

ICI OPERATIONS

APRIL 2020

Estimating Omnibus Account Dividend and Capital Gains Disbursements

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Introduction

The mutual fund transfer agency landscape has evolved to the point where significant numbers of mutual fund shares are now held in intermediary-controlled omnibus accounts. ICI's Broker-Dealer Advisory Committee Omnibus Distributions Task Force has developed the following definition of *omnibus accounts*.

Omnibus accounts hold mutual fund shares that are registered with the mutual fund's transfer agent in the name of the financial intermediary. The intermediary maintains the underlying shareholder (beneficial owner) account information on its own subaccounting or retirement plan participant recordkeeping systems¹ and reports share transactions to the fund on an aggregate basis. The intermediary or its agent handles all communications and servicing of its customer accounts.

The omnibus model offers certain operating efficiencies for the intermediary in servicing beneficial owners. However, as the underlying shareholders in an omnibus account do not directly interact with the mutual fund company and its transfer agent, these parties may have limited to no knowledge or transparency about the underlying shareholders.

One important operational area where this lack of transparency is especially notable for funds is when they are planning for payment of dividend² and capital gains distributions. When a fund declares a dividend or capital gain, its investment manager must ensure that there is sufficient cash available for the fund to pay distributions to shareholders who have elected to receive proceeds in cash.³ While the fund's transfer agent can survey its books and records to determine shares eligible for distributions paid in cash versus reinvestment, there are limitations to that approach when certain omnibus accounts are considered.

To assist fund and transfer agent personnel who may plan for and execute payment of dividend and capital gains distributions, the Investment Company Institute's Broker-Dealer Advisory Committee (ICI BDAC) convened a working group of members—funds, intermediaries, and service providers—to identify strategies to more effectively incorporate omnibus accounts into the preparation and management of dividend and capital gains distributions and payments. The working group's goals are to educate asset managers, intermediaries, and service providers about various options available and to promote the intermediaries' adoption of resources that help to provide important beneficial owner transparency to their fund counterparties. The paper highlights the use of solutions provided to the industry by the Depository Trust & Clearing Corporation (DTCC) Wealth Management Services (WMS) Mutual Fund Services business unit to facilitate efficient, high-volume distribution event processing between counterparties.⁴

¹ In many instances, intermediaries in the bank/trust and retirement plan participant recordkeeping distribution channels provide omnibus account transparency differently than broker-dealers. While this paper is germane to all intermediaries, its primary audience is broker-dealers.

² Dividends may include periodic distributions and daily accrual funds that pay out earnings on a scheduled basis.

³ A shareholder can typically elect to receive distributions either in cash or in additional shares purchased by use of distribution proceeds (reinvestment). Cash distributions are the focus of this paper because they require movement of cash/settlement between counterparties (fund and intermediary/shareholders). Money movement for reinvested distributions occurs within the portfolio and does not engage outside counterparties.

⁴ As the industry's utility for trading, clearance, settlement, and information sharing solutions, DTCC WMS offers its members solutions created by the National Securities Clearing Corporation (NSCC), such as Fund/SERV®, Defined Contribution Clearance & Settlement (DCC&S), Mutual Fund Profile Services I (Price/Rate) and II (Security Database; Distribution Declaration Database), Networking, and Omni/SERV® to support efficient communication about and processing of dividend and capital gains events.

Background

Distribution Options and Beneficial Owner Accounts

Each account maintained on the fund's transfer agent system typically has one distribution option for dividends and a second for capital gains.⁵ Options are established on account opening or maintained thereafter on the basis of shareholder instruction. In the absence of explicit instructions, options are established by a default value specified in the fund's prospectus. Most omnibus intermediaries elect to reinvest distribution proceeds into their omnibus accounts, which is consistent with many fund default distribution payment options and—not surprisingly—how many shareholders receive their distributions. An omnibus intermediary, like any shareholder, may elect to receive distribution proceeds in other permissible payment options, including cash.⁶

Because the omnibus account represents the interests of multiple underlying shareholders, the dividend or capital gains option elected on the omnibus account held by the fund's transfer agent does not typically represent the actual elections made by *all* underlying shareholders.⁷ Instead, the omnibus intermediary holds this information on its recordkeeping system for underlying beneficial owners; details are not directly available to the fund's transfer agent. Mutual fund companies and their transfer agents require additional transparency into the distribution elections made by the underlying shareholders to most accurately estimate fund shares subject to payment of distribution proceeds in cash or reinvested shares.

