Delta Data

Unraveling Intermediary Oversight:

4 Essential Strategies for Asset Management Firms

As the mutual fund industry evolves, intermediary distribution continues to play a prominent role. These financial intermediary relationships are often complex arrangements and require oversight by management of the fund.

THE FOUR STRATEGIES

Overcoming the challenges of intermediary oversight

A core compliance activity for mutual fund managers is monitoring the operations of their intermediary partners that distribute fund shares and understanding the effectiveness of the controls in place to ensure that obligations to the investor community are met. Taking into account the number of dealer relationships a fund typically has and the evolving regulatory landscape, the scale and complexity of these obligations can be overwhelming.

For asset managers, intermediary oversight is a portion of a broader oversight mandate covering all critical third-party relationships. As oversight responsibilities continue to expand, budget pressure demands that activities become more efficient. These competing forces present some notable challenges.

In this ebook, we explore four strategies that compliance teams can employ to increase the effectiveness and efficiency of their intermediary oversight program.

01 Understanding the risks to determine levels of intermediary oversight activity

02 Conducting ongoing oversight to maintain due diligence across time

03 Identifying exceptions and gaps in control reports to efficiently allocate oversight resources

04 Staying on top of industry changes and trends to ensure emerging best practices are implemented to maintain an effective oversight program

STRATEGY 1

Understand the Risk – Tiering & Risk Ranking

When fund companies are building their intermediary oversight program, there are different elements that should be considered to determine the level of oversight activity to apply to each intermediary. A Risk Assessment is a fund's process for identifying and analyzing risks relevant to achieving its objectives, as well as forming a basis for determining how those risks should be managed.

It's important to establish a customized inherent risk ranking process and incorporate the results into oversight reports, as this approach to risk calculations should provide the consistency and flexibility needed to accommodate the wide range of distributors that are typically included in a fund company's intermediary oversight program.

Tiering

Tiering on a robust risk assessment enables funds to focus their attention effectively and respond to changing circumstances. A negative news item that reveals significant fines or a rise in 22c-2 violations may affect an intermediary's tier within a fund's risk ranking process, particularly if a fund has concerns that the intermediary won't be able to fix the issues within a year timeframe.

Focus Oversight Activities on High-Risk Intermediaries

Focusing on dealers with the most critical risk profiles will ensure maximum efficiency of an organization's oversight resources and help reduce overall operating risk. It's not always the largest intermediary that has the highest risk, even though they're probably the largest in terms of AUM. Rather, it's the smaller and mid-size intermediaries that may not have the infrastructure and internal controls that the larger firms have.

By understanding the totality of the intermediary and stratifying the risk across each of them, funds can focus their time and effort on the higher risk intermediaries, where possible.

Priority Rankings for Industry Benchmarking

Fund companies can priority rank the controls that are most important to them based on how relevant they are to their business and specific circumstances. But even if a fund doesn't currently rank a certain control as a high priority, access to industry benchmarks for the priority of FICCA-related controls is important to understand how peers are considering specific activities.

Benchmarking is particularly useful in board conversations about whether a fund is applying the same level of rigor to key oversight topics as others in the industry.

Assess Fourth-Party Risk

Just as organizations are outsourcing critical operations to third-party service providers, those third parties are in many cases outsourcing key functions to their own network of service providers.

These fourth-party dependencies pose potential risk, as the initial organization typically does not maintain a direct relationship with those downstream vendors.

STRATEGY 2

Conduct Ongoing Oversight

Organizations should conduct frequent conversations with their intermediaries to review the status of priority KPIs and address all possible issues as they arise. This approach can help ensure commitment to predefined goals and adequate performance throughout the engagement.

It is critical that organizations have ongoing third-party risk management procedures in place to constantly assess all possible risk factors and maintain due diligence across time.

Thorough Control Report Review

On-site visits, questionnaires, and attestation inherently rely on the fund or intermediary's judgment. Control reports, on the other hand, describe the intermediary's control environment from an independent auditor's perspective. For fund families, control reports offer advantages in the exact areas where the aforementioned methods fall short, namely in their efficiency, economy, and reliability.

This analysis serves as a critical component of the fund's intermediary oversight program operation. While reviewing control reports is only one piece of the oversight puzzle, it's a critical, cost-effective one.

Looking deeply into each document should give fund families invaluable comfort in knowing their third parties have accurate, suitably designed, and effective controls to carry out the contracted services.

