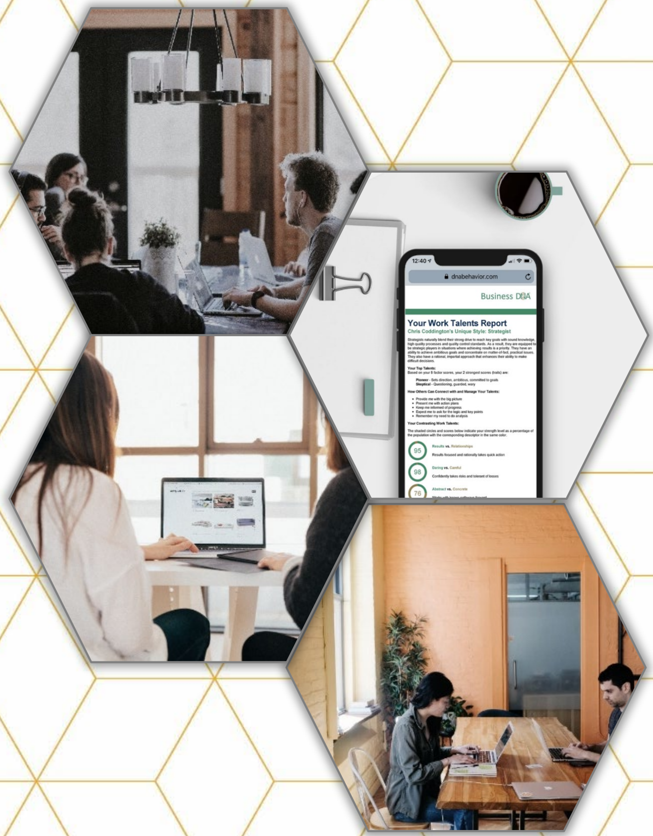

Behaviorally Smart Compliance Management for Financial Services Firms

DNA Behavior®

INTRODUCTION

In April 2016 the Department of Labor (DOL) released its final ruling requiring advisors; *to act under a fiduciary standard to put their clients' interests ahead of their own.*[1]

This ruling ensured that putting the interest of clients first, moved from being a marketing slogan to the law.

There are significant consequences for financial advisors and firms if they fail to understand the principle of 'clients first' and 'suitability', and all it entails in terms of compliance management. Breaches of fiduciary duties where people lose money based on negligent advice, will likely result in significant complaints, followed by compensation. Reparation that restores clients financial standing and makes up for potentially lost profits suffered, could well have the further impact of bringing financial institutions to their knees under the weight of legal expenses and time lost in defending complaints.

These mandated regulations apply not only to the advisor/client relationship, but more broadly the very institutions themselves. The financial services industry is front and center of the regulatory spotlight and only by demonstrating a true understanding of know your client (KYC) procedures, can organizations avoid the offences that could tie advisors and companies up in litigation for years.

Investment mistakes made in good faith based on sound judgment and wise counsel is understandable in an uncertain world; but bad investment advice resulting from advisors placing their own interests above those of the client or more importantly, failing to uncover significant information about their client, carries significant issues for the financial services business.

Advisors should now be seeing themselves as the gatekeepers to the integrity of the industry they represent. They cannot assume current methods used for client onboarding are robust enough to satisfy regulations.

Further, FINRA is widening their oversight to focus on explicit and implicit norms, practices, and expected behaviors that influence how company executives, supervisors and employees make and implement decisions in the course of conducting a business. Whilst not dictating 'culture' their audits will oversee culture compliance and risk management.

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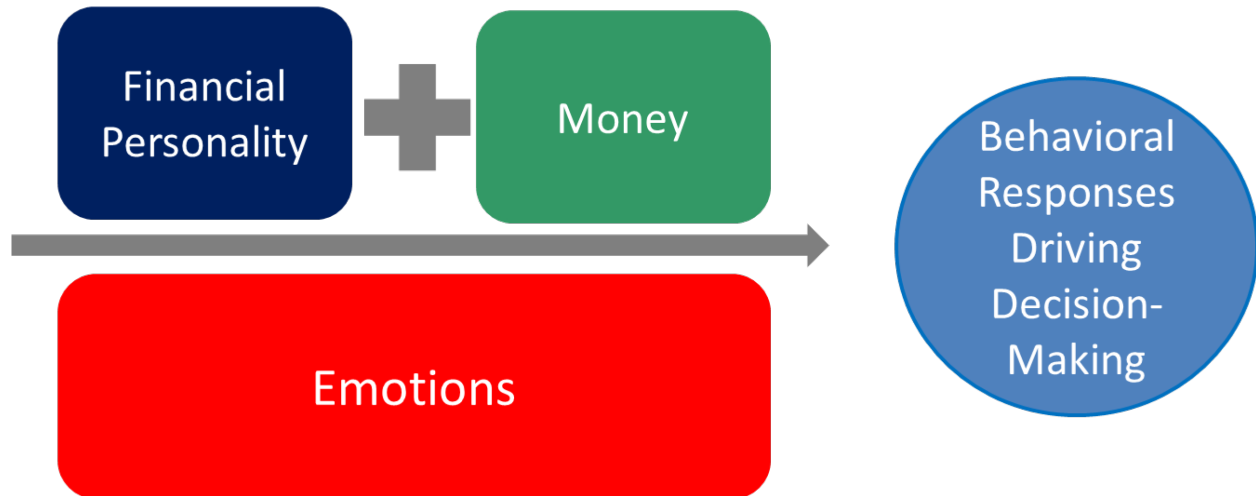
https://www.federalregister.gov/documents/2016/04/08/2016-07928/amendment-to-and-partial-revocation-of-prohibited-transaction-exemption-pte-84-24-for-certain

The Issue

The starting point for every financial advisor is to understand what is at the core of compliance risks:



Financial Personality + Money = a hot bed for emotions. Both the client and advisor need to understand the behavioral responses driving decision making. Without this mutual insight every outcome of the financial planning process is on track to become a complaint.

