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Transfer Agency Fees: A Board's Perspective

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Transfer agents perform myriad services for their mutual fund clients, some of which fulfill regulatory obligations. The principal arrangements between a transfer agent and a fund, including a description of the services the transfer agent is obligated to perform for the fund and the fees to be paid by the fund for those services, are set forth in a written contract approved by the fund's board. It has become increasingly challenging for mutual fund boards to analyze these contractual arrangements because of the changing dynamics of the transfer agent business, the expanding variety and complexity of services provided, and the changing service needs of funds. This outline discusses the role of transfer agents, the profit models they employ and the legal standards related to board consideration of transfer agency arrangements. This outline also seeks to provide an analytical framework for use when reviewing or approving transfer agency arrangements.

I. Services Provided by Transfer Agents

A. Overview

1. Transfer agents provide services to fund shareholders pursuant to a contract that is subject to board review and approval.

2. Transfer agent contracts may provide for a wide range of services for a mutual fund and its shareholders.

3. The cost of transfer agent services is typically a fund expense and is usually paid out of the fund's assets and included as part of the expense ratio. Fees for extraordinary services (*e.g.*, wire transfers, check writing, exchanges, *etc.*), however, may be charged directly to individual shareholders.

B. Services provided

1. Transfer agents are regulated under Section 17A of the Securities Exchange Act of 1934, as amended (the "1934 Act"). Section 3(a)(25) of the 1934 Act defines the term "transfer agent" to mean any person who is engaged on behalf of an issuer of securities in:

a. Countersigning securities upon issuance

b. Monitoring the issuance of securities with a view to preventing unauthorized issuance, a function commonly performed by a person called a "registrar"

c. Registering the transfer of securities

d. Transferring recorded ownership of securities by bookkeeping entry, without the physical issuance of securities certificates[1]

2. Traditional services provided to mutual funds

   a. Processing mutual fund account applications

   b. Maintaining shareholder account information, including purchases, redemptions, and balances

   c. Effecting the purchase of fund shares by processing payment for shares

   d. Processing the reinvestment of fund dividend and capital gains distributions

3. Shareholder services

   a. Performing front-office operations and interacting with customers

   b. Communicating and corresponding with shareholders (*e.g.*, automated telephone systems, delivery of fund disclosure documents via mail or electronic delivery, and account statements)

   c. Registering different account types (*e.g.*, individual accounts, joint tenants with rights of survivorship accounts, tenants by entirety accounts, transfer on death accounts, institutional accounts, and omnibus accounts)

   d. Performing and facilitating online and web-based transaction and customer support services

4. Transaction processing services

   a. Guaranteeing accurate account transactions

      (1) Processing account applications, which provide the fund with the information necessary to establish a shareholder account

[1] The SEC's description of transfer agents is available at http://www.sec.gov/answers/transferagent.htm.

(2) Ensuring that each application has the required information (*e.g.*, Taxpayer Identification Number, the amount of investment and name of fund, the applicable share class and any shareholder specific privileges such as breakpoints, rights of accumulations or letters of intent)

b. Posting dividend payments

c. Reconciling cash on a daily basis

(1) Daily cash reconciliation is important in determining liquidity needs (*i.e.*, the amount of cash needed to pay investors who have made redemption requests)

(2) After depositing monies received for the fund daily with the custodian, the custodian will notify the fund's investment adviser of the amount of cash available for investment

d. Preventing the over or under-issuance of securities[2]

5. Fund operations services

a. Preserving accurate records of accounts and transactions on a daily basis

b. Creating confirmations and periodic statements

c. Print-mail services

d. Know Your Customer and Anti-Money Laundering compliance

e. Monitoring of "market timing" and excessive trading

6. Fund administration support services

a. Supporting audits

b. Tracking fees between the transfer agent and the fund

c. Monitoring state law registration fees

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[2] Because mutual funds organized as business or statutory trusts generally authorize an unlimited number of shares, over- or under-issuance of shares is unlikely to be a concern. Funds organized as corporations, however, generally authorize a finite number of shares and must work with their transfer agent to ensure that over- or under-issuance is avoided. While this is typically the duty of the stock registrar for operating companies, the transfer agent often functions as the stock registrar in the mutual fund context.

d. Ensuring shareholders are eligible to purchase shares in particular fund classes

II. Types of Transfer Agents and Profit Models

A. Captive vs. Third Party Transfer Agents

1. Captive – a wholly owned or affiliated, internal organization of the fund's investment adviser or sponsoring entity

a. Some fund managers choose to have their own internal transfer agent. The principal advantage of this arrangement is it allows a fund to monitor closely the delivery and quality of services provided to shareholders.

b. Captive transfer agents are often better suited to make shareholder service a distinct competitive advantage. Indeed, a captive transfer agent, as an affiliate of a fund, has an incentive to be dedicated to the business.

c. Larger fund complexes may be more likely to use an affiliated entity as a transfer agent because they may be better able to accommodate the costs required to develop and maintain the extensive technology systems needed to provide service to a large number of accounts.[3]

(1) Transfer agents often incur substantial costs related to hiring, training, and licensing qualified personnel; larger fund complexes may be better suited to handle these human resources needs.

