

The Evolution of the Financial Intermediary Controls and Compliance Assessment

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Introduction

Financial intermediary relationships are complicated arrangements, demanding significant commitment from fund complexes for management and oversight. As regulators create new compliance requirements—and expand existing ones—funds’ intermediary oversight programs continue to grow and evolve. The Financial Intermediary Controls and Compliance Assessment (FICCA) is designed as one tool to assist funds and intermediaries with the challenges associated with oversight of an intermediary’s activities.

Background

Intermediaries¹ have played a critical role in the exponential growth of the fund industry. As the fund industry has evolved, the influence of intermediary distribution partners in that development has grown significantly. Investors rely on intermediaries for many benefits:

- » a convenient, single point of contact facilitating their financial activities—typically providing an array of investment choices, including stocks, bonds, options, exchange-traded funds, and mutual funds;
- » help with managing their accounts, including through automation, cost-effective trading, account maintenance, and communication, regardless of the type of security owned;
- » a one-on-one relationship with the intermediary, leading to a high level of personalized service; and
- » a variety of service models, enabling investors to choose the type and level of service that best fits their individual needs.

Due to the large number of shareholders who choose to work with intermediaries, they have become a common link between funds and shareholders. Among other things, intermediaries:

- » provide financial guidance and counsel;
- » maintain financial records and account information of shareholders;
- » disburse dividend and capital gain distributions;
- » mail trade confirmations, shareholder reports, and prospectus updates; and
- » complete year-end tax reporting.

When fund shareholders receive these services from a single intermediary, instead of multiple fund complexes, they can more easily manage their fund investments regardless of how many different funds they own.

Intermediaries typically use two basic account structures when opening and maintaining accounts with fund complexes for their clients’ fund investments: individual Networked² accounts and omnibus accounts. The intermediary determines which account structure or structures it will use to support its mutual fund business.

¹ Intermediaries—such as broker-dealers, financial advisers, retirement plan recordkeepers, and banks and trusts—are integral to the distribution of mutual funds. Most funds distribute their shares through intermediaries, and most investors buy and sell fund shares through intermediaries.

² “Networked” refers to the National Securities Clearing Corporation (NSCC) Networking Service, which supports the exchange and reconciliation of investor account activity data between funds and intermediaries.

Individual Networked Accounts

Individual Networked accounts are used by many broker-dealers. An individual Networked account is opened and controlled exclusively by the broker-dealer, meaning that the broker-dealer generally provides all shareholder servicing. Individual Networked accounts are typically registered on the fund transfer agent's books in the broker-dealer's name, and "for the benefit of" the individual client. Although the registered representative at the broker-dealer associated with the investor's account is identified on the account registration, information identifying the underlying investor (beneficial owner) may or may not be included.

Omnibus Accounts

An omnibus account is a master account on the fund transfer agent's books, opened in the name of the intermediary and representing subaccounts of multiple investors. When using an omnibus account, the intermediary aggregates trade activity for the subaccounts, and generally sends one or a few trades (each representing the net of all purchases or redemptions of the underlying subaccounts) to the fund transfer agent each day. The fund complex typically has little information relating to the beneficial owners of the subaccounts.

Some omnibus accounts may contain only a specific type of subaccount. For example, an omnibus account may be opened to aggregate all individual investor accounts that have the same dividend reinvestment option, or may be used by the intermediary to manage different lines of business. In the retirement plan market, an omnibus account generally will be opened for a single retirement plan containing many underlying plan participant accounts. This is known as a "plan-level" omnibus account.

In other circumstances, an omnibus account may represent the subaccounts of a mix of account types, including individual investor, multiple retirement plan, and other pooled accounts. This type of omnibus account is sometimes referred to as a "super" omnibus account.

Omnibus accounts have been in use for decades. Initially, omnibus accounts were used by very few broker-dealers, though omnibus was (and remains) the most common structure for retirement plan accounts. Over the past seven or eight years, system technology and capabilities for recordkeeping of taxable subaccounts improved, and it became easier to integrate recordkeeping functions with existing brokerage systems. As a result, many broker-dealers now use omnibus accounts to hold mutual fund positions.

Funds' Intermediary Oversight Obligations

Intermediaries perform a range of vital functions for funds and fund shareholders, such as applying fund policies; providing disclosures, confirmations, and account statements; calculating breakpoint discounts; and monitoring for frequent trading. A fund's oversight of intermediaries performing these activities is critical, and includes some review of the adequacy and effectiveness of an intermediary's compliance controls. The level of review deemed appropriate is determined by fund management.

Although intermediary oversight has always been a significant focus of the mutual fund industry, certain regulatory initiatives over the past few years have elevated oversight management. As new and expanded

compliance requirements³ emerge, fund complexes have amended oversight procedures and programs to ensure that intermediaries—as important business partners of funds and fund shareholders—are meeting their obligations. Accordingly, all parties have generally sought to achieve greater levels of transparency across the industry.