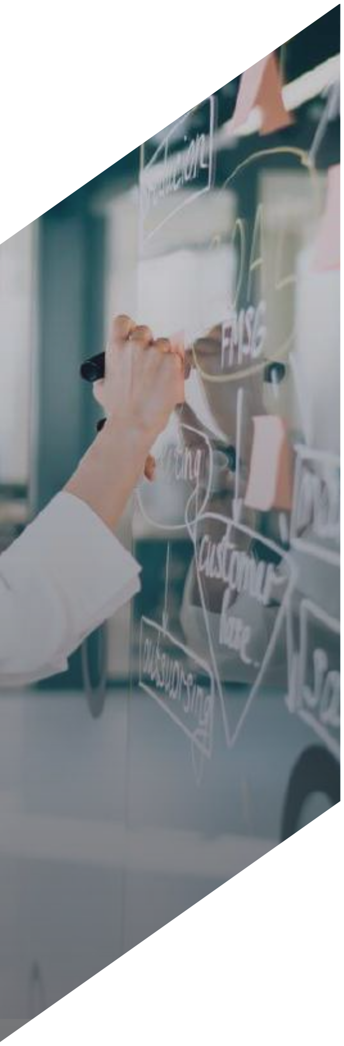
Firms can implement ongoing oversight by...

- Requesting and reviewing intermediary control documents, including SOC 1, SOC 2, and FICCA reports
- Requesting yearly compliance certifications
- Routinely assessing internal processes
- Ensuring ongoing communication of expectations and performance

Internal Controls

Internal controls are the set of policies and procedures designed, implemented, and maintained by governance, management, and other personnel charged with providing reasonable assurance about the achievement of the entity's objectives regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

As part of ongoing processes, there should be a constant effort to enhance monitoring and oversight, which includes reporting capabilities and a structure in place to provide greater transparency around operating effectiveness of compliance policies/procedures and related control activities. This includes 22c-2 monitoring and reporting, as well as effective management and allocation of intermediary fee payments.



Update Processes Regularly

The business practices of intermediaries constantly undergo change, as do the goals and responsibilities of a fund company.

Fund companies should continually reevaluate intermediary due diligence protocols to ensure that any new regulatory mandates are addressed and emerging tools, opportunities, and threats are considered.

Train Staff on Best Practices

Successful implementation of due diligence processes requires that all senior management, junior staff, and even the third parties themselves receive adequate training and information about risk mitigation standards.

Internal staff should receive periodic training on the latest changes and updates to processes in a way that is specific to their job responsibilities so they can most effectively and proactively identify any potential breaches.

STRATEGY 3

Identify Relevant Exceptions and Gaps

An exception is a deviation in the operating effectiveness of an intermediary in comparison to their stated controls, processes, and policies. It occurs when, over the course of third-party testing, the auditor observes that a control does not perform up to the described standards.

Understanding exceptions is important because they indicate a discrepancy between the way an intermediary describes its controls and how it actually performs. This intelligence is essential to funds satisfying their third-party oversight requirements.

Exceptions are just one piece of a recommended much more in-depth analysis, which identifies not only the FICCA framework content that *is* addressed, by a control report, but also the FICCA content that is ***not*** addressed.

Gap Analysis

It is critical to perform a gap analysis between the areas covered in the intermediary's control reports and the 17 Areas of Focus outlined in the FICCA. This gap analysis becomes particularly useful when funds go beyond the 17 Areas of Focus; for example, the review framework provided by NQR, a Delta Data Company, considers 82 specific controls derived from the **Points to Consider within the FICCA guidelines**.

FIGURE 1

FICCA's 17 Areas of Focus

1	Management Reporting (Quality Control)
2	Risk Governance Program
3	Third-Party Oversight
4	Code of Ethics
5	Information Security Program
6	Anti–Money Laundering (AML) & the Prevention of Terrorist Financing Program
7	Document Retention and Recordkeeping
8	Security Master Setup and Maintenance
9	Transaction Processing, Financial & Nonfinancial (e.g., Account Setup and Maintenance)
10	Cash and Share Reconciliations
11	Lost and Missing Security Holders
12	Shareholder Communications
13	Subaccount Billing, Invoice Processing
14	Fee Calculations
15	Information Technology (incl. Internet & VRU)
16	Business Continuity/Disaster Recovery Program
17	State of Sale Reporting (for Blue Sky purposes)

