THE QUALITY FORUM
December 2010 Volume 5, Issue 5

Intermediary Oversight

MANAGING RISK ACROSS THE EXTENDED SERVICE MODEL

by James Nee, Senior Manager, Deloitte & Touche LLP

Background

The Mutual Fund industry's push toward expanded distribution channels has resulted in a paradigm shift in the conventional transfer agent shareholder servicing model. Roles and responsibilities traditionally reserved for the transfer agent, whether internal to the funds or external with a third party service provider, are continuing to be pushed outside the walls of the mutual fund complex and into the hands of distribution partners through the expanded use of omnibus accounting practices. As the number of omnibus relationships grows, funds must increasingly rely upon the capabilities of a growing number of external systems and service operations to deliver customer service and comply with industry and fund rules. This brief article has been created to highlight some of the issues and challenges that the industry faces, as well as the drivers behind creating oversight programs to span across the entire spectrum of accounts.

Why is oversight important?

The paradigm shift in shareholder servicing has coincided with a general increase in attention to risk, which incorporates multiple considerations such as financial impact, regulatory compliance, and reputational harm. Market events, as well as regulatory mandates, continue to place pressure on mutual fund boards and fund companies to reassess compliance and risk management as it applies throughout their extended enterprise. This has prompted many fund companies to increase their scrutiny beyond the confines of their own operations and consider the potential impact that their business partners may have on them. With the growing level of accounts and service fees shifting to intermediaries, this broader risk perspective is beginning to extend to the review of the compliance controls of the broker-dealers, fund supermarkets, and other financial intermediaries that hold clients' mutual fund investments.

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SAVE THE DATES
OCTOBER 4-5, 2011

2011 NQR Client Conference

at the

SEAPORT HOTEL AND WORLD TRADE CENTER

Boston, MA

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NQR National Quality Review

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Managing Risk Across the Extended Service Model

What are some of the industry challenges?

The shift in shareholder servicing is not new to the industry, but there are a number of challenges to the mutual funds in terms of performing oversight, which include, but may not be limited to:

- **Cost:** Building and maintaining the processes and infrastructure necessary to conduct timely and effective oversight;
- **Lack of tools:** Standard tool sets are limited, resulting in funds developing custom or ad hoc solutions;
- **Limited access to data:** Lack of transparency into the underlying data and trading files;
- **Lack of expertise in data capture and analytics:** Not generally a core competency or focus of Asset Managers/mutual funds; and,
- **Limited efficiency/effectiveness:** Many programs have not achieved sufficient maturity to offer scale and discipline to efficiently achieve results.

What does the future hold for the industry?

The aforementioned list of challenges is not to be considered comprehensive, but has been shared to highlight some of the key issues firms are dealing with as they look to build oversight programs, which may be either "home grown" or through working with or outsourcing to a service provider, in order to guard against the financial, regulatory, and reputational risks that are involved in its operations. While challenges exist, the continued expansion of omnibus suggests increased attention is needed. As the shift in the service model continues to evolve and more assets are being serviced by financial intermediaries, will you be prepared to speak with your Board about what is going on across the entire enterprise?

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2011 Cost-of-Living Adjustments to Contribution Limits for Retirement Plans

TYPE OF LIMITATION		2010	2011
Elective Deferrals	401(k), 403(b), and 457(b)	$16,500	$16,500
	Simplified Employee Pension	$16,500	$16,500
	SIMPLE Retirement Accounts	$11,500	$11,500
Catch-Up Deferrals *(Age 50)*	401(k), 403(b), and 457(b)	$5,500	$5,500
	Simplified Employee Pension	$5,500	$5,500
	SIMPLE Retirement Accounts	$2,500	$2,500
Defined Contribution Maximum Annual Addition	Lesser of 100% of Compensation or	$49,000	$49,000
Simplified Employee Pension Maximum Annual Addition	Lesser of 25% of Compensation or	$49,000	$49,000
IRA Contribution Limits	Traditional and Roth	$5,000	$5,000
IRA Catch-Up Contributions *(Age 50)*	Traditional and Roth	$1,000	$1,000

