Compliance analytics and supervision

Mutual fund sales practices

Enhancing oversight with data analytics

December 2016
Is your firm’s regulatory compliance program taking full advantage of your data? The SEC and FINRA are.

Compliance analytics and supervision for wealth and asset management firms.
I. Introduction

With both the Financial Industry Regulatory Authority (FINRA) and the U.S. Securities and Exchange Commission (SEC) affirming their commitment to utilizing data analytics in order to identify abuses in the market, there is an undeniable imperative that compliance teams arm themselves with similar cutting-edge technology and methods as the regulators. In doing so, firms can be proactive in monitoring specific problem areas before they are investigated by the SEC or FINRA. In particular, firms must be aware of the increased scrutiny of mutual fund sales practice issues, as well as the analytical methods that can be leveraged to stay ahead of the regulators’ actions.

The table below highlights some of the various mutual fund risk areas that are currently under the regulatory microscope.

<table>
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<th>Topic</th>
<th>The issue</th>
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<td>Suitability</td>
<td>Is the mutual fund transaction suitable for the customer based on their investment profile?</td>
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<td>Switching</td>
<td>Is the net investment advantage of a recommended switch from one fund to another undermined by the transaction fees associated with the switch?</td>
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<tr>
<td>Householding</td>
<td>Did the customer receive the eligible breakpoint discount based on the volume of their investment within a given household and fund family?</td>
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<tr>
<td>Load waivers</td>
<td>Did the customer receive a load waiver for which they were eligible based on fund family policy?</td>
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II. Background

The mutual fund industry is one of the staunchest pillars of the financial services sector, controlling nearly $16 trillion of total assets in the United States alone. Nearly all participants in the American economy – from individuals to institutions – are involved in the mutual fund market in some form, whether through 401(k)s, IRAs, pensions or other means.

Thus, there should be no surprise that regulators such as FINRA and the SEC have increased their oversight of mutual fund practices in recent years. These agencies are utilizing sophisticated data analytics techniques to identify trends that could indicate potentially inappropriate behaviors. Both the SEC and FINRA established divisions devoted entirely to data and analytics, such as the Division of Economic Risk Analysis (DERA) and the Office of Advanced Data Analytics, respectively.

In response, wealth and asset managers should incorporate the same level of analytical supervision in order to survive in the current regulatory environment and protect their customers and firms. In particular, firms that provide mutual fund services can take advantage of big data solutions to identify potential issues in order to strengthen their mutual fund sales practice supervision and monitoring processes.
III. Industry trends

Big focus on big data

The SEC continues to be aggressive in its efforts to incorporate data analytics across the agency, supporting its core mission of protecting investors and maintaining efficient markets. In fact, the SEC chairwoman, Mary Jo White, has stated, “Over the last three years, we have changed the way we do business on the enforcement front by using new data analytics to uncover fraud, enhancing our ability to litigate cases and expanding the playbook, bringing novel and significant actions to better protect investors and our markets.” The SEC’s DERA arm integrates financial economics and rigorous data analytics to create the appropriate policies, rules, enforcement actions, and examinations for the current regulatory environment. DERA relies on a variety of academic disciplines, and quantitative and qualitative approaches to assist the SEC with its efforts to identify, analyze and respond to risks and trends, including those associated with new financial products and strategies.

The Quantitative Analytics Unit, housed within the Office of Compliance Inspections and Examinations (OCIE), consists of specialized examiners with PhDs and extensive backgrounds in mathematics, statistics, physics and computer science. These skills are mobilized to play a key role in examinations of sophisticated algorithmic trading firms, adviser and investment companies.

Just like their SEC counterparts, FINRA is also intensifying their focus on data analytics to identify potential abuses and protect investors. Through the use of cutting-edge technology, the agency is able to process between 50 billion to 75 billion transactions per day and monitor for malicious activity.

Targeting sales practices of mutual funds

As regulators continue to ramp up their use of analytics to monitor for abuse across the market, they are simultaneously setting their sights on specific target areas. Given the importance of mutual funds to the typical retail investor, the SEC and FINRA are prioritizing problem areas related to mutual funds.

