Implications of the Final DOL Fiduciary Rule for Asset Managers

By Julia Binder

n February 2015, President Barack Obama directed the U.S. Department of Labor (DOL) to update requirements for advisors of retirement plans to abide by a fiduciary standard and put their clients' best interest before their own profits. The final DOL fiduciary rule, aka conflict of interest rule, was published on April 8, 2016, and is planned to be fully implemented by January 1, 2018. Despite the short-term disruption, the reforms should be positive for the standards and professionalism of the advisory business over the long haul.

The DOL fiduciary rule will likely also fast-track trends that already are afoot in financial services, including the move from higher-cost actively managed products to lower-cost passive investment products, the shift from commission-based to fee-based accounts, and the use of automated digital advice. Leading asset managers already have been working on initiatives to address these changes, anticipating opportunities to better position their businesses for the future.

Key DOL Rule Changes That Affect Asset Managers

Two key elements of the rule will affect how asset managers do business:

1. Regulatory authority over financial advice to retirement account holders is expanded
2. Compensation models that conflict with the client's best interest are prohibited

Authority over Financial Advice to Retirement Account Holders Is Expanded

Under the DOL's definition, an investment advice fiduciary is generally defined as any-one who receives compensation for providing investment and investment management recommendations if those recommendations reasonably can be viewed as a suggestion that a plan sponsor, plan participant, beneficiary, or individual retirement account (IRA) owner engage in or refrain from taking a particular course of action.

The fiduciary can be a broker, registered investment advisor, insurance agent, or other client-facing professional. Absent a specific exemption, the Financial Industry Regulatory Authority suitability standard under which brokers have been operating will be accompanied by the DOL rule's more stringent fiduciary standard with respect to these advice recipients.

Retirement investment decisions can include, but are not limited to, which assets to purchase or sell, and whether to take a distribution, including rollovers, from an employer-based plan to an IRA.

Under the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code, certain transactions involving fiduciaries are deemed “prohibited transactions” because they may create a material conflict of interest. The DOL's rule provides an exemption to these prohibited transaction rules by allowing fiduciaries to qualify for a principles-based exemption called the Best Interest Contract Exemption (BICE). The BICE is intended to ensure that the investor is adequately protected, even in situations where a potential conflict exists.

Rollovers are included. The rule governs any recommendation to roll money out of a qualified plan and the investment advice provided once a rollover is completed. The rule applies to plan advisors who work with individual participants and to independent advisors—unaffiliated with the plan or sponsor—who are advising clients on their retirement rollovers.

Compensation Models That Conflict with the Client’s Best Interest Are Prohibited

Individuals providing fiduciary investment advice to plan sponsors, plan participants, and IRA owners cannot receive payments that create conflicts of interest without a prohibited transaction exemption (PTE). Unlike existing PTEs, which cover narrower categories of specific transactions under more-prescriptive and less-flexible conditions, the BICE allows firms to set their own compensation practices, as long as they adhere to impartial conduct standards that put the client's best interest first, adopt policies and procedures reasonably designed to mitigate material conflicts of interest, and disclose any material conflicts that may prevent them from doing so.

Common forms of compensation in use today, such as 12b-1 fees, commissions, and revenue sharing, are permitted under this exemption, whether paid by the client or a third party such as a mutual fund. To qualify for the BICE, the advisor's firm (i.e., the advisor's employer and other institution(s) with which the advisor is affiliated) needs to enter into a legally enforceable contract with individual retirement account holders that meets the requirements of the fiduciary standard.

Entering the contract. Under the final rule, the best interest contract now can be signed at the same time as other account-
opening documents. However, any advice given before the contract was signed must be covered by the contract and also meet the best interest standard. The final rule also simplifies the contract requirement so that it is between only the firm and the client, rather than individual employees and the client.

Eligible assets. The final rule does not include the list of approved eligible assets from the proposed rule, so advisors recommending any asset type, including, for example, non-listed options and non-traded real estate investment trusts, can take advantage of the BICE to continue receiving the most common forms of compensation. The final rule also includes special provisions clarifying how the BICE can be used for recommending proprietary products from a limited menu including mutual funds and variable annuities, as long as they satisfy the best interest standard.