Processing Distributions

When a fund company declares a dividend or capital gain, it publishes the following attributes regarding the event:

- » **Record date:** Date used to determine shareholders of record, and quantity of shares owned, who are entitled to receive distribution proceeds
- » **Payable date:** Date on which distribution proceeds are paid to shareholders
- » **Ex date:** Date on which the fund's net asset value (NAV) price per share is adjusted to no longer reflect the value of the distribution payment
- » **Reinvest date:** Date on which distribution income is reinvested into the shareholder's account
- » **Dividend or capital gains rate per share:** The amount of distribution received for each share held by investors on record date

This information is typically made available to intermediaries through the National Securities Clearing Corporation (NSCC) Mutual Fund Profile Service II⁸ and through direct distribution to intermediaries by the fund or its agent, often by email or fax.

⁵ Most differentiate between short-term and long-term capital gains because of historically different tax treatment of those two categories of distributions.

⁶ All available payment options for the fund are determined by fund documents (e.g., prospectus and statement of additional information). However, *any* payment option that involves moving money from the fund (CUSIP) receiving the dividend into a different fund (CUSIP) is fundamentally a cash payment (from the fund's perspective).

⁷ Some intermediaries may hold multiple omnibus accounts in a fund, each with unique dividend and capital gains payment options. This action provides greater precision for calculating and reconciling a distribution event.

⁸ Refer to www.dtcc.com/wealth-management-services/mutual-fund-services/mutual-fund-profile-service-ii for more information.

The fund's transfer agent will process the dividend or capital gains event, applying the rate per share to the record date balance on each eligible account found on the transfer agent system. The transfer agent system will post a transaction to the account that is consistent with the shareholder's distribution election: a cash payout or a reinvestment transaction.

Each omnibus intermediary must also process the dividend or capital gains event on its subaccounting, trust accounting, or retirement plan participant recordkeeping system. The intermediary's processing uses the same attributes published by the fund company regarding the event and applies them to each eligible underlying shareholder (beneficial owner) account in the same way that the fund company processes this event on the transfer agent system. The typical result is that some of the underlying shareholders will receive a cash payout, while other underlying shareholders will receive reinvested shares. This means that the omnibus account distribution, with 100 percent either reinvested or paid in cash, will be out of balance with its aggregate underlying shareholder accounts, where a portion of distributions are reinvested versus proceeds paid in cash.

Reconciling Distributions Paid to Omnibus Accounts

Most omnibus intermediaries elect to receive distributions as reinvested shares into their omnibus accounts on the fund's transfer agent system, with a much smaller number electing cash payment. Because underlying shareholders may have elected to receive distribution proceeds differently than the omnibus account held with the fund, the distribution transaction creates an "out of balance" situation that must be quickly remediated.⁹

Omnibus intermediaries receiving all reinvested shares into their omnibus account from a distribution event must sell a portion of those shares from the omnibus account to balance with their underlying shareholder accounts and to raise cash equal to the amount needed to pay cash out to their underlying shareholders. Intermediaries place a redemption order, often referred to as a "div sell" (dividend sell), with the fund. Alternatively, omnibus intermediaries receiving all cash proceeds for distributions related to their omnibus account must submit a purchase order, often referred to as a "div buy back" (dividend buy back), to purchase shares necessary to reinvest in the underlying subaccounts.¹⁰

⁹ Remediation needs to occur with the fund while its books are still open/being reconciled for payable/reinvest date to avoid a potential gain or loss on the adjusting transaction due to daily changes in the fund's NAV.

¹⁰ Most distribution reconciliation activity pertains to broker-dealer subaccounts. Most retirement plan participants elect to reinvest shares to maximize the deferred tax benefits of such plans.

Fund/SERV DCC&S and Omnibus Distribution Processing

Most intermediaries will use Fund/SERV DCC&S to facilitate the sell or buy orders necessary to reconcile the omnibus account balance to the aggregate underlying shareholder account balances. The sell transaction raises cash to pay shareholder distribution proceeds. A buy transaction acquires the shares necessary to cover shareholder reinvested dividends.