2. Third Party – an external entity that is not affiliated with the fund complex

a. Certain managers may use a third party transfer agent because they do not want to commit to or make large expenditures that are associated with implementing and maintaining a captive transfer agent. Third party transfer agents will promote the efficiency by utilizing a firm that specializes in the transfer agency function.

b. There is a trend toward externalization of the transfer agent function, principally due to the large capital investments involved in serving as a transfer agent.

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3 Investment Company Institute, The Role and Responsibilities of a Mutual Fund Transfer Agent (Workbook) (2001).

(1) In 2007, only 20 percent of fund complexes relied on a fully internal transfer agent, and that percentage was down from 30 percent in 1999.[4]

c. Some fund groups use a "hybrid" model – with a captive transfer agent providing certain services but sub-contracting certain other services to a third party.

B. Profit Models – "At Cost" vs. For Profit

1. "At Cost" model (non profit)

a. The transfer agent provides services "at cost" and does not take a profit from the provision of transfer agent services.

b. Excess revenues may be accumulated and used to invest in the business or to reduce future transfer agency fees.

2. "For Profit"

a. The SEC has indicated that an affiliated service provider may earn a profit from its contract if the investment company complies with certain conditions, which included requirements that the independent directors make certain findings about the service arrangement.[5]

b. Per account charges

(1) Under a "per account" charge model, each account is charged a flat fee for each account.

(a) Flat-fee structures are the predominant arrangement in the mutual fund industry.

(i) Provide a simple billing arrangement

4 *See* Pozen & Hamacher, THE FUND INDUSTRY: HOW YOUR MONEY IS MANAGED 354-55 (2011) (citing ICI Mutual Fund Transfer Agents – Trends and Billing Practices (unpublished 1999 and 2007)).

5 *See Notice of Proposal to Amend Rule 17d-1*, Release No. IC-8245 (February 25, 1974) ("17d-1 Proposing Release"), and *Investment Company Contracts for Services With Affiliated Persons Withdrawal of Proposed Rule Amendment,* Release No. IC-10822 (August 8, 1979). Although earlier "no action" relief granted to transfer agents affiliated with funds had been conditioned upon services being provided "at cost," the SEC stated in the Proposing Release that the conditions in the proposed amendments to Rule 17d-1 were not intended "to preclude affiliates who perform services for investment companies from realizing reasonable profits necessary to afford economic incentives."

(ii) Complex billing structures often require substantial and costly systems modifications to support the structure

(b) Flat-fee structure is administratively simple, but it prevents a fund from adjusting fees to reflect the volume of shareholder transactions

(2) Fee may depend on factors, including:

(a) Account size (total or net assets)

(b) Mandatory reports

(c) Ancillary services

(i) Many flat fee arrangements superficially offer low-priced per account fees; however, they may require customers to use ancillary services that have separate and independent charges. It is imperative that directors analyze these arrangements closely, as the menu of services and fees attached are often complicated.

(d) Investment objectives of fund

(e) Type of distribution channel

(i) Fees may vary depending on the whether the distribution channel is an affiliated broker or independent broker, or if it is retail channel, captive or otherwise

(f) Captive vs. third party transfer agent

c. Transaction charges

(1) Accounts are charged fees based on the frequency of their transactions, which include purchases, redemptions and exchanges

(2) Although transaction charges accurately reflect the volume of transactions, they are often more difficult to administer

d. Basis Point Charges

(1) Accounts are charged based on the average amount of assets per account

e. Alternative Pricing Arrangements

(1) Fund may charge a relatively low flat fee for each account and then add transactional charges for certain services

(2) Fund may charge a relatively low flat fee for each account and then add a basis point charge as determined by the value of the assets in the account

(3) The expansion of financial intermediaries and retirement marketplaces has been the catalyst for the development of alternative billing arrangements specifically for accounts created through these channels

(i) Certain complexes charge for services at the plan sponsor level or the intermediary level

(ii) Other complexes charge for services to financial intermediaries and retirement accounts on a per-account basis using a basis point or flat-fee arrangement

3. Shareholder-paid fees[6]

a. This structure requires individual shareholders to pay for certain services that are provided by the transfer agent. The services and associated fees will be disclosed to the shareholders of the fund. Shareholder-paid fees are more appropriate for services that are specific to certain investors

(1) Certain structures only require the shareholder to pay fees for extraordinary services, such as wire transfers, IRA custodial fees, small account fees, exchange fees, redemption fees, *etc*.

b. Business considerations

(1) Using shareholder-paid fees may serve to influence customer behavior and allow for the shifting of costs to individual investors and away from the fund pool and force individual investors to reimburse the fund pool for disproportionate service demands

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6 POZEN, ROBERT C., THE MUTUAL FUND BUSINESS § 9.5 (2001).