Existing investments. The BICE includes a grandfathering provision that allows for additional compensation from previously acquired assets, including recommendations to hold, as well as systematic purchase agreements. But any additional advice must satisfy basic best interest and reasonable compensation requirements.

Level fee provision. Advisors and firms that receive only a level fee in connection with the advice they provide can rely on the BICE without entering into a contract, as long as they can document that certain specific recommendations (for example, rolling over assets from an employer plan to an IRA) are in the customer's best interest.

Disclosure requirements. The requirements of using the BICE have been streamlined to reduce compliance costs for firms and to ensure that firms can continue offering commission-based advice to clients for whom it is the best option.

Data retention requirements. Firms must retain the records that show they complied with the law (in this case, the BICE), as they would in other situations.

Opportunities for Asset Managers
Most asset managers will have to adjust their current business strategies to comply with requirements of the new rule. Leading firms already have been adapting or developing new business models, collaborating with technology vendors, and making strategic acquisitions in response to the broader trends in financial services outlined above. They are aggressively positioning themselves to capture market share.

Adapting to New Disclosure Requirements
Among the requirements of the BICE, certain compensation disclosures must be made to the public via websites and to retirement account holders at the point of sale. The requirements for transaction disclosure focus on revealing any material conflicts of interest by the firm, as well as specific costs, fees, and compensation reasonably designed to allow the investor to make an informed decision regarding cost and severity of conflicts of interest.

Among other requirements, website disclosure must describe the scope, magnitude, and nature of compensation arrangements and material conflicts of interest in sufficient detail to permit visitors to make an informed judgment about the impact of the compensation practices and material conflicts of interest with respect to transactions that are recommended. Website disclosures must be updated at least quarterly.

Working with their service providers, firms should prioritize making changes to websites, agreements, forms, and other documentation to meet compliance requirements for additional disclosure. But implementing these changes also provides an opportunity for asset managers to offer education to clients about the services that fees and compensation pay for.

Helping Individual Retirement Account Holders to Receive Needed Advice
According to the 2016 Investment Company Fact Book, one in three U.S. households invests in at least one IRA. Total IRA assets topped $7.3 trillion in the fourth quarter of 2015. That represents nearly one-third of the total retirement market in the United States. The largest component of IRA assets is invested in mutual funds, followed by other assets, including exchange-traded funds (ETFs), individual stocks and bonds, and other securities held through brokerage accounts. The mutual fund industry’s share of the IRA market was 48 percent at year-end 2015, the same as at year-end 2014.

Rollovers have fueled the growth of IRAs. Traditional IRA-owning households generally researched the decision to roll over money from a former employer’s retirement plan into a traditional IRA. The most common source of information was professional financial advisors, who were consulted by 63 percent of traditional IRA-owning households with rollovers.

Asset managers need to adopt a more comprehensive advising role and provide financial advisors with educational resources that help them identify the best options and justify any choices that may be more costly but provide a better outcome.

Rethinking Call Center Support
The impact on call centers is dependent on how an asset manager uses the call center staff today. For firms with call centers that use personnel as commissioned IRA sales people, the impact is clear—those actions would trigger fiduciary status. If a retirement account holder contacts a call center seeking advice about specific fund options or whether to exchange, roll over, open, or contribute to an IRA, that conversation likely would require a contract under the BICE. The same could be true for an existing IRA account holder who is performing one of these actions with his fund company or intermediary providers for the first time after the rule goes into effect.

However, a call center representative who stays within the general communication, investment education, and order-taking guidelines and does not make a specific recommendation, or recommend a specific individual or firm who will provide investment advice, will not trigger fiduciary status, regardless of how the representative is compensated.
Firms likely will need to retrain their call center teams to provide only general information and investment education, and to steer callers seeking investment advice to appointed plan fiduciaries.

Providing General Information and Investment Education Content

Under the rule, advisors and plan sponsors can provide general information and investment education about retirement saving across employment-based plans and IRAs without triggering fiduciary duties. Using or conveying information contained within general circulation newsletters, television, radio, and public media talk show commentary, remarks made at speeches and conferences, research reports prepared for general circulation, general marketing materials, prospectuses, performance reports, price quotes, and market data, asset managers can provide savers and advisors with information that reasonably would not be viewed as investment recommendations.