Fund/SERV DCC&S orders are sent early in the first business day following a distribution event with a trade date corresponding to the previous business day (the reinvest date of the distribution). If confirmed by the fund during the DCC&S processing window, the transaction will be included in net settlement of trading activity as if occurring the previous business day. This eliminates any gain or loss incurred on the adjusting transaction, as it will be executed at the same NAV as the original distribution transaction. Funds can also adjust the shares outstanding of the portfolio to correctly reflect the adjusting transaction.

When placing a Fund/SERV DCC&S order, the omnibus intermediary designates the order as a distribution reconciliation transaction through the asset type indicator field. The following values apply:

- » L = Omnibus dividend reconciliation
- » S = Omnibus short-term capital gains reconciliation
- » T = Omnibus long-term capital gains reconciliation

Use of the correct asset type indicator is essential for the fund to understand what the omnibus intermediary is attempting to accomplish.

The Fund's Omnibus Account Challenge

Before executing the distribution event, the fund's transfer agent can run a report of current-date share balances by distribution election for accounts on the transfer agent system to estimate the total shares electing to receive cash versus reinvested shares. The investment manager may use this information to determine the estimated cash needed in the fund's portfolio to meet the cash distribution payout. However, since most intermediary omnibus account shares often represent both cash and reinvestment options elected by underlying shareholders, but only one option is possible on the transfer agent system, omnibus account estimates based on the elections on the transfer agent system alone are not accurate. This is where the fund companies need additional transparency into the elections made by underlying shareholders and held on corresponding subaccounts.

This issue of transparency is generally associated with broker-dealer-controlled omnibus accounts where there is often a mix of shareholders electing cash and those electing reinvested shares for distributions. The situation is less common with retirement plan omnibus accounts, or super-omnibus accounts used by retirement plan recordkeepers, as retirement plans and participants generally are set to reinvest all dividends and capital gains. Trust companies, as intermediaries, may also hold omnibus accounts on funds' transfer agent systems. However, they typically maintain separate omnibus accounts for shareholders electing reinvestment versus cash payments. Therefore, estimating activity from the transfer agent system is often effective for these types of omnibus relationships.

Historically, fund companies have attempted to estimate the cash needed by omnibus dealers that reinvest their distribution proceeds by analyzing prior distribution events. This is done by reviewing the "div sell" and "div buy back" activity submitted in omnibus accounts the last time a dividend or capital gain was paid. This process is inherently flawed, as many funds pay dividends or capital gains so infrequently (typically annually) that significant changes in the shareholder account base undermine the efficacy of the approach. Factors such as natural investment activities (e.g., buys and sells), changes in the account types invested in a fund, share class launches and conversions, new or additional omnibus intermediaries that were not part of previous events, changes in clearing firm arrangements, and other activity may fundamentally alter the fund's overall shareholder base and render this backward-looking analysis ineffective.

Risks Associated with Lack of Transparency

With omnibus accounts holding significant percentages of shares outstanding in many funds, the inability to accurately assess their cash distribution payment needs creates significant portfolio management and settlement risk for asset managers and operational risk for funds and their transfer agents. Significantly underestimating cash available to meet the cash distribution payouts and “div sells” could cause the fund to delay cash disbursement until cash is available. If the fund chooses to meet the cash disbursement needs, it may require use of other liquidity available to the fund (e.g., lines of credit) or the fund portfolio could be put into an overdraft position. Either of these scenarios can lead to unnecessary use, penalty, and interest charges that the fund absorbs, increasing expenses for all shareholders. The scenario may require an investment manager to liquidate securities on short notice to raise cash. This can lead to inefficient execution of orders within a fund’s portfolio, adversely affecting trading costs and performance, both to the detriment of the fund’s shareholders.

Conversely, overestimating cash needs means that fund assets may be less efficiently deployed within the portfolio than optimally possible. This can contribute to lower performance of the fund and is especially challenging with funds tracking their composition and activities to an index.