Intermediary relationships are complicated arrangements and do not lend themselves to one standardized type of oversight program. A fund’s ongoing monitoring will vary in frequency, content, and scope, based on the type of intermediary, its business model, and the information deemed necessary.

Typically, in an initial phase in the development of an oversight program, funds risk-rank their intermediary relationships based on a number of factors, such as the size of the relationship, the type of intermediary (e.g., broker-dealer, retirement plan recordkeeper), the services provided, and the amount of servicing/recordkeeping fees paid to the intermediary. The risk-ranking process generally assists the fund in establishing a scope of review and oversight review cycle for each intermediary relationship. As a result, funds generally develop an oversight program that is tailored to address the array of relationships into which it has entered.

To achieve oversight objectives, funds often will use a combination of methods, such as:

- » Risk-based assessment of each intermediary
- » Periodic questionnaires on operational and compliance practices
- » Periodic certifications from intermediaries on compliance and operational obligations outlined within the firm’s selling and/or servicing agreements
- » Review of third-party reports, such as:
 - » FICCA
 - » AT Section 801 (formerly SSAE 16)⁴
 - » Other available third-party reports
- » Data transparency, such as:
 - » Monitoring under SEC Rule 22c-2⁵
 - » Receipt of Omni/SERV files⁶
- » Site visits to an intermediary’s office(s)
- » Conference calls with the intermediary to discuss compliance controls

³ For example, Securities and Exchange Commission (SEC) Rule 38a-1 under the Investment Company Act of 1940 requires the fund’s board of directors, including a majority of its independent directors, to approve the compliance policies and procedures of the fund and each of its service providers.

⁴ SSAE 16 was codified in the attestation standards as AT Section 801 (AT 801) in April 2010.

⁵ Rule 22c-2 requires most open-end registered investment companies’ boards of directors to consider the merits of establishing a redemption fee on short-term trading of fund shares. The rule also requires funds to enter into written agreements with financial intermediaries obligating each intermediary, on request, to provide the fund complex with specified, account-level trading information and to block trading of fund shares by accounts in violation of the fund’s short-term trading policies.

⁶ The DTCC Omni/SERV solution leverages DTCC connectivity to allow efficient transmission of intermediary subaccounting activity and position information to fund complexes.

- » Review and validation of invoices submitted by intermediaries
- » Review of the general status of the day-to-day relationship
- » Review of negative news from regulatory and media sources

Use of these mechanisms varies depending on the policies and procedures that best fit the monitoring needs as determined by the fund.

Evolution of the FICCA Engagement

Before the development of the FICCA, intermediary oversight was particularly challenging for both funds and intermediaries, due largely to the volume of requests for information and to the lack of a standard mechanism for exchanging information. Intermediaries were receiving multiple, largely duplicative requests for information and data from fund complexes with which they had relationships. Some funds were frustrated with intermediaries' varied degree of responsiveness to their requests for information.

Recognizing the benefits of creating a standard, efficient way for financial intermediaries to report on the effectiveness of their control environment, a working group of ICI member firms and representatives of the four national accounting firms developed the initial FICCA engagement framework in 2008. The framework calls for the omnibus account recordkeeper to engage an independent accounting firm to assess its internal controls⁷ relating to specified activities the intermediary performs for fund shareholder accounts.

The FICCA engagement is performed under attestation standards issued by the American Institute of Certified Public Accountants (AICPA). The auditor's report expresses an opinion on its evaluation of an intermediary's assertion that it has established specified objectives and related controls that are suitably designed and operating effectively. The FICCA framework provides an efficient method for an intermediary to provide its fund partners with a standard assessment of its internal controls of the functional areas deemed most critical by the funds.

2014 Enhancements to the Framework

As the use of the FICCA continued to grow, a new, expanded working group of ICI member firms, representatives of the four national accounting firms, and financial intermediaries met throughout 2013 to review the 2008 FICCA framework. The review was conducted to promote broader use by intermediaries and funds by enhancing the performance of future engagements and to improve the reports issued. Other objectives of the working group were to provide a forum for sharing experiences and challenges with creating and using the FICCA framework, and to develop a better understanding of the engagement process and the nature of FICCA reports issued to date.

The working group's review culminated in a variety of enhancements to the 2014 FICCA framework, including removing "Financial Viability"⁸ from the list of controls, adding "Blue Sky Reporting" as a control topic, clarifying that all 17 areas of focus outlined in the framework should be addressed on an annual basis, and adding a glossary of key terms.

⁷ The independent accounting firm assesses the effectiveness of internal controls by testing a representative sample of the overall population of the related control objective.

⁸ "Financial Viability" is covered in the intermediary's audited financial statements, not as part of a FICCA or an AT 801 report.

