How Should Asset Managers Prepare for the DOL Fiduciary Rule under the New Administration?

By Julia Binder, Matthew Fronczke, and Lawrence Petrone, CFA®

Editor’s note: Information in this article is current as of the date of publication.

The Department of Labor (DOL) fiduciary rule is one of the most significant regulatory challenges for asset managers in the past 40 years. Although the new administration has signalled that implementation of the fiduciary rule might be delayed from the initial implementation deadline of April 2017, or even repealed, many firms already have changed compensation and other policies to align with the rule.

On March 10, the DOL announced a proposed delay from April 10 to June 9, 2017, as the rule’s effective date. This delay is in response to the February 3 Presidential Memorandum directing the DOL to re-examine the rule. It is widely anticipated that the DOL will provide temporary relief from enforcement to guard against disruptions attributed to uncertainty regarding the timing of the DOL decision on whether to delay the effective date or not. Adding to the confusion (as of when I-Am WM went to print), President Donald Trump’s nominee for DOL Secretary has yet to be confirmed.

Imminent Initial Deadline
Regardless of what the new administration ultimately decides, we believe that firms should forge ahead with compliance because the current timetable doesn’t give them the opportunity to wait and see what happens next. Many industry experts believe that the essence of the rule will move forward, even if the timing and methods of compliance are altered.

Unstoppable Industry Trends
Long before DOL’s publication of the fiduciary rule in 2016, leading asset managers anticipated several industry trends that are not expected to change, including the growing demand for lower-cost passive investment products, the shift to fee-based accounts, and the use of automated digital advice.

Advisor use of fee-based arrangements has grown significantly from 2009 to 2016. Advisors in the independent broker-dealer channel have experienced the highest percentage increase in assets under fee-based arrangements (see figure 1). DST kasina’s research shows that 68 percent of advisors expect their fee-based revenue to increase in 2017, compared to just 9 percent of advisors who expect revenue to increase for their brokerage businesses. The need to comply with the requirements of the rule has spurred more firms to review their business arrangements with distributors and analyze product lineups. We believe that the asset management industry is headed for transformative changes in sales, marketing, and product strategy.

Addressing Immediate Challenges
Asset managers face several immediate challenges, including the introduction of no-load share classes stripped of fees, the reduction of management fees, and the restructuring of products.

Flattening Share Classes and Eliminating Commissions
A few distributors have announced plans to move their retirement and individual retirement account (IRA) rollover business exclusively to non-commissioned share

Figure 1: Growth of Advisor AUM under Fee-Based Arrangements, 2009–2016

<table>
<thead>
<tr>
<th>Year</th>
<th>Average Advisor AUM under Fee Based Arrangements</th>
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</thead>
<tbody>
<tr>
<td>2009</td>
<td>51.8%</td>
</tr>
<tr>
<td>2012</td>
<td>49.1%</td>
</tr>
<tr>
<td>2015</td>
<td>50.8%</td>
</tr>
<tr>
<td>2016</td>
<td>55.2%</td>
</tr>
</tbody>
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Source: DST kasina Advisor Insights in partnership with Horsesmouth, 2016

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classes. These firms represent some of the better-known mutual fund distributors in the United States, including Merrill Lynch and Commonwealth Financial Network.

Asset managers need to begin putting plans in place to transition share classes with loads and 12b-1 fees payable to advisors or others making recommendations that are sold to defined contribution platforms, irrespective of plan size. They also should be prepared to revise policy decisions about share class availability on platforms, particularly for their best products. Specifically, firms might consider which distributors warrant R5 and institutional shares, and when platforms merit share classes without embedded sub-transfer agency fees through the sale of R6 or similar retirement shares classes.

That same evaluation might be warranted for IRA sales, although the flattening impact on share class offerings potentially could be much more drastic, because most firms currently sell A and C shares with loads to retail clients within IRA accounts. Also, distributors are expected to more closely track sales for IRA rollovers, and many asset managers appear to be putting plans in place to do the same. Asset managers also could consider focusing on special non-commissioned IRA institutional class sales, particularly for those distributors where sales transparency is unclear.

