Intermediary Oversight: The ongoing evolution of Barrington's survey.

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INTRODUCTION

This past fall Barrington Partners ('Barrington') conducted its fourth Intermediary Oversight Survey ('Survey'). The 20 participants reported intermediated AUM of $1.6 trillion and the preponderance of those AUM were subject to oversight – a robust 90%. The term *intermediary oversight* or *subject to oversight* in this and all prior Surveys encompasses any intermediary to which a service fee is paid.[1]

As is our standard practice with any Barrington survey, we sought direction from a Steering Committee of individuals who 'live' intermediary oversight to ensure that the Survey targeted the most crucial topics, industry challenges and developing trends. The following are examples of refinements implemented in this Survey:

- Examined oversight program refinements contemplated for 2019, as well as those recently implemented
- Explored how and to what extent DSA/DSP files are being used for data mining and program enhancements
- Probed on effective in-person intermediary interactions
- Analyzed the relationship between the importance of individual oversight tasks, the supporting service model, and time spent on each assignment by the oversight team
- Expanded the lens of audited reports from solely the FICCA to the panoply of FICCA, SOC-1 and SSAE-18
- Refined and expanded the criteria employed in a risk assessment

Sufficiency of Board reporting on oversight matters is a focal point for all our clients with intermediary distribution programs. With this year's Survey we inaugurated the *Document Exchange,* which was designed as a voluntary knowledge-share on reporting to a Funds' Board of Trustees and other program documentation, such as certifications, due diligence questionnaires and due diligence checklists. Exchange participants were able to submit anonymized Board oversight reporting templates[2] and in return received similar documentation from other participants under a 'you give, you get' credo. Most Survey participants took part in the Exchange and the feedback was uniformly positive about its worth.

[1] The terms *service fee, sub-TA fee* and *recordkeeping fee* have similar meanings and may be used interchangeably throughout this Paper.

[2] All potential identification, such as the name of the firm or any statistics, were removed by the participant and rechecked prior to the electronic exchange with other firms.

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FOCUS OF 2018 INTERMEDIARY OVERSIGHT SURVEY

The 2018 Survey focused on the following major topic and sub-topic areas:

Intermediary Program Profile	Tools Used in Oversight Program	Related Topics
Oversight Program Resources	Audited Documents	Intermediary Agreement Terms
Changes to Oversight Programs	Oversight Visits	Terminating Intermediary Agreements
Onboarding Activities	Reconciling Intermediary Information	Dealer Resignations
Oversight Process	Resolving Issues with Intermediaries	Money Market Reform and Blue Sky
Board Reporting and Internal Governance	Technology and Vendor Solutions	Oversight with Clearing Firms
Ranking Intermediaries Subject to Oversight	Intermediary Oversight Program Topics	
Risk Assessment Process		

We continued with the free text section entitled **Successes, Challenges and Opportunities for Improvement** where participants were able to share their observations about each major oversight program element. Their views were complemented with our insights.

SELECTED FINDINGS FROM THE 2018 SURVEY

Worth of Onsite Visits

Since the commencement of the Survey, participants increasingly have been abandoning dedicated oversight visits at the intermediary. In the 2014 Survey nearly one-half of participants included oversight visits in their programs but cautioned about their effectiveness. In the 2016 Survey[3], in the broker-dealer/supermarket channel (by far the largest from a distribution and oversight perspective) fewer than one-third of the 20 participants conducted oversight visits and only two firms incorporated due diligence visits with other omnibus intermediaries (e.g., TPAs).

In the Challenges section of that year's Survey, the use of oversight visits "will remain constrained due to limited staff resources and greater accessibility to third-party audited documents, such as the FICCA, SOC-1 and/or SSAE-16 [as it was then known]."

Moving forward to this year's Survey, the use of specific oversight visits has been largely abandoned.[4] Challenges cited were the resources and staff availability for visits; costs and travel expenses; time commitment; and most importantly, the unwillingness of certain intermediaries to engage in these types of meetings.

As one participant indicated, "…oversight visits are reserved for high risk relationships, but at present no relationships carry that designation. A more apt description is *as needed.* No onsite visits are scheduled in 2018 or planned for 2019."

Another participant stated that the onsite oversight visits have been eliminated and replaced with dedicated oversight calls.

Much more successful replacements have been operations/back office and/or relationship visits, which were deemed to have noticeably greater worth. Participants deemed these formats to be more effective in intermediary relationship management and issues resolution and they also provide a better understanding of the control environment.

Supporting the FICCA Analysis

While the Survey results corroborated the vital importance of the FICCA as the foundation for any oversight program, there were two significant corollary trends. In the 2016 Survey, we observed that,

"A related and burgeoning trend is the outsourcing of the review of audited statements to a third party. Given staff constraints, we expect either of the following two potential outcomes: (a) the default will be to rely on external solutions; or (b) the statement review process will be limited to those intermediaries deemed to have the highest risk rankings."