2015 Enhancements to the Framework

In 2015, ICI reconvened the working group to conduct a review similar to the one in 2013. The enhancements in the 2015 FICCA update⁹ were primarily technical. They include:

- » conforming requirements for several control items to the attestation standards of the AICPA;
- » clarifying that an intermediary's controls should address oversight of any third-party vendors to which the intermediary has outsourced activities or functions related to FICCA areas of focus;
- » streamlining compliance monitoring and annual independent testing of the intermediary's anti-money laundering and prevention of terrorist financing program; and
- » clarifying the intermediary's role in providing data to the fund or its designated Blue Sky agent.

Adoption of the FICCA

Recognizing the value of the FICCA, many fund complexes have encouraged and requested FICCA reports from their significant intermediary partners. In response to these requests, several intermediaries, including the majority of the larger firms, have conducted FICCA engagements and provided their reports to fund partners. The number of intermediaries that have undertaken a FICCA engagement, or plan to do so, continues to grow.¹⁰

Value

To increase account transparency, provide assurances regarding the intermediary's controls, and help mitigate some of the cost and uncertainty, the industry developed a number of tools to automate information flow and enhance independent review for specific compliance purposes. The FICCA is one of those tools. It has become a key oversight means used by the industry because it affords an intermediary the ability to respond efficiently to multiple, duplicative requests with a single document, and provides funds with one comprehensive report covering fundamental areas of concern.

Flexibility

The scope of an auditor's examination within a FICCA engagement is intended to be flexible for the intermediary completing the engagement. The specific details of the engagement are agreed upon by the auditor and the intermediary. For example, if an omnibus firm has previously engaged an auditor to perform an examination under AT Section 801, *Reporting on Controls at a Service Organization*, covering certain aspects of its operations, the FICCA could be used to provide assurance on those of the 17 FICCA areas of focus that are not covered by the AT 801 Report, thereby eliminating any redundant audit work. As a result, the intermediary may provide the FICCA report along with other control reports to all of the funds it represents, reducing the need for overlapping compliance reviews by each fund complex.

⁹ The most recent FICCA documentation is available at https://www.ici.org/pdf/ppr_15_ficca.pdf.

¹⁰ Similar to any audit effort, a FICCA engagement is a substantial undertaking by an intermediary. Due to the comprehensive scope of the engagement and the significant commitment of resources required, smaller or midsize intermediaries may choose not to adopt the FICCA. Funds are encouraged to discuss with intermediary partners current and future plans to provide the FICCA.

Practical Uses

The FICCA framework describes 17 areas of focus where fund sponsors are seeking assurances. The areas of focus were determined by both funds and intermediaries to be essential to the oversight process, and are the typical topics that funds seek assurances and detailed information on from intermediaries. Some of these areas are document retention and recordkeeping, transaction processing, shareholder communications, privacy protection, subaccount billing and invoice processing, fee calculations, and anti-money laundering.¹¹

Choosing from the tools outlined above, funds determine the best method(s) to oversee the designated intermediary. The FICCA provides funds with a comprehensive report covering multiple essential functions/areas performed by an intermediary and, when available, is becoming a preferred tool for funds to achieve cross-functional oversight.

Once a fund receives a FICCA report, it typically uses established policies and procedures to review and evaluate the report and to follow up with the intermediary as necessary on any findings outlined within the document or on missing or incomplete control objectives.

If a FICCA report is unavailable, or if an intermediary has not undertaken a FICCA engagement, the overall framework can still be valuable to a fund. The FICCA framework and its 17 areas of focus can assist the fund in reviewing other third-party audit reports (e.g., AT 801), and in targeting certifications, questionnaires, or due diligence meetings to specific areas/functions of importance. The framework is a valuable tool to assist the fund in mapping functions performed by the intermediary to appropriate oversight tools and ensuring coverage of all applicable areas.

Future of the FICCA

The FICCA framework is a living document that will continue to evolve with the industry. ICI's Operations Committee will periodically review the FICCA document and framework, and reconvene stakeholders as necessary to keep up with regulatory and industry trends. Currently, the Operations Committee is considering whether the FICCA should be fine-tuned to adequately cover retirement plan recordkeepers.

¹¹ See the appendix for a list of the 17 areas of focus.

Appendix: The 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 and the Prevention of Terrorist Financing Program
7. Document Retention and Recordkeeping
8. Security Master Setup and Maintenance
9. Transaction Processing—Financial and 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 (including Internet and Voice Response Units)
16. Business Continuity/Disaster Recovery Program
17. State of Sale Reporting (for Blue Sky Purposes)

* Areas of focus 1–3 are not controls and are not within the scope of management's assertion and the independent accountant's report. For more information, see the FICCA document at https://www.ici.org/pdf/ppr_15_ficca.pdf.



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