4. The number of services performed by transfer agents is expanding. The broadening of services offered has resulted in new arrangements whereby some of the services traditionally performed by the transfer agent are now provided by a service agent or sub- transfer agent.

   a. Fees traditionally charged by transfer agents may be split among distribution fees, transfer agent or sub-transfer agent fees, and costs borne by the advisor, which can have the effect of reducing charges classified as transfer agent fees

III. Multi-Class Structures: Consideration of Different Fees for Different Classes

A. Rule 18f-3 under the 1940 Act

1. Mutual funds often offer multiple classes of shares for sale in a variety of distribution channels and investor markets. Different classes may charge different transfer agent fees. Certain regulations require board members to evaluate whether charging different fees is appropriate.

   a. Rule 18f-3 allows a fund to have multiple classes. Multiple classes allow a fund sponsor to "tailor products more closely to different investor markets."[7] Rule 18f-3 states that each class "shall have a different arrangement for shareholder services or distribution of securities, or both…"

   b. Rule 18f-3 also provides that different classes may pay different shares of expenses, if the expenses are actually incurred in a different amount by the class or if the class receives different services

   c. It is the responsibility of the fund's board to examine differences between class expenses and find that the fee arrangements are in the best interests of the classes individually and the fund as a whole[8]

2. Board considerations when evaluating transfer agency arrangements for different classes under 18f-3 include:

   a. The relationship among the classes and potential conflicts of interest among the classes regarding the allocation of fees;

   b. The level of services provided to each class, the cost of the services;

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7 *Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master-Feeder Funds; Class Voting on Distribution Plans,* Rel. No. IC-20915 (Feb. 23 1995) ("18f-3 Adopting Release").

8 17 C.F.R. § 270.18f-3(d).

c. Whether the allocation of expenses is reasonable; and

d. Whether the fees for each class are reasonable and the criteria for determining who is eligible to invest in one class over another are rational and designed to complement different "investor markets."[9]

3. The 18f-3 Adopting Release raises the concern of cross-subsidization between classes without providing guidance regarding what cross-subsidization means.[10]

a. A board should consider whether transfer agent fees for different classes have been set to pay for the services provided under each class's transfer agent arrangement.

b. A board should also consider whether the transfer agent fees for different classes are discrete fees for each class that have been set with reference to competitive pricing models, rather than fees charged to the fund as a whole and allocated among individual classes.

B. Example

A board may consider that different transfer fees for different classes may be required in order to gain access to different market segments. For example, it may be appropriate for funds to offer share classes with lower transfer agent fees to retirement plan customers who either pay for transfer agent services by other means (*e.g.*, by paying an up front fee, or by fees paid directly by the plan), or to retirement plan customers who require fewer shareholder services or less costly shareholder services per account. Such share classes appropriately reflect the different transfer agent service needs of a segment of the retirement-plan market.

IV. Legal Standards Applicable to the Consideration of Transfer Agency Arrangements

A. Applicable Standards

1. Unlike the detailed provisions of Section 15(c) under the 1940 Act, which govern a board's consideration of a fund's investment advisory contracts, no specific provisions of the 1940 Act or the rules thereunder relates to a board's consideration of a fund's transfer agent or other servicing arrangements.

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9 18f-3 Adopting Release, at n. 45.

10 18f-3 Adopting Release (stating that the board must monitor the use of waivers or reimbursements to "guard against cross-subsidization between classes" and that the deletion of restrictions on waivers in the final rule is not intended to "provide a means for cross-subsidization between classes").

2. Under the business judgment rule, board action, including the approval, ratification, or renewal of a contract, is protected from judicial inquiry as long as the board acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the fund.

3. Since a board must act on an informed basis to receive the protection of the rule, it is important that a board obtain sufficient information to adequately evaluate a transfer agent arrangement. Specifically, the board should be certain that it is fully informed about the nature of services to be provided, and fees to be charged to the fund.

4. If the transfer agent is an affiliate operating on a for-profit basis, the SEC could consider the transfer agent fees to be advisory fees in another form.

    a. In light of the SEC's recent Mutual Fund Fee Initiative,[11] many fund complexes have seen the SEC staff probe non-investment advisory fee arrangements with fund affiliates.

5. The SEC staff has addressed certain factors that a board should consider, especially when approving a servicing arrangement with an affiliated person of the fund's investment adviser.