Nevertheless, not all distributors have taken a non-commission sales stance; for example, Morgan Stanley, Raymond James, and Cetera are keeping retirement account commission sales (see table 1). In fact, many distributors that have publicly addressed the issue have chosen to maintain commission-based options for retirement accounts and IRA sales. These firms and their affiliated advisors will rely on the best interest contract (BIC) exemption for commissioned sales to retirement accounts. So asset managers that want to do business with these firms will need to offer share classes that accommodate both brokerage and advisory platforms. However, we believe the decision by certain brokers to maintain business as usual is just an initial reaction to rule implementation and an evaluation of the BIC exemption. Even these distributors may have a change of heart and eventually take the same course of action as Merrill Lynch.

Driving toward Even Lower Fees
The potential for share class flattening and the elimination of load-bearing funds by distributors are expected to lead to lower sales transaction fees for retirement investors, which is one of the DOL objectives. But we do not believe that the elimination of loads and more-costly share classes will be the only catalyst for lower fees in the future. Fund companies and their distributors should more clearly justify the value of their active strategies relative to the costs to retirement plans.

The DOL rule does not explicitly provide direction on the types of products provided to retirement accounts and their costs, but it does state that those dispensing advice and selecting investment products for compensation have a fiduciary duty, which requires them to carefully weigh the costs of recommended products against the value they offer clients. Specifically, costs need to be reasonable in light of associated services and, therefore, asset managers may want to review whether the costs reflect the investment performance and value of a given strategy. Advisors must compare costs across the range of suitable products when selecting for specific requirements. If there is little or no differentiated performance, then the advisor may want to look elsewhere or expect client fees to align with passive fund strategies.

Given this focus on value and relative costs, and the aforementioned migration to no-load share classes, we expect continued pressure on fees. Add to that a steadily increasing allocation to low-priced passives among advisors, active-pedigree fund managers likely will find it difficult to maintain fees at current levels. The most effective way to respond to that is to begin identifying the differentiating performance and design characteristics of funds, thereby providing justification for fund costs.

Considering Alternative Product Vehicles
Firms also might consider a vehicle-agnostic approach to the market. Mutual funds continue to be the most prevalent fund structure in the retirement market, given their first-to-market advantage. The Investment Company Institute estimates that mutual funds represented approximately 54 percent of the $7 trillion in IRA assets and 47 percent of the $7.5 trillion in defined contribution assets as of Q2 2016.1

But given the inherent regulatory, custody, and trading costs, mutual funds are not necessarily the cheapest structure available. With a premium placed on costs by the DOL, asset managers may want to explore alternative fund vehicles for investment strategies sold in the retirement market. That includes considering collective investment trusts (CITs) and exchange-traded products/exchange-traded funds (ETPs/ETFs), both of which typically offer a more cost-effective fund vehicle for retirement accounts.

But like most investment options, tradeoffs are associated with both CITs and ETPs/ETFs. Asset managers have to weigh the cost advantages against potentially lower access and demand, lower investment

### Table 1: How Distributors Plan to Handle Retirement Account Commission Sales

<table>
<thead>
<tr>
<th>Halting Retirement Account Commission Sales</th>
<th>Keeping Retirement Account Commission Sales</th>
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<tbody>
<tr>
<td>JP Morgan (Chase Wealth Management, Private Bank and JP Morgan Securities)</td>
<td>Morgan Stanley</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>Ameriprise</td>
</tr>
<tr>
<td>Commonwealth Financial Network</td>
<td>Cetera Financial Group</td>
</tr>
<tr>
<td>Edward Jones</td>
<td>Cambridge Investment Research (leveling of commissions across categories)</td>
</tr>
<tr>
<td>Raymond James</td>
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transparency, diminished fund portability, higher trading and custody costs, and other structural disadvantages. But with a premium on lower costs in the retirement market, firms should consider starting that analysis now for each of the investment strategies sold to the retirement market.

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Endnote


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