and emerging cybersecurity risks. In the end, fund companies' executives focused less on the form fees took than they did on ensuring they received value for the services, the fees were competitive, and the billing model benefited investors.

Transparency and oversight

Despite the omnibus model's many efficiencies, it has made it more difficult for mutual fund managers and their boards to monitor the quality and accuracy of transaction processing, service levels, and compliance with regulatory requirements and prospectus guidelines. Since a single transfer agent no longer exclusively performs or maintains all the core functions—customer service, transaction processing, recordkeeping, and shareholder communications—that agent can no longer supply a fund's management and board with all the detailed information associated with those functions without gathering data from intermediaries.

In fact, these functions are now spread among numerous intermediaries and third-party members and across numerous technology platforms (see Figure 3). In addition, omnibus subaccounting typically offers transfer agents little or no visibility into the underlying subaccounts because intermediaries communicate only aggregated trade data.

Figure 3: Shareholder servicing and recordkeeping functions provided for the mutual fund industry.



The resulting lack of transparency impairs the funds' ability to view detailed transaction activity for each shareholder account. While fund companies have always had intermediary oversight programs, these developments presented a new challenge, spurring many fund companies and their transfer agents to revisit and strengthen oversight programs.

Fund companies have taken varied approaches. To monitor performed functions, some sought greater transparency into the intermediary's internal control environment by conducting on-site visits and reviewing internal control reports. Others pushed for additional transparency into the underlying accounts and transactions to perform their own compliance monitoring. Because no universally accepted industry standards for evaluating intermediaries yet exist, the breadth, depth, and effectiveness of these intermediary reviews differ greatly across firms.

The prevalence of the omnibus model in the industry has also escalated the debate about increased transparency and risk versus responsibility. If transfer agents gain more transparency into the underlying accounts and records of intermediaries, then they may implicitly accept greater responsibility for compliance monitoring and oversight of investor activity.

While this approach may enable transfer agents to better fulfill the fund's fiduciary responsibilities to their fund clients, there is also a counter-argument: Because they are no longer recordkeepers for shareholders, transfer agents should not have primary responsibility for shareholder-level monitoring and compliance. If an intermediary is not in compliance, then mutual fund transfer agents may not want to be "on the hook" simply because they had access to the underlying data.

In more recent years, many transfer agents have begun detailing specific intermediary monitoring requirements in their subaccounting contracts. This helps to delineate responsibilities, align associated fees, and reduce the required level of due diligence efforts transfer agents need to perform to achieve their compliance objectives.

Customer data

Increased automation has enabled significant advancements in the collection of customer information that facilitates data analytics, regulatory compliance, and other organizational initiatives. However, as the relationships among mutual funds, their intermediary partners, and their transfer agents have evolved, information sharing has become more complex; it now requires new forms of contractual working relationships to clarify roles and responsibilities.

In the days when transfer agents had access to most customer accounts, they could collect data and maintain the related records. Now that a majority of customer accounts are handled through omnibus subaccounting arrangements, intermediaries collect and maintain shareholder records, while the fund and transfer agent have only the omnibus account in the name of the intermediary on their books.

Funds, intermediaries, and transfer agents can share shareholder information electronically. However, intermediaries generally do not have their customer data formatted in the same way. Often, information storage and sharing of information—both internal and external—are not optimal.

The lack of universal adoption of industry-wide standards for the sharing of information between transfer agents and intermediaries that exists today further complicates the issue. No established industry norms exist for what data should be shared between multiple organizations, at what frequency, and in what format. The industry continues to work to develop such norms, which would—in theory—help define the roles and responsibilities of each stakeholder in the process and enable the same level of transparency across organizations.

However, factors point to the disparities between transfer agent and intermediary systems. These include the lack of integration between them and variances in the way they store data (which could make implementing such a standard challenging and costly for some). Also cited is the increased risk of compromising the security and integrity of the data through more extensive and frequent transmission.