B. Applicability of Section 36(b) of the 1940 Act

1. By the plain language of the statute, the fiduciary duties in Section 36(b) apply to the receipt of compensation by any affiliated person of a fund's investment adviser; however, courts applying Section 36(b) have reached varied conclusions with respect to its scope.

    a. Several courts have found that Section 36(b) should be only applied to money paid in connection with advisory services (*see, e.g., Green v. Nuveen Advisory Corp.*, 186 F.R.D. 486, 492 (N.D. Ill. 1999); *Levy v. Alliance Capital Mgmt.*, 1998 U.S. Dist. LEXIS 16749 at 11 (S.D.N.Y 1998); *Halligan v. Standard & Poor's/Intercapital, Inc.*, 434 F. Supp. 1082, 1085 (E.D.N.Y. 1977)).

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11 In September 2010, Robert Khuzami, the director of the SEC's Enforcement Division, announced in testimony before the Senate Judiciary Committee several new initiatives that his division will focus on over the coming months and years. Among these will be a "mutual fund fee initiative" to "develop analytics … for inquiries into the extent to which mutual fund advisers charge retail investors excessive fees." *Investigating and Prosecuting Fraud after the Fraud Enforcement and Recovery Act: Hearing Before the S. Comm. on the Judiciary, 111th Cong.* (Sept. 22. 2010) (statement of Robert Khuzami, Director, Division of Enforcement, SEC), *available at* http://www.sec.gov/news/testimony/2010/ts092210rk.htm. Since Mr. Khuzami's testimony, Bruce Karpati and Robert Kaplan, co-chiefs of the Division of Enforcement's Asset Management Unit, stated that the analytics will be used "to determine appropriate candidates for further review" while noting that analytics are already being used by the SEC. Beagan Wilcox, *SEC Sheds New Light on Fund Fee Initiative,* Ignites (Oct. 21, 2010).

b. Other courts, however, have held that Section 36(b) applies to non-advisory services (*see, e.g., Meyer v. Oppenheimer Mgmt. Corp.*, 764 F.2d 76, 82 (2d Cir. 1985); *In re Evergreen Mutual Funds Fee Litig.*, 423 F. Supp. 2d 249, 258-59 (S.D.N.Y. 2006); *Pfeiffer v. Integrated Fund Services, Inc.*, 371 F. Supp. 2d 502, 508 (S.D.N.Y. 2005)).

2. The SEC has stated its belief that board members have fiduciary duties under Section 36 in the approval of affiliated service provider arrangements.[12]

a. When considering a service agreement involving affiliates, the SEC stated that board members should consider:

(1) The extent to which the fee structure of any such agreement provides for a reduction in payments resulting from economies of scale; and

(2) Whether it provides a reasonable rate of return on the capital invested by the affiliated service provider.[13]

b. The SEC also stated that these considerations are not intended to preclude affiliates from realizing reasonable profits, but to ensure that affiliated service providers do not abuse their relationship with the fund.

3. Should a board determine to employ an analysis of a transfer agency contract based on Section 36(b), it should employ the analysis set forth in *Gartenberg v. Merrill Lynch Asset Management, Inc.*,[14] which the Supreme Court affirmed as the appropriate standard for Section 36(b) claims in *Jones v. Harris Associates L.P.*[15]

a. This analysis may be conducted in connection with a board's annual consideration of advisory arrangements under Section 15(c) of the 1940 Act, although it need not be.

C. Affiliated Transfer Agency Arrangements – Applicability of Section 17(d) of the 1940 Act

1. Section 17(d) of the 1940 Act and Rule 17d-1 thereunder generally prohibit an affiliated person, or an affiliated person of such affiliated person, of a fund, acting as principal, from participating in or effecting any transaction in

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12 17d-1 Proposing Release, *supra* note 5 (stating that proposed amendments to Rule 17d-1 "will not diminish in any way the fiduciary responsibilities under Section 36 of the [1940] Act of the persons enumerated in that section.")

13 *Id*.

14 694 F.2d 923, 928 (2d Cir. 1982).

15 130 S. Ct. 1418 (U.S. 2010).

connection with a "joint enterprise or other joint arrangement or profit-sharing plan" in which the fund is a participant unless authorized by the SEC.

a. Rule 17d-1(c) defines "joint enterprise or other joint arrangement or profit-sharing plan" to include any contract or arrangement concerning an enterprise or undertaking whereby a fund and any affiliated person of the fund (or an affiliated person of such person) have "joint or joint and several participation, or share in the profits of such enterprise or undertaking."

b. The legislative history of the 1940 Act suggests that Section 17(d) was designed to prevent self-dealing and overreaching in transactions involving an investment company and its affiliated persons.

c. Courts have recognized that the objective of Section 17(d) is to prevent affiliated persons of a fund from injuring the interests of the fund's shareholders by causing the fund to participate in a transaction on a basis different from or less advantageous than that of any other participant (*see, e.g., SEC v. Talley Industries, Inc.*, 399 F.2d 396, 405 (2d Cir. 1968)).

d. In the past, the SEC staff has applied Section 17(d) and Rule 17d-1 to a variety of servicing arrangements between a fund and its affiliated service providers, reasoning that an arrangement may be deemed to be a "joint enterprise" where the service provider's fee was based on a percentage of the fund's net asset value, since this "value" would include appreciation.

