Complex Rev-Share Deals Become Compliance Pain Points

By Jill Gregorie June 1, 2017

As the nature of fee arrangements between fund manufacturers and distributors grows increasingly complex, so too do the compliance concerns around monitoring them.

“We’re seeing the proliferation of new technology and different solutions to catch up, but at its core, the process is challenging,” says Tim O’Sullivan, managing director, Deloitte.

That challenge was highlighted in recent claims brought by the SEC against William Blair. The regulator fined the fund provider $4.5 million for what it described as improper payments to distributors for marketing and sub–transfer agency services made to four distributors between 2010 and 2014, as reported.

According to the SEC, the Chicago-based firm improperly used shareholder assets beyond the board-approved 12b-1 plan earmarked for such purposes to pay two intermediaries for marketing and distribution help. The fund shop “misclassified” certain provisions in those contracts, causing more than $900,000 in fund assets to be improperly spent.

Other violations involved sub–transfer agency payments. At a third intermediary, William Blair exceeded a board-mandated 15 bps cap on sub-TA fees. As a result, the funds paid $262,244 beyond the cap over the course of four years, according to the SEC.

In its order, the regulator cited William Blair’s transition “from a manual oversight system to an increasingly automated system” as part of the root of the problem.

That case, as well those against Calvert and First Eagle, underscores the challenges that fund companies face when overseeing intermediary agreements, consultants say. The case against William Blair specifically also points to the need for firms to assess whether their technological systems are effective, they add.

For one, fund companies rely on invoices that intermediaries draw up, based on the terms of their contracts and the type of distribution being performed, O’Sullivan says. Fund companies often have hundreds of relationships with intermediaries, and each may provide a “different level of detail in terms of how they got to that number,” he adds.

In some cases, payments are a mix of 12b-1 or fund service fees that come from the fund expenses, and money paid straight from the distributor’s profits, further complicating accounting.

Even at one intermediary, those terms can vary by fund, O'Sullivan says. A fund company's contract terms with a single intermediary may contain varied fee schedules for specific funds based on fund type (e.g. equity, fixed income) or share class.

Fund boards can also set caps on the amount of fund assets that may be used for various services, with the advisor responsible for expenses beyond that, O'Sullivan adds. The Securities and Exchange Commission claims that William Blair funds paid in excess of the limit placed on sub-TA fees at two intermediaries, a transgression that contributed to the $4.5 million fine.

Other challenges can also arise when intermediaries generate a bill for services based on the level of assets at a distributor, which can be based on less sophisticated calculations such as point in time or beginning and ending period average assets, as compared to the more common average daily asset calculations used by the funds, O'Sullivan says.

Many of the cases the SEC brought forth after its distribution-in-guise sweep show "poor operational control" and insufficient attention to payment allocation, says Whitfield Athey, CEO and president of **Delta Data**, a Columbus, Ga.-based distribution consulting and software provider.

Although the SEC's order in the case of William Blair suggested that introducing automation triggered the problems, manual processes can also leave shops exposed to errors, Athey says. Many firms find it difficult to tally marketing and sub-TA expenses by hand, and adding revenue-sharing payments on top of those is another pain point, he adds.

"Broker-dealers are manually processing revenue-sharing payments, which are very easy to screw up in spreadsheets," Athey says. Carefully written computer programs can sift through massive amounts of data to analyze and detect payment errors, he argues.

Regulatory forces are pushing distributors and product manufacturers alike to be clearer about fee arrangements between them, says Chris John, a general manager and head of revenue and expense management solutions at Broadridge.

"I think there's a push — some of which is coming from the DOL rule — for transparency all the way through to the end customer," he says.

For fund shops that do turn to technology to help monitor distribution fees and sub–transfer agency payments, fund companies should examine the process the computer follows and ensure it addresses different contract terms and other nuances, says Athey.

Uploading invoices onto a technological platform allows fund companies to "detect any variances or anomalies within the invoice process," such as whether the intermediary is charging an incorrect fee, Deloitte's O'Sullivan says. The system can also help make sure invoices for account services remain separate from revenue sharing and other bills for payment, he adds.

To avoid compliance gaps, fund firms should routinely check whether the rule sets they upload onto the tech platform are up-to-date with distributor agreements, which can change frequently, O'Sullivan says.

Firms should also check through regression tests that help verify their models, especially after any change in the terms of an agreement, O'Sullivan says.

In the end, however, the push toward products stripped of fees, including funds with clean shares and T shares, may eliminate many of these challenges regardless, Broadridge's John says.

"We have seen a movement towards a more level pricing model, and it really doesn't matter what the arrangement is between the distribution and fund manufacturer," he says.

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