riskalyze

No Need to Panic

A Roadmap to the DOL's Final Fiduciary Rule and What It Means for Firms and Advisors.

A TechLeaders White Paper

Riskalyze, Inc. and Beacon Strategies, LLC

THE DEPARTMENT OF LABOR RELEASED ITS MUCH-ANTICIPATED FIDUCIARY RULE, ENDING SPECULATION BY INDUSTRY EXPERTS AND TECHNOLOGY VENDORS ALIKE. WHAT DOES THIS RULE ACTUALLY CONTAIN? WHERE DO ADVISORS AND FIRMS GO FROM HERE?

BACKGROUND OF THE RULE

The Department of Labor (DOL) released its fiercely-debated and widely-discussed final fiduciary rule on April 6, 2016—arguably the most significant piece of government regulation to affect registered representatives and broker-dealers since the Dodd-Frank Act.

It was under the Dodd-Frank Act that the Department of Labor first introduced the original version of a rule that would require all financial professionals to adopt a fiduciary standard of advice. Born from concern that commission products such as annuities and mutual funds could influence an advisor to act in her own self-interest, the DOL sought to advance a requirement that advisors who oversee retirement accounts put client interests ahead of their own by mandating adherence to a fiduciary standard.

A similar proposal to substantially expand the definition of “fiduciary” under the Employee Retirement Income Securities Act (ERISA) was introduced in 2010 but was dropped in 2011 amid industry outcry. [1] Interested stakeholders suspected (correctly) that a modified version would eventually be reintroduced, but it wasn’t until February 2015 that this was substantiated.

On February 23, 2015, in a speech before the American Association of Retired Persons (AARP), President Obama directed the Department of Labor to reexamine the scope and definition of fiduciary requirements placed on Advisors who manage individual retirement savings. President Obama said there are many financial advisors who receive “back-door payments or hidden fees for steering people into bad retirement investments that have high fees and low returns,” that ultimately reduce retirement savings. [2] Two months after the President’s speech, the Department of Labor released an updated proposal to change the definition of a fiduciary.

What followed was a comment period lasting over five months, in which the DOL received “extensive feedback” during four days of public hearings, over 3,000 comments, and more than 100 meetings with industry and consumer stakeholders. [3]

One year later, on April 6, 2016, the DOL released the final rule, with a “phased-implementation” schedule ending on January 1, 2018.

No longer can advisors simply ***act*** in a client’s best interest; they must also be able to ***prove*** it.

THE BEST INTEREST CONTRACT EXEMPTION (BICE)

Under BICE, broker-dealer firms are allowed to **accept common types of compensation—like commissions and revenue sharing payments—if they commit to putting their client's "best interest" first.** This includes proprietary products offered by the firm.

Specifically, the rule states that BICE can apply as long as the firm:

- ***Commits to providing advice*** *in the client's best interest, charge only reasonable compensation, and avoid misleading statements about fees and conflicts of interest.*
- ***Adopts policies and procedures*** *designed to ensure that advisors provide best-interest advice, and prohibits financial incentives for advisors to act contrary to the client's best interest.*
- ***Discloses conflicts of interest.*** *The firm may direct the customer to online resources disclosing the firm's compensation arrangements. Customers must be aware of their right to information about the fees they are charged.*

While certain investments and actions taken by the advisor might involve a potential conflict of interest, they could nonetheless still be in the client's best interest. For that reason, broker-dealer firms must ensure that all accounts with potential conflicts of interest have a signed BICE contract. It may become a daunting system for any compliance department, as this exposes firms to potential breach-of-contract lawsuits.

OVERVIEW OF THE RULE

According to the DOL, advisors who "receive compensation for making investment recommendations that are individualized or specifically directed to a particular plan sponsor running a retirement plan, plan participant, or IRA owner" is a fiduciary.Think about this for a moment: all advisors must now act in the best interests of their clients. The suitability standard is gone, replaced by a fiduciary duty to do right by the investor. Many consider this a landmark achievement.

The fiduciary standard requires that advisors receive level, fee-based compensation. If advisors want to recommend products with variable compensation instead of flat compensation, they will have to prove that they are acting in a client's best interests, and they will be exposed to massive litigation risk if they fail to do so.

OTHER EXEMPTIONS

The DOL clarified that a range of investment education activities would not trigger a fiduciary duty, including statements made in general marketing materials, as long as a "reasonable person" would not view the statements as an investment recommendation. The rule also does not impose a fiduciary mandate on statements made in "general circulation newsletters, television, radio or public media talk show commentary or remarks at conferences." [4]

The proposed rule also distinguishes order-taking as a non-fiduciary activity. The advisor is exempt from fiduciary duty when placing a trade at the direct request of the client.

EFFECTS OF THE RULE

An initial reading of the final rule reveals several key impacts:

- RIA's will have to prove that their IAR's are acting in the best interest of their clients, even though they already do business as fiduciaries under the Securities and Exchange Commission's (SEC) definition. This creates a need for additional methods of determining best interest and documenting those decisions.
- Broker-Dealers will have to reassess their revenue models in preparation for shifting away from commission-based fee structures on their retirement accounts. This migration from variable compensation would likely make it more difficult to profitably serve clients with smaller accounts.
- The day of the 8% variable annuity is over. Financial services firms will find it difficult to try and claim these kinds of products are selected in the best interests of their clients—they won't be able to afford defending indefensible recommendations in court.
- Implementation of the Best Interest Contract Exemption will actually be less cumbersome than originally expected. Early drafts of the rule attempted to legislate which products consumers could choose in which accounts, and inflate contracts with meaningless 300-page disclosures that consumers would never understand. The final rule is far more effective.
- Though not as severe as initially feared, there still exists a compliance burden where BICE is concerned. Contracts are still required, which creates a need to facilitate and verify the delivery of documents.
- Advisors are now subject to increased legal exposure from breach-of-contract lawsuits when operating under one of several exemptions in the final rule.