2. Proposed amendments to Rule 17d-1

a. In order to address the issues identified above, in 1974 the SEC proposed amendments to Rule 17d-1 (the "Proposed Rule") which would have excluded from the definition of "joint enterprise or other joint arrangement or profit-sharing plan" service arrangements approved and renewed in the matter required for advisory contracts under Sections 15(a) and 15(c) of the 1940 Act.

b. Specifically, the Proposed Rule would have required a majority of the independent board members to determine that, with respect to a service provider contract:

(1) Such contract is in the best interest of the company and its shareholders;

(2) The services to be performed pursuant to the contract are services required for the operation of the company;

(3) The affiliated person or principal underwriter can provide services the nature and quality of which are at least equal to those provided by others offering the same or similar services; and

(4) The fees for such services are fair and reasonable in light of the usual and customary charges made by others for services of the same nature and quality.

3. No-Action Letters

a. Although the Proposed Rule was withdrawn in 1979, in the release withdrawing the Proposed Rule, the SEC noted that the Division of Investment Management had taken no-action positions with regard to service contracts which complied with the provisions of the Proposed Rule, and stated that the withdrawal was not intended to indicate a change in the no-action positions, or to indicate that action in accordance with its provisions would be inappropriate (*Investment Company Contracts for Services With Affiliated Persons Withdrawal of Proposed Rule Amendment*, Rel. No. IC-10822 (Aug. 8, 1979)).

(1) *Pegasus Income & Capital Fund, Inc.* (pub. avail. Dec. 31, 1977) (contract between an investment company and an affiliated service provider that allowed the service provider to assume management and administrative functions including custodian, transfer agent, registrar and dividend disbursing agent for the fund)

(2) *Investors Syndicate of America, Inc.* (pub. avail. May 19, 1977) (contract between face amount certificate company and an affiliated service provider to perform record-keeping and other management functions for the fund)

(3) *Funds, Inc.* (pub. avail. Oct. 4, 1975) (contract between funds and an affiliated service provider to perform transfer agency and dividend disbursing agent functions for the funds)

(4) *Arnold Bernhard & Co.* (pub. avail. Sept. 18, 1974) (contract between a fund and an affiliated service provider to perform transfer agency, computer and shareholder services for the fund)

b. Since the withdrawal of the Proposed Rule, the SEC staff has issued additional no-action letters indicating that certain arrangements between a fund and an affiliated service provider are not "joint enterprises" for purposes of Section 17(d) and Rule 17d-1.

(1) *Flex-Fund* (pub. avail. Nov. 22, 1985) was one of the first letters to explicitly provide that an affiliated service provider could earn a profit from an arrangement. In *Flex-Fund*, the SEC staff stated it would not recommend action pursuant to Section 17(d) or Rule 17d-1 against fund, its investment advisor or its affiliated service company where the affiliated service provider performed stock transfer and accounting services for the fund. These services were initially to be rendered at a loss by the service provider, but the terms of the agreements were such that at a future date the service provider could "earn profits from the performance of the contracts."

(2) In *Washington Square Cash Fund, Inc.* (pub. avail. Jul. 9, 1990), the SEC staff indicated that "[g]enerally speaking, we would not recommend enforcement action with respect to an agreement for services entered into in the ordinary course of business between a fund and an affiliated person (or an affiliated person of an affiliated person), such as an agreement to provide shareholder services under Section 17(d) or Rule 17d-1, if the compensation provided for in such had adequate safeguards . . . to prevent overreaching." The SEC staff also said that it did "not believe that the mere provision of services to a fund by an affiliated person, without more, establishes the degree of combination required by [S]ection 17(d) and [R]ule 17d-1."

c. Of course, whether a particular arrangement is a "joint enterprise" is a fact specific inquiry, and the SEC staff has not always been clear as to what constitutes a joint enterprise.

(1) In several earlier no-action letters, the SEC staff concluded that the arrangement at issue was not a joint enterprise because the affiliated service provider's fee was not based on the size of the fund's assets and there is some residual confusion with respect to affiliated transfer agency arrangements that provide for an asset-based fee.