Recent Enhancements to the Research and Benchmarking Website

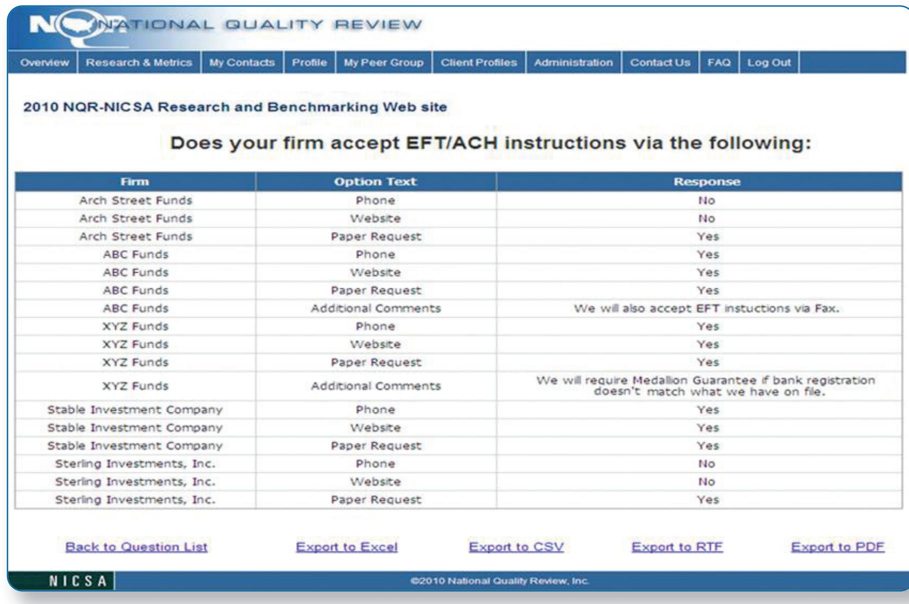
www.nqrbenchmarking.com

The NQR-NICSA Research and Benchmarking Website is an easy to use interactive portal that provides real-time financial services benchmarking information. As a result of feedback from our clients, we are pleased to announce the following recent enhancements:

- **The ability for subscribers to view and sort qualitative results.** The qualitative results are presented in a table format that allows the viewer quick and easy access to industry practices and trends. Some examples of these qualitative questions include industry practices on Electronic Fund Transfers, Authorized Traders/Signors, and Low Balance Accounts.

- A **Client Profile Center** that displays certain demographic information of participating companies such as Number of Active/Open Accounts, Total Assets, and Distribution Methods. We encourage you to complete the demographic section in order to populate the Client Profile Center.

- **The ability for subscribers to export** qualitative results to the following formats: Excel, PDF, RTF, and CSV.



Firm	Option Text	Response
Arch Street Funds	Phone	No
Arch Street Funds	Website	No
Arch Street Funds	Paper Request	Yes
ABC Funds	Phone	Yes
ABC Funds	Website	Yes
ABC Funds	Paper Request	Yes
ABC Funds	Additional Comments	We will also accept EFT instuctions via Fax.
XYZ Funds	Phone	Yes
XYZ Funds	Website	Yes
XYZ Funds	Paper Request	Yes
XYZ Funds	Additional Comments	We will require Medallion Guarantee if bank registration doesn't match what we have on file.
Stable Investment Company	Phone	Yes
Stable Investment Company	Website	Yes
Stable Investment Company	Paper Request	Yes
Sterling Investments, Inc.	Phone	No
Sterling Investments, Inc.	Website	No
Sterling Investments, Inc.	Paper Request	Yes

The Benchmarking Website has seen increased activity resulting from new questions that have been added by the Website participants. After adding new questions, these same participants are utilizing the social networking function to invite others in the industry to answer the questions. New questions in the following areas have recently been added:

- Electronic Funds Transfers
- Customer Communications
- Low-Balance Accounts
- Authorized Traders/Signors
- Paperless Legals

Subscribers can easily add new research questions to the Website by simply clicking the link on the Research and Metrics Page titled "Request a New Question." Once submitted, NQR will post your question to the Website and notify you to invite others to respond to this new question.

Effective January 1, 2011, subscribers to the Research and Benchmarking Website will be able to enter data for the 2011 benchmarking period. Subscribers will also be able to enter data for previous years by selecting the particular years of interest in the Research and Metrics page.

As always, if you are interested in learning more about the NQR/NICSA Research and Benchmarking Website, please click the following link www.nqrbenchmarking.com or contact Catherine Coyne at ccoyne@nqrinc.com or Chuck Rollins at crollins@nqrinc.com. They can also be reached at 617-426-0616.

NEWS CLIPS

529 PLANS IN 2011

Qualified Expenses

For tax years 2009 and 2010, the IRS expanded the definition of Qualified Expenses for 529 plans to include computer equipment and technology, and Internet access while enrolled at an eligible educational institution. However, the expanded definition goes away on December 31, 2010. Effective January 1, 2011, Qualified Expenses reverts to the more limited definition of tuition, fees, books, supplies, and equipment required by the educational institution, plus room and board for minimum half-time students.

