Maximize Your Revenue Sharing Opportunities

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Introduction

Under the watchful eye of the SEC and other regulatory bodies, financial intermediaries have an increasing need to maintain control over the process of collecting, re-distributing and accounting for fees based on revenue sharing contracts with mutual fund companies.

Publicized allegations and citing of regulatory violations within the mutual fund industry in recent years have done more to erode assets than changes in market condition. Within the context of bad press that has plagued the mutual fund industry, financial intermediaries that stay abreast of regulatory issues, and implement procedures to ensure compliance with those issues, stand to gain a significant advantage over the competition.

What is Revenue Sharing?

Revenue sharing is a contractual relationship between the fund and a financial intermediary whereby the fund agrees to pay the financial intermediary for services rendered on its behalf. Under revenue sharing agreements, the fund recognizes the benefits of the intermediaries' distribution channels, record keeping services, transaction processing or general shareholder servicing. These services add value to the shareholders of the fund by attracting new assets. They may also help reduce expenses of the fund.

Even firms that give up revenue sharing opportunities to third-party record keepers or clearing agents in exchange for outsourced services have an increased interest in the value of their assets to the fund. As a result, these third-party service providers are succumbing to the pressure of having to pass through 100 percent of fees earned from revenue sharing agreements to the financial intermediary and then invoice them for the full value of their services. This disclosure enables financial intermediaries to better evaluate the full cost and benefit of outsourced services.

Many financial intermediaries have numerous revenue sharing agreements with fund companies. As mutual fund assets continue to grow, the challenge of accurately monitoring and tracking revenues can increase significantly. The responsibility for monitoring and tracking revenue is often delegated to a small number of analysts who rely on desktop applications, such as Microsoft Excel or Access, to facilitate this process.

These same individuals may also be responsible for allocating collected fees to the appropriate lines of business, other pass-through entities, or to clients. As the number and complexity of fee structures increase, the process of collection and re-distribution utilizing desktop applications becomes difficult to manage and susceptible to errors. These errors increase the potential for revenue to slip through the cracks and leave a fragmented audit trail for regulators and auditors to follow.

Fee Types & Tracking

Although desktop applications serve as an inexpensive, short-term tool for tracking fees and revenue, they are not robust enough to support the long-term needs of a growing organization. To effectively control the myriad of revenue sharing contracts and processes, financial intermediaries require solutions that can monitor and track all of their fee agreements and perform calculations that can be used as a benchmark for matching payments, identifying variances that exceed prescribed tolerances, and identifying payments overlooked by the fund company. These solutions should also include a means for generating the necessary output to substantiate back-fee requests to the funds on a timely basis.

Some of the more common fee agreements that must be tracked include, but are not limited to, the following:

- **12b-1 Fees:** Under rule 12b-1 of the Securities Act there are two defined components of this asset-based fee. First, there is the marketing and distribution component fee which is limited to 75 basis points. The second component is the shareholders servicing portion of the fee which is limited to 25 basis points. Payments under the rule cannot be made by the fund without approval from its Board of Directors and disclosure to shareholders. In addition, payments made to outside intermediaries are made in accordance with executed agreements between the financial intermediary and the Fund's Distributor Company.

- **Administrative Fees:** These are asset-based fees that are not paid by the fund and do not require approval by the Board of Directors of the fund; nor do they require disclosure to shareholders.

- **Sub-TA Fees:** Sub-Transfer Agent fees represent the portion of compensation received by financial intermediaries that is normally paid by the fund to the transfer agents. These fees are paid to intermediaries for performing shareholder accounting/recordkeeping, recording daily activity, and handling shareholder servicing—ranging from issuing account statements, transaction confirmations, and tax statements to maintaining customer service departments on behalf of the mutual fund. Sub-accounting services provided by the financial intermediary enable the fund and the plan to benefit from omnibus accounting, thereby reducing the reporting and processing costs of the fund. As a result, the fund passes a sub-transfer agent fee to the financial intermediary as compensation for providing the service. These revenues may take the form of asset-based fees, fixed-fees per-sub-account, or a combination of both.

- **Fixed Contract Fees:** These fees are set at a fixed-dollar amount and remain the same from one payment cycle to another. Fixed Contracts may be assessed at a client or account level and transcend across all positions. A fixed contract fee may represent a minimum charge and be supplemented with other fee arrangements.

- **Finder's Fees:** Finder's fees are paid to intermediaries for new assets coming into a fund through an initial purchase. They exclude new money coming into a fund from an exchange transaction. Finder's fees represent compensation in the form of a percent of initial investment in a mutual fund – typically 25-100 basis points of new money – paid out of the mutual fund company's own resources, usually by the fund's distributor. These fees are not an expense to the fund. Some funds pay finder's fees only to securities dealers as a commission, while others treat them as a service.