Many transfer agents employ system controls on the transfer agent system to mitigate the risk of unplanned large redemption orders. Transfer agents may systematically or procedurally reject or delay confirmations of redemption orders that exceed a predetermined threshold, including those sent via Fund/SERV or Fund/SERV DCC&S. A reject or delay in confirmation for a large redemption order coded as a “div sell” or a large purchase order coded as a “div buy back” could be disruptive to normal processing for an intermediary, transfer agent, and investment manager. These time-sensitive events may require manual processing for both the transfer agent and the intermediary, leading to an increased risk of a processing error. Orders processed outside of DTCC must be manually settled; the size of the transaction may require numerous reviews and approvals before cash is transferred separately. This can also lead to the delayed settlement of redemption orders, ultimately delaying the delivery of cash to underlying shareholders.

These risks exist any time a fund declares a distribution. However, the risk escalates as omnibus accounts continue to grow in number and size (e.g., holding greater percentages of shares outstanding) as well as when funds declare larger rates per share, as is often the case for periodic distributions (e.g., capital gains or special/supplemental dividends). Large rates result from numerous factors, including if there is high portfolio turnover—sometimes caused by fund acquisitions, mergers, or investment team turnover—or if the underlying securities generate more income than projected. Since the need to distribute remains, and the size of the distribution rate per share often cannot be reduced, solutions must be focused on the operational and information aspects of planning for and managing the effects of the distribution payment on the portfolio, to the benefit of all fund shareholders.

Mitigating Risk Through Information Sharing

The fund's lack of transparency into underlying shareholder distribution elections that exists at the fund transfer agent is a significant risk surrounding cash distribution processing. Fortunately, there are solutions to address transparency issues. One such solution, sponsored by ICI BDAC in 2009, was to take an existing omnibus transparency file process and standardize it through the DTCC. Omni/SERV® transparency files include a position file (known as the DSP) that provides information about the underlying shareholder accounts held within an intermediary's omnibus account. The DSP was enhanced in 2017 to include information related to the underlying shareholder's dividend and short- and long-term capital gains elections.

The relevant DSP field is named DSPDCO, and information regarding the values provided in this field is noted below.

FIGURE 1

Omni/SERV Position File (DSP): Account Distribution Options

Field name	Starting position	Ending position	Length	Field description			
DSPDCO	292	292	1	Dividend, Long-Term Capital Gain (LTCG), and Short-Term Capital Gain (STCG) distribution options			
				Field value	Dividends	LTCG	STCG
				0	Cash	Cash	Cash
				1	Reinvest	Reinvest	Reinvest
				2	Cash	Cash	Reinvest
				3	Cash	Reinvest	Reinvest
				4	Cash	Reinvest	Cash
				5	Reinvest	Cash	Cash
				6	Reinvest	Reinvest	Cash
7	Reinvest	Cash	Reinvest				

Note: Refer to "DTCC Networking: Omni/SERVSM Omnibus Position Record Layouts" for additional details. Available at www.dtcclearing.com.

The field is an optional field on the DSP; however, for the reasons identified previously, it is vitally important for intermediaries to provide these details to funds to help manage the operational, liquidity, and portfolio risk around distribution events. Intermediaries using Omni/SERV have, in large part, adopted populating this field. Other intermediaries that may use the Omni/SERV layouts but not its transmission protocols mostly have not adopted the field.

Best Practices for Intermediaries

Intermediaries that hold omnibus accounts with the fund should ensure that the fund understands the allocation of underlying shareholder distribution payment elections between cash and reinvestment. As previously noted, that is accomplished in some cases through using separate omnibus accounts based on distribution election (e.g., a cash payment omnibus account and a reinvestment omnibus account). At other times, the nature of the intermediary and account type (e.g., retirement plan participant recordkeepers) allows the fund to use the omnibus account as proxy for individual shareholder elections.