Many organizations are not sure what it takes to translate the vast quantity of information they now possess into business insights and intelligence. Some organizations use data in very specific ways—for example, to meet certain compliance requirements (such as mutual fund redemption fee Rule 22c-2)—while ignoring other uses that may help them better understand customers. Even if they wanted to use the data more broadly, the main issue is whether the organization has the skill set to use the data effectively. Still, finding innovative ways to use all this data may offer transfer agents a way to transform their business models.

Structural and organizational shifts

Structural trends in the industry have driven a dramatic shift in the nature of the services that transfer agents perform, as well as in the make-up of the workforce needed to perform them. The once back-office, operations-heavy transfer agent business has slowly transformed into more of a specialized operations function that requires heavy compliance and oversight monitoring capabilities.

In considering the history of shareholder servicing, it is important to understand the differences among the three types of transfer agents: internal, external, and hybrid. Internal transfer agents are affiliated with the fund complex; external transfer agents are unaffiliated; and hybrid arrangements involve an affiliated transfer agent who performs some of the transaction processing, shareholder servicing, and recordkeeping functions, while an unaffiliated transfer agent performs others.

While all three types of transfer agent arrangements have been in place for years, more recently, hybrid and external models have begun to predominate. Many transfer agents began to lose the economies of scale they had established through high volume transaction processing. This is especially true for small and midsize internal transfer agents, for whom the decline in transaction volumes did not cut costs commensurately due to significant fixed overhead costs. As a result of this and other industry developments, many fund companies with internal transfer agents took a harder look at that model.

In many cases, they opted for more cost-effective hybrid or external transfer agent arrangements. According to a 2014 ICI study, the percentage of fund companies with internal transfer agents decreased from 48% to 27% from 2009 to 2013, while the percentage of both external and hybrid arrangements grew over that time.[5] Meanwhile, particularly as quality of service evened out across the transfer agent industry, fund companies with external and hybrid transfer agent arrangements often looked for the lowest cost provider with the highest operational efficiency.

These changes have all contributed to an increasing problem with staffing. Although never easy, staff replacement was a demanding process for high-volume back offices and call centers. Now that intermediaries handle the majority of transactions and customer service interactions, those transactions that do come through to transfer agents tend to be more complex, which means they require more highly skilled personnel.

While in the past transfer agents could fill these skilled positions with homegrown talent trained in their large-scale operations, this is now proving increasingly difficult. Bringing in more “advanced” back-office staff and customer service resources from outside is much harder in the current environment, where they are in short supply. The hiring process takes longer, and top people are harder to retain—for both transfer agents and outsourcing providers.

Outsourcing has created further challenges for the mutual fund industry, particularly in protecting the privacy of shareholder data as it moves back and forth to third parties. As they have implemented increasingly robust compliance and oversight programs, transfer agents have needed to hire more specialized technology, compliance, and risk management staff to monitor data and systems security at intermediaries and outsourcing vendors.

Demand for these specialists has risen due to the increase in the level of oversight of intermediaries, as well as the rise in the incidence and severity of data security breaches throughout the industry.

In general, omnibus conversion, outsourcing, and offshoring have fueled demand for greater third-party compliance and oversight, as well as for data analysis personnel at transfer agent firms. This demand has only grown along with regulation, particularly because the rise in both regulatory scrutiny and third-party oversight programs has not been unique to the mutual fund industry—transfer agents naturally have to compete for compliance and oversight staff with the rest of the financial services sector.

Increasing regulation

As the mutual fund industry has evolved, so too has regulation. During the past 20 years, 12 major new rules (see Figure 4) have required substantial investment from transfer agents, intermediaries, and mutual fund companies.

In our view, however, these rules do not entirely reflect the changing structure of the mutual fund industry and the shifting roles and responsibilities of transfer agents and intermediaries. Regulators still hold transfer agents largely accountable for core shareholder servicing functions, despite the significant shift of first direct accounts and then networked accounts off their platforms.

Transfer agents, likewise, retain contractual and fiduciary responsibilities to fund management for these functions. Applying the existing regulatory framework to this changed business model presents challenges to not only fund and transfer agent management teams but also mutual fund boards, as they execute their oversight responsibilities.

[5] PwC compiled data from the Investment Company Institute, “Mutual Fund Transfer Agents, Trends, and Billing Practices,” 2009, 2011, 2013. This study is available only to those ICI members that agree to participate.