Whether we like it or not, as human beings we all have a financial personality which can get sparked off when talking about and dealing with money matters and heavily triggered by our emotions. Some responses are positive some negative. Some reactions come from a place of fear others from a feeling of exuberance.

At DNA Behavior we have spent the last 15 years understanding each human being's financial personality, whether advisor or client in terms of how that drives decision making.

If the advisor/client relationship begins with only a surface understanding of each other's personality, decisions made in such an environment will always be based on superficial client insight and bias consequently, increasing the potential for mistakes and subsequently complaints.

It is important to understand the human context within which crucial decisions are being made:

Advisors can only engage 40% of their clients, leaving 60% not feeling connected with and under serviced.
5% of advisors are potentially rogue, costing 5% of revenue in losses/claims.

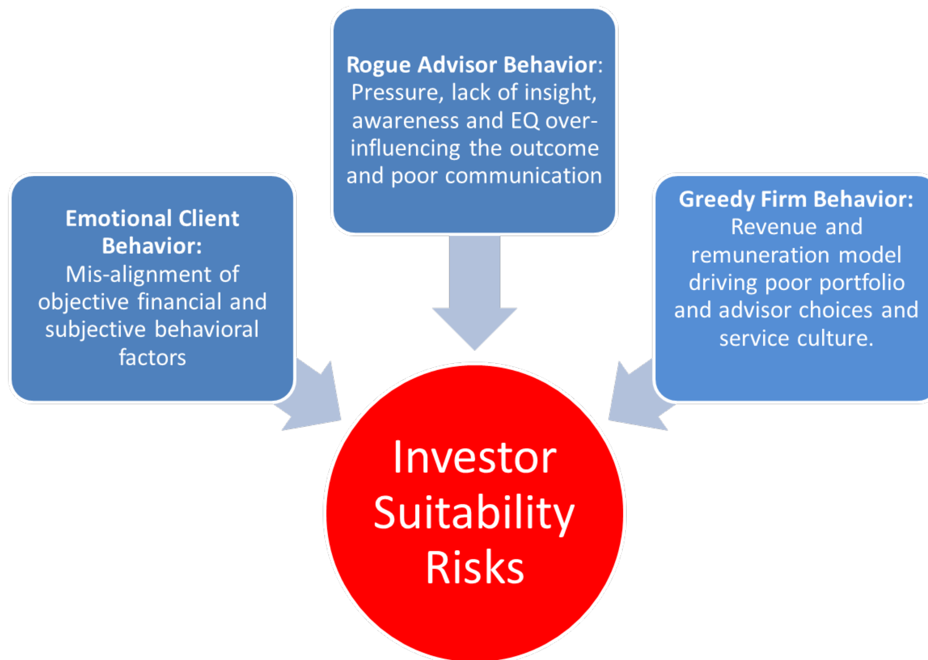
Advisors are only 40% accurate in identifying the client risk profile.
Investor emotions can cause 7.45% per year portfolio under-performance.
Advisor biases cause under-performance by 1% to 3% per year.
Team differences and blockages cause productivity loss by up to 70% per year.
Firm/advisor centered culture leads to fundamental biases in solutions offered – in other words remaining tied to old ways of operating.

Sobering statistics! But financial advisors are not trained to uncover significant, often hidden, information about their clients. They may well not have skills to better understand the psychology, bias, risk tolerance and emotions underlying clients' decision making approach. Moreover, advisors may have no real insight into their own bias and decision making process. Gaining this knowledge will empower both parties to make better decisions.

Relying simply on a traditional risk profile instrument will never guarantee the unlocking of a client's financial personality, their emotional reaction or tolerance to market movements. It's important to understand what lies behind a risk profile and what does it reveal: does it predict behavioral change under pressure? Our extensive research and analysis says it will not.

Endeavoring to manage the growing regulatory compliance avalanche, the introduction of a behavioral management system at the outset, to grow relationships and minimize risk is a fundamental step to protecting advisors and businesses from litigation. In addition, having a robust validated process to reveal a client's financial personality at a deeper level from the outset will set the relationship up for success. Further, it will be a significant move towards satisfying the regulations 'know your client' as they progress at a pace towards making investor suitability, and acting in clients' best interests, the highest priority.

FINRA's Rule 2111 on Suitability states that firms and their associated persons "must have a reasonable basis to believe" that a transaction or investment strategy involving securities that they recommend is suitable for the customer. A reasonable basis to believe must be based on a proper due diligence process to ascertain a customer's investment profile.



If the financial industry does not fully appreciate how to address these compliance regulations the risks and the complaints will continue.

Both client and advisor will have different personalities, different EQ, different biases. If these differences are not revealed and managed, formulating a plan will inevitably be misaligned given that both are coming from different starting points.

Failing to appreciate each other's communication style, misunderstandings (at best) will occur; and if the culture of the business puts an advisor under pressure to perform, and condones the lack of real in-depth insight into a client's personality, or the degree to which emotion is driving the clients decision making, the temptation will be to create an investment plan that satisfies the advisors agenda rather than providing the client with the best outcome from their investments.

Though the current US regulatory environment is strengthening its approach to 'know your customer' and 'suitability', making it clear that clients' interests come first, companies may be *technically* fulfilling the regulatory compliance rules, however, the shift by FINRA to looking at culture demonstrates there is more to do to make the industry compliant.