SOFTWARE SOLUTIONS

No longer can advisors simply act in a client's best interest; they must also be able to prove it. Advisors who are equipped with the right tools will turn these industry challenges into opportunities.

The right financial technology should position advisors and firms for success by being able to do the following:

- **Assist in demonstrating that advisors are acting in their client's best interest.** The DOL rule seeks to ensure that clients are being treated as individuals. Go beyond stereotyping clients and labeling them with subjective semantics like "conservative, moderately conservative, etc." Supply each investor with an individual Risk Number.
- **Showcase alignment between portfolio risk and investor risk tolerance.** A robust risk-alignment platform will calculate how much risk a client wants, how much risk a client needs to take to reach their goals, and how much risk they currently have in their portfolio. Quantifying risk alignment is the future of showcasing that an advisor is acting in a client's best interest.

No longer can firms simply ***act*** in a client's best interest; they must also be able to ***prove*** it. Firms equipping themselves with the right processes are turning these regulatory challenges into opportunities.

- **Document a point-of-contact audit trail with clients.** Make sure these records are automated. The right platform can document everything from initiating the client relationship, to education, to investment recommendations, to client reviews.
- **Manage the procurement of each advisor's BICE forms.** With the right tools at hand, document management doesn't need to be a headache. Find your favorite BICE device and allow it to do the chores for you.
- **Empower supervision and operations teams to focus where needed.** The advent of "big-data" compliance tools empower supervisory and operations teams to search across accounts and zero in on problems such as missing BICE documentation, mismatched risk objectives, high-risk positions, a high rate of 401(k) rollovers, or hyperactive accounts that may be abusing commission-based compensation.
- **Leverage digital advice platforms to effectively serve smaller accounts.** Though the rule makes it difficult to profitably serve smaller accounts, advisors shouldn't lose these accounts altogether. Many advisors will leverage digital advice, married with automated asset management, to convert old, commission-based A-shares into fee-based accounts that are covered under the DOL's fiduciary standard. Products exist that integrate easily into a firm's existing website with just a few lines of code. This ultimately lets advisors offer fixed, predictable costs and low minimums, allowing them to profitably serve clients large and small.

WHERE DO WE GO FROM HERE?

FEB 23, 2015	APR 20, 2015	APR 6, 2016	JUN 9, 2017	JAN 1, 2018
Obama Commissions the DOL	DOL Rule Proposed	Final Rule Released	Applicability Date	Implementation Date

There will be little room for procrastination. Implementation of the DOL's fiduciary rule will happen quickly. The transition timeline has been extended to twelve months, which could give many advisors the false sense of freedom to defer solution strategies. However, the firms who respond quickly and prepare themselves for DOL compliance will be the ones positioned to turn these industry challenges into opportunities.

Smaller accounts will be up for grabs. Perhaps the greatest opportunity lies with the small accounts that will slip through the cracks. Many firms will drop these accounts because their perceived compliance risks outweigh their potential estimated revenue. It may seem easier to abandon these accounts than to adapt them to the new regulations, but firms who can transition these smaller accounts onto a next-generation, fee-based digital advice platform will be able to take advantage of a unique opportunity.

Those with the right tools will win. Compliance cannot be done by hand. Implementing the right software platforms will be crucial to every firm's success under the new regulations. Digital solutions for showcasing alignment between an advisor's actions and a client's best interest already exist. Adoption of new technology can be seamless and pay dividends in the future.

Future Uncertain?
The rule has been delayed in the past, and the odds that it may get scrapped (or replaced with a more comprehensive fiduciary standard by the SEC) remain high. Either way, many believe "the best interest economy" is here to stay.

Special thanks to Beacon Strategies, LLC for contributing to this white paper.

[1]"DOL to Re-Propose 'Fiduciary' Definition Regulation in Wake of Considerable Criticism." natlawreview.com. Nov. 21, 2011.

[2]"Obama directs Labor Department to move ahead on fiduciary rule." investmentnews.com. Feb. 23, 2015.

[3]"Middle Class Economics: Strengthening Retirement Security by Cracking Down on Conflicts of Interest in Retirement Savings." white-house.gov. April 6, 2016.

[4] "DOL Releases Final Fiduciary Rule." wealthmanagement.com. April 6, 2016.

ABOUT RISKALYZE

Riskalyze is the company that invented the Risk Number®, which powers the world's first Risk Alignment Platform, empowers advisors to automate client accounts with Autopilot, and enables compliance teams to spot issues, develop real-time visibility and navigate changing fiduciary rules with Compliance Cloud. Advisors, broker-dealers, RIAs, asset managers, custodians and clearing firms use Riskalyze to empower the world to invest fearlessly. To learn more, visit www.riskalyze.com.

Riskalyze
373 Elm Avenue
Auburn, CA 95603

855-RISKALYZE
530-748-1660
Fax 530-748-1661

Follow @Riskalyze