Figure 4: Mounting regulation in the mutual fund industry.

1996 National Securities Markets Improvement Act

1999 The Gramm-Leach-Bliley Act

2001 The USA Patriot Act

2002 Sarbanes-Oxley Act

2003 SEC Rule 38a-1 under the Investment Company Act of 1940

2004 Amendments to Rule 12b-1 under the Investment Company Act of 1940

2006 SEC Rule 22c-2 under the Investment Company Act of 1940

2007 Internal Revenue Code section 403 (b) reporting and disclosure obligations for mutual funds providing 403 (b) plan investment options

2008 Emergency Economic Stabilization Act of 2008 (Cost Basis Reporting)

2010 Money Market Reform FATCA the Dodd-Frank Act

2013 Red Flag Rule

2014 Money Market Reform Rules Amendments

Regulators have continued to add new requirements without reviewing or removing old ones, which has proven problematic for the industry. These requirements include addressing late trading and market timing, fees, and recordkeeping for short-term fund redemptions, money laundering, and customer identification. They also involve mandating floating net asset values for money market funds and participation in the enforcement of the Foreign Asset Tax Compliance Act (FATCA) and IRS cost basis reporting rules.

In many cases, these regulations have required both intermediaries and transfer agents to implement new programs and policies. At the same time, dated mutual fund regulations, supplemented only by regulatory guidance, have not kept pace with industry developments. As a result, transfer agents have been left to interpret these dated rules and determine how they would apply in an increasingly automated environment. This uncertainty can hinder transfer agents as they implement emerging, more efficient technology.

Cybersecurity and data protection

It is clear that cybersecurity is not just an information technology issue anymore. It represents a challenge with wider operational, regulatory, and risk implications, especially as the advancement of social media, mobile, and cloud computing prompts the mutual fund industry to rethink how it does business. Mutual fund boards are increasingly interested in understanding the risks and what their providers are doing to protect shareholder information.

This has placed even more pressure on transfer agents and intermediaries to respond to the hundreds of questionnaires from customers inquiring about each of their firm's data security and privacy practices. Currently, there is no consistent, industry-standard report that firms use to inform customers about the processes and controls in place at service providers to ensure data security. This has left companies to create their own questionnaires of varying depth and complexity and ranging from one or two pages up to 100 pages.

To further complicate matters, firms must comply with the hundreds of state and federal laws pertaining to data privacy and security. These laws can be general in nature, such as the Federal Trade Commission's prohibition of unfair and deceptive practices, or they may apply to specific types of data, particular industries, or activities such as website data collection. Furthermore, many mutual funds, transfer agents, and intermediaries have international employees or customers and must therefore comply with the emerging data privacy and security rules in those countries, as well.

Last year, the SEC launched an initiative to examine cybersecurity compliance and controls at broker-dealers and investment advisers. The SEC has stated it will continue these efforts and expand them to include transfer agents as part of its examination priorities in 2015.[6]

The guidance will be welcome. Mutual funds, transfer agents, and intermediaries are currently on their own when it comes to a cybersecurity framework. How much private shareholder information should be stored? Should transfer agents be allowed to analyze the data? How do boards know data is properly protected? Without clear guidance, mutual funds, transfer agents, and intermediaries are unsure about what can and cannot be done and how to manage data requests.

[6] SEC, "Examination priorities for 2015," www.sec.gov, accessed June 29, 2015.

The future of the transfer agency

As the mutual fund industry landscape has continuously reshaped itself over the past 30 years to accommodate the move of investors toward working with intermediaries, shareholder servicing has shifted with it. If transfer agents are to remain relevant players in the mutual fund industry, they must continue to evolve and adapt, finding ways to bring value to the mutual fund firms they serve.

