



Fee and Commission Types in the Mutual Fund Business

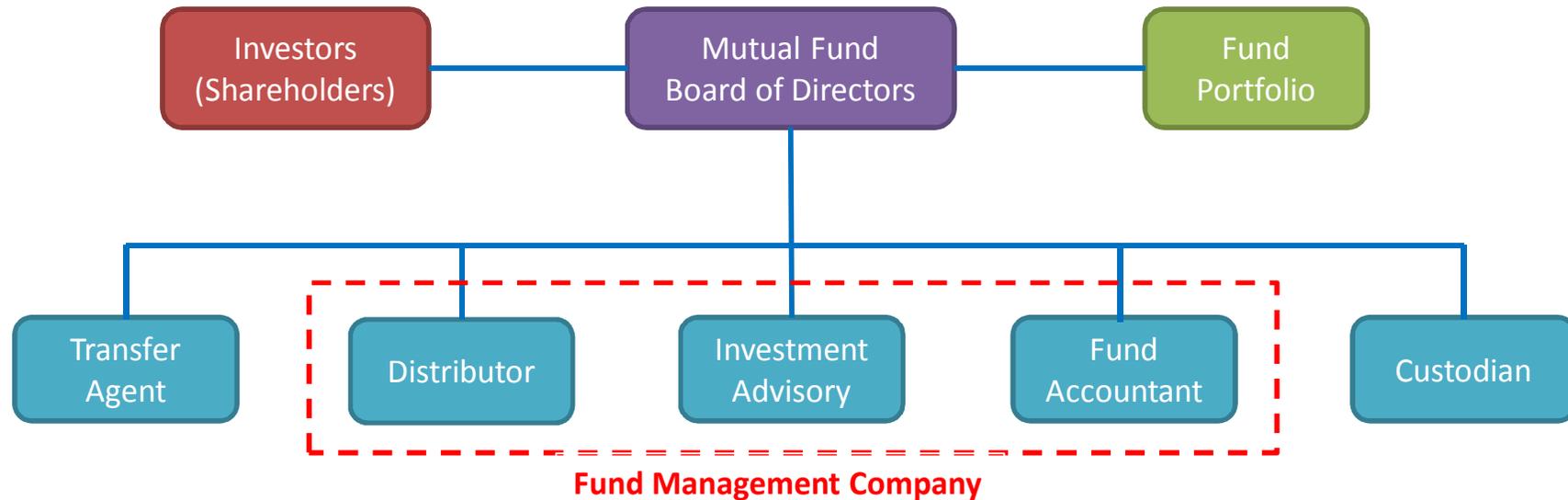
with an Introduction to Industry Structure and Primary Service Providers

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Overview to Fund Industry Structure



- The blue boxes above, from the transfer agent to the custodian, are *service providers* to the fund.
- Two additional primary service providers are the *auditer* and the *legal counsel*.
- Custodian, legal counsel and auditor must be separate independent organizations by law; all other services can be provided either by the management company, or by 3rd parties.

Overview to Services of primary Service Providers

Board of Directors: Negotiates and signs contracts with service providers (typically with the management company as the topmost primary service provider) and oversees their performance.

Investment advisory: Investment and portfolio management for the fund; trade order management for the underlying assets.

Custodian: Typically a custody bank; safekeeps (i.e. custody) and maintains an accurate inventory of fund's securities. Provides detailed inventory information to fund's accounting for NAV calculations.

Fund accountant: Keeps fund's cash and security inventory records reflecting trading and non-trading transactions (corporate actions); calculates & publishes daily NAV per share values; passes dividend and interest payment information to transfer agent, which calculates the distribution amount for each shareholder and makes the payments; prepares financial statements for annual and semi-annual shareholder reports.

Distributor: Sells fund's shares to investors (shareholders) either directly, or indirectly through intermediaries like brokers or 3rd party financial advisers.

Transfer agent: Shareholder record keeping (back-office) and shareholder services (front-office); distribution payments (interest or dividend) and reporting to shareholders.

Investment Advisory - Front Office

Taking investment decisions (security allocation and selection) and implementing them via trading

Primary services:

- Investment analysis (equity, fixed income, etc.) and portfolio management
- Trade order management: Implementation of investment decisions through trading; typically in interaction with a broker
- Trade order management: Broker selection for best execution

Costs:

- Management fees (investment advisory and administration fees incl. both front & back office); typically 100 BP, 50 BP of it for investment advisory
- Trading (i.e. transaction) costs; about 60-80 BP on average (of Asset under Management, annually) for actively managed equity funds

Notes:

- Front and back office operations are usually performed by separate organizational units within a management company.

Investment Advisory - Back Office

Things that need to be done for operating a fund; usually not seen as strategic or added-value services.

Primary services:

- Data management (security set up, interfaces with custodian, prices, exchange rates ...)
- Fund accounting (closely interacts with custodian; match security inventories)
- Completing trade operations (interacts with clearing agents & depositories; clearing & settlement)
- Compliance & risk monitoring (interacts with custodian)
- Overseeing custody of assets (interacts with custodian)
- Interact with 3rd party service providers like clearing agents, depositories and custodians for the services above.