Know and Retain, Essential Facts…Reasonable Basis…Reasonable Diligence…Analyze Customer Specific Factors… Overall Quantitative Suitability

In particular they place front and center how financial business will operate in situations where there is potential or actual conflicts of interest. Its clear FINRA wants to understand how firms, "establish, communicate and implement cultural values" in their organizations and how those values may be guiding how these firms do business.

Firm culture has a profound influence on how a broker-dealer conducts its business, including how it manages conflicts of interest. A culture that consistently places ethical considerations and client interests at the center of business decisions helps protect investors and the integrity of the markets. Conversely, failures in these areas can impose significant harm on investors and the markets as well as firms themselves. One estimate places fines and litigation costs to firms, or their parent companies, related to cultural failures at over $300 billion since 2010. (McLannahan, Ben, "Banks' Post Crisis Legal Costs Hit $300bn." The Financial Times, June 8, 2015). This underscores the critical importance of firms establishing and implementing strong cultural values (*http://www.finra.org/industry/establishing-communicating-and-implementing-cultural-values)*

In their October 2016 report the US Securities and Exchange Commission (SEC) announced that it filed 868 enforcement actions exposing financial reporting-related misconduct by companies and their executives and misconduct by registrants and gatekeepers. The SEC's most significant enforcement actions in fiscal year 2016 include:
Insider trading and beneficial ownership reporting-related charges.
Insider trading charges.
A $415 million enforcement action for violating customer protection rules by misusing customer cash and putting customer securities at risk.

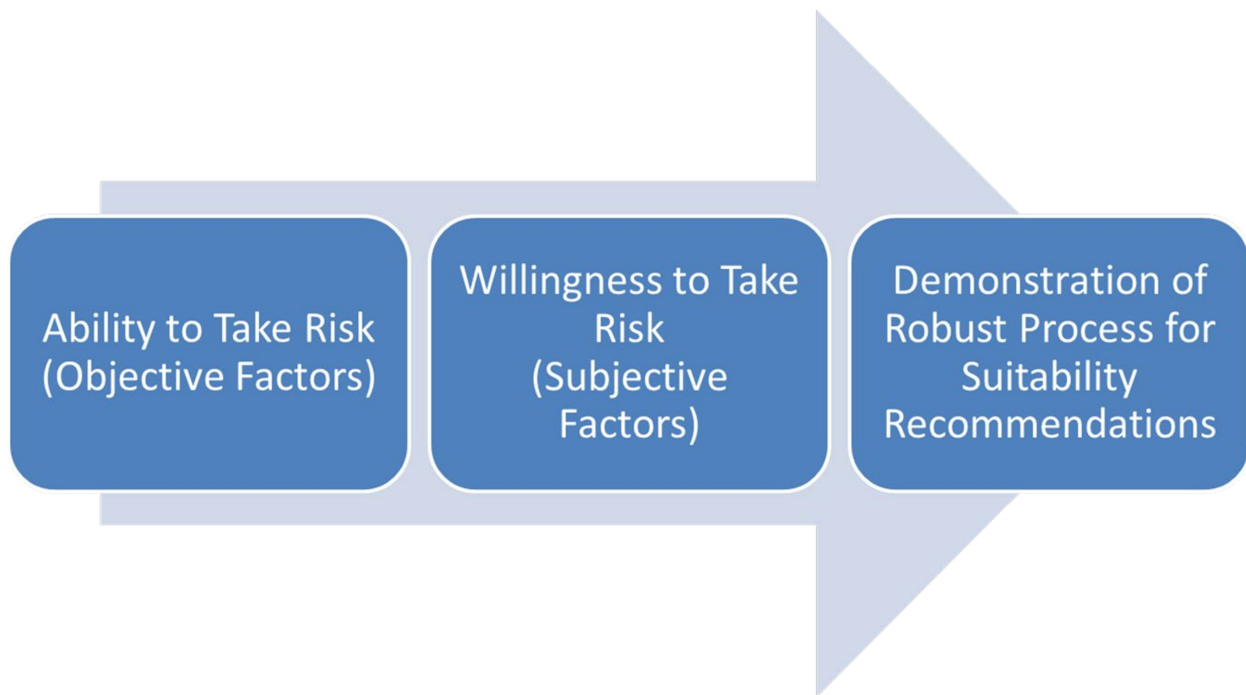
A $267 million enforcement action for failing to disclose conflicts of interest to clients.
FCPA cases in which the companies paid hundreds of millions of dollars to settle the charges.
Source: https://www.sec.gov/news/pressrelease/2016-212.html

The regulatory trend is fast moving towards making investor suitability and acting in clients best interests the highest priority starting with a deeper level of behavioral insights to "know your client". Whilst investor protection is clearly the intention of these regulations, it is fair to say that the real issues have been missed.

A deep and objective understanding of client's ability to take risk.
A willingness to take risk based on subjective factors.
A clear demonstration of robust processes in terms of the suitability of recommendations made.
A compliance structure that addresses complaints quickly and appropriately.

A far-reaching importance of suitability regulations is the obligation to link KYC data to portfolio management. Failure to fully understand clients, and relying only on superficial or surface knowledge of clients, is no long sufficient to offer advice that will stand the test of time, withstand complaints and the costly legal process of defending decisions. Therefore, it is incumbent upon individual advisors to know their clients on a deeper level and to intentionally take action to prevent suitability complaints.

"Tick the box" compliance does not provide legal protection the action needs to be preventing suitability complaints.



