

WHITE PAPER

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Approximately 52% of mutual fund purchase transactions are completed by using the traditional “check-and-app” methodⁱⁱ.

Raising the Bar for Direct Business Compliance Functions

A case for replacing manual processes with automated systems

With more than 8,700 mutual funds offered by approximately 500 fund families, many broker/dealers find it virtually impossible to meet their clients’ diverse needs solely through the products that are supported on their brokerage clearing platformsⁱ. Limited offerings, unsupported registration types and frequent product gaps on brokerage platforms necessitate that broker/dealers engage in mutual fund direct or “away” business.

However, today’s direct business—or, more specifically, the processing and management of direct business—is mired in antiquated, inefficient processes that present challenges for broker/dealers. This white paper focuses primarily on the challenges of performing compliance functions over direct business, and offers proprietary solutions to help broker/dealers to overcome these challenges.

Industry & Regulatory History

Roughly 30 years ago, when direct business first began gaining traction among broker/dealers, there was one process for managing this business: the “check-and-app” method, whereby brokers merely retained a photocopy of paper records in a file. Today, more than half of all brokers who engage in direct business still rely on this entirely paper-based process. Although grossly inefficient in many aspects, the “check-and-app” method is favored by brokers, particularly those characterized as “independents”, for perceived benefits that include the ability to maintain more control over direct business and to gain better access to fund companies. It is also viewed by brokers as the simplest, least expensive way to trade funds directly, allowing them to bypass the order entry process, avoid costly ticket charges, and to “fly under” the compliance radar, so to speak.



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The reality is that the democratization of the financial markets and a more rigid regulatory backdrop have caused the process of direct mutual fund investing to increase in both complexity and cost. Once perceived as a pastime for only the ultra-wealthy, investing is now accessible to people of varying income levels. Yet the prevalence of investing has come at a price, particularly for broker/dealers engaged in mutual fund direct business. Inefficiencies resulting from manual processes have required brokerage firms to bolster their back office and accounting staffs to keep pace with the high volume of manual reconciliation and build in additional layers of review to ensure account applications are complete and accurate. Likewise, firms without automated processes are spending more money and time on issues related to data aggregation, records maintenance, portfolio-level review and suitability. As such, the theory that the “check-and-app” method is still one of easiest and cheapest ways to trade mutual funds directly no longer holds water.

Trends

Firms without automated processes are spending more money and time on data-related issues.

The rising cost of managing direct business is just one of many trends with which broker/dealers are faced. A daunting regulatory backdrop also presents challenges.

The letter of the law

Increased regulatory scrutiny is no figment of the imagination. Securities regulators are instituting new laws at a pace unseen in previous decades—and enforcing them with a vengeance. In 2005 the Financial Industry Regulatory Authority (FINRA, formerly the NASD) levied \$125.4 million in fines against the brokerage industry for violations, including abuses in sales of mutual funds and variable annuities. This represents a 21% increase over 2004 and an 84% increase since 2002ⁱⁱⁱ.

Fines against the brokerage industry increased 84% between 2002 and 2005.

Compliance costs are also soaring. The Securities Industry Association of New York (now SIFMA, Securities Industry and Financial Markets Association) and Washington reports that compliance costs for the securities industry surpassed \$25 billion in 2005 compared to \$13 billion in 2002.

With regulatory oversight reaching an all-time high, and enforcement over mutual fund sales tightening, traditional paper-based processes have become increasingly complicated for broker/dealers striving to meet rising reporting and compliance demands. Specifically, brokers are challenged with the following compliance hurdles:

- Books and Records (SEC Rule 17a-3) Creation and Retention
- Suitability
- Anti-money Laundering
- Breakpoint Calculations
- Share Class Violations
- Portfolio Level Review/Monitoring

Books & Records/Suitability

The SEC’s books and records rules require broker/dealers to create and maintain certain records so that securities regulatory authorities may conduct effective examinations of broker/dealers^{iv}. Required records include

copies of account applications and suitability information such as clients' investment objectives and financial wherewithal. Brokers must verify this information with clients no later than 30 days after a client opens a new account and/or changes his or her investment objective on an existing account, and every 36 months thereafter (if no other changes trigger an interim mailing). Because most brokers do not have an automatic or systematic process in place to capture this information, maintaining such records can be a substantial administrative burden.