Note: The descriptions listed above are intended to be a broad overview of some of the more common types of fees collected by financial intermediaries and should not be used as an authoritative interpretation by a legal or regulatory body.

Solutions for Managing Revenue Sharing Contracts and Controlling the Fee Collection Process

In order to effectively manage and control the collection and redistribution of shared revenue with the mutual fund companies, financial intermediaries must develop a strategy to build or purchase enabling technology that will service the needs of the organization well into the future. This technology is a must for intermediaries that operate in an omnibus environment and want to continue receiving sub-TA fees. Investments in the right solution promise to add value to the entire process through enhanced efficiencies, stronger controls, complete audit trails and the ability to quickly react to changes that occur in the marketplace.

Delta Data's Revenue Manager is a proven software solution that is sophisticated in its ability to manage an unlimited number of fee agreements. With the use of step-by-step wizards, Revenue Manager guides users through the fee setup process and enables them to perform any type of fee calculation using the same methodology as the fund companies.

Revenue Manager is pre-programmed to send and receive data files in NSCC format. In this way, participating Fund Companies can electronically pass payment and supporting detail through NSCC Commission Settlement files. Transmitted payment detail received from the funds is electronically matched by the system against its internal calculations. Revenue Manager also provides standard application programming interfaces (API's) that enable users to map data from other electronic forms of payment detail and import the data for automatic matching. Variances that exceed user-defined tolerances setup within the system can be researched and resolved quickly.

The system also maintains a comprehensive audit trail of daily positions, daily prices and extended values for each account during the payment cycle, compliant with expectations set forth under the Sarbanes-Oxley bill. Any requests for back-fees can be submitted to the funds with full supporting documentation.

Because Revenue Manager calculates earned amounts at the account/position level (whether fully disclosed or sub-omnibus), the system can build reports or generate files for redistribution of collected revenue back to specific lines of business or other third party relationships. When billing funds for sub-TA services, Revenue Manager can automatically generate invoices and send the information via direct transmission, email or by fax. The system even creates required journal entries for each revenue sharing transaction to ensure accurate and timely reporting to accounting.

Solving the Short-Term Redemption Fee Dilemma

In addition to the functionality for tracking revenue sharing arrangements, Revenue Manager has been enhanced to perform short-term redemption fee processing as mandated by many fund companies as a way of stopping the abusive practices of market timing. The application supports the aging of share lots using either the LIFO or FIFO method, and supports lot aging for sub-omnibus positions that are included in calculations for determining short-term redemption fees.

Retirement plan service providers can import participant level trades into the Revenue Manager for aging and calculation purposes as well. Service Providers that have record keeping systems capable of performing short-term redemption fee calculations can pass the fee information onto Revenue Manager and allow it to schedule and process payments back to the funds.

Most intermediaries are as yet unable to support the processing of short-term redemption fees for sub-omnibus positions. Yet the fund can only support the tracking if accounts are fully disclosed. Therefore, if the intermediary cannot support the process, they are tasked with breaking out their omnibus positions into fully-disclosed positions so that the fund can do the tracking. What's more, intermediaries that receive sub-TA fees for omnibus positions held at the funds are at risk of losing those revenue streams if they are unable to internalize a short-term redemption fee process.

On the other hand, financial intermediaries that enhance their internal systems to support the processing of short-term redemption fees will be positioned to retain and potentially build their sub-TA revenue stream. This added capability may also provide leverage for re-negotiating sub-TA agreements at a higher rate.

Since Revenue Manager warehouses all revenue sharing arrangements, assets, head counts and fees, financial intermediaries can utilize this consolidated source of information for providing leverage in negotiating all revenue sharing agreements with the funds.

Beyond Compliance...

By employing fee and revenue sharing software solutions, financial intermediaries can ensure that they are collecting all types of revenue due to them while maintaining complete audit trails that can be easily followed by internal/external auditors and outside regulators.

The optimum approach from an enterprise perspective is adopting a single solution that performs the necessary fee calculations and also manages fee relationships by monitoring fee agreement data from all sources. Implementation of a comprehensive solution can enable financial intermediaries to realize revenue that has previously eluded them. Uncovering and collecting untapped revenue helps drive profitability and long-term sustainability as it builds a lasting competitive advantage.

An Illustration: The Impact of Short-Term Redemption Fees on Sub-TA Revenue

- Assume that it costs the fund $38 per year to support one account.
- Assume that a financial intermediary has 50,000 sub-omnibus positions rolling up to 2,000 omnibus positions at the fund.
- Based on these assumptions, the funds pay $76,000 ($38 per acct X 2,000 accts = $76,000) per year to support omnibus positions for the financial intermediary.
- If the financial intermediary had to convert its omnibus positions into fully-disclosed or long-title positions, the funds would then pay $1,900,000 ($38 per acct X 50,000 accts = $1,900,000). The net increase in annual fund expenses would be $1,824,000 ($1,900,000 - $76,000 = 1,824,000).

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