For instance, the SEC’s Examination Priorities for 2016 letter highlights a significant focus on protecting retail investors saving for retirement. The letter specifically calls out a focus on funds holding “alternative” investments due to their higher risk, as well as funds that have significant exposure to interest rate increases.

Similarly, in FINRA’s 2016 Regulatory Examination Priorities Letter, mutual funds are called out throughout the letter. Of particular import is suitability, sales charge discounts and waivers, as well as sales to seniors and other vulnerable investors.

Furthermore, in 2016, mutual funds were among the top four security types involved in FINRA arbitration events (as of July 2016). In one such instance, FINRA fined a major global investment bank nearly $14 million for unsuitable mutual fund transactions and related supervisory failures.
IV. Enhancing mutual fund sales oversight with data analytics

The regulators are doing it – and so should you

The concurrent trends of data analytics utilization and mutual fund sales scrutiny are dominating today’s regulatory landscape and shows no sign of abatement; the SEC and FINRA are using analytical tools at their disposal to identify abuses conducted in the mutual fund markets.

Fortunately, compliance professionals have the opportunity to take advantage of similar data analytics tools and techniques as the regulators. In doing so, compliance teams will be in the best position to mitigate the risks of financial and reputational damage. The graphic below provides a high-level illustration as to how data analytics can be utilized to monitor mutual fund sales practices on a real time surveillance and look-back basis.

Real-time surveillance vs. look-backs

To incorporate data analytics into a firm’s compliance program, it is important to understand the differences between real-time surveillance and performing look-back analyses. At a high level, real time monitoring involves surveilling current trends that may indicate compliance breaches, regulatory issues, or control weaknesses. Monitoring on a go-forward basis using analytics is beneficial, because it permits firms to identify potential issues that would be difficult to expose during traditional periodic testing.

In addition to real-time surveillance, compliance teams may also utilize analytical tools to conduct look-back analyses. Once a known issue is identified, look-backs allow firms to parcel through massive amounts of data to forensically test the severity and pervasiveness of the problem. Additional benefits of performing look-backs include calculating client harm, identifying bad actors and facilitating remediation efforts.

Mutual fund suitability

The issue

FINRA’s suitability rule is grounded in the fundamental principle that financial advisers must recommend investments that are suitable for their customers. Specifically, they should “have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the [firm] or associated person to ascertain the customer’s investment profile.” The determination of suitability is based upon numerous facts about the investor, including, but not limited to:

- Age
- Other investments
- Financial situation and needs
- Investment objectives
- Investment experience
- Investment time horizon
- Risk tolerance

“More than ever, the SEC is developing in-house innovative analytical tools to take advantage of today’s data-rich environment. The result is that the number of cases we are able to originate in-house has risen dramatically”

– Mary Jo White, U.S. Securities and Exchange Commission Chair
At the surface, these guidelines may seem straightforward—if not obvious. However, suitability issues are among the top FINRA arbitration events as of July 2016, constituting 11% of all arbitration cases.\footnote{Customer allegations in FINRA arbitration events}

After establishing the data sets for customer information and mutual fund transactions, the data are processed through an analytical engine. The analytical engine utilizes a bifurcated process in order to determine the suitability of the transaction:

1. Transaction analysis: (i) compare the customer investment objective to the fund objective; and (ii) compare the appropriate fund characteristics for the fund type against the customer risk tolerance. If the majority of the characteristics match, the customer risk tolerance may match the fund characteristics.

2. Account-level analysis: analyze the customer’s account asset allocation against the customer’s stated risk tolerance. If an account holding was more conservative than the customer’s risk tolerance, the transaction analysis outcome will be used to determine if the transaction was suitable.

This dual approach allows firms to analyze suitability at both a transaction level and an overall account holding level for insight into the suitability against the investment strategy.

Yet another layer of analysis that firms can perform is the suitability of the share class purchased. In contrast to the transaction and account-level analyses, the share class analysis utilizes a quantitative approach. By using various pieces of information about the customer’s transaction and the mutual funds purchased—such as holding period and sales charge—compliance teams can calculate whether the purchased share class was the appropriate share class for that customer.