Additionally, the final rule provides greater clarity as to the types of plan information; general financial, investment, and retirement information; asset allocation models; and interactive investment materials that would be considered education. As a result, firms likely will need to review any content that correlates abstract categories and actual investments in their educational materials to make sure they comply with the investment education requirements included in the final rule. Additionally, website tools that prompt investors to enter information about themselves and their investment goals and provide hypothetical illustrations that are specific and tailored to those goals could trigger fiduciary status if they do not comply with the conditions outlined for such tools in the final rule.

Driven by plan sponsors, the demand for retirement and financial education services that can be passed on to employees has never been higher. Leading firms are developing or enhancing digital tools that help wholesalers to provide guidance with portfolio modeling and allow users to compare and contrast portfolios and prices. They will initiate training programs with their sales teams to clarify any necessary changes to advisor education.

Anticipating Demand for Lower-Cost Product Options

Many asset managers already have expanded share class offerings of mutual funds that comply with the DOL rule to meet the demands of plan sponsors for lower-cost options. They also have added low-cost, passively managed options, including ETFs, to their product line-ups. Plan sponsors and their recordkeeping partners, as well as payroll providers, likely will need to demonstrate to their plan participants that they negotiated with asset managers to include cheaper share classes optimized for retirement plans, including “T” or “R” share classes. They will be pushing harder for R5 (no 12b-1 fees) and R6 (no 12b-1 fees and sub-transfer agent fees) share classes. And they likely will turn to asset managers that can provide them with products that meet their requirements for performance at lower cost.

Ensuring Continued Servicing of Small Business Plans

Of the $15 trillion invested in retirement savings, $472 billion is invested in plans provided by small business owners, for more than 9 million U.S. households. Many small businesses may not be able to offer a 401(k) plan because of cost, administrative complexity, or eligibility rules. So, they rely on simplified retirement plans to cover their owners and employees, including SEP and SIMPLE IRA plans.

It has been argued that it will become cost-prohibitive to service smaller accounts that historically have compensated advisors with commissions, but the Secretary of the DOL has stated and other sources indicate that there will be no shortage of advisors willing to take on smaller accounts. As it stands, more than half of client assets are managed in fee-based accounts today, and a number of advisors to IRAs and small 401(k) plans already are compensated on a flat-fee basis in a manner consistent with DOL requirements.

To comply with the new rule, commission-based advisors and their financial institutions likely will have to adjust how their products and services are structured, and how the retirement plans and IRA accounts are charged fees. Even before the final rule was published, LPL announced fee reductions and lower minimums for some of its products. For financial advisors working for asset managers or insurers that offer investment products, steps will need to be taken to eliminate material conflicts of interest in recommending their own products.

1. Asset managers must provide customers with fully transparent and detailed information on products in which commissions or third-party payments are received (e.g., annuities) and disclose any material conflicts of interest.

2. Firms should be able to demonstrate that their proprietary products are optimally priced within the competitive market, that the compensation they will receive is reasonable for the services offered, and that clients are not driven to more-expensive funds.

3. Multi-asset portfolios will be scrutinized for the typically high fees incurred by the inclusion of proprietary, actively managed funds, especially when they are the qualified default investment alternative. They will come under pressure to include passive investment options when there is no justification for higher-priced actively managed asset categories.

Identifying Options for Small, Potentially Orphaned, Retirement Accounts

Evidence from outside the United States—specifically from the United Kingdom, Australia, and Canada, which have implemented rules discouraging or prohibiting sales commissions—suggests that U.S. investors with modest retirement accounts (less than $25,000) face the potential of becoming “orphaned,” in the sense that no one will be willing to provide them with investment advice. Some advisors may determine that servicing smaller accounts poses too much risk for litigation and too little profitability under the new rule.
Digital platforms are in a strong position to fill the advice gap and likely will be one of the primary beneficiaries in the wake of more stringent fiduciary rules. The technological advances in the advice space are increasingly sophisticated, efficient, customizable, and popular. They broaden access to quality, tailored investment advice and investment choices at an affordable price. They also provide asset managers integrating these services with a new opportunity to reacquaint themselves with shareholders and their needs.