However, *when neither of these options is applicable*, intermediaries should provide funds with the distribution election for shares that make up the omnibus account. This can be done in the following ways:

1. Supply the Omni/SERV DSP file to funds and ensure that they are populating the DSPDCO field as defined by DTCC. ***This is the recommended practice and is the most efficient way to consistently provide accurate, current information about underlying shareholder elections to funds.***
2. If an intermediary is not providing Omni/SERV DSP with the DSPDCO field populated, the following optional practices may be considered:
 - » Evaluate and, if feasible, adopt Omni/SERV DSP in support of this and other transparency needs.
 - » Continue to provide existing alternative transparency solutions to funds instead of the Omni/SERV DSP, ensuring that whatever is provided includes the underlying shareholder elections.
 - » Develop and provide an alternative reporting method to funds that communicates the breakdown of omnibus account shares associated with underlying shareholder elections of cash versus reinvested distributions. This information should be provided monthly for both dividends and capital gains for each CUSIP where the intermediary holds an omnibus account. ***This practice should be pursued only if other transparency files (e.g., Omni/SERV DSP, alternative transparency solution) do not already exist or cannot be provided.***

Best Practices for Mutual Funds/Transfer Agents

Mutual fund companies or their transfer agents should use the transparency data provided by intermediaries to improve their understanding of cash obligations related to distribution events. Intermediary data should replace the associated omnibus account information obtained from the transfer agent system. The combination with other non-omnibus account data should provide the investment manager with accurate fund level estimates of cash versus reinvest to plan for cash distribution needs.

Transparency data can also be analyzed at the CUSIP and omnibus intermediary account level. Once the shares associated with cash and reinvest options are obtained, the shares can be multiplied by the anticipated distribution rate per share. The transaction dollars or shares (or both) can then be compared to any system edits or procedures surrounding large dollar redemption or purchase activity. System edits could be revisited for temporary adjustment or processing teams alerted to prepare for anticipated large dollar activity that will require prompt attention.

Even with these preparations in place, all parties are reminded that the transparency data are typically provided by omnibus intermediaries once each month. Regardless of the timing of the distribution event in relation to when data are received, these data should be considered “stale” when used to estimate distribution activity. Existing underlying shareholders could alter distribution options or buy/sell shares; new underlying shareholders could open and fund new accounts; accounts that are fully liquidated or have shares exchanged out often automatically pay out distributions in cash, regardless of the account option. Any of these transactions may change the total cash versus reinvestment allocation of omnibus account shares. Therefore, the results should still be considered estimated, but the estimate accuracy should be much greater than if no action were taken.

A Sample Process for Estimating Fund Cash Distribution Obligations

The following summarizes one approach funds can use to aggregate intermediary and transfer agent data in order to analyze, report on, and estimate cash projections when approaching a distribution event. The approach relies on a combination of actual (known) and estimated (unknown) data, depending on what is available to the fund. Funds may have other approaches that use the same, or different, information in support of their planning and estimation process.

Recommended data elements to obtain are listed below. When reporting on intermediary omnibus accounts that submit a “div sell” or “div buy back,” fund companies should consider how those accounts are identified for other reporting purposes. This may be done by social (ownership or account type) code, house (omnibus) account flag, or some other method defined by the fund company.

Cash shares (transfer agent): The total number of shares that have elected cash distributions in accounts on the transfer agent system. Intermediary omnibus accounts that submit a “div sell” or a “div buy back” should be excluded from these data.

Reinvested shares (transfer agent): The total number of shares that have elected to reinvest distributions in accounts on the transfer agent system. Intermediary omnibus accounts that submit a “div sell” or a “div buy back” should be excluded from these data.

Cash shares (omnibus): The total number of shares that have elected cash distributions in subaccounts where transparency data have been provided. The DSPDCO field on the DSP files can be used to identify this information, or, as previously described, other intermediary-provided data can be used.

Reinvested shares (omnibus): The total number of shares that have elected to reinvest distributions in subaccounts where transparency data have been provided. The DSPDCO field on the DSP files can be used to identify this information, or, as previously described, other intermediary-provided data can be used.

Total known cash shares: The sum of transfer agent and omnibus cash shares to identify the total amount of shares that have elected to receive cash distributions.

Total known reinvested shares: The sum of transfer agent and omnibus reinvested shares to identify the total amount of shares that have elected to reinvest distributions.

Once the fund has identified the total known cash shares and the total known reinvested shares, this information can be used to provide estimates. These totals may not represent all of the outstanding shares of a fund. The difference would be in any shares held in intermediary omnibus accounts where transparency is not provided. The fund company may use this information to calculate the following percentages, based on the total shares outstanding of the fund.