**Mutual fund switching**

**The issue**

In addition to suitability, regulators are focused on mutual fund switches. Mutual fund switching can be potentially harmful to investors due to the front-end and/or back-end charges that they otherwise would not have incurred if they had remained in their original position.

Many advisers recommend appropriate mutual fund switches with ethical intentions—such as reacting to external market events, or a change in the customer’s investment objective. In these situations, any fees incurred by the investor could potentially be justified. However, as outlined in FINRA’s Notice to Members 94-16, 95-80 and 07-06, the adviser’s recommendation must “not [be] based on the desire of the firm or representative to obtain compensation that it would not otherwise receive had the customer retained the previous fund.” Advisers “have an obligation to ensure any
recommendation to switch mutual funds is evaluated with regard to the net investment advantage to the investor."\(^{13}\)

In other words, the recommendation that an investor switch from one mutual fund to another must always be made with the intention of benefitting the investor.

**Utilizing analytics**

The vast majority of advisers act in the best interest of their customers. However, the actions of predatory advisers recommending mutual fund switches solely for personal monetary gain necessitate that compliance teams watch for inappropriate switches — to protect their customers, as well as their firm’s reputation. Data analytics provides an excellent method for mitigating the risks associated with inappropriate switching.

The process of identifying inappropriate mutual fund switches begins with specifically defining a switch for the data being analyzed. At a high level, a switch pair can be defined as an instance in which a customer sells a mutual fund and subsequently purchases another mutual fund within a short time span. Firms can then analyze their transaction database to establish the population of switch pairs.

With the population established, the appropriateness of each switch pair is then determined. Mirroring the suitability analysis, each fund is assigned various mutual fund characteristics (e.g., fund type, market cap or geography). By utilizing the analytical engine to compare the characteristics of each mutual fund, firms can identify whether the switch occurred between similar or equivalent funds. If the switch did indeed occur between equivalent funds, the switch could be considered inappropriate due to the investor paying a fee to switch into a similar fund.

Even if the mutual funds were not considered equivalent, an additional level of analysis should be performed. Returning to the analytical engine, firms can analyze their mutual fund sell list to consider whether a no-fee option was available for the fund purchased within the original fund family.

**Mutual fund householding**

**The issue**

Another aspect of mutual fund sales practices that is in the regulatory crosshairs involves sales charge discounts. Many funds offer volume discounts, also known as breakpoints, for investors that purchase a minimum amount of shares of a particular mutual fund or fund family. Furthermore, many mutual funds make breakpoints eligible for investors living within the same household; for example, spouses, who individually purchase shares of the same fund or fund family may be eligible to receive a breakpoint as if they were a single individual purchasing the shares. This practice is known in the industry as “householding.”

Industry trends indicate that many advisers are either unaware of such breakpoints or explicitly choose not to employ these discounts for their customers, because breakpoint discounts typically reduce the commission that is collected by the adviser.

**Utilizing analytics**

Compliance professionals can utilize data analytics to mitigate householding risks for their firms. While many firms store their customer name and address data in inconsistent formats, analytical tools allow for a data enrichment process, which is critical to identify individuals living within the same household. The customer’s investments are also identified, along with the sales charge incurred for each purchase. This information is cross-referenced using an analytical matrix that incorporates the official or negotiated breakpoints for each fund, as well as the householding requirements outlined in the fund’s prospectus. The analysis identifies whether the customer was eligible for a breakpoint, yet did not receive one.

**Mutual fund load waivers**

**The issue**

Additionally, regulators have increased scrutiny of advisers failing to recommend eligible sales charge waivers (“load waivers”) to qualifying investors. In May 2016, FINRA issued targeted exam letters to a number of broker-dealers, requesting information on their mutual fund waiver processes and controls (“Mutual Fund Waiver Sweep”).\(^{14}\) Regulators are increasingly interested in evaluating whether advisers are making investment recommendations with a customer’s investment profile, eligibility for load waivers, breakpoints, and less expensive investments in mind.