Gift Tax Exclusion

The IRS also recently announced, in Revenue Procedure 2010-40, that the Gift Tax Exclusion for 2011 will remain the same as it was in 2009 and 2010. For 529 plan purposes, this means that the annual contribution limit per individual taxpayer to the account of a single beneficiary is $13,000. ■

KIDDIE TAX FOR 2011

In Revenue Procedure 2010-40, the IRS announced that there will be no change for 2011 in the way that federal income tax applies to unearned income for dependent children under UTMA/UGMAs. Therefore, the unearned income for a dependent child under age 19 (or under age 24, if a full-time student) would be treated as follows:

- the first $950 is tax-exempt;
- the next $950 is taxed at the child's rate (generally 10%);
- the excess over $1,900 is taxed at the parents' rate. ■

CLARIFICATION OF RULES ON IN-PLAN CONVERSIONS TO DESIGNATED ROTH ACCOUNTS

In September, the Small Business Jobs and Credit Act of 2010 was signed into law. One of the provisions of this legislation would permit non-Roth deferral account assets in 401(k) and 403(b) plans to be converted within the plan to designated Roth accounts. In-plan conversions would become available to 457(b) government plans after 12/31/10. The conversion provision is only applicable to amounts which are eligible for distribution.

When this legislation was passed, many practitioners in the retirement industry commented on the lack of guidance with regard to how these conversions were actually going to be processed. The IRS announced recently, in Notice 2010-84, a set of guidelines to clarify some of the issues around the conversion process which include the following:

- There are two types of in-plan conversions:
  1. A **direct conversion** where the trustees transfer the proceeds from the participant's non-Roth deferral account to the participant's designated Roth account in the same plan;
  2. A **60-day conversion** where the participant deposits an eligible rollover distribution from the participant's non-Roth account to the participant's designated Roth account in the same plan within 60 days of having received the distribution.
- The conversion will be available to plan participants, surviving spouse beneficiaries, and alternate payees (who are current or former spouses).
- A participant may not recharacterize any amount attributable to an in-plan Roth conversion.
- Spousal consent is not required for an in-plan Roth conversion.
- The conversion is:
  1. A taxable transfer subject to ordinary income tax;
  2. Not subject to the 10% penalty tax on premature distributions;*
  3. Not subject to 20% mandatory withholding.

* *A special recapture rule applies if a plan distributes any portion of an 'in-plan' conversion amount within a 5-taxable-year period, making the distribution subject to the 10% penalty tax on premature distributions.* ■

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NEWS CLIPS

EXTENSION OF SUNSET PROVISIONS FOR COVERDELLS

On December 17, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010. This new legislation extends the sunset provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) for Coverdell Educations Savings Accounts (ESAs) through December 31, 2012.

This means that:

- The maximum annual contribution limit will remain at $2,000 (was scheduled to decrease to $500 effective Janaury 1, 2011);
- The definition of Qualified Expenses will continue to include expenses for elementary and secondary (K-12) school education (was scheduled to be limited to college expenses effective January 1, 2011). ■

DEFINITION OF FIDUCIARY

This fall, the Department of Labor (DOL) issued a proposal to update the definition of *fiduciary* under the Employee Retirement Income Security Act (ERISA). This proposed rule "would protect beneficiaries of pension plans and individual retirement accounts by more broadly defining the circumstances under which a person is considered to be a fiduciary." In conjunction with updates to the definition of *fiduciary*, the DOL discussed changes to the definition of *investment advice*. The Labor Department is seeking comments from the public on the proposed rule through January 20, 2011, at e-ORI@dol.gov. ■

TARGET DATE FUND DISCLOSURE

On November 29, 2010, the Employee Benefit Security Administration (EBSA) of the Department of Labor (DOL) announced a proposed rule to increase disclosures about target date retirement funds. The proposed rule would amend regulations already in place regarding "qualified default investment alternatives" and "participant-level disclosure." The new rule would require that participants and beneficiaries must be provided with specific information about the design and operation of target date funds including:

- asset allocation;
- how the allocation will change over time;
- significance of the investment's target date.

Comments from the public must be received by the DOL at e-ORI@dol.gov no later than January 14, 2011. ■

COMPLIANCE CALENDAR

Q1 2011

January 14, 2011 Date by which comments on proposed rule for Target Date Fund Disclosure need to be received by the Department of Labor.

January 20, 2011 Date by which comments on proposed rule for fiduciary and investment advice definitions need to be received by the Department of Labor.

January 31 Date by which Form 1099-R needs to be furnished to participants reporting 2010 distributions.

February 15 Date by which Form 1099-B needs to be furnished to recipients.

February 28 Date by which Form 1099-R is due to the IRS if not filed electronically. ■

NQR National Quality Review

Editor: Patricia D. Jones, Director of Compliance
Published by: National Quality Review
Summer Exchange Building, Suite 50, 101 Arch Street, Boston, MA 02110-1155