Anti-money Laundering

Brokers are also required to implement reasonable procedures to verify the identity of any person seeking to open an account; to maintain records of the information used to verify the person's identity (e.g. name, address or SSN); and to determine whether the person appears on any lists of known or suspected terrorists or terrorist organizations provided to broker/dealers by any government agency^v. Firms that have not implemented a comprehensive anti-money laundering program find it extremely difficult to acquire, store, verify and maintain this information.

Breakpoint Calculations

While it is the responsibility of the fund company to calculate breakpoints, it is a broker/dealer's regulatory obligation to ensure that a client is charged the appropriate sales charge when buying funds. Verifying this information is no small task. Brokers must not only be aware of the balances in their clients' accounts but also balances in the accounts of family members who own the same fund or fund family. Only after calculating these various account balances can a broker determine the correct sales charge^{vi}. Without effective procedures in place, determining the appropriate level of breakpoints can be extremely time consuming for brokers. In addition, a firm must make a reasonable attempt to examine the client's holdings across fund companies to determine, for example, if the allocation of investments is cost-effective for the client.

Checks & Balances

No matter how difficult or costly it is for broker/dealers to comply with securities regulations, it must be done. In fact, regulators now insist on knowing exactly what a firm's procedures for compliance entail and require that senior executives establish, maintain and enforce those procedures. Among other things, these requirements, as specified in NASD rule 3012, state that "Each member shall designate and specifically identify to NASD one or more principals who shall establish, maintain, and enforce a system of supervisory control policies and procedures that (A) test and verify that the member's supervisory procedures are reasonably designed with respect to the activities of the member and its registered representatives and associated persons, to achieve compliance with applicable securities laws and regulations, and with applicable NASD rules and (B) create additional or amend supervisory procedures where the need is identified by such testing and verification." Loosely translated, this means broker/dealers must document every step of a transaction or be prepared to pay the piper.

Thus far, few cases of non-compliance with rule 3012 have made headlines. However, now that FINRA members have had ample time to adapt to the rule (effective January 31, 2005), many believe that regulators will tighten their focus and increase the number of audits they perform.

Challenges

It's all about the data. Broker/dealers relying on antiquated processes to capture and manage data for directly-held business have a higher margin for error and a greater potential for securities violations. The threat of non-compliance looms even larger for small brokerage firms lacking the financial means to build and incorporate their own system of checks and balances. Specifically, issues that firms face include the following:

Capturing new account information

Following initial completion of a new account application, which may be required by a firm, there is generally no way to capture, change or update client information under the "check-and-app" method. In turn, suitability, anti-money laundering and breakpoint issues can arise.

Normalizing third-party position data

With direct business, broker/dealers have the freedom and flexibility to execute business wherever they wish (subject to selling agreements). However, given that no two mutual fund companies report alike, collecting and consolidating account information such as assets and activity from various mutual funds is a challenge.

Creating & maintaining a security master

A security master provided by a clearing firm provides only information about the securities held on a broker/dealer's platform. Therefore, if a broker chooses to engage in direct business, he or she has no option but to rely on a subscription-based service such as New River, Inc., Morningstar, Inc. or Value Line, Inc. to track down even the most basic mutual fund information.

Matching & reconciling data

To abide by certain securities regulations, it's imperative that broker/dealers be able to view clients' portfolios through a broad lens; in other words, monitor various account types and transactions. However, they also must keep abreast of client family members' accounts. Given that the data reported by fund companies differs from company to company, aggregating this data in any relational way is problematic.

Monitoring mutual fund adjustments

Timely, accurate and consistent communication about mutual fund information is often hampered by problems resulting from discrepancies in fund family names, descriptions and CUSIP codes. For example, a fund name change or merger can make it difficult for a broker to stay abreast of capital and dividend distributions and reinvestments, particularly when he or she is relying solely on manual information-gathering processes.

Variable annuity data dilemma

While the issues of managing directly held variable annuity (VA) data are similar to those mentioned above, VAs also come with their own unique challenges. Among other things, VAs require another level of licensing; generally have limited or no clearing firm capability for trade entry; make it difficult to track sub-account activity; involve another level of security master information; and require brokers to enter, maintain and reconcile

another level of client activity. In addition, brokers must comply with new FINRA rules for VA sales that require firms to review and document suitability factors such as age and liquidity needs before recommending a VA^{vii}. Needless to say, processing VA business can be an even greater challenge than processing mutual fund direct business.

Confirming settlement dates

Although broker/dealers working with clearing firms are generally ensured that executed trades are settled within a specified period of time, managing disparate feeds from clearing firms and integrating them into a broker/dealer's own database can be a drain on resources. The paper process presents even greater challenges. Specifically, brokers who rely on the "check-and-app" method have no proof of delivery and no system for accountability.