Total known cash percentage: The percentage of total fund shares outstanding that have elected cash distributions for shareholders serviced directly by the transfer agent or represented in omnibus accounts where transparency data have been provided.

Total known reinvesting percentage: The percentage of total fund shares outstanding that have elected reinvested distributions for shareholders serviced directly by the transfer agent or represented in omnibus accounts where transparency data have been provided.

Total fund shares: The overall total shares outstanding in a CUSIP. It includes non-omnibus accounts on the transfer agent system, omnibus accounts where transparency data have been provided, and omnibus accounts where no transparency data have been provided.

Omnibus non-disclosed shares: This represents omnibus accounts on the transfer agent system where the intermediary is not providing supplemental transparency data or where details about the allocation of cash versus reinvestment are not known by the fund company. This should include only omnibus accounts where the intermediary submits a “div sell” or “div buy back.”

Disclosed percentage: The percentage of total fund shares where the distribution election is disclosed to the fund company either on the transfer agent system or via omnibus transparency data. It is a sum of the total known cash percentage and total known reinvesting percentage.

Omnibus non-disclosed percentage: The percentage of total fund shares outstanding where the distribution election is not disclosed to the fund company.

The following values can be cross-checked for accuracy:

- » Total fund shares = total known cash shares + total known reinvested shares + omnibus non-disclosed shares
- » Disclosed percentage + omnibus non-disclosed percentage = 100 percent

Once this information is aggregated, funds can analyze and make decisions on how to use the information. Possible uses are listed below:

Total known cash shares: This amount can be used to estimate cash projections by multiplying the estimated dividend or capital gains rate by the number of total known cash shares. This establishes an estimated minimum cash amount needed to meet cash distribution needs. Actual amounts would be affected by transaction activity, changes to distribution options, and the effect of omnibus accounts that have not provided transparency data.

Disclosed percentage versus **omnibus non-disclosed percentage**: This comparison may help funds determine whether the amount of the omnibus non-disclosed shares is significant or material to the overall distribution event of the fund.

Funds or their transfer agents can consider using the calculations to estimate what is unknown. In other words, it may be beneficial to apply the total known cash percentage to the omnibus non-disclosed shares to estimate additional cash distribution needs. This may also be a place where historical ranges of omnibus account cash versus reinvestment activity could inform what range of omnibus non-disclosed shares may be anticipated to require cash distribution payments.

Additional estimate precision could be recognized by fund companies evaluating the business model of the intermediaries that do not provide transparency. By discussing with the intermediary the characteristics of its underlying shareholder base, the fund may determine whether the shareholder base is consistent with other omnibus intermediaries and, therefore, subject to similar cash versus reinvestment distinctions. Potential questions to consider, including how the responses may affect shareholder distribution election behaviors, include the following:

1. Is there a concentration of retirement assets?
2. Is there a concentration of advisory clients because of an advisory model?
3. Does that advisory model consider pending distributions in determining asset allocation rebalance events?

As previously noted, analyzing an intermediary's prior "div sell" and "div buy back" activity has many limitations. However, a long-term track record of transactions may help determine ranges or mean/median of what to expect of the intermediary that does not disclose transparency information.

Conclusion

Mutual fund investment managers must constantly monitor the overall liquidity and cash flow within a fund to effectively manage the fund's overall portfolio. Distribution events such as payment of dividends and capital gains often significantly affect cash flow. These distribution events often represent the largest cash money movement transactions for the fund's portfolio. The ability of funds to estimate cash flow, especially to support the payment of cash distribution proceeds, is critical to managing liquidity and minimizing portfolio risks.

Fund operations play an important role in the successful processing of these important events by working with portfolio management, as well as key intermediary partners, to obtain and provide the information necessary to ensure that these major events occur efficiently and with minimal disruption to the overall portfolio—both of which contribute to a positive shareholder experience. The ability of funds to estimate these cash flows depends on transparency into underlying shareholder elections and related shares held being provided by omnibus intermediaries.

Omnibus intermediaries can help minimize these risks for funds, the intermediary, and all shareholders—including the intermediary's customers who are beneficial owners of the fund—by providing the transparency needed by fund companies through adoption of the recommended practices outlined in this paper.



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