Mitigating Risk By Narrowing Your Designated Broker List

Reduced complexity, cost savings and a higher level of data security are among the potential benefits of narrowing your designated broker list.

These are challenging times for financial services compliance professionals charged with managing their firms’ investment surveillance programs. Many find themselves weighing the cost and complexity of monitoring trading activity against the perceived benefit of providing employees with the freedom to conduct business at brokerage firms of their own choosing.

Maintaining a long list of designated brokers with whom employees can hold brokerage accounts may please employees and minimize requests for exemptions to your firm’s trading policy. However, these considerations should be weighed against the potential benefits of reducing your designated broker list to the most efficient, least costly and most secure brokers in the industry. Doing so may reduce your firm’s exposure to the potential financial, legal and reputational consequences of questionable (or even illegal) trading activity.

This paper explores the challenges today’s compliance professionals face in managing designated brokerage programs, the rationale for narrowing your list of preferred brokers and the suggested best practices for implementing and communicating program changes.

Key Takeaways

• Limiting the number of firms on your designated broker list may help reduce the odds of an employee privacy breach.

• Decreasing the number of relationships with brokers and data aggregation firms may help reduce expenses and simplify administration.

• Key criteria to consider when selecting brokers include each firm’s reputation and its ongoing technology investments, data security procedures, customer service and pricing.

• When consolidating brokers, careful consideration should be given to employee communications, implementation and onboarding.
Why More Sometimes Means Less

Compliance professionals are well acquainted with New York Stock Exchange Rule 407 and NASD Rule 3050. The rules require employees of FINRA- and NYSE-member firms to gain prior written consent of their employer before they open a securities account or execute transactions with another broker-dealer firm.

The rules also mandate that executing broker-dealers provide duplicate statements and trade confirms to the employees’ employers to enable the employers to monitor the employees’ trading activity. While registered investment advisors and other non-FINRA financial firms are not bound by Rules 407 or 3050, they too have a need to keep close tabs on their employees’ trading activity.

Prior to the advent of electronic data feeds, duplicate statements and confirms were delivered exclusively by mail. This created mountains of paperwork for compliance departments. Although some firms still rely on hard copies, most firms today receive direct or indirect electronic data feeds on covered accounts from their approved brokers.

The ease with which information can now be exchanged has led some firms to maintain a large number of brokers in their designated brokerage programs. In a 2014 survey of Fidelity Designated Brokerage Services clients, nearly three-quarters (74 percent) of the 89 survey respondents indicated that they currently allow employees to trade at 10 firms or more, or have no limits in place. However, this openness comes with a cost.

“While the desire to allow employees the freedom to choose from a wide variety of brokerage firms is understandable, we believe – and many of our clients agree – that financial services companies may be better served by moving in the opposite direction,” says Andrew Brownsword, senior vice president of Fidelity Designated Brokerage Services.

Many firms in the survey shared this opinion, with nearly two-thirds (64 percent) of firms that offer five or more brokers indicating a preference for reducing the number of brokers in their designated brokerage program. The following benefits were cited as the top reasons for moving to a smaller list:

- Elimination of paper statements (63%)
- Increased reliability of data feeds (57%)
- Fewer vendor relationships to manage (49%)
- Reduced expenditure for third-party data aggregation (16%)

1 The following benefits were cited as the top reasons for moving to a smaller list:
However, because many firms perceive that reducing the numbers of brokers will be a difficult process, only 16 percent plan to do so within the next three years. The challenges cited most often included:

![Challenges Cited](chart)

**Potential Benefits of Narrowing Your Designated Broker List**

**Reduced Risk of Compromising Employee Privacy.** Brokerage account data includes highly personal and sensitive data, such as employees’ Social Security numbers, account numbers, balances and transactions. If this information were to fall into the wrong hands, it would put your employees at great risk of cyber fraud and identity theft.

Firms that limit the number of brokers in their designated brokerage program reduce the number of parties (companies and people) they need to trust with the transmission of their employees’ data. “Each additional firm in your preferred program represents another unit of risk to your employees’ personal information,” says Kurt Nelson, vice president of Fidelity Designated Brokerage Services. “Reducing the number of brokers may help limit the odds of an employee privacy breach and the related damage this can do to your firm’s reputation.”