The fundamental causes of investor suitability risk starts with a combination of poor communication, low trust in the advisor, and poor decisions on both sides and an overall lack of behavioral management at key points of the client life-cycle.

Regardless of whether the advisor has "technically" made a suitable recommendation or not, the practical situation needs to be addressed. For example such issues as:

Poor advisory "bedside" manner resulting in hiding information and elevating client anger.
Mismanagement of heightened client emotions, coupled with advisor fear.
Processes not followed appropriately requiring lawyers to have to dig around to establish whether or not relevant details were/were not recorded or disclosed.
Reasonable basis being easily argued against by lawyers, in terms of appropriate research and investigation, for any investment analysis, recommendation or action.
The heavy financial and time costs once a complaint is made subjecting advisor and organization to lengthy litigation.
The potential outcome of terminal brand damage

Beyond the regulatory aspect, being able to **prove** that required processes took place is the only way to mitigate exposure to litigation and complaints. Adopting a client first approach to business, delivered with excellence, will not only increase share of wallet, but throw a net of protection over the entire business.

The KYC regulation includes understanding the client's investment objectives, their risk appetite, their capacity for loss, their financial knowledge and experience, their bias, decision making approach, in other words their financial personality. Therefore, this ruling has far reaching implications for the entire advisory process.

To fully adhere to the new regulatory requirements every client relationship should be re-examined, to identify opportunities for greater understanding. Extending the onboarding process to "re-boarding", will reveal any inaccuracies or evidential problems that can be corrected.
'Know your client' has to be a completely dynamic process throughout the life of the relationship with the client. This is not just a 'tick-box' exercise; this is a new way of working.

Most might argue that the client onboarding process will become heavily time consuming as financial advisors strive to understand client's propensity for risk, their vision for their wealth creation; their family circumstances and succession planning. But this will not necessarily be the case. Having a validated, sophisticated KYC tool and procedures process that can be used at first point of client contact, or as part of a re-boarding process, is a necessity. Further, having a robust and validated system for the ongoing monitoring of clients, advisors and portfolios is the only way forward to satisfy this complex regulatory requirement and ensure compliance.

The Culture

When the clients are better understood there is a much better relationship developed, they feel their interests are being totally protected. This is a positive for the ongoing relationship, regardless of what the law says or Donald Trump seeks to do around the DOL rule; every advisor needs to be taking this approach of building a far more engaging experience that will, inevitably, increase revenues and reduce the potential for costly complaints.

The introduction at the first point of connection of behaviorally smart compliance management process that facilitates a know, engage and grow approach for both advisor and client will go a long way to allaying potential complaints.

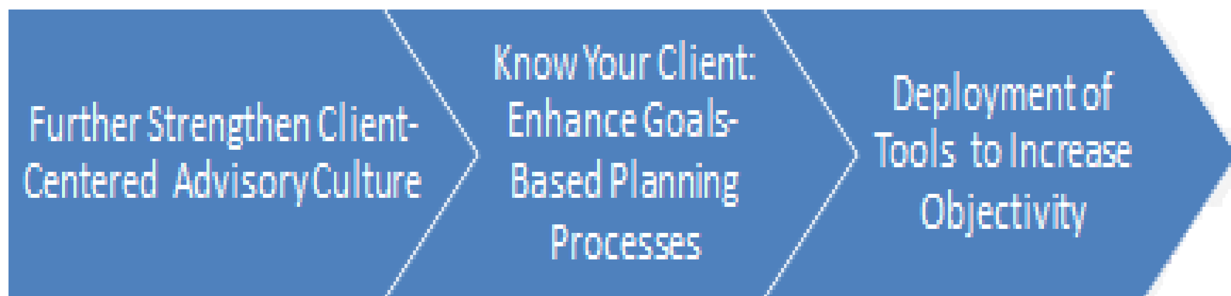
When from the very first touch point with a client, an advisor can uncover significant information about the clients relationship to their money and wealth creation, their emotional balance and their bias, it radically changes the safety, compliance and professionalism of the journey they are about to undertake with a client. But this needs to be a two-way process. If your services can be improved by knowing your client, trust and longevity of relationship can be increased by the client knowing you. This form of communication and behavioral management exceeds the 'old way of doing things'.

The traditional risk profiling model, are based on 5 to 25 questions tend to be highly situational in nature. This means the results can change over time and generally the outcomes are not reliable enough to be predictors of behavior. Further, they are one dimensional – only telling you about the client's propensity to take investment risk. They do not tell you about the client's financial personality at the broader level.

This is why using a discovery instrument that holistically uncovers all of the client's behaviors, and offers a complete and reliable prediction of the client's behavioral biases, and not just investment risk profile, is the paradigm shift in the advisory process that will set businesses apart and ensure a safer more compliant theatre of operations.

Regulators have tended to adopt a principles based approach to compliance and do not prescribe specific tools and methodologies. As guidance:

All advisory tools need to be "fit for purpose" and built into deeper processes that are in the client's best interests.
Business Revenue Model needs to be modified to ensure there are not incentives, biases and policies which lead to unsuitable offerings (e.g. too much, or too little risk in portfolios).
Advisor Background Checks need to be expanded to predict which rogue behaviors will be exhibited in pressure circumstances.
Holistic "Know Your Client" processes are needed for arriving at a client specific Risk Profile based on objective and subjective factors, and the making of suitable recommendations.
Client Communication Monitoring is needed to ensure the engagement is high and issues do not become complaints.



The Solution

DNA Behavior's proven financial personality discovery process is designed to help financial advisors to Know, Engage and Grow the advisor/client relationship beginning at the first meeting. Having expert knowledge in this field, and understanding the specific problems advisory firms face, the DNA solution has not only the ability to solve it, but delivers the balance to address the regulatory challenge of the day together with building client relationships to a level that radically reduces complaints.