Moreover, because transfer agents no longer handle most individual shareholder records in-house, they must work with mutual fund companies to change the way they interact with intermediaries on behalf of the funds to ensure correct processing and protection of shareholder information. Finally, mutual fund companies and transfer agents must work together to ensure a clear understanding of the redistribution of transfer agent fees, so they can ensure that shareholders are paying a fair price for services. We recommend five key steps:

1. Reimagine the transfer agent model

In our view, it is important for transfer agents and mutual fund companies to work together to assess the current environment. With all the changes that have occurred in the recent past, the roles and responsibilities of many of the industry's players have shifted. Mutual fund companies need to continue to maintain a clear delineation of services, as well as an updated understanding of who is performing key functions such as shareholder servicing and recordkeeping, external reporting, and compliance and oversight.

This mapping should include all third parties involved in providing these services and the process for monitoring their performance against their contractual obligations. This is a critical undertaking for transfer agents, who are ultimately responsible for maintaining the books and records of the funds' shareholders.

With this information in hand, stakeholders can determine what the core competencies of the transfer agent should be. This will likely include continued focus on functions—such as compliance, risk management, and data analytics—that will enhance the value transfer agents provide to funds.

As part of the overall assessment and "wiring diagram," transfer agents and mutual funds should look at fees, and how well aligned they are with current shareholder servicing and recordkeeping arrangements. The industry uses a variety of billing methods and fee structures, none of which represents a universally accepted standard because no common principles or prescriptive cost allocation methods currently exist.

Historically, mutual funds tended to pay transfer agents a per-account fee. Intermediaries and other outsourcing vendors predominately received a percentage of average net assets (usually calculated in basis points). Considering the drastic reduction in the number of accounts transfer agents have on their books, these billing models have been evolving. At the very least, funds and transfer agents should reevaluate this structure periodically to determine whether its relationship with underlying business activities is still optimal.

2. Reshape workforce composition to better reflect current and future needs

The rise in demand for data analysis, compliance and oversight, risk management, and cybersecurity personnel has grown dramatically over the past decade. As a result, transfer agent organizations have had to rethink their staffing models. Back-office operations personnel and customer service representatives are not as abundant in transfer agent organizations as they once were, and those who remain are required to have more advanced skills to handle the complexity of the transactions that come directly from shareholders.

Transfer agents should perform a talent management review of their current resources and capabilities, as well as determine the core competencies they will likely be performing in the future. They should then adjust their hiring practices and talent retention programs to address both current and future organizational needs.

Despite the massive shift to omnibus subaccounting by intermediaries, many transfer agents will continue to find success by performing their core functions. Smaller in-house transfer agents have seen the number of shareholder accounts on their books diminish to a point where they lose efficiency and cost effectiveness. However, larger external transfer agent service providers may be able to continue to create critical mass by consolidating shareholder servicing and recordkeeping for multiple fund companies. As a result, fund companies should consider conducting a cost-benefit analysis to establish whether outsourcing these functions to third-party transfer agents could further reduce costs.

3. Evolve intermediary oversight programs

Fund companies are increasingly spending more resources on compliance and oversight, especially of intermediaries who now perform shareholder servicing functions for their funds. However, these oversight programs can be executed more effectively. We believe that transfer agents and fund companies should work together to redesign these programs to provide greater assurance that intermediaries are performing the contractually agreed upon functions for a reasonable fee. At a minimum, stakeholders should address the following questions:

Are we paying a fair shareholder servicing fee?

Mutual funds can only pay distribution fees to intermediaries through a plan that the fund board and fund shareholders have reviewed and approved. Because funds are now chiefly paying intermediaries instead of transfer agents for shareholder servicing and recordkeeping functions, regulators are concerned that funds are making "distribution in guise" payments—or improperly including additional fees for distribution—with these shareholder servicing payments. Further complicating the situation is that different funds may have different ways of negotiating fees and paying intermediaries for their services.

A leading practice in the industry is for a fund to develop a list of intermediary services and a table of corresponding fee ranges that the fund is willing to pay for those services. Funds sometimes have an outside source benchmark the cost of each service to determine that those ranges are reasonable. Once the fund board has approved these fee ranges, additional approval would be required for any subsequent deviations. In some cases, the transfer agent may periodically compare the intermediary's shareholder servicing fee to the underlying transaction detail to determine if the billed amounts are accurate. Many third-party transfer agents have automated this process and now offer it as a service.