Costs:

- Advisory and administration fee (incl. both front & back office)
- Custody fees (paid to custodian)
- Typical 3rd party service providers: Clearing agents, depositories, custodian

Term: Fund Administration

Fund administration in the broad sense:

Everything about running a fund excluding investment advisory and distribution.

Fund administration in the narrow sense:

Administering fund's contracts with its service providers, and taking care of compliance and reporting functions

Fund administration (broad) is usually the responsibility of the management company that is delegated by the board of directors. Management company can sign contracts with 3rd party service providers like custodian, auditor and legal adviser etc. to administer a fund.

Role: Fund Accounting

Primary services:

- Keeps fund's cash and security inventory records reflecting trading and non-trading transactions (corporate actions like dividend and interest payments of underlying securities, stock splits etc.)
- Keep general ledger and books of records.
- Calculate & publish daily NAV per share values
- Reconciliation of accounting's projections (f.e. accruals, security set up for dividend and interest payments etc.) with the activity records of the custodian
- Pass dividend and interest payment information to transfer agent, which in turn calculates the distribution amount for each shareholder and makes the payments.
- Prepare financial statements for annual and semi-annual shareholder reports

Costs:

- Annual cost of fund accounting ranged between 0.4 and 2.7 BPs (1998, Pricewaterhouse study).
- Cost factors: Type of securities, complexity of pricing (NAV?), amount of trading, number of funds, economics of the contract with the 3rd party accounting provider, other services bundled with accounting ...

Notes:

- Some bigger management companies perform fund accounting internally; some hire 3rd party service providers.
- Many custodians provide also accounting services

Role: Custodian

Primary services:

- Safekeeping (i.e. custody) of fund's securities; in most cases computer records with depository and issuer information
- Maintains inventory of fund's securities
- Maintains both cash and security accounts at each depository
- Interacts with depositories to handle security transactions
- Initiates cash movements and monitors cash balances
- Provides information to fund's accountant for NAV calculation

Optional services (i.e. extended offerings):

- Short term credit for redemptions
- Fund accounting, administration compliance and risk monitoring
- Reporting and information delivery
- Transfer agency and shareholder processing

Notes:

- Custody: High concentration, low-margin, high entry-barrier business. Large investments are required for specialized IT systems.
- Average custody fees only about 2 BP accros all funds in 1998 (US).
- Pure custody: Low margin business → custodians try to increase profits though added-value services with higher margins

Role: Transfer Agent

Primary services:

- All aspects of shareholders' interactions with the fund
- Mainly, two kinds of services: a) Shareholder record keeping (back-office), b) Shareholder services (front-office)
- Set up and maintain shareholder account records; these records control how the transactions for the account are processed and reported.
- Process fund transactions: Purchases, redemptions, exchanges and distributions
- Account information and fund reports to shareholders; daily account update and transaction confirmations, quarterly account statements with position details, semi-annual performance reports, annual tax reports ...
- Customer inquiries and problem resolution; customers can be shareholders or their financial advisors (i.e. intermediaries selling to shareholders).
- Compliance checks: Fund prospectus, privacy protection, tax etc.

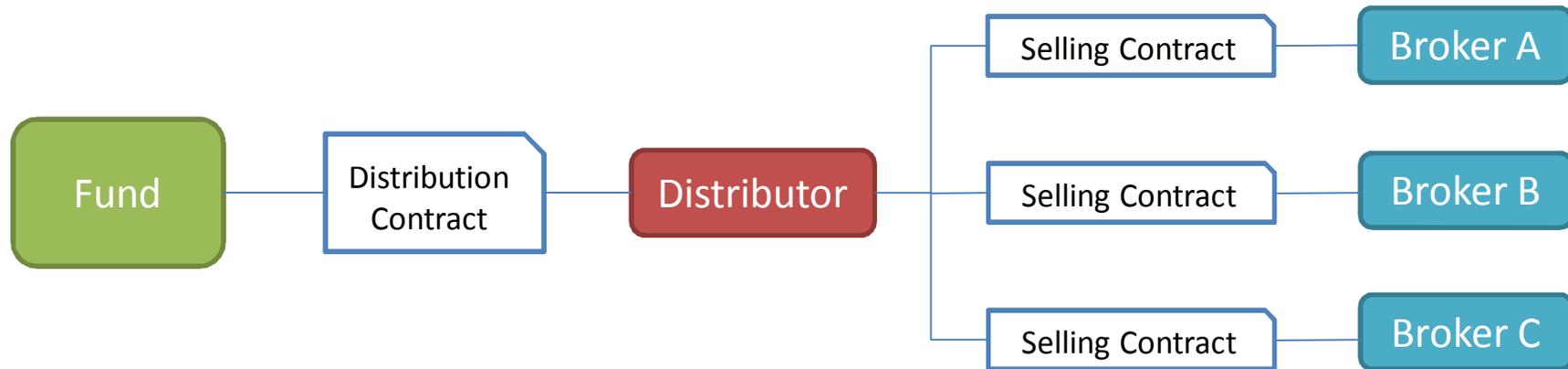
Costs:

- Typically \$20 - \$40 per shareholder, depending largely on the sales channel

Notes:

- High-concentration business (few large dominant market players) with significant economies of scale; huge amounts of investment required in IT systems and staff

Distributors and Brokers



- Most funds sign contracts with a principle underwriter (distributor) that sells fund's shares to others.
- Principle underwriter has exclusive right to distribute fund's shares.
- A distribution contract governs the relationship between the fund and the distributor.
- A distributor may distribute fund shares through its own representatives, or through other agents like 3rd party brokers or financial advisers.

