

Monitoring Direct-at-Fund Assets and Accounts with Grandfathered Compensation in Response to the DOL Fiduciary Rule

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Introduction

On April 6, 2016, the Department of Labor (DOL) issued a final regulation (final rule) defining who—as a result of giving investment advice to an employee benefit plan, plan fiduciary, plan participant or beneficiary, individual retirement account (IRA), or IRA owner—is a “fiduciary” under Section 3(21) of the Employee Retirement Income Security Act of 1974 (ERISA) and Section 4975(e)(3) of the Internal Revenue Code. As the DOL notes, the final rule treats persons who provide investment advice or recommendations for a fee or other compensation with respect to assets of a plan or IRA as fiduciaries in a wider array of advice relationships.

The Best Interest Contract exemption (BICE),¹ issued by the DOL at the same time as the final rule, includes an optional grandfathering provision that allows fiduciaries (e.g., intermediaries) to continue to retain current compensation arrangements for assets acquired before June 9, 2017, the applicability date of the final rule.² Assets acquired after the applicability date are not eligible for this grandfathered status unless they are acquired under certain systematic purchase programs³ established before the applicability date.⁴ After this date, when assets are acquired by an investor acting on an intermediary’s new recommendation, any compensation related to those assets must be paid under the BICE, a BICE level-fee⁵ compensation arrangement, another applicable prohibited transaction exemption, or an arrangement that does not constitute a prohibited transaction.

To ensure that compensation received after the applicability date is compliant with the final rule, intermediaries must be aware of all investor transactions and activities that could affect the grandfathered status of a mutual fund account and its assets. This is especially challenging when investor accounts associated with the intermediary are serviced by the fund’s transfer agent (i.e., held direct-at-fund). The intermediary is typically not aware of the investor’s plans, and, as a result, must react after financial transactions or certain activities have occurred on direct-at-fund accounts.⁶

¹ 81 Fed. Reg. 21002 (April 8, 2016). Along with the final rule, the DOL issued a number of prohibited transaction exemptions, including the BICE. A Best Interest Contract is an agreement between the retirement investor and the financial institution that meets the specific terms outlined within the exemption (e.g., written acknowledgment of the adviser’s and financial institution’s fiduciary duty to the investor, disclosure of compensation, and other fee information). Such an agreement allows payment of “reasonable” compensation otherwise prohibited under the final rule.

² Originally, the final rule set the applicability date for April 10, 2017. On April 5, 2017, the DOL finalized a 60-day delay to the applicability date from April 10, 2017, to June 9, 2017 (82 Fed. Reg. 16902 [April 7, 2017]). The notice of delay is found [here](#).

³ Systematic purchase programs include any rebalancing program, systematic purchase plan (including dividend reinvestments), or exchange privilege (provided that the exchange does not result in more compensation to the adviser or an affiliate than they were entitled to before June 9, 2017).

⁴ The intermediary may make certain recommendations regarding grandfathered investments after June 9, 2017, but recommendations will be subject to the best interest standard. Compensation must satisfy the “reasonable compensation standard” under ERISA and the final rule. For an overview of grandfathering, see 81 Fed. Reg. 21002, at 21065–6.

⁵ 81 Fed. Reg. 21002, at 20183–4. A level fee is defined in the exemption as a fee or compensation that is provided on the basis of a fixed percentage of the value of the assets, or a set fee that does not vary with the particular investment recommended, rather than a commission or other transaction-based fee.

⁶ The direct-at-fund servicing arrangement is common for retail IRAs.

To assist the industry in addressing this challenge, the Investment Company Institute (ICI) sponsored an industry working group of intermediaries, fund companies, and related service providers to address challenges and identify potential solutions for ongoing monitoring of direct-at-fund accounts that are grandfathered under the BICE. The working group focused on leveraging and, where necessary, enhancing currently available solutions to facilitate monitoring.