Who is responsible for the relationship?

With multiple points of contact across the organization, it is not always clear who owns the relationship with the intermediary and who is empowered to enter into a contractual arrangement and negotiate corresponding fees. One leading practice is for fund companies to segregate the fee negotiations for distribution fees from all other non-distribution fees paid to intermediaries. For example, a fund's sales organization might negotiate distribution fees while the operations department (typically the internal transfer agent) might negotiate shareholder servicing and recordkeeping fees. This separation helps create independence in perception, as well as in practice.

What's in the contract?

Mutual funds should consider separating contracts with the intermediary for distribution arrangements from those for shareholder servicing. Although this sounds challenging, many fund companies have done it, particularly for large intermediaries and as part of the contract renewal process for the remainder of their smaller intermediaries.

Separating out the contracts helps when addressing proposed fee modifications for work to be performed by an intermediary. This way, the fund company has documented the shareholder services the intermediary is providing and can require the intermediary to detail the additional shareholder services it will perform for the extra fees. To pay any new fee unrelated to shareholder servicing, a fund would need to amend the contract, subject to approval from its distribution arm.

Can we use data to identify anomalies?

The development of better data analytics capabilities will enable funds to identify anomalies that should be reviewed by management and their boards. Fund companies can work with industry utilities and service providers to standardize file layouts for efficient collection of data and identify those elements needed to ensure that critical information is accurate. For example, funds populate the DTCC's Profile service to ensure that their fund prospectus requirements and operational rules have been updated correctly. Now, intermediaries need to expand receipt and use of this repository.

Is the intermediary's control environment effective?

Fund companies and transfer agents can also use standard auditor reports to assess an intermediary's control environment. Many intermediaries now provide a Financial Intermediary Controls and Compliance Assessment (FICCA) report.[7] For this report, the fund company and/or the transfer agent needs to ensure that the report's scope covers the relevant areas. One leading practice is to publish this report annually for review and discussion.

[7] Investment Company Institute, "Financial Intermediary Controls and Compliance Assessment Engagements," www.ici.org, accessed June 29, 2015.

The FICCA framework describes 17 areas of focus where fund sponsors may seek assurance, including document retention and recordkeeping, transaction processing, shareholder communications, privacy protection, and anti-money laundering, among other things. The intermediary may provide the FICCA report to all the funds it represents, which may reduce the need for overlapping compliance reviews by each fund company.

4. *Design programs to combat new threats and vulnerabilities*

The number of technology and cyber threats targeting the mutual fund industry is increasing every day. Compounding such problems is the fact that many firms still perceive cybersecurity as an IT-only responsibility. Not only does this perception increase an organization's potential exposure to attack, it also widens the communications gap between those charged with protecting the enterprise and those whose obligations are to help ensure a return to investors and shareholders and maintain strong corporate governance.

Mutual funds, transfer agents, and intermediaries need to develop strong programs to deal with cybersecurity threats. The first step is to identify all sensitive data, determine how that data is handled and protected, and identify who has access to that data.

The United States National Institute of Standards and Technology (NIST) released its Cybersecurity Framework in February 2014. The framework is a risk-based compilation of guidelines and programs. The NIST framework describes five core functions of effective cybersecurity that can form the basis of an effective program (see Figure 5).

By using this framework, fund companies, transfer agents, and intermediaries can better understand the risks and how to manage them. For a more in-depth look at these standards, please see our May 2014 paper.[8]

Figure 5: Five core functions of effective cybersecurity.

Functions	Definitions	Categories
Identify	An understanding of how to manage cybersecurity risks to systems, assets, data, and capabilities	Asset management, business environment, governance, risk assessment, risk management strategy
Protect	The controls and safeguards necessary to protect or deter threats to cybersecurity	Access control, awareness and training, data security, data protection processes, maintenance, protective technologies
Detect	Continuous monitoring to provide proactive and real-time alerts of cybersecurity-related events	Anomalies and events, continuous monitoring, detection process
Respond	Incident-response activities	Response planning, communications, analysis, mitigation, improvements
Recover	Business continuity plans to maintain resilience and recover capabilities after a cyber-breach	Recovery planning, improvements, communications

[8] PwC, "Why you should adopt the NIST Cybersecurity Framework," May 2014.

