Mutual Fund Direct Business

Is it a good option for brokerage firms?

TERRAPIN
Industry Perspectives

Introduction

Many brokerage firms process a portion of their business directly with mutual fund companies. Simply put, mutual fund direct business involves direct transactions – which encompass reporting, compliance checks, and paperwork – between a brokerage and mutual funds. For many firms, direct processing of mutual fund business reduces clearing costs and improve internal monitoring processes.

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When does it make sense to "self-clear" mutual fund transactions by means of direct business? That is the question this paper will explore. It is not meant to argue for one method of mutual fund transaction management over another. In fact, we don't believe that anyone can make such a general argument for all brokerage firms. But we do think that firms should understand their service options and mutual fund direct business is not a well-understood option within the industry.

How Mutual Fund Direct Business Works

On the surface, mutual fund direct Business is simple. It can be carried out in one of three ways:

1. **Check and App.** This is the "old fashioned" method. After the brokerage and advisor fills out a paper application, the investor writes a check to a mutual fund. Then the brokerage sends the check and the paperwork directly to the mutual fund.

2. **Wire Transfer.** The brokerage firm arranges for an electronic transfer from an investor's account to the mutual fund. In some cases, firms use a special holding account for all transfers. Normally, paper applications are faxed when the funds are transferred.

3. **Fund/SERV.** Although Fund/SERV clears mutual fund transactions and is not a pure direct business option, it deserves a mention here because brokerage firms can use it to manage their mutual fund transactions. It is a basic platform for mutual fund transactions offered to NSCC members which is compatible with other NSCC services.

Most brokerage firms use some or all of the above mechanisms, along with clearing firms, for managing mutual fund transactions. The complications associated with mutual fund direct business – which prevent some firms from even considering the option of using it more – revolve around managing the numerous reporting and compliance requirements that are normally handled by a clearing service.

Benefits Of Mutual Fund Direct Business

- **Direct access to mutual fund's customer services.** Clearing firms often hold "omnibus" accounts for mutual funds, which means that individual investors officially have accounts with the clearing firm, not the mutual fund. In such cases, investors – and their advisors – usually don't have access to a mutual fund's customer services. By using direct business, which establishes a unique account at a mutual fund for each investor, brokerage firms secure access to that fund's customer service for the investor and advisor.

- **Tax reporting responsibility.** The mutual fund generates and sends out tax statements, which means that the brokerage does not have to pay the per-mailing fee charged by a clearing firm.

- **Simplicity for advisors.** Direct business allows advisors to set up accounts directly with mutual funds and thus bypass the extra steps involved in setting up an account with a clearing firm. This is especially helpful when establishing smaller and simpler mutual fund accounts.

- **Smaller fees.** Postage and wire transfer fees are the largest direct expense associated with direct business mutual fund transactions, but they are often much smaller than a clearing firm's per-transaction fees. Direct business also frees brokerage firms from fees associated with maintaining accounts with clearing firms.

- **Less ongoing cost.** Committing to a clearing firm for mutual fund processing means committing to their fee hikes or the expense (and hassle) of switching providers.

Costs Of Mutual Fund Direct Business

The central cost for firms using mutual fund direct business is a platform and a back office system that carries out functions normally done by clearing firms. They need, in other words, to have a system – or, in today's world of cloud computing, subscribe to a hosted service – that does the following:

1. Interfaces with different mutual funds.

2. Tracks commissions, advisor information, and dozens of other data points associated with mutual fund transactions.

3. Aggregates account data.

4. Generates reports, notifications, and alerts for ongoing monitoring and internal and external audits.

Purchasing, installing, maintaining, and updating such a system is, of course, capital intensive, both in terms of dollars and employee hours. Subscribing to a hosted service normally does not require much of an up-front capital investment, but ongoing payments, along with the employee hours needed to manage the services and interface with the service provider, need to be taken into consideration.

A brokerage that uses mutual fund direct business also needs to train advisors to use different investment platforms, even in the process of serving a single investor. In addition, direct business requires a solid relationship with a trusted back office service provider.

Questions To Ask

Our research has shown that the following three broad questions are common among brokerage firms who have considered using direct business for some portion of their mutual fund business:

The consequences of incomplete or incorrect reports can dwarf any advantages gained by bringing mutual fund transactions in-house.

- **Is mutual fund direct business even possible for us?** Do we have the industry expertise to utilize it effectively? What is our level of confidence in our internal systems and back office partners? These are probably the most critical questions. Today's regulatory environment – and, in all likelihood, tomorrow's as well – leaves very little margin for error when it comes to break points, suitability reviews, and other compliance mandates associated with mutual funds. The consequences of incomplete or incorrect reports can dwarf any advantages gained by bringing mutual fund transactions in-house.

- **How much does each option – mutual fund direct business, a clearing firm, and Fund/SERV – cost in real dollars?** The answer primarily depends on the number and size of mutual fund transactions a firm handles each year. In general, a large number of smaller mutual fund transactions may make a clearing service exceptionally expensive. But services to advisors and customers also need to be considered. Clearing firms can manage mailings and other notifications, for example, but at a price that can be higher than the postage and employee-hours a firm would have to pay.

  We'll note here that it is difficult to find comparative pricing information for clearing services outside of direct negotiations with clearing firms themselves. Fees for bank services, mutual fund accounts, wealth management advice, and many other financial services are accessible, but fees associated with clearing services remain opaque at best.

- **How much does each option cost in employee hours?** Direct business processing requires not only a reliable provider of back office services, but at least one person on staff who understands the trading platform, reporting systems, compliance requirements, and other details intrinsic to mutual fund transactions. Such a person (or a team of people) would also consume hours to manage system changes. On the other hand, brokerage firms using clearing services need to manage clearing firm accounts and provide customer service that a mutual fund would normally provide. In terms of compliance, regulations require that firms provide the same suitability oversight for both options, so neither is a time-saver.

When considering direct business, a brokerage also has to factor in its goals for mutual fund transactions and its overall business plan. In some cases, using direct business for more mutual fund transactions can free up capital to invest in marketing and new services for investors. In other cases, using (or staying with) a clearing firm for the majority of mutual fund transactions ensures that staff can invest time in generating new business among existing and potential customers.

Conclusion

A difficulty for brokerage firms considering mutual fund direct business is, again, finding comparative pricing information for clearing services. Still, we think that "Should we increase our mutual fund direct business?" is a worthwhile question for firms to ask, and we believe that we have provided a framework to help find the answer. And because we think it's always a good idea to examine current costs and procedures, we encourage all brokerage firms to see if mutual fund direct business makes sense for them and, perhaps, improve their bottom line in the process.

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