Many advisers make investment recommendations with ethical intentions; however, due to nebulous and varying eligibility requirements across fund families, as well as insufficient advisement training, load waiver eligibility appears to be overlooked at times by financial advisers. In 2015 alone, FINRA ordered eight firms to pay more than $55 million in restitution to over 75,000 eligible accounts that had failed to receive

"It is critical for regulators to use 21st-century data analytics in order to keep up with 21st-century markets. ... [The Office of Advanced Data Analytics] will develop cutting-edge data analytics tools to help FINRA better utilize the data we collect in order to fulfill our mission of protecting investors and ensuring the integrity of our markets”

— Richard Ketchum, FINRA Chairman and CEO
available load waivers. Firms leveraging data analytics are better able to identify when customers are eligible to receive load waivers and less expensive investment opportunities, as well as identify instances in the past when customers may have failed to receive available load waivers.

**Utilizing analytics**

The complexity of determining load waiver eligibility puts many advisers and their firms at risk of violating FINRA’s guidelines. Data analytics provides an excellent method for mitigating the risks associated with the increasing scrutiny of load waiver eligibility.

Typically, load waiver eligibility tends to stay consistent within a fund family across multiple years. Subject-matter experts identify the types of accounts and qualifying investors eligible for load waivers for each fund family. With the use of data analytics, this information is cross-referenced on an automated basis against a customer’s account nature to determine the customer’s load waiver eligibility. Data analytics creates streamlined processes and robust controls for firms to assess load waiver eligibility. The use of analytics also allows firms to identify expense ratios and load percentages for a universe of mutual fund investment products to make sure customers are receiving the most cost-efficient investments in line with each customer’s investment profile and eligibilities for breakpoints and load waivers.

**V. Benefits**

The use of data analytics for supervising mutual fund sales practices allows firms to take full advantage of their data to identify trends that are otherwise difficult to detect.

Some benefits of implementing data analytics in mutual fund sales practices include:

- Enhanced ability to detect and prevent potential unsuitable transactions, mutual fund switches, missed breakpoint discounts, missed sales charge waivers, and other violations
- Increased automation and comparability of a client’s investment objective, risk tolerance, and financial needs to those of numerous funds resulting in:
  - Strengthened analysis for determining suitability of mutual fund purchases
- Fewer opportunities for representatives to recommend purchases outside of a client’s best interests
- Enhanced customer experience and satisfaction
- Strengthened processes for monitoring compliance on an on-going and automated basis, allowing firms to identify and report trends to senior management in an effective and timely manner
- Protecting the firm’s hard-earned reputation

**VI. Getting started**

As the SEC and FINRA continue to invest in data analytics to identify abuses in the market, it is imperative that firms evolve their compliance testing procedures with similar cutting-edge technology and methods as the regulators to correctly assess and maintain and advance their firm’s compliance program.

To begin implementing data analytics capabilities, some questions one needs to consider include:

- What are some opportunities to improve and automate current processes and procedures through the use of data analytics?
- Will data analytics capabilities be implemented to improve real-time and go-forward processes or to test compliance of historical information? Or both?
- What potential risks do you want the data analytics capabilities to test?
- What methodologies or frameworks will be followed to test for these potential risks?
- What external and internal data are required to perform the analytical capabilities?
- What tools and resources are needed to build, implement and maintain these analytical capabilities?
VII. Conclusion

The litany of issues in the mutual fund space for which investment advisers must be aware are numerous. However, through the use of data analytics, compliance teams can have the tools at their disposal to monitor these issues and identify them before the regulators do. This paper explored some of the hot topics in the mutual fund space, such as suitability, switching, householding, and load waivers; however, these are only the tip of the iceberg. In addition to these topics, analytical techniques can help thwart various other risk areas, such as sales to vulnerable investors and liquidity exposure.

Furthermore, compliance teams can incorporate publicly available methodologies into their analytical approaches - such as leveraging FINRA’s turnover rate and cost-to-equity ratio calculations to monitor and investigate for potential short-term trading issues. As these mutual fund issues clearly demonstrate, it is incumbent upon firms to adopt the latest analytical tools to survive the ever-modernizing regulatory landscape. The regulators are doing it and so should you.

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VI. Appendix

Sources

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1803-2650691
SCORE no. 4530-161US
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