When clients are better understood an improved relationship is developed with the client. They feel their interests are being totally protected and this is a positive position to be in with clients. Regardless of what the law says or Donald Trump seeks to do around the DOL rule, every advisor needs to be going down this track of building a far more engaging experience that will increase revenues and reduce the potential for costly complaints.

Our objective as a firm is to help you have much higher levels of investor suitability and believe using our DNA Compliance program can get that number up to 99.75%. Not only in terms of reducing complaints, but more broadly the fact is that suitability levels at the moment are

probably down at 40 or 50% basically because the advisor doesn't understand the client and follows a less than perfect superficial KYC process.

DNA Behavior works with organizations to deliver a superstar client service experience but also ensuring they are rock solid from a compliance perspective. Importantly this process needs to start at the top, beginning with the advisory firm culture, the remuneration charging model, and the team culture. Followed by looking at communication and how this outworks when meeting with clients, running meetings and generally correcting 'poor bedside manner' in order to enhance communications.

Getting these foundational issues right are crucial to producing an effective goals based planning process that is behaviorally driven. From this point, ongoing behavioral monitoring of the solutions offered to the clients risk profile and to their behavioral style, together with ongoing monitoring and coaching not only strengthens advisor client relationships, but satisfies regulatory requirements that go to company culture.
The higher the client involvement in every stage of the planning process, the more likely the solution you arrive at will be compliant, but also the client will be engaged in it and will have signed off on it.

When considering the compliance management steps for your firm, a significant issue for advisors to be aware of is that they will be held personally liable for any breakdown in satisfying regulatory requirements. Advisors not only have to demonstrate their compliance with all the changing requirements, they have to show regulators they are meeting the standards advisors have set for themselves.

Personal liability looks set to become a practical reality in 2016. In theory, individuals could already have routinely been held accountable, but it was often simpler, quicker and easier for regulators to pursue firms. Regulators have themselves been criticized for their approach to senior individuals and, in particular, for not having been seen to hold relevant personnel to account for the failings that led to the financial crisis. The U.S. Attorney's Manual has been updated to facilitate holding individuals accountable for corporate wrongdoing.[2]

Financial DNA can take away the fear of litigation through delivery of the world's most robust KYC process. Through a highly accurate, reliable and scientifically validated financial personality discovery process, which is "fit for purpose, it can fundamentally shift the advice landscape to deliver compliance and peace of mind.

Further, it delivers recommended goals-based planning processes which utilize the financial personality insights with active client and advisor interaction, making it less likely that clients will complain because they feel they are emotionally engaged.

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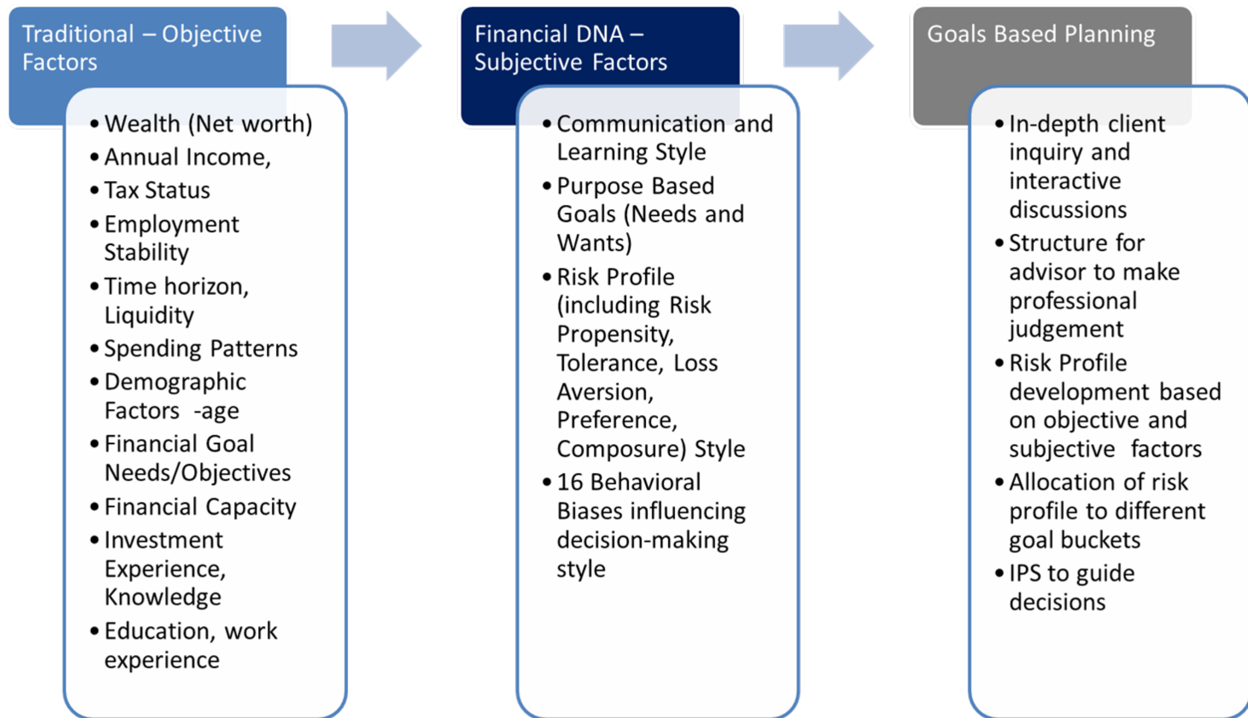
[2] https://risk.thomsonreuters.com/content/dam/openweb/documents/pdf/risk/expert-talk/5-key-risks-firms-2016-expert-talk.pdf