(a) In *The Hartford Money Market Fund, Inc.* (pub. avail. Feb. 14, 1983), the SEC staff stated that an administrative agreement that had an asset-based fee may be deemed a joint enterprise with the meaning of Rule 17d-1 because the "'value' upon which the fee would be computed would include any appreciation" in the fund's assets. However, the SEC staff went on to grant to no action relief for such an arrangement on grounds that a service arrangement between an investment company and an affiliated non-advisory service provider that is approved and renewed in a fashion that meets the requirements of Sections 15(a) and 15(c) should not constitute a "joint enterprise or other joint arrangement or profit-sharing plan" under Rule 17d-1(c).

(b) The fact that the SEC staff issued several letters that superseded the Hartford letter, none of which concerned arrangements with an asset-based service fee structure, exacerbated the confusion regarding asset-based fees. *See, e.g.*, *Lindner Fund For Income, Inc.* (pub. avail. May 10, 1984).

(2) The SEC staff, however, has since recognized that "the prohibitions of Section 17(d) and Rule 17d-1 do not reach every economic relationship between an investment company and its affiliates; rather 'some element of combination' must first be established" (*PNC Bank, N.A.* (pub avail. June 10, 1997) (citing *Talley Industries, Inc.*, 399 F.2d at 403)).

(3) Accordingly, the SEC staff will likely require "some element of combination" beyond an asset based fee to justify the conclusion that an arrangement with an affiliated service provider is the type of "joint enterprise" prohibited by Rule 17d-1.

d. The no-action letters generally are conditioned on a majority of a fund's independent board members making the findings that would have been required by the Proposed Rule.

V. Board Considerations in Reviewing and Approving Transfer Agency Arrangements

In June 2007, the Independent Directors Council of the Investment Company Institute released a white paper that provided information as to factors that a board should consider when overseeing service providers.[16]

A. A key question for boards to consider is how to evaluate the nature and quality of the services provided by the transfer agent in exchange for the transfer agent fees.

1. The board should consider the level of service and quality of services that will be provided, the technological capabilities of the service provider and any internal controls and compliance policies and procedures of the service provider.

[16] Task Force Report of the Independent Directors Council of the Investment Company Institute, *Board Oversight of Certain Service Providers*, June 2007, available at http://www.idc.org/pdf/21229.pdf (the "IDC Paper").

   a. The level of service will be required will depend on the types of shareholders in the fund.

   b. For example, if a fund is mostly made up of large institutional shareholders, it may not need the same level of service as a fund with a large number of small shareholders.

2. With respect to current service providers, a board should evaluate the provider's performance over the term of the prior contract.

   a. If a board determines that the current service provider has not met expectations, a new service provider can be sought.

   b. Boards should understand, however, that there are difficulties associated with changing service providers, and the process can be expensive.

   c. Boards should verify that management has carefully planned the transition in order to avoid technical difficulties or lapses in service.

3. Additionally, the IDC Paper lists specific issues that boards should consider when evaluating transfer agents, including the following:

   a. The size of the fund complex, and the nature of the funds to be serviced;

   b. The primary method of distribution used for the fund;

   c. The number of accounts to be serviced;

   d. Types of accounts to be serviced (such as omnibus, institutional, retirement, networked);

   e. Average account size and transaction frequency;

   f. Need for shareholder intermediary interaction and technology requirements;

   g. The transfer agent's promptness of responses by phone or mail or quality of phone experience;

   h. The shareholder complaint mechanism and the reporting mechanism for the board to stay apprised of such complaints;

   i. The flexibility, stability and functionality of the technology platform of the transfer agent; and

j. Who receives the interest and credit on deposit accounts for the transfer agent.

4. It can be difficult for a board to gauge the quality of services that a transfer agent provides to a fund.

   a. Many fund complexes use surveys to analyze objective and subjective components of the service.

   b. Fund complexes may, for example, collect statistics on call center wait times, number of web transactions, or the accuracy of account transactions. But, customer satisfaction as gauged by a survey cannot be the only consideration as responses clearly may be influenced by fund performance.

5. Factors to a board should consider when determining whether to implement a captive or third party transfer agent arrangement (or to change a fund's current transfer agent arrangement):

   a. The relative cost of internal transfer agency support versus the cost of utilizing a third party transfer agent;

   b. The level of customer service that is available through an internal transfer agent versus a third party transfer agent;

   c. Whether the size of the fund or fund complex lends itself to an internal or external model; and

   d. The ability of the board to monitor the performance of an internal transfer agent or a third party.

B. Another important issue in considering a transfer agency arrangement is the fee structure.

1. The IDC Paper points out that while fees charged are important, they are just one factor, and hiring the lowest priced service provider may not necessarily be in the best interest of shareholders.