Shareholder Fees

Fee type	Purpose	Paid by	Paid to
Front-end sales load (% of subscription amount)	Sales commission to intermediary	Investor	Distributor; reallocated to intermediary
Back-end sales load (% of redemption amount)	Sales commission to intermediary	Investor	Distributor
12b-1 fees (% of Assets under Management)	Cover distribution costs of the fund	Fund's portfolio	Distributor; may partially be reallocated to intermediaries
Purchase fee (% of subscription amount)	Cover fund's costs related with the subscription	Investor	Fund
Redemption fee (% of redemption amount)	Cover fund's costs related with the redemption	Investor	Fund
Exchange fee (% of exchanged amount)	Cover fund's costs related with shares transfer within the same fund family	Investor	Fund

- Sales loads and 12b-1 fees are called distribution charges, as they are used to defray distribution costs.
- Purchase, redemption and exchange fees are called shareholder transaction fees.

Volume Discounts for Front-end Load

Purchase amount	% of share price
0 to less than \$50,000	5.00%
\$50,000 to less than \$100,000	4.50%
\$100,000 to less than \$250,000	3.70%
\$250,000 to less than \$500,000	2.80%
\$500,000 to less than \$1,000,000	2.00%
\$1,000,000 or more	0.00%

- Front-end load is charged directly to the investor; the rest of the subscription amount is then invested in the fund.
- Favorable conditions with asset pooling: Volume discounts for a fund family, or for a group of funds

A Typical Back-end Load Fee Table

Holding period after purchase	% deducted from redemptions
Through 1. year	5%
Through 2. year	4%
Through 3. year	3%
Through 4. year	2%
Through 5. year	1%
Longer than 5 years	0%

Contingent Deferred Sales Charge (CDSC) Arrangement:

- Fund's distributor pays a sales commission (for example 5% of sales amount) to the intermediary in advance, without a direct charge to the investor
- Distributor covers this commission expense with the annual 12b-1 fees paid from the fund's portfolio
- An additional redemption load will be charged to the investor if he redeems shares too early in order to cover the rest of the sales commission

Share Classes of a Fund

Share Class	Front-end load	Back-end load (CDSC)	12b-1 fees	Class Name
Class A	5.5% with volume discounts	none	0.25%	Load shares
Class B	none	5% first year, declining 1% per year thereafter	1.00%	Spread load
Class C	none	1% per year for two years	1.00%	Level load
Class I	none	none	none	Institutional
Class R	none	none	0.50%	Retirement

- CDSC: Contingent Deferred Sales Charge with back-end load
- Class C: Eventually converted to class A (SEC requirement). Most class B shares are also converted into class A shares after a certain number of years.
- Class I: No-load funds that require a very high minimum investment amount.
- Class R: Shares to be used in retirement plans.

Fund Management and Service Fees

Fee type	Purpose	Paid by	Paid to	% op. cost
Management fee (% of Assets under Management)	Investment advisory, and administration fees that are not included in other fee categories	Fund	Management company; may partially be reallocated to intermediaries as revenue share	50%
12b-1 distribution fees (% of Assets under Management)	Marketing and distribution expenses; may also include shareholder services	Fund	Distributor; may partially be reallocated to intermediaries	22%
Transfer agency fee		Fund	Transfer agent	16%
Administrative services incl. fund accounting		Fund	Fund administrator	4%
Shareholder communication services	Printing, postage etc.	Fund	Service provider	6%
Audit and legal services		Fund	Service provider	<1%
Custodian fee		Fund	Custodian	<1%
Board of director fees and expenses		Fund	Directors	<1%

Management fee rates can vary between 20-100 BP (100 BP = 1%) depending on the fund's composition and investment strategy.

Fee Schedule for Management Fee

Assets under Management (AuM)	Fee rate
$0 \leq \text{AuM} < \$10 \text{ million}$	80 BP
$\$10 \text{ million} \leq \text{AuM} < \50 million	70 BP
$\$50 \text{ million} \leq \text{AuM}$	60 BP

Example fee schedule (or fee scale) with tiered (or scaled) fee rates

Operating Expense Ratio

Category	Expense as of % AuM
Investment advisory and fund administration	%0.500
Shareholder servicing	%0.140
12b-1 distribution fees	%0.250
Custody	%0.012
Audit	%0.004
Legal	%0.004
Other operating expenses	%0.006
Total (expense ratio)	%0.916

Other operating expenses include board of directors, interest, registration, postage, shareholder meetings and taxes