**Reduced Expenses.** Electronic data feeds have helped streamline the process of reconciling employees’ trading activity and holdings. However, each firm’s file feed differs from another firm’s in some way. Therefore, the more brokerage relationships you manage, the more variation in data feeds you will have and the more resources you will need to reconcile the data and ensure consistency. While data aggregation firms can help reduce this burden on compliance departments, their services come with a financial cost. In some cases, the more feeds they are maintaining for you, the higher your cost.

“The bottom line is that each additional brokerage relationship you maintain may require incremental resources to manage.”

—Kurt Nelson, vice president of Fidelity Designated Brokerage Services

“The bottom line is that each additional brokerage relationship you maintain may require incremental resources to manage,” says Nelson. “Reducing the number of relationships may help reduce overall expenses and simplify administration of your designated brokerage program.”
Enhanced Responsiveness to Regulators and Auditors. When the regulators come calling, they are usually seeking answers quickly. In one recent case, a Fidelity Designated Brokerage Services client received a request for records covering 51 months of equity compensation activity. Because this firm maintained an exclusive relationship with Fidelity, the task of retrieving those records was much easier than if the firm had to coordinate with multiple brokerage firms.

Opportunities for Enhanced Service. Firms that consolidate the number of brokers in their designated brokerage programs may find that their preferred brokers are willing to provide additional services to their compliance organization and to their employees that enhance the overall relationship value. This may include onboarding assistance, trade restriction functionality, customized data feeds, commission discounts, support for employee financial wellness campaigns, and enhanced levels of service for senior executives.

Protecting Employee Privacy

New York Stock Exchange Rule 407 and NASD Rule 3050 state that covered employees of FINRA-member firms must gain prior written employer consent prior to opening a securities or commodities account or executing transactions with another broker-dealer firm. However, because the rules are ambiguous for employees and companies not covered by Rule 407 or Rule 3050, the process for gaining employee consent when sharing their personal data varies among brokerage firms.

Under privacy laws, neither a firm’s internal Code of Ethics nor its internal consent process gives any brokerage firm the implied permission to share customers’ personal data with any third party without the customer’s consent. Therefore, Fidelity Designated Brokerage Services requires positive authorization from its customers to share personal data with their employer or any other entity.

Recent enhancements to Fidelity’s procedures have streamlined the process for gaining customer consent. The newly automated online process enables employees to provide data-sharing consent with a few clicks of their mouse.

If your firm is still relying on paper forms, please contact a Fidelity Designated Brokerage Services representative at 877-907-4424 to inquire about moving to Fidelity’s new online process.
Putting a Plan in Motion

The first question that arises when moving to consolidate the number of brokers with whom your employees can do business is deciding on how many brokerage choices to allow.

This number will vary for each firm, based on company size and corporate culture. In many cases, additional services and better pricing may be achieved by entering into an exclusive or semi-exclusive relationship with a single brokerage firm.

Case Study: Benefits of an Exclusive or Semi-Exclusive Relationship

In 2013, a major broker-dealer decided to build a Preferred Broker program consisting of three outside firms in addition to its own brokerage offering. The firm believed that building such a program could help it better automate its compliance operations, help reduce overall personal-trading risk, and be presented as an extended benefit for its associates.

To help this firm achieve its goals, Fidelity provided the following services:

- A customized trade restriction engine that allowed the company to update its restricted securities and other policies throughout the day. With this information, Fidelity blocks any attempted trades that do not adhere to current policies.
- An automated process for adding and deleting accounts from the transmission feed and for reconciling new accounts.
- The ability to separate out covered employees from uncovered employees for the purposes of account reconciliation and extension of special offerings.
- Data feeds with customized data fields.

For the company’s employees, Fidelity offered:

- A reduced commission for all online stock and option transactions.
- $0 commission for online trading of the company’s stock.
- Offers on new accounts, including covering close-out fees from other brokers.
Other critical questions that must be addressed include:

**What criteria should we use for selecting brokers?**

Compliance professionals should consider a brokerage firm’s entire suite of services, as well as other factors, when selecting brokers. Keep in mind that employees and compliance personnel may have different criteria for choosing a broker, which may or may not include the following:

**Business-to-Business Considerations**

- **Reputation**: How is the firm’s brand perceived in the marketplace? Does the firm have a track record for honest, ethical behavior?