5. *Collaborate with regulators to modernize the rules*

As the mutual fund industry has continued to evolve, the basic tenets of the regulatory regime governing transfer agents' performance of their core shareholder servicing and recordkeeping functions have not changed. Accordingly, it is important to consider whether existing transfer agent rules continue to serve investors' needs in a mutual fund industry that now uses modern customer interaction methods. These rules may be affected by the increasing role of intermediaries in shareholder servicing functions, too.

The transfer agent rules also leave many current day scenarios open to interpretation. As a result, different mutual fund firms and transfer agents may interpret the rules differently, leading to inconsistencies in practice. Some transfer agents have decided to proceed with new technology-based services and have interpreted the regulations as they believe they were intended. Others have refrained from such advancements due to fear of non-compliance.

Additionally, retirement recordkeepers are not subject to transfer agent rules even though they perform the same type of services.[9] The Department of Labor plays no active role in regulating retirement participant recordkeeping, but broker-dealers have stringent books and records requirements.

This presents an opportunity for mutual funds, transfer agents, intermediaries, and other stakeholders to work with regulators to modernize the regulatory framework so it is more reflective of the current landscape. For example, this may include revisiting the information contained in the required transfer agent filings and determining if there is more helpful information that they could provide.

[9] Broker-dealers are not subject to transfer agent rules either, but they are subject to very stringent books and records rules.

What this means for your business

Mutual fund companies, their transfer agents, and financial intermediaries are operating in an increasingly complex environment as the shareholder servicing and transfer agent model changes in response to the diversification of mutual fund products and increasing regulatory requirements. All three participants need to review, and evolve as necessary, their operating practices in response to the shifting risks and opportunities.

Transfer agents and the fund companies they serve should collaborate to construct a "wiring diagram" for the industry as it stands now. After taking this step, transfer agents and fund management companies may be able to see a more effective "rewiring" for the future. This can include new ways for transfer agents to provide value, since they no longer do the bulk of the shareholder servicing and recordkeeping.

These new transfer agent functions will likely continue to include oversight and monitoring of intermediaries to ensure compliance with regulatory and prospectus requirements, as well as with cybersecurity controls. Transfer agents are also well positioned to help mutual fund companies implement programs to continue to ensure that fees align with the performance of contractually agreed upon services.

Meanwhile, now is a good time for mutual fund companies, transfer agents, intermediaries, and other stakeholders to proactively come together, as they have in the past, and drive consistency and agreement in the market on intermediary oversight, data protection, cybersecurity, and the modernization of the regulatory framework. Working in collaboration with regulators is essential to ensuring that mutual fund and transfer agent rules reflect current industry realities.

Regardless of the specific approach, we recommend comprehensive processes that can be consistently performed on an on-going basis across all the entities involved. Doing so will enable transfer agents to continue to evolve and protect their shareholders in this changing environment.

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For a deeper conversation, please contact:

Barry Benjamin
barry.p.benjamin@us.pwc.com
(410) 659 3400
https://www.linkedin.com/pub/barry-benjamin/21/106/7

Kevin O'Connell
kevin.w.oconnell@us.pwc.com
(617) 530 7785
https://www.linkedin.com/in/kevinoconnellpwc

Nicholas D'Angelo
nicholas.dangelo@us.pwc.com
(617) 530 7319
https://www.linkedin.com/pub/nick-d-angelo/84/164/396

Scott Esposito
scott.esposito@us.pwc.com
(860) 241 7436
https://www.linkedin.com/in/scottespositopwc

Gena Wilson
gena.m.wilson@us.pwc.com
(617) 530 4157
https://www.linkedin.com/in/genamwilson

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Marie Carr
Principal

Cathryn Marsh
Director

Emily Dunn
Senior Manager

Kristen Grigorescu
Senior Manager

"Evolution of the mutual fund transfer agent: Embracing the challenges and opportunities," PwC, July 2015, www.pwc.com/us/assetmanagement