The use of wrap and fee-based accounts is likely to accelerate, as is the use of low-cost, passive investment products. However, the final rule specifies that moving investments from a direct to a wrap account must be in the shareholder's best interest, which could stem a general move to omnibus accounts, at least in the form of bulk conversions of IRAs.

The new rule may contribute to increasing popularity of several new business models, including the following:

**Portfolio outsourcing.** Focus on holistic financial planning while outsourcing the investment management function to managed accounts or solutions-based multi-asset products provided by the home office or third-party asset and wealth managers. Scale and asset accumulation are critical to the health of this business model.

**Proprietary investment management.** Manage client assets in-house utilizing proprietary optimized portfolio models. The models use both active and passive strategies. However, there will be a concentrated use of active strategies as passive products and ETFs make up a greater portion of the portfolio. Scale and asset accumulation are still important, but the continuous attraction of new clients is less critical because these firms and advisors attract a high-net-worth clientele.

**Total scaled advice platform.** Provide a range of automated to full-service financial planning and investment management, utilizing a combination of human and digital advice to provide services based on assets under management. Leading firms using this business model will be the incumbent broker–dealers who are most adept at integrating digital services into their existing wealth management practice and scaling their services for various levels of investor assets.

**Automated investment platforms.** Also referred to as “robo-advisors,” they provide low-cost automated investment management services to investors. The ability to achieve scale and profitability will determine the future of automated advice providers, which haven’t been around long enough to be tested in down markets or among a broad variety of investors. Asset managers will either adopt or acquire these platforms, taking the lion’s share of automated advice assets. An obvious target for robo-advisors is accounts with balances below $25,000, which are projected to be orphaned because they are not big enough to meet the minimum balances of fee-only advisory firms.

Asset managers whose businesses aren’t suited to servicing digital advice platforms need to find ways to adapt their products as candidates for inclusion on these platforms. Most of these platforms are currently ETF-centric, but as digital platforms grow they are likely to support multiple types of vehicles. A consistent element for digital platforms and the other business models discussed above will be an emphasis on fees. Thus, low-cost no-load mutual fund share class options and ETFs will be critical to the retention and growth of product assets for the aspiring and leading asset managers. Asset managers that adapt and manage their product lines to most effectively address the product demands of the various business models will emerge as leaders under the new rule.

**What Leading Firms Are Doing**

Asset managers that are actively addressing opportunities created by the growing trends in financial services are best positioned to succeed, regardless of the requirements of the DOL fiduciary rule. The demand among investors for transparency, lower fees for advice, and lower-cost products is undeniable and undiminished. Firms that are positioning themselves to thrive in the future are:

- Working closely with key distribution partners to deliver competitive products and services
- Integrating digital portfolio-building and advice options
- Obtaining deeper insight into advisors and investors to provide better support and service
- Overhauling and extending product offerings that anticipate demand for efficient management
- Augmenting required disclosure of costs and fees with education and explanation
- Developing communications initiatives to build interest and trust with investors in addition to advisorst

Julia Binder is the head of strategic marketing research at DST kasina LLC. Her reports, articles, and blog posts cover a range of topics from digital engagement strategies to advanced analytics. Contact her at jbinder@kasina.com.

This information is intended to provide a general overview of certain market developments and is not an offering or commitment to provide any services. DST kasina, LLC, is a wholly-owned subsidiary of DST Systems, Inc. This information is for use by institutional clients only and is not intended to be relied upon by retail clients. This information, which may be considered advertising, is for general information and reference purposes only and is not intended to provide legal, tax, accounting, investment, financial, or other professional advice and should not be used as such. Neither DST kasina, LLC nor DST Systems, Inc., or any of their affiliates warrants or guarantees the accuracy or completeness of, nor undertakes to update or amend the information or data contained herein. We expressly disclaim any liability whatsoever for any loss howsoever arising from or in reliance upon any of this information or data. Trademarks and logos belong to their respective owners.

© DST kasina, LLC 2016

---

**FEATURE | IMPLICATIONS OF THE FINAL DOL FIDUCIARY RULE FOR ASSET MANAGERS**

---

© 2016 Investment Management Consultants Association Inc. Reprinted with permission. All rights reserved.