The 2018 Survey confirmed the mounting reliance on external solutions. Participant endorsement of an outsourced review of audited documents to an unaffiliated third party surged from four firms in the 2016 Survey to seven firms. Outsourcing of this core task allows a participant's oversight team to focus on an analysis of the results and the implications for the program.

The retooling of the section of the Survey dealing with the relationship between the importance of individual oversight tasks, supporting service model and time spent by the oversight team[5] surfaced another essential observation. Audited documents are the single most valued resource in the oversight program and far outpace the utility of any other element. The Time Spent % (of oversight personnel resources) on audited documents was disproportionately high vis-à-vis each of the next five elements and is all the more telling in importance given the number of firms that utilize a third-party solution for the core evaluation. In fact, that time spent allocation ranged from a low of 10% to a lofty 65% (26% on average).

[3] Data was collected and reported by channel in the 2016 Survey but was eliminated in the 2018 Survey since oversight programs typically do not make such distinctions.

[4] Twelve of the 20 Participants in the 2018 Survey also participated in the 2016 Survey.

[5] The *service model* (internal or outsourced) and the *time spent* were enhancements in the 2018 Survey and replaced *effectiveness*. The Steering Committee felt that participants were eager to understand staff deployment for an array of oversight tasks and the means by which each task was performed.

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Ranking Intermediaries Subject to Oversight

An enhancement in this year's Survey was to rank intermediaries subject to oversight based on importance. The response selections were: *high, medium, low* and *do not tier*.[6] The *high* and *do not tier* responses comprised the majority of intermediaries and demonstrated the risk – financial, reputational or otherwise – and importance associated with those two rankings. Three-fourths of participants complete extensive oversight on these two cohorts annually, while multi-year frequencies were the norm for low ranked intermediaries.

Risk Assessment

Risk assessment was the second highest consumer of oversight staff time and was accorded a second-place rank in importance of program elements; together, these confirm that risk assessment remains a fundamental underpinning of any oversight program. Virtually all firms (19 of 20) have either a formal or informal exposure assessment process.

The common backbone in the risk assessment across the four Surveys was AUM. The 2016 Survey emphasized the *high*-ranking assessment elements as intermediary AUM, availability of audited statements and service fees paid, and that constancy continued with this year's Survey. When we consider total scores regardless of the level of importance, AUM was the governor for oversight, followed by regulatory history, changes in control environment and negative news reports. The amount of service fee payments ranked in a lowly seventh place among the 24 elements polled.

DSA/DSP Files in Oversight Program

In this year's Survey, we distinguished using the DSA/DSP files for any reason (such as 22c-2) or for specific oversight program use. Even though the most common applications for these files continue to be 22c-2 and excessive trade monitoring, the DSA/DSP files are also being employed for oversight functions like fund and share class appropriateness, underlying correspondent firm, AUM and cash flows, Blue Sky and low balances.

Firms are in the process of more comprehensively integrating the DSA/DSP files into their programs by defining requirements, capturing appropriate fields, and testing. However, the use of these files is a nascent trend because firms generally have not yet solved for the lack of processing capabilities, the need to implement a technology platform, resource constraints on the analysis, risk vs. return on costs (defined as resources and systems) and the need for a vendor to support the requisite reporting. As data becomes increasingly more vital in an oversight program, we expect that outsourcing solutions will prevail for processing and data analytics.

FINAL THOUGHTS

While we may think of oversight programs as being mature given their longevity, we caution that *mature* and *static* are not synonymous. A modest number of participants (6) rank their program as *mature*, and another seven classify their program as *somewhat mature.*

Changes to oversight programs over the past two years were primarily aimed in two areas – updating service agreements and expanding written procedures. The leading program evolution for 2019 is a sharply greater emphasis on investments in data transparency/analytics; interestingly, this was the only oversight program element to record an uptick. The responses suggest tactical refinements in other program aspects absent a regulatory dictum or Board-requested program enrichment. The shift in oversight program priorities demonstrates program fluidity and corroborates the findings about the mounting importance of data.

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Founded in 1995, Barrington Partners offers competitive intelligence, tailored solutions, and merger and acquisition services to the investment management industry.

If your fund company is interested in learning more about the Intermediary Oversight Survey and/or wants to work with Barrington on the next survey questionnaire, please contact Hubbard Garber (617.482.3300), Judy Benson (617.482.3303) or Ellen Pedro (617.320.9918).

[6] Firms selecting *do not tier* provide the same level of oversight for all intermediaries and were classified as *high.*

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