

WHITE PAPER

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Solving Direct Business Commissions Problems

High-tech solutions reduce inaccuracies while saving time and money

Once regarded as a simple, inexpensive way to process direct mutual fund business, the traditional “check-and-app” method is falling short on a number of fronts. Among other things, this manual, paper-based process has a propensity to result in copious inaccuracies, lengthy order-processing cycles and higher operating costs for broker-dealers.

This white paper addresses the inefficiencies of “check-and-app” business, focusing primarily on commission-related issues, and proposes automated solutions as a way to rise above these issues.

Background

That was then...

When broker/dealers first began trading mutual funds directly, they relied primarily on the “check-and-app” method of transacting this business. This method required brokers to review each new account application with their client, mail the completed application and a paper check to the fund company, then wait patiently for the fund company to process the application and send a commissions payment to the home office. Even then, however, the process was not complete. Upon receiving a check from the fund company, which generally lumped commissions for all brokers and transactions into a single monthly payment, the home office had to manually reconcile and enter the data into its commission accounting system before paying the rep. A lengthy process, indeed, and one that was applied to the hundreds of checks and applications received by a broker/dealer in any given month.

This is now...

Some traditions die hard. More than 50% of all broker/dealers still rely on the “check-and-app” method for their direct business—a startlingly high proportion considering the additional time, resources and money it now takes for brokers to complete this labor- and paper-intensive process^{i,ii}. —Yet with



370 17th Street, Suite 3400
Denver, Co 80202
888-687-4555
www.fetterlogic.com

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perceived benefits that include greater control of direct business and better access to mutual fund managers, the “check-and-app” remains the preferred method of trading mutual funds directly.

Industry Trends

Despite the popularity of “check-and-app” business, a number of industry trends may cause brokers to consider alternative solutions.

Increased regulation

A sharp increase in securities regulations and infractions triggered by the 2003 mutual-fund scandal have revealed an obvious need for better monitoring and supervision of broker/dealers’ direct business. Specifically, the brokerage industry experienced an 84% increase in fines between 2002-05 for violations that included abuses in sales of mutual funds and variable annuitiesⁱⁱⁱ.

Rising costs

To augment internal controls and supervision, many broker/dealers are finding it necessary to make larger investments in compliance-related technologies and systems. The Securities Industry Association of New York and Washington reports that compliance costs for the securities industry surpassed \$25 billion in 2005 compared to \$13 billion in 2002.^{iv}

More errors

Manual data entry is not only time-consuming, but also has a high rate of inaccuracy. Although some fund companies send commission information to brokers via electronic files, others use paper statements, requiring accounting personnel to manually enter line-item information into the brokerage firm’s commissions accounting system. Reversing numbers or omitting decimal points may be easy mistakes to make but they cannot be easily reconciled.

Challenges

While the need for an automated model for mutual fund transactions is becoming increasingly obvious to broker/dealers, a number of barriers stand in the way.

High cost of daily data feeds

Through membership in the National Securities Clearing Corporation (NSCC), broker/dealers and mutual fund companies have the option of subscribing to various services including Fund/SERV, a highly automated system that centralizes order entry, confirmation, registration and settlement of mutual fund transactions; and Comm/SERV, a service that provides firms with commission data and dollars feeds. While Comm/SERV requires a \$20,000 deposit plus additional monthly fees, Fund/SERV requires a deposit, of as much as \$1 million, in addition to supplemental net capital and another regulator.

Firms that find the steep costs of daily data feeds prohibitive can opt for monthly or bi-monthly feeds for mutual fund and variable annuity data through information processing firms such as DST Systems or PFPC. While more affordable, this option cannot guarantee that data is up-to-date given

the infrequency of the feeds. In addition to the high cost of services, the application process for NSCC membership and Fund/SERV services may take as long as eight months to one year before a firm's membership is active.

Data does not integrate with existing systems

Although transfer agency systems offer broker/dealers a step toward automation, they do not provide a complete solution. Oftentimes, data feeds received from transfer agencies do not integrate with a brokerage firm's existing systems, requiring manual reconciliation. Some firms build and incorporate tools into their systems that enable them to accept disparate data, however, doing so requires a substantial investment of time and money.

Data is not cleansed, normalized

Data received by broker/dealers from clearing platforms and transfer agencies generally is not cleansed. As a result, matching data to the correct fund position or account can be problematic. Specifically, data that is not cleansed prior to commissions processing and payment can result in commission inaccuracies, delays and disputes.

The Fetter Logic Solution

Broker/dealers want paperless, enterprise-wide solutions that offer seamless integration with their firm's existing applications. At Fetter Logic, we offer fully automated solutions that help brokers increase the accuracy of their data and decrease the time between when an order is processed and a commission is paid. Details of our commission-related solutions follow:

Commission-Data Collection Service

Through Fetter Logic's automated Commission-Data Collection Service, data feeds are collected directly from the NSCC and are cleansed, reconciled and normalized before being passed on to broker/dealers in an electronic format compatible with the broker's internal systems.

Retail Commission Management System

Fetter Logic's Retail Commission Management System (RCMS) is a fully automated, outsourced solution that supports complex commission structures and revenue aggregation across multiple business lines. RCMS supports commissions for multiple data sources and enables broker/dealers to increase their efficiency with regard to monitoring and paying out commissions, but also to gain the flexibility to accommodate virtually any pay structure. In addition, this proprietary software solution provides broker/dealers with a comprehensive, side-by-side view of mutual fund commissions from direct business and those from the clearing firm.

RCMS

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, reps, 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 to us 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 250 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 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/breakpointing.htm>

ⁱⁱ *Investment News*, “Check and App processing is expensive, study finds”, 11/19/07

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

^{iv} *Investment News*, “SIA study blames regulators for soaring compliance costs”, 3/26/2006