Grandfathered Direct-at-Fund Account Monitoring

Grandfathered direct-at-fund accounts can be subject to both financial transactions and clerical updates that disqualify newly acquired assets from grandfathered status.⁷ Therefore, intermediaries that choose to use grandfathering will need to adopt policies and procedures for monitoring direct-at-fund assets and accounts for disqualifying transactions. Examples of potentially disqualifying transactions and updates include:

Financial

- » A subsequent purchase (e.g., IRA contribution) pursuant to a new recommendation
- » An exchange purchase into a different fund in the investor's name, funded by proceeds from shares sold from a grandfathered account and resulting in greater compensation paid to the intermediary, pursuant to a new recommendation

Account Maintenance: With Future Financial Impact

- » Systematic purchase instruction changes that increase dollar amount or frequency, pursuant to a new recommendation
- » Rebalance program asset allocation changes that increase the compensation received by the intermediary from the account/rebalance program, pursuant to a new recommendation

Account Maintenance: Other Impact

- » A change to the broker-dealer of record on the account post-applicability date. The assets and account cannot qualify for grandfathering with the new broker-dealer because the grandfathering arrangement is not transferrable.

⁷ Assets are ineligible for grandfathered status if they are acquired after June 9, 2017, based on an intermediary's recommendation that resulted in intermediary compensation. Compensation generated by such assets must be paid in accordance with the BICE, another applicable prohibited transaction exemption, or an arrangement that is not a prohibited transaction. The compensation restrictions under the final rule only apply once a recommendation has been made.

Under current industry practices, most mutual fund transfer agents would accept an investor's instructions to facilitate these transactions and updates.⁸ In this situation, the intermediary would typically have no knowledge of these transactions before their occurrence. Given that these activities could now disqualify newly acquired assets or the account itself⁹ from grandfathering, intermediaries will need to implement post-activity monitoring to identify these scenarios, research their circumstances to determine whether the compensation earned by the related assets and/or account remain eligible for grandfathered status, and take appropriate action.

Post-Transaction Monitoring Alternatives

The mutual fund industry has developed multiple methods for sharing information about direct-at-fund accounts with their associated intermediaries. The following list highlights some key tools that intermediaries could use in support of post-transaction grandfathered account monitoring of direct-at-fund accounts.

NSCC Solutions

As the industry's utility for facilitating trading and information exchange, the National Securities Clearing Corporation (NSCC)¹⁰ offers a number of widely used solutions that may assist intermediaries' monitoring activities. Members of the working group have highlighted direct account Networking and Depository Trust & Clearance Corporation (DTCC) Payment aXis[®] as especially beneficial in this regard.

In some instances, the solutions listed below are being enhanced in response to the final rule. Details regarding NSCC enhancements, including anticipated delivery to the industry, are distributed through the DTCC's "Important Notices" available at www.dtcc.com/legal/important-notice.

Direct Account Networking

In 2005, NSCC Networking was enhanced to include direct account details, known as "direct account networking."¹¹ Intermediaries make arrangements with funds to receive an initial "scrub" file of the intermediary's direct-at-fund (non-networked) accounts. The data received include important attributes that may support monitoring grandfathered status under the BICE. The fund subsequently provides daily financial and clerical change, and periodic position (i.e., account balance) records, at an agreed-upon frequency between the intermediary and fund.

⁸ Mutual fund transfer agents complete "good order review" (e.g., ensure transactions satisfy regulatory requirements, conform to the fund prospectus and other fund documents, and comply with internal processes and procedures) before acting upon transaction instructions.

⁹ Note that the investment of additional amounts may not disqualify the existing grandfathered assets in the account. See Question 29 of FAQs issued by the DOL on October 27, 2016, describing circumstances in which additional deposits will not cause compensation attributable to existing invested assets that predated the applicability date to become ineligible for grandfathering treatment (available at www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/faqs/coi-rules-and-exemptions-part-1.pdf).

¹⁰ The National Securities Clearing Corporation (NSCC) is a subsidiary of the Depository Trust & Clearance Corporation (DTCC) and provides trading, clearing, and settlement services as a utility to the mutual fund industry through solutions such as Fund/SERV[®], Networking, Payment aXis[®], and the Mutual Fund Profile Service.

¹¹ NSCC Networking supports the exchange and reconciliation of investor account activity data. Direct account networking was created to support Recommendation L (Broker-Dealer Transmission of TIN/BIN Data) of the Joint NASD/Mutual Fund Industry Task Force on Breakpoints, as well as to assist intermediaries with their "books and records" requirements under SEC Rule 17a-3(a)(1). Refer to www.dtcc.com/wealth-management-services/mutual-fund-services/networking for additional details.