Exception Trends

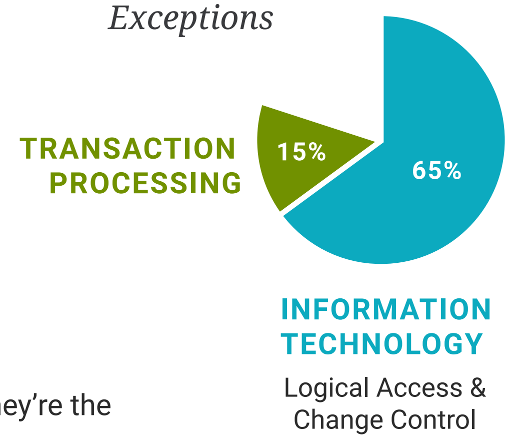
In 2023, NQR, a Delta Data Company, examined data for 88 firms – just over 150 audit documents.

Nearly two-thirds of the exceptions that appeared were in the **Information Technology Area of Focus**. The majority of those were logical access, followed by change control.

The second largest area of exceptions (15.0%) fell under **Transaction Processing**.

FIGURE 2

Most Common Exceptions



The reason those two areas come up most frequently is because they're the broader operational areas. There are often multiple systems involved and a lot of manual intervention. This is particularly true of Information Technology, which draws a lot of focus – constant actions being taken with a lot of changes. All of those multiple systems affect how the exceptions tend to lean into these distinctive operational areas.

In the grand scheme of Intermediary Oversight, exceptions and gaps are significant pieces of the puzzle that must be included in the monitoring process in anticipation of the report results auditors may or may not reveal.

Review of the same NQR data revealed additional insight:

FIGURE 3

Areas of Focus most likely to ***not*** *be covered within a control report:*

- State of Sale Reporting (Blue Sky)
- Lost and Missing Security Holders
- Fee Calculations
- Sub-Account Billing
- Invoice Processing

In many cases, asset managers should take time to fully understand whether these areas are not addressed because they are outsourced to another provider and attempt to understand the intermediary's oversight of that provider. Funds should also examine their own controls to identify whether the resulting risk is sufficiently mitigated.

STRATEGY 4

Stay on Top of Industry Changes and Trends

The industry regulatory agenda is extensive and constantly evolving, and the attention and questions around issues like cybersecurity continue to expand in scope, which makes staying on top of industry changes and trends a necessary component of an oversight program. Asset managers should utilize resources both externally and internally to track the complex and ever-changing environment.

Industry Networks

It's important to monitor industrywide due diligence, which means staying close to what's going on in the industry by attending conferences and webinars, actively participating on industry committees and discussion groups, and reviewing industry publications. These all serve as excellent resources for every organization to get a solid idea of what peers in the industry are doing in terms of their intermediary oversight programs.

Any individual that leads an intermediary oversight program should be talking to their peers, especially at industry and trade group events. Staying connected to industry peers and industry networks, groups like Nicsa and ICI, is a resourceful way to understand how industry policy and regulation are changing and how peers are adapting their operations in response.

Internally

Intermediary oversight is not just a job for the back office – it is an enterprise initiative that brings together output from processes performed throughout the organization.

A fund's intermediary oversight team should stay in touch with and work closely with the fund's legal and compliance teams. Fund companies' sales teams operate in the territories and are often able to bring information to the funds' attention regarding intermediaries. Home office groups at the funds are certainly also talking to intermediaries and can be sources of information as part of an efficient oversight program.

Quarterly meetings, where every group at the fund is included, are opportunities to compare notes across the organization and incorporate those developments into ongoing monitoring strategies.

CONCLUSION

Evolving Distribution Requires Agile Intermediary Oversight Practices

Continued attention to this key component of your comprehensive compliance programs will help you to meet the needs of the changing business.

The continued and increasing focus on compliance has created an environment where asset managers could easily devote significant time and personnel to intermediary oversight activities. **In response, more organizations are turning to third-party automated solutions and managed services offered by industry experts to streamline their oversight activities.**

> Deploying third-party automated solutions reduces risk by eliminating manual processes, enabling firms to automate counterparty management, consolidate risk information through due diligence workflows

> Maximize efficiency by reallocating resources and personnel to other high-priority oversight activities

> Layering managed services on top of technology enables the delegation of critical but repetitive tasks to subject-matter experts

This is a moving target, and an intermediary program needs to continually understand risk, understand the changes in the industry, and focus in on oversight activities where they're most powerful, while exploring external solutions and services to maintain best practices and efficiency.