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DUE DILIGENCE WORKS

Product Research Departments are Scrambling for Annuity Due Diligence.

"Right now it is clear, if you are recommending the product to your client, you need to have the product covered."

"FINRA Exam Priorities — This may include examining firms' product vetting processes…"

"Due diligence [analyst turnover]… spend the first-year training…, then the next year is spent doing the job, then the third year is spent replacing."

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Executive Summary

Product research (or due diligence) departments have typically focused on Alternative Investments or Managed Money; however, with the Fiduciary Standard now in place for the transactional business, how are firms performing due diligence on insurance products like annuities? Some firms are finally investing in these Research teams that have been stretched too thin for too long. The problem is, most research managers are not insurance experts. When they are tasked with this new scope of responsibility, they need to hire a new type of resource and learn a new area of the business. This article discusses…

- New Due Diligence Mandate
- Reducing Conflicts of Interest
- Improving Documentation of Product Due Diligence
- Managing a New Conviction List to Prove Best Interest Advice

New Due Diligence Mandate

The regulations by FINRA and the DOL all make it clear that product due diligence is expected for each product a firm chooses to put on its' shelf.

FINRA 2017 Regulatory and Examination Priorities Letter – Product Suitability and Concentration

This may include examining firms' product vetting processes, supervisory systems and controls to review recommendations.

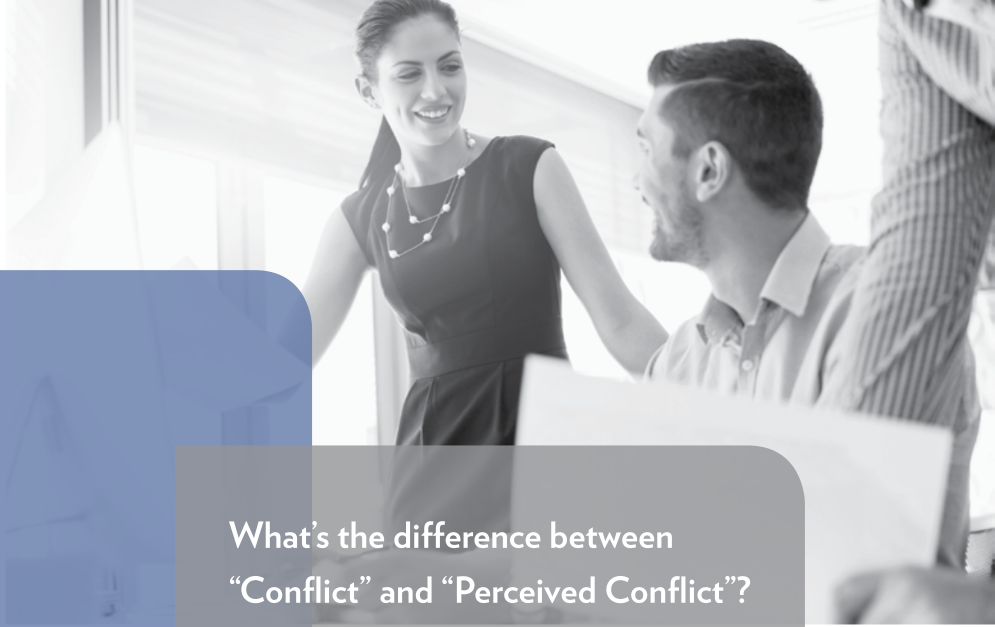
DOL Fiduciary Rule – Simply Stated

Give the Best Advice you can, beyond reproach and prove it.

What do these regulator statements mean?

In the past, some firms simply reviewed the carrier stability for insurance products, but firms should now be prepared to demonstrate their vetting process for each annuity product on the product shelf. Annuities are not like mutual funds; each one is a little different. Annuities have a chassis, numerous riders (both accumulation and income), and differing investment options and rates. When a traditional due diligence analyst starts looking into these products, they quickly realize that their existing processes don't really apply to these products, and their skills don't easily convert to reviewing annuities. Herein lies the industry problem. To meet the increased regulatory expectations, we need to retrain our people, acquire new skills, or look for outsourced expertise.

Demonstrating the right advice and meeting the new "Best Interest standard" requirement. Advisors may say they have been doing this for years. And for the good ones, most would agree. But if you don't have the best products on the shelf, it is impossible to offer the best products to your clients. So how do firms know if they have the right products on the shelf and the right process in place to identify those products? It is hard work; firms have to look at a broad selection of industry products and prove (document) why they selected the product universe. We call this Product Shelf Optimization. Firms may have 10% to 20% of the industry products on their product shelf. When looking at products they don't cover (potentially a 5X increase in scope), this can be overwhelming.



Reducing Conflicts of Interest

What's the difference between "Conflict" and "Perceived Conflict"?

Answer: Nothing.

We all manage conflicts in life and especially in financial services. But there are a few basic best practices we can follow to reduce our conflicts. The primary caution is, be careful who you empower to perform due diligence.

Advisors Are Conflicted. Advisors have a conflict of interest because they are incented to sell products that pay higher commissions.

- PREVENTION STRATEGY #1: Levelize product commissions. While every investment and insurance product does not need to pay the same commission, products that are substantially similar should pay the same commission. (Based on "Neutral Factors.")

- PREVENTION STRATEGY #2: Minimize or eliminate the gifts and non-cash compensation Advisors are permitted to receive.