In August 2016, a working group made up of members of ICI's Broker/Dealer Advisory Committee and Bank, Trust, and Retirement Advisory Committee (ICI BDAC/BTRAC Working Group) partnered with DTCC to develop and approve modifications to NSCC Networking in response to the final rule. Two key updates will communicate detailed information on systematic investments and branch and representative information associated with direct-at-fund accounts. Intermediaries can use existing fields on these data files to isolate their grandfathered account population and subsequently review financial and clerical activity for transactions that may potentially disqualify the account and related assets from grandfathered status.¹²

DTCC Payment aXis

DTCC Payment aXis automates and streamlines the processing of commissions (both direct and trailing, such as 12b-1) and various mutual fund fee types. Firms that are active in retirement plan processing can service firm-to-firm commissions in the same manner as fund-to-broker commissions.¹³

The ICI BDAC/BTRAC Working Group has recommended extensive changes to DTCC Payment aXis in response to the final rule, most notably to provide intermediaries with the ability to return commission payments received from the fund through Payment aXis. Additional identifiers on commission payment records will allow intermediaries to more easily cross-reference them to direct account Networking records. These capabilities provide intermediaries with a clearer understanding of the compensation received related to direct-at-fund accounts and, where applicable, to work with funds in a streamlined fashion to return compensation that is incorrectly received.

Other Solutions

In addition to NSCC solutions, there are a number of other alternatives pursued by funds and intermediaries to share information on direct-at-fund account activity, balances, and commissions earned. These include third-party data aggregation solutions, proprietary data files, and ad hoc/custom data files.¹⁴

Third-Party Data Aggregation Solutions

Within the mutual fund industry, third-party service providers offer solutions that provide intermediaries with a common access point to direct-at-fund account information from multiple fund complexes. Intermediaries typically register for or subscribe to receive data from the service(s) through a portal, website, or file transmission. The common access point provides intermediaries with efficiencies in data access and analysis to monitor for direct-at-fund transactions and activity. It is not uncommon for funds and intermediaries to support and use multiple third-party solutions.

¹² A separate paper titled "Operational Considerations in Response to the Fiduciary Rule: Accounts Held Direct-at-Fund" addresses operational practices for servicing these accounts, regardless of intermediary relationship. It also describes the setup and use of direct account Networking. The paper can be found on the [ICI DOL Fiduciary Rule Resource Center](#) and at www.ici.org/pdf/ppr_17_operational_considerations.pdf.

¹³ Firm-to-firm payments allow a trust or recordkeeper to receive fund commissions and subsequently administer level compensation arrangements for broker-dealers across commissionable plan assets or in support of a plan-level advisory arrangement. Additional information about DTCC Payment aXis is available at www.dtcc.com/wealth-management-services/mutual-fund-services/dtcc-payment-axis.

¹⁴ As always, it is an independent business decision of each fund and intermediary as to what services they will use.

Proprietary Data Files

Some funds and intermediaries have long-standing arrangements for direct-at-fund information to be provided by proprietary files developed by one or both parties, or by a service provider for one of the parties. These existing proprietary files may need to be reviewed to identify whether additional data are required. If changes are needed, both parties may want to consider moving toward industry-standard solutions.

Ad Hoc/Custom Data Files

The working group discussed the fact that some parties may attempt to use ad hoc or custom data files to serve as a data source for direct-at-fund account information. For instance, many funds and intermediaries have used conversion files to move direct-at-fund accounts into intermediary subaccounts. Working group members correctly noted, however, that these files are typically point-in-time in nature and do not have the same, if any, capabilities to denote changes to data. Intermediaries that choose to use files such as these for their grandfathered direct-at-fund account monitoring activities should understand the benefits and limitations of the approach.

Other Considerations

To comply with the final rule, some intermediaries may ask fund companies to reduce or eliminate the need to monitor activity related to grandfathered accounts by the following means:

1. Prevent the creation of new direct-at-fund accounts associated with the intermediary.¹⁵
2. Restrict purchases, exchanges, or changes to systematic investment plans on the intermediary's existing grandfathered accounts.