The Financial DNA KYC process:

Prepares a **Compliance Enhancement Road-Map** and execution plan for demonstrating compliance commitment to the regulators.
Employs a **Human Risk Forecasting Model** based on knowing the behavioral style of every advisor and their motivations, building an organizational map and identifying key psycho-org dynamics triggering compliance and operational risks.
Provides a customized **Behavioral Management Program** to pro-actively mitigate the human behavior risks on compliance and business operations generally
Implements **Advisor EQ Training** for enhanced self-awareness and improving client interactions – communication, goals, risk, and behavioral management.
Conducts a **Wealth Management Business Model Review** to identify and manage the biases inherent in the business and remuneration structure.
Strengthens the **KYC Discovery Model** for use of the current fact find (objective) and risk profiling (subjective) processes to make suitable recommendations.
Designs and implement further enhancements of **Goals-Based Planning Processes** with alignment to solutions offered.
Delivers **Digitalized DNA** insights and tools on the firm Platform for use of validated, deeper and more objective insights in all stages of the client lifecycle.
Builds a comprehensive **Compliance Monitoring Process** that operates real-time.
Implementing a **Client Communication Monitoring System** to ensure the engagement is high and issues do not become complaints.

The traditional approach to risk discovery is outdated – demonstrated by 'wrong data in means wrong data out'. Investment Risk Tolerance Profiles only provide a singular measurement. They are situational in nature and not reliable in changing circumstances. DNA Behaviors financial personality discovery process more objectively and reliably measures every dimension of who the client is, including the risk profile, at a deeper level; revealing both biases and communication styles. All behaviors cause risk to achieving goals if not managed, and therefore must be known.

Uniquely the next generation business model discussed here is based on directly involving the client in all aspects of the behavioral discovery. But it is now incumbent on financial advisers to have conversations with clients about the importance of completing a discovery process.



DNA Behavior is helping firms build compliance programs the elements of which are very detailed. This begins by ensuring you have the right advisors on the platform that fit the organizational culture; that they are managed properly; that their EQ is developed; to building a strong KYC process uncovering all of the objective elements, particularly the risk element, for providing the right portfolios, building a goals based planning process and then having the monitoring systems which will also include technology.
Based on robust research from across the Globe, we know that these are the elements needed to be able to build a strong KYC process.

Some Robo and even banks are guessing the client behavior based on demographics information or known actions of the client, but that doesn't tell advisors the full story. Generally speaking if this is your approach then under FINRA rules 2090 and 2111 this is a good start. However, just understanding the risk leaves out the elements on the subjective side to understand the client's emotions. There is no argument that can be levelled against a process that includes profiling, because the use of the psychometric instrument is to enable advisors to narrow this gap of understanding the client in specifics. In other words clients can have very similar backgrounds in terms of resources but are likely to have very different human behavior reaction to their finances and therefore need to be managed very differently. Armed with this client insight and knowledge the next step of delivering a goals based planning process is likely to be more accurate, more effectively sustained and less likely that the client will complain.

Human behavior is 93% predictable[3] and, therefore, taking a scientific psychodynamic approach has many positive points. Understanding combinations of human behavioral factors that trigger emotions, when facing investment decisions, can provide financial advisors significant insight into client behavior and the degree to which bias and emotions can skew, not only the decision making process, but also the advisory/client relationship.

As this approach has parallels with emotional intelligence and inherent behavior, uncovering these behaviors can deliver key insights into understanding how a client deals with their emotions; further, it alerts advisors to their own behaviors that need to be managed.

One of the significant ways in which to give clients a voice in the decision making process is to match advisory teams, clients, goals and solutions to suitability. DNA Behavior provides a single cloud based "RegTech" platform which delivers practical and scalable behavioral intelligence solutions to "Know, Engage and Grow" every advisor, employee and client online. Additionally, it will enable you to incorporate questions into your client meetings that address how they "feel"— not just how they "think" facilitating discussions to take place that will help clients react to the emotional side of the decisions they are making. The outcome is the building of a client-centered business which is compliant and out-performs.

Using scientifically validated suites of financial personality discovery systems, DNA Behavior provides (i) the advisory teams with the financial planning processes and tools for offering suitable solutions and (ii) the leadership and compliance teams with highly reliable insights, robust processes and real-time monitoring systems for managing behavior through the client life-cycle, including detailed reports on where compliance risks may exist with specific advisors and teams.

The online tools and strategies for addressing and monitoring suitability compliance on a real-time basis also serves as the foundation for building a client-centered culture and enhanced service experience.

The DNA discovery process has been reviewed and validated by regulatory bodies all over the world

Financial DNA delivers the world's most robust KYC process through:

A highly accurate, reliable and scientifically validated financial personality discovery process which is "fit for purpose"; and