The Fetter Logic Solution

The answer to the above challenges lies in an efficient, automated solution that can assist broker/dealers with the aggregation of assets held away. Fetter Logic's proprietary suite of products provides brokers with a single, holistic view of critical data, enabling them to more easily and effectively meet regulatory demands and reporting requirements. These products include:

DataHelm™

DataHelm™

DataHelm collects, cleanses, reconciles, and enables compliance reporting on directly-held mutual fund data.

Quadron®

Quadron®

Quadron is the industry's first application that aggregates cleansed and reconciled, directly-held mutual fund and annuity data with that on a broker/dealer's clearing agent's platform, while enabling a fully integrated suite of advanced tools to report on it. Powered by Fetter Logic's proprietary data store platform as a single-source of "books-and-records quality" data to mine and report upon, Quadron enables: compliance, representatives, branch and sales managers, finance, and operations to address and solve critical business issues related to direct mutual fund and annuity business.

CASS

Cost-Effective Compliance and Surveillance

In an environment where greater public scrutiny and stringent regulatory oversight have elevated the need for targeted and cost-effective broker and trade surveillance, Fetter Logic's Compliance and Surveillance Solution (CASS) is a viable option. CASS streamlines the process of identifying and investigating conditions exceeding a firm's risk profile, thereby cutting the time a broker/dealer's compliance staff spends on trade, broker and account review. Combined with Fetter Logic's Principal Review Blotter, CASS can increase productivity of branch managers and provide a robust audit trail of supervisory review.

Principal Review Blotter

Principal Review Blotter

Branch office managers are the first line of supervision in reviewing the business of brokers in their office. The Principal Review Blotter (PRB) is a key element in the supervisory process and contains the aggregated activity and positions in client investment accounts, greatly facilitating

documentation of the review and approval process required for regulatory compliance. The PRB provides significant efficiencies, substantially increasing the productivity of all parties, and providing a detailed audit trail of supervisory review.

The Fetter Logic Difference

At Fetter Logic we provide the knowledge, experience, consultative approach, and products our clients need to efficiently and effectively meet the growing demands of regulators, representatives, sales, operations, and the “C” suite at any financial services firm.

Where we provide a value that is truly unique in our industry is in the quality and integrity of our data.

The combination of process, technology, and resources that we utilize to gather, scrub, cleanse, reconcile and maintain data is unparalleled.

Our years of experience on “the other side of the desk” have proven that regardless of how great industry software tools are, they are only as useful as the data that the tools rely on.

Although not all of our clients are on the front lines and dealing with data issues on a daily basis, they have employees who are. Employees who will benefit from Fetter’s data stewardship by being able to focus on their primary roles—and not on cleaning up data.

Quality data is the underpinning of all of Fetter’s products and services, and is what enables our clients to turn data into intelligence.

About Fetter Logic

Founded in 1997, Fetter Logic, Inc. is the premier full service provider of advanced data and information management solutions for the financial services industry, aggregating and cleansing financial data on all assets.

Serving over 150 retail and institutional broker/dealers (including banks and clearing firms), the Fetter platform currently services more than six million accounts and \$250 billion in assets.

For more information on Fetter Logic, visit www.fetterlogic.com.

ⁱ 2007 Investment Company Fact Book, 47th Edition, Overview of U.S.-Registered Investment Companies, http://www.ici.org/stats/latest/2007_factbook.pdf

ⁱⁱ Joint SEC/NASD/NYSE Report of Examinations of Broker/dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds, <http://www.sec.gov/news/studies/breakpointrep.htm>

ⁱⁱⁱ *Investment News*, "NASD fines reach record levels; Up 84% since '02; resolved cases up just 15%", 1/16/06

^{iv} SEC, Books and Records Requirements For Brokers and Dealers Under the Securities Exchange Act of 1934, <http://www.sec.gov/rules/final/34-44992.htm>

^v SEC, Joint Final Rule: Customer Identification Programs For Broker-Dealer, <http://www.sec.gov/rules/final/34-47752.htm>

^{vi} ICI, Understanding Mutual Fund Breakpoints, http://www.ici.org/funds/inv/bro_brkpts.html

^{vii} NASD, State Regulators Issue Joint Statement to Support Insurance Regulators' Model Annuity Suitability Regulation, <http://www.finra.org/PressRoom/NewsReleases/2007NewsReleases/p019123>