Ideally, restrictions on activity would be managed systematically using various account and transaction identifiers at the fund's transfer agent (e.g., the intermediary's broker-dealer number, type of account, transaction, etc.). However, working group members noted that the restriction of specific intermediary activity by the fund's transfer agent is complicated and has numerous barriers toward implementation. Fund companies and key fund transfer agent system providers (both third-party and proprietary system users) indicated at best, limited, or nonexistent capabilities to systematically restrict activity as desired. The restrictions described above significantly and adversely affect current transfer agent operations.¹⁶ Therefore, intermediaries with grandfathered direct-at-fund accounts should be prepared to adopt an activity-monitoring strategy or risk noncompliance with the final rule.¹⁷

¹⁵ Funds and their transfer agents should evaluate this request for any implications under Securities and Exchange Commission (SEC) Rule 22c-1 of the 1940 Act.

¹⁶ Examples include check handling and processing, the selective suppression of some transactions (e.g., new/subsequent direct purchases by wire, exchanges in) but not others (e.g., subsequent systematic purchases, redemptions, exchanges out, dividend reinvestments), good order review procedures, and effects to subsequent investor communication.

¹⁷ See "Operational Considerations in Response to the Fiduciary Rule: Accounts Held Direct-At-Fund" on the [ICI DOL Fiduciary Rule Resource Center](http://www.ici.org/pdf/ppr_17_operational_considerations.pdf) at www.ici.org/pdf/ppr_17_operational_considerations.pdf for additional discussion.

Remediating Disqualifying Activity

Some of the financial transactions and account maintenance activities previously mentioned only affect newly acquired assets.¹⁸ Generally, a prohibited transaction under the final rule only occurs when the fiduciary (in this case, the intermediary) is compensated for newly acquired assets resulting from a recommendation. For this reason, some intermediaries and funds are considering processes and procedures to remediate disqualifying activities identified through the grandfathered account monitoring program before payment of compensation.¹⁹

Numerous remediation strategies may be possible. For example, the intermediary may want to separate newly acquired, non-grandfathered assets into a new or existing direct-at-fund account under a new BICE or BICE level-fee compensation arrangement, another applicable prohibited transaction exemption arrangement, or an arrangement that does not constitute a prohibited transaction. Alternatively, the intermediary may recommend that the investor move all assets (including the grandfathered assets) into one of the structures described above. This may require all shares to be moved into a different share class and/or account servicing model.²⁰ The potential proliferation of direct-at-fund accounts under either of these alternatives has cost and servicing implications for both fund companies and intermediaries and should be a consideration of an overall remediation strategy. Intermediaries and funds should discuss their default approach to remediation, to assist all parties with staff training and development of procedures to effectively manage the process.

Because remediation requires changes to the transaction, regardless of the remediation pursued, investor communication is critical. Intermediaries should lead all communication with the investor, as the intermediary is the party pursuing remediation. Funds should follow all established procedures regarding good order review of subsequent remediation instructions before execution.

Conclusion

The DOL expressly noted that grandfathering was “a means of affording the industry time to transition to the new regulatory structure, and to minimize disruption of existing arrangements.”²¹ Intermediaries will vary in their use of grandfathering, both for near- and long-term final rule compliance. Intermediaries that elect to grandfather direct-at-fund accounts must take into consideration that some investors will transact directly with the fund without prior notice to the intermediary. The intermediary, in turn, must have policies, procedures, and supporting data flows in place—by the applicability date—to ensure effective monitoring and appropriate response to direct-at-fund account activity that may affect the continued use of grandfathering. Funds should assist intermediaries by providing information that supports the intermediary’s monitoring program. In addition, funds and their transfer agents should assess what role, if any, they can play in supporting the intermediary’s future business decisions regarding direct-at-fund accounts and the use of grandfathering.

¹⁸ Others, such as a change of broker-dealer or exchange into a fund with higher compensation paid, affect the entire account.

¹⁹ Remediation activities that require both intermediary and fund action must be agreed to by both parties and may not be possible in all circumstances. Depending upon the applicable agreement, intermediaries may need to indemnify funds from liability to make requested changes.

²⁰ For example, an intermediary that recommends a BICE level-fee arrangement for the investor may require shares to be moved into a different share class and/or held in the intermediary’s omnibus account with the fund. The investor’s position becomes a subaccount of the omnibus account and is serviced directly by the intermediary.

²¹ See 81 Fed. Reg. 21002, at 21065.



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