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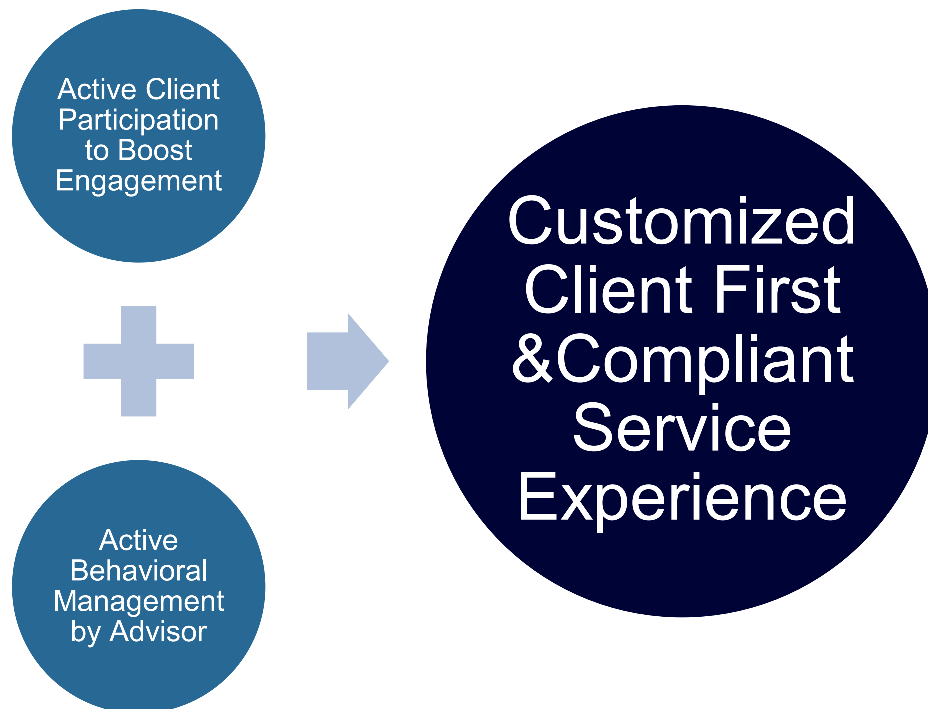
[3] (Northeastern University Professor of Physics Albert-László Barabási http://www.northeastern.edu/news/stories/2010/02/network_science.html)

Recommended goals-based planning processes which utilize the financial personality insights with active client and advisor interaction.



Cost of Complaints

The Consumer Financial Protection Bureau (CFPB) defines consumer complaints as "submissions that express dissatisfaction with, or communicate suspicion of wrongful conduct by an identifiable entity related to a consumer's personal experience with a financial product or service.

Almost all (92 percent) of financial service organizations expect the cost of handling complaints to increase. Almost three out of four (72 percent) already have experienced a jump in their regulatory compliance costs since the CFPB started regulation and enforcement. With complaints in the CFPB spotlight, the majority said more scrutiny will lead to increased complaint volume, and none said complaint volume would decrease.[4]

[4] http://www.aptean.com/company/news/2014/financial-services-executives-expect-consumer-complaint-costs-to-rise-due-to-cfpb-regulations

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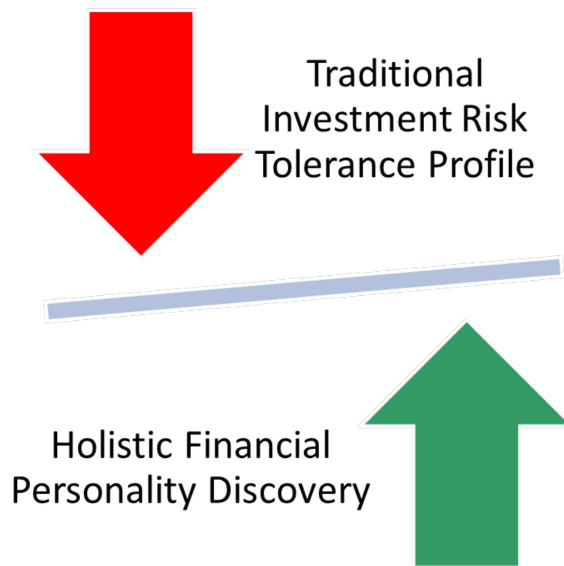


1. **Investment Risk Tolerance** Profiles only provide a singular measurement.
2. They are situational in nature and not reliable in changing circumstances.

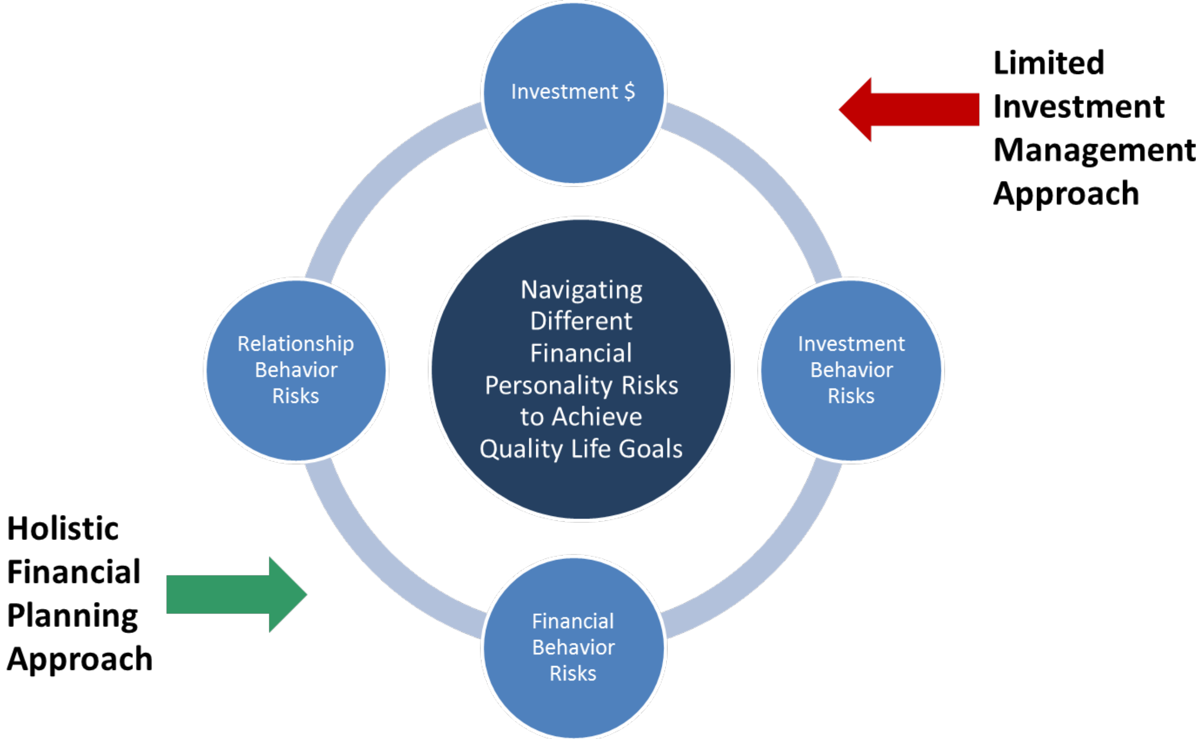
3. **Financial DNA - Financial Personality Discovery** more objectively and reliably measures every dimension of who the client is, including the risk profile at a deeper level, biases and communication style.
4. All behaviors cause risk to achieving goals if not managed, and therefore must be known.