2. The general standard for assessing fees is whether they are reasonable in the light of the services to be provided. Boards may wish to consider resources that include, but are not limited to:

   a. Surveys on transfer agent fees, such as the one conducted by the Investment Company Institute;

   b. Comparative data from third-party vendors or consultants; or

c. A request for proposal ("RFP"), which can help a board either find a transfer agent with better fee rates and/or services, or help the board negotiate with the current transfer agent for lower fees.

3. Fee structures

a. As discussed above, fund complexes structure transfer agent fees in different ways.

b. When evaluating whether the costs under an "at cost" arrangement are reasonable, a board may wish to consider:

(1) Is the transfer agent providing services in an efficient manner?

(2) Are costs being artificially inflated to mask a profit?

(3) How do costs compare to those of transfer agents to other fund complexes?

(a) A fund could evaluate costs against average transfer agent fees/expenses for a group of funds with similar characteristics.

(b) For example, a board may evaluate a large cap equity fund's costs by analyzing the median of fees for current funds in the Lipper Large-Cap Growth Funds Index.

(4) How can the board verify that an "at cost" transfer agent has no profit?

c. When evaluating whether fee structures are reasonable under a "for profit" model, a board may wish to consider:

(1) What is the appropriate level of profit?

(a) Courts have resoundingly rejected the theory that an affiliated transfer agent must provide services on an "at cost" or cost plus basis, frequently citing the legislative history of Section 36(b) (*see, e.g., Kalish v. Franklin Advisers, Inc.*, 742 F. Supp. 1222, 1231 (S.D.N.Y. 1990)).

(b) Thus, a board could find a fee for an affiliated transfer agent to be reasonable even if the transfer agent earned a profit.

(c) In the 17d-1 Proposing Release, the SEC noted that although it believes board members have fiduciary duties under Section 36 of the 1940 Act, and that board members should consider certain items when approving affiliated service provider arrangements, the considerations are not intended preclude affiliates from realizing reasonable profits, but to ensure that affiliated service providers do not abuse their relationship with the fund.

(d) The SEC also states in the Proposing Release that in order to ensure that affiliated service providers do not abuse their relationship with the fund, a standard of reasonableness should be applied not only to the profits to be gained from the specific services, but those from the affiliated relationship viewed as a whole.

(e) A board may consider various items to determine whether the level of profit that a transfer agent receives is appropriate, including information from third-party consultants.

(f) In any situation, affiliated or otherwise, boards should ensure that they have sufficient information to make the determination that the fees charged and the profits realized by the service provider are fair and reasonable in light of the services being rendered.

C. SEC Enforcement Actions Relevant to Board Consideration of Transfer Agency Arrangements

1. *In the Matter of BISYS Fund Services, Inc.*, Rel. No. IC-27500 (Sept. 26, 2006)

a. In the proceeding, the SEC found that BISYS Fund Services, Inc. ("BISYS"), a mutual fund administrator, and 27 mutual fund advisers entered into "improper arrangements" in which BISYS "aided and abetted the advisers' improper use of fund assets for marketing and other expenses incurred by the advisers." Specifically, BISYS entered into side agreements, some written and some oral, which were not disclosed to the boards of the funds or to shareholders.

(1) The side agreements described how the administration fee would be used by BISYS and the adviser, and usually took the form a sub-administration fee paid to the adviser, a marketing fee, and a net BISYS administration fee.

(2) The side agreements generally became binding upon the subsequent execution of new administration contracts, and after entering into the side agreements, the adviser would recommend BISYS to the fund board

(3) BISYS set up marketing budgets for the adviser from the administration fees they received, out of which they would pay marketing expenses; at times, these budgets would go into the negative, and BISYS would agree to forgive the deficit if the adviser would recommend BISYS be re-approved for a long term contract (up to five years).

(4) The SEC found that BISYS aided and abetted in (i) fraudulent conduct by the advisers, under Sections 206(1) and 206(2) of the Investment Advisers Act of 1940, as amended, (ii) the advisers' violations of Section 34(b) of the 1940 Act, which prohibits the making of any untrue statement of material fact in any registration statement, and (iii) violations of Section 12(b) of the 1940 Act and Rule 12b-1 thereunder, since the directors were not furnished with sufficient information to determine whether the funds' 12b-1 plans should be implemented or continued.

(5) The BISYS action should not stand for the proposition that an adviser can never have an undisclosed side deal with a service provider; however, in this context, knowledge of the side deals would have been material to a board's consideration of whether to approve the administration agreement and whether to approve 12b-1 plans, and therefore, they should have been disclosed.

b. To protect against such side deal arrangements, boards may wish to inquire into other business relationships between the adviser and the transfer agent, and whether there are any similar side deals with the transfer agent.

c. At least one member of the SEC staff stated at an industry conference that he did not think there was "an expectation that directors will find oral, undisclosed side deals."[17] He did state that boards should ask why a transaction is entered into, and who benefits from the transaction.

d. It may also be helpful for a board to discuss with management why a particular transfer agent was chosen over other service providers.

