As Finra's mutual fund waiver sweep continues, medium and small broker-dealers are targets

Lessons can be learned from larger firms that have completed Finra's examinations, and from the safeguards they've built to avoid future problems

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Since Finra began its investigation of mutual fund waivers in 2014, most of the industry's largest broker-dealers have engaged in negotiations with the agency to address whether correct sales charges were applied to certain types of mutual fund clients. The agency has also been reviewing process and supervisory procedures at those firms to ensure that fee waivers are properly assigned in the future.

The reviews center largely on Class A mutual fund share classes, involving retirement accounts and charities, for which front-end load charges are often waived. To date, Finra has assessed millions of dollars in penalties and restitution for overcharges from a number of large broker-dealers. And last May, the agency announced that an unspecified number of broker-dealers had been asked to explain their practices, signaling a continuation of the targeted reviews, and serving as a shot over the bow for firms that have not yet self-reported the existence of fee waiver issues.

The good news for firms currently undertaking a review is that they can benefit from the experience of broker-dealers that have completed the exam, and can replicate the solutions larger firms have developed to avoid future problems.

Based on what we've learned from helping firms remediate appropriate waivers, here are a few best practices to consider, before and after Finra knocks on your door:

1. It's all about the data. The volume and complexity of the data involved in a remediation calculation can be overwhelming for a firm of any size. For starters, transactional data must be matched and validated with holdings data, and must reflect all purchases, sales, transfers, exchanges and dividend reinvestment. If your firm already has systems that capture high quality data, the investment will pay off here. Either way, the manner in which your data is presented to Finra is the critical factor to an equitable resolution.

Broker-dealers lacking a dedicated technology team will have difficulty generating an accurate remediation outcome, given the complexity of the analysis, which will include applicable contingent deferred sales charges, upfront charges, expense differentials and IRS interest rates compounded daily. From the outset, it's important to appoint a dedicated project manager, and to assemble a team that includes technology, compliance, legal, operations and product professionals.

2. Focus on process and procedure. Fee waiver oversights represent only half of what's involved in Finra's sweep. You'll also need to demonstrate that your firm has new or strengthened protocols in place for mutual fund trade compliance.

Defining rules that incorporate amendment dates can be a difficult task for any small or medium size broker-dealer. Ensure that you're using the appropriate fund family rules at the time of a transaction, as qualifiers change over time. Several of the prospectus definitions are open for interpretation, and in many instances will warrant a call to the fund complex for clarification. You'll need to regularly review fund selling agreements for unique language or limitations, and to maintain an accurate library of current rules.

3. Communicate. Communicate. Communicate. Because the agency's goals are clear, your communication with Finra can be the easiest part of the sweep process. Your firm's remediation-related communications with financial advisers and clients are often far more nuanced, and likely to have much greater impact on the firm's reputation and operating culture over the long term.

Internally and externally, many questions and sensitive issues will be raised during the remediation process, ranging from the interpretation of the fund family rules, to how the cost of the remediation will be managed by the firm. In addition to making tough decisions quickly, broker-dealers need to create a formal communication matrix that identifies a “who, what, how and when” messaging strategy, from the outset of remediation to its completion.

To ensure that new fee waiver-related process and procedures are understood and properly applied, firms will also need to design and implement communication tactics to train and support financial advisers and other internal staff.

Although it may seem obvious, it's critical for broker-dealers to alert the finance team of any potential liability related to the remediation that might have a significant effect on the firm's net capital.

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