Who uses a risk profile? Do you know what is behind it?

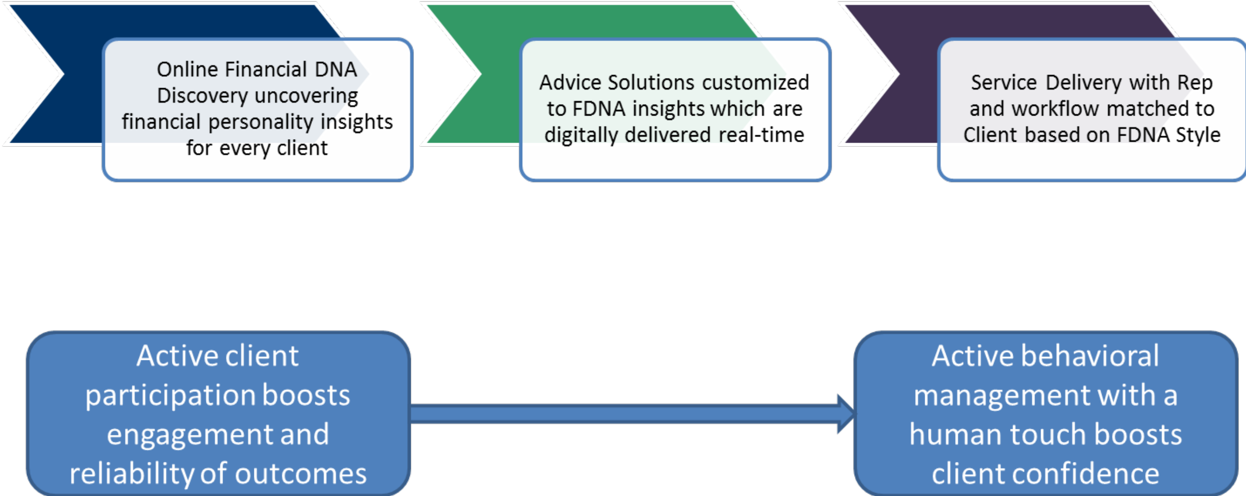
The traditional risk profiling models are based on 5 to 25 questions. The questions are highly situational in nature which means the results can change over time and generally the outcomes are not reliable enough to be predictors of behavior. Further, they are one dimensional in nature – only telling you about the client's propensity to take investment risk. They do not tell you about the client's financial personality at the broader level.

This is why it's imperative to use a discovery instrument that holistically uncovers all of the client's behaviors in order to gain a reliable prediction of all of the client's behavioral biases and not just investment risk profile. Further, the behavioral biases, if not managed could result in greater risk.

In Summary



Satisfying the KYC rule and significantly reducing costly complaints and potential loss of brand reputation requires delivering a transforming client experience.



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The Know Your Client rule requires financial organizations to know and understand their clients and their financial dealings to be able to serve them better and manage the potential for risk prudently.

Conversations are taking place across the world around standardizing reporting, understanding how best to satisfy the KYC regulations. RegTech businesses are spearheading the formation of standardizing reporting platforms BUT we cannot forget that human factors; understanding clients financial personality, managing advisor/client bias; radically pursuing the need to change rogue culture and determining the cooperation needed between all touch points in terms of the clients requirements should be font and center of the discussions.

As the financial industry seeks to gain a better understanding of regtech options and prioritize their objectives in terms of partnering with such firms DNA Behaviors offers a solution which is a comprehensive approach to satisfying the compliance regulations and reducing costly complaints.

It offers:

Client completion of an objective and validated assessment process to reliably uncover their financial personality (including risk) and communication style.
Framework for the advisor and the home office to communicate with the client on their terms in every interaction.
Recognition in building an investment portfolio of both the client's propensity to take risks and willingness to live with potential losses.
Alignment in making recommendations of the client's risk level against their goals, financial capacity and key learned behaviors, with client sign off of an Investment Policy Statement.
Real time management of the advisor and client's behavioral biases to market movements.
Technology systems for dynamic monitoring of the recommendations made to the influence of advisor biases, the client's financial personality and changes in client needs and circumstances, with real time exception reporting.
A structured in-person meeting and documentation process for discovery to initially address the client's needs, financial situation and other life circumstances, with regular annual (or more) review.

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To learn more about DNA Behavior International and the solutions we offer, please visit:
www.dnabehavior.com

If you have any questions or would like to discuss with an executive on our team, please email us at:
inquiries@dnabehavior.com