Sales Managers Are Conflicted. Sales Managers have a conflict of interest because they are incented to influence Advisors product recommendations. Their compensation is based on the revenue of their Advisors whose revenue is based on the commissions of the products that Advisors sell.

- PREVENTION STRATEGY #1: Levelize product commissions that Advisors receive so that Sales Managers have no reason to promote one product or product category over another.

- PREVENTION STRATEGY #2: Minimize or eliminate the gifts and non-cash compensation Sales Managers and their Advisors are permitted to receive.

Product Team Members Are Conflicted. Product Team Members have a conflict of interest for a surprising number of reasons, but which generally boil down to "follow the money."

- CONFLICT #1: Product Team Members may be responsible for negotiating revenue sharing deals with product manufacturers; therefore, teams can be conflicted when deciding which products make it on the product shelf. (Note: Revenue sharing encompasses more than just money. It also includes resources and non-cash support that product manufacturers can give broker-dealers, sales manager and Advisors.)

- CONFLICT #2: Product Team Members may be compensated based on the monetary success of the broker-dealer; therefore, they are incented to promote those products that generate the most revenue for the broker-dealer.

- CONFLICT #3: Product Team Members, especially those who are in-the-field "wholesaling to Advisors," are often paid variable compensation based on the sales of certain product categories, which creates a conflict.

So, what to do? Introducing the newest member of the C-Level Team: The Chief Due Diligence Officer. Some firms have created a C-level position with the privileges and responsibilities of a C-level executive for the purpose of highlighting the importance of due diligence to everyone in the Broker-Dealer. Other firms have partnered with an outside independent firm to lead their due diligence or provide a second look.

Improving Documentation of Product Due Diligence

We all have documentation files. They exist in shared folder, on SharePoint, or in old-school files stuck in a drawer. The problems we all face is where to find them, are they consistent, are they comprehensive, and are they current. Most firms who have in house resources performing annuity due diligence spend the first-year training them, the next year spent doing the job, the third year spent replacing them (as they have moved on to another role). With this constant flow of people through the role, it's not surprising that product due diligence files are often hard to find, are inconsistent, and out of date. This coupled with requirements to perform enhance due diligence at the product level and on an ongoing basis, it's no wonder people's heads are spinning and due diligence departments are always scrambling to catch up.

Annuities are not like mutual funds or a BDC or a non-traded REIT, they have material changes at least annually and for rate oriented products, it could be monthly or more. For due diligence departments used to reviewing traditional products such as mutual funds, the amount of qualitative review can be overwhelming. These products don't fit nicely into an existing mutual fund review process, which is often quantitative led with a qualitative overlay. Annuities are just the opposite, where the qualitative review dominates. Alternatives investments, such as BDC and non-traded REIT reviews create a different set of comparative issues. These product reviews are often "one-and-done." Annuities change frequently and the due diligence work rests solely on the distributor.

Creating, maintaining, updating and even finding these files is not easy. Even for the most advance annuity due diligence analyst, assuming the same person is going to be in the role three years from now is unlikely, when the regulator is asking for your files. So, your choices are simple, invest in building out an annuity due diligence department with proper procedures, file storage, and redundancies built in, or look to an outsourced provider who performs annuity due diligence.

Managing a New Conviction List to Prove Best Interest Advice

In the Managed Account world, conviction means our best thinking, best ideas. In the new fiduciary standard, the products we recommend need to all be our best ideas to meet a best interest standard for the client. A Conviction List for annuities is exactly as it sounds, our best effort to identify the right products, as a result of our best thinking and best due diligence and research. In the new paradigm, the Conviction List is our only list of products to be sold.

The list is created through all the good work on due diligence and product shelf optimization. By scouring the universe of available products and performing detailed due diligence on each and every one. Doing so in a repeatable process that is dynamic enough to change over time (as product innovation occurs very frequently in the annuity business). Then stacking up the products to make sure you have each client need covered.

	Accumulation	Income Now	Income Later	Wealth Transfer
Principal Protected				
Partial Protection				
Market Exposure				

Doing this work is not only required to meet the Best Interest standard, but the firms that do this have shown to be top tier on several key performance indicators; product penetration, multiple product sales, (avoiding the one trick pony), and revenue per advisor. The reason being, they are enabling their advisor to focus on client relationships and advice, and not requiring them to do all the research themselves.

It is high time the transactional business learned something from the managed business, and adopted the Conviction Based Product List. Clients will still need the income protection only annuities can provide, firms just have to do their due diligence the right way and provide advisors and clients with the right products.

The Final Word

With all of the regulatory, industry and product changes over the last few years, Research Departments have been through quite a bit. Things will continue to evolve but it's clear firms need to establish a strong team of professionals to ensure ALL of their products meet the new standards. The question is only, how best to accomplish this — either internally, expanding the team, or externally, relying on firms designed specifically to support your due diligence needs.

ABOUT DUE DILIGENCE WORKS

- We enable Wealth Management Firms to deliver "Best Interest Advice":
  - Ongoing Due Diligence of investments and insurance products,
  - Product Shelf Management helping firms review the entire universe of products (not just the platform); ensuring the best products are on the shelf with supporting documentation.
- All in a variable cost model that can reduce cost, improve quality, and stand the test of regulatory scrutiny. Some clients also see enhanced revenue.

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