- **Technology**: Is the firm continually investing to remain in the forefront of brokerage technology? Can it offer additional functionality, such as real-time, online investment monitoring and reporting, and automated trade blocking?

- **Data Security**: Are the broker’s systems, backup procedures and disaster plans reliable and tested? Does it have controls in place to minimize the risk of cyber fraud and identity theft? How does the firm’s designated brokerage service safeguard the privacy of employee data and provide additional levels of security?

**Business-to-Customer Considerations**

- **Service**: Does the firm exhibit a culture of excellent customer service? Does it rank highly in independent surveys of brokerage firms? Does it offer most or all of its services through a variety of channels, such as online, mobile, phone-based or branch office locations? Can it provide the compliance department with a dedicated relationship manager?

- **Value**: Does the firm offer access to a wide range of securities and mutual funds? Are the firm’s commission rates competitive? Can it offer additional discounts or value-added services to your employees, such as financial wellness programs or other financial planning tools?

**How should changes be communicated to employees?**

Notifying employees who will be affected by a change in your designated brokerage program requires significant planning. Some employees may be unhappy about having to move their assets to a different broker, and your communications plan should take this into account.

“One way to signal the importance of complying with your firm’s designated brokerage policy is to assign a member of your firm’s senior management team as the sponsor for these efforts,” says Dan Anicito, vice president of Fidelity Designated Brokerage Services. “In their communications, senior
Managers should remind employees about the importance of employee trading regulations and the risks not only to the company, but also to employees themselves."

Employee communications should also stress the potential benefits of preferred pricing, ease of execution and efficient onboarding. Consider ways to make it easy for employees to comply with the new policy by conducting onsite informational and onboarding sessions.

At Fidelity, companies that have had the most successful transitions have emphasized the following points in their communications to employees:

- The benefits to the firm and to employees of maintaining a shorter designated brokerage list.
- The selection criteria that the organization used to narrow down the broker list.
- Any preferred pricing or services that the chosen broker or brokers offer.

To help ensure employees take full advantage of the services and tools available to them, ask your designated brokers to create customized communications materials, landing pages or events to educate your employees.

**How should we implement our program changes?**

When it’s time to roll out your enhanced designated brokerage program, consider making the changes effective with new hires and then phasing in existing employees later. A gradual approach may work better in large companies where change is easier to manage in smaller increments.

You may also want to work closely with your designated brokers to ensure employees have a smooth onboarding experience. For example, some firms will deploy staff to a firm’s offices to help process new account applications and associated paperwork. Or they may have a branch office located nearby that can facilitate the process. Don’t forget to consider the needs of non-employees whose accounts you may also be monitoring, such as other covered persons in an employee’s household, retired employees or employees on leave.

Of course, requests for exceptions to the new policy are to be expected and should be handled on a case-by-case basis. That said, consider developing the criteria you will use to evaluate these requests in advance so you can be consistent in your dealings with employees.
Mapping Your Strategy

As you seek out ways to enhance your firm's investment surveillance and designated brokerage programs, there are many variables to consider. While inertia may seem hard to overcome, more and more firms are finding that reducing the number of firms on their designated broker list is well worth the effort.

To learn how Fidelity can help you choose a path that's right for your firm's unique needs, please call a Fidelity Designated Brokerage Services representative at 877-907-4424 or visit www.fidelity.com/DesignatedBrokerage for more information.

Fidelity Designated Brokerage Services:
A strategic partner in your company's success.

Can your firm benefit by narrowing its list of designated brokers? Contact us to learn how we can help you monitor trading activity and safeguard sensitive personal data.

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1 An external research firm (Market Probe) conducted an online survey of approximately 800 firms that use Fidelity Employee Compliance Reporting (ECR) Services. The survey was conducted between February 20 and March 13, 2014. Fidelity ECR was identified as the sponsor of the research. Results reflect responses from 89 firms that participated in the survey. Fidelity Brokerage Services LLC, Member NYSE, SIPC, 900 Salem Street, Smithfield, RI 02917 701442.1.0