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17 Amanda Gerut, *SEC Official: Directors Not Expected to Unearth Side Deals*, Board IQ, June 12, 2007.

2. *In the Matter of Smith Barney Fund Management LLC and Citigroup Global Markets, Inc.*, Rel. No. 34-51761 (May 31, 2005)

   a. In 2005, the SEC settled with Smith Barney Fund Management ("Smith Barney") and Citigroup Global Markets over alleged issues involving a transition in the transfer agency arrangements for their funds.

      (1) The SEC alleged that Smith Barney, the adviser, recommended that the funds contract with an affiliate of the adviser as transfer agent, which would perform limited services and sub-contract with the fund's existing unaffiliated transfer agent.

      (2) According to the SEC, the existing transfer agent performed almost all of the same services it had previously performed but at deeply reduced rates, the savings of which were passed on to the adviser's affiliate.

      (3) The SEC alleged that the adviser misled the board by omitting material facts as to the division of labor and the limited role that the affiliated transfer agent would play, and as a result, improperly profited from the transfer agent function at the expense of the funds; the adviser and the affiliated transfer agent settled for over $200 million.

   b. In evaluating such arrangements, boards should consider whether an unaffiliated transfer agent could provide the same services, and as discussed above, the potential costs that would come with a change to an unaffiliated transfer agent.

   c. If the affiliated transfer agent subcontracts out a portion of the transfer agent services to an unaffiliated sub-transfer agent, a board should pay close attention to whether there is any benefit that the affiliated transfer agent receives other than the fees paid under the contract.

   d. A board should also pay close attention to the fees that the affiliated and unaffiliated transfer agents receive relative to the services performed by each under the contracts.

D. Omnibus Accounts and Sub-Accounting

1. Increasingly, intermediaries transact with a fund on behalf of their clients through a single or "omnibus" account.

   a. Under an omnibus account arrangement, a fund does not have information about the underlying shareholders and transactions within the account. The intermediaries generally handle all client transactions, communications and reporting. [18]

b. In a non-omnibus environment, funds and intermediaries typically utilize the networking service offered by National Securities Clearing Corporation (NSCC), through which customer account-level information can be exchanged and reconciled between fund companies and broker-dealers (or other intermediaries).[19]

2. These intermediaries provide the sub-accounting for their clients – in effect, serving as a "sub-transfer agent."

   a. This fact is not that surprising in light of the fact that 80 percent of households that own fund shares outside a workplace retirement plan purchased those shares through a professional adviser.[20]

   b. Stated another way, only 11 percent of such households hold fund shares exclusively through fund companies and discount brokers.[21]

3. A board's principal concern with respect to oversight of a fund's arrangements with its transfer agent would be to assure that omnibus accounts carry their fair share of transfer agent fees charged to each fund.[22]

   a. For example, consider a fund complex with an affiliated transfer agent. In a profitability analysis of that transfer agent's contracts, the funds' sponsor would not be permitted to include as an expense any revenue-sharing expenses that the sponsor pays out of its own pocket to omnibus account holders (so-called "revenue sharing").

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18 Under recent amendments to Rule 22c-2, a fund that permits intermediaries to transact with the fund through omnibus accounts must enter into shareholder information agreements with the intermediaries. Under these agreements, an intermediary agrees to provide, upon the request of the fund, information regarding shareholders who have purchased, redeemed or transferred shares of the fund through the account and to restrict transactions in the fund for shareholders who have violated policies with respect to frequent trading.

19 There are various levels of networking which provide different levels of reporting control for different client accounts. For example, with a Level 1 networked account, the intermediary maintains most but not all control over the fund assets in the customer account. The intermediary sends orders and issues client statements, but the fund handles tax reporting. With a Level 3 networked account, the intermediary handles all client orders, customer statements and reporting and clients have no direct privileges with the fund.

20 *See* ICI, 2010 Investment Company Factbook 85.

21 *See id.*

22 At least one commenter has argued that the trends toward omnibus accounts has been accompanied by additional charges to fund investors such as increased broker-dealer account maintenance fees, shareholder servicing fees and adviser-paid revenue sharing. *See* Coalition of Mutual Fund Investors, *The Costs of Providing Shareholder Services to Hidden Mutual Fund Accounts* (Aug., 18, 2010) available at http://www.investorscoalition.com/CMFIWhitePaperAug18.pdf (emphasis in original). These kinds of fees are not central to board oversight of arrangements between a fund and its transfer agent, although they may be relevant to the consideration of a fund's investment advisory and distribution fees.