U.S. Department of Labor’s proposed fiduciary rule: three outstanding questions
The U.S. Department of Labor’s (DOL) proposed fiduciary rule (the Rule) has become a very hot topic in the retirement market. The DOL's stated objective of the proposed rule is to mitigate conflicts of interest that exist between firms, advisors and their clients and to address concerns that firms and advisors are incentivized to recommend their product or service that may not be in the best interest of the customer. Although industry participants broadly agree that the client's best interest should be put above the interest of an advisor or firm, many caution that it's important to understand the full impact this rule will have on the industry and retirement ecosystem before moving forward.

Through the public comment letters and testimony, a number of stakeholders have expressed concern the Rule may reduce access to advice and limit product choice for many customers. These stakeholders believe the Rule is too far-reaching and ambiguous in several respects, including the definitions of “best interest,” “recommendations” and “reasonable compensation.” Although recognizing the proposed rule’s potential impact on education, advertising and marketing programs, the industry has focused its commentary on a few key areas, including the need for additional “carve-outs” for product manufacturers, IRA rollover advice and other areas.

While the Rule is not yet final, firms should consider how they should prepare for implementation. Barring legislative action, the DOL is expected to issue a final version of the Rule within the first half of 2016. The original rule was to become effective eight months after issue, but we expect the DOL to provide a phased implementation period given the expected time firms will need to make necessary operational changes. Based on more than 3,900 comments from the industry, multiple public hearings, more than 25 panel discussions and private meetings with industry leaders, the DOL is making adjustments to the language and planning to release the final version in the first half of 2016. Separately, the U.S. Securities and Exchange Commission (SEC) does not expect to issue a uniform fiduciary standard rule proposal until late 2016, which may potentially create two separate standards and sets of compliance requirements that firms and advisors will have to manage, if the agencies’ rules are not aligned.

This article will highlight some of the most important practical impacts of the proposed rule and suggest how firms can and should respond, especially if they are to seize some of the opportunities that the Rule presents.
The Rule – what it says and what it means

It’s worth examining the proposed rule to clarify its potential impact. First and foremost, the Rule expands the definition of who is deemed a fiduciary under the Employee Retirement Income Security Act (ERISA). The rule simplifies the test to determine whether a recommendation constitutes investment advice, thereby including some of the key daily activities of brokers and other advisors under the fiduciary umbrella. Further, the Rule expands the scope to include advice to small retirement plans, retirement plan participants and even individuals. It is important to note, however, that there are several carve-outs and prohibited transaction exemptions (PTEs), which may allow an adviser to continue existing practices, provided they satisfy certain requirements. It also redefines advice on distributions and rollovers from a retirement plan or IRA as investment advice, which would become subject to the proposed fiduciary standard.

In terms of the most likely impacts, financial institutions serving the retirement market will likely need to adjust the ways in which they conduct day-to-day business, such as monitoring business activities, gathering information, disclosing fees and compensation, approaching advisor recruitment and succession planning. The Rule would require financial institutions to develop new policies and procedures and enhance compliance and surveillance programs and processes to meet its requirements. Another important impact: the proposed rule would grant clients a private right of action in the event that there is a breach of contract, which would create a significant amount of reputational exposure.

Perhaps the largest overall impact is on distribution and advice channels. The proposed rule will affect broker-dealers, registered investment advisors (RIAs), private banks, insurance agencies and even self-service platforms and digital channels. Firms will likely see a significant increase in the compliance costs associated with implementing the best-interest contract exemption for non-discretionary accounts. Some of those costs will result from the requirement to document that advice and products offered to clients are truly in the “best interest” of the client (and that the client understands this point, as well as the costs of the products and remuneration paid to the advisor and their firm). Such confirmation will need to occur at the point of sale.

The financial impacts are expected to be in the form of additional costs for increased staff, new systems, tools and data that will be necessary to supervise the services provided to retirement accounts. But insurers may be able to identify and seize new revenue opportunities by expanding income capabilities inside retirement plans, enhancing fixed annuity offerings and more clearly articulating the value propositions behind their products.

The Rule may also provide an impetus to develop new revenue sources, such as fee-based financial planning services and self-service advice models. By forcing more conversations and engagement with their customers, the Rule may enhance insurers’ ability to assist clients achieve their retirement income objectives.

Now, let’s look a little closer at several of the key questions.
What does “best interest” really mean?

Many comment letters from the industry either directly or indirectly raise the question, how will financial advisors, firms and other distributors know what is in clients’ best interest? The DOL has yet to define this, and the commenters very much wanted clarity. The proposed rule is principle-based and, therefore, open to interpretation.

The DOL appears to use cost as the main indicator of, or as proxy for, best interest. This linkage may not always make sense, as in the case where consumers need protection against longevity more than the lowest-cost investment products. Similarly, in times of market volatility, clients may see value in having (and be willing to pay for) access to an advisor who can provide perspective.

At a minimum, navigating the Rule will require that advisors develop a process to demonstrate and document that they have acted in their client’s best interest. Such a process will serve to provide a rationale or justification for their recommendations. The use of the 1035 Exchange form, which features comparisons of costs and benefits, may provide something of a template for documenting and justifying these recommendations.

Annuity providers, whose products are important solutions for customers seeking to generate retirement income, will also need to articulate the benefits they offer. As such, having a framework for demonstrating best interest in terms of both cost and value will be necessary.
2. What is reasonable compensation?

While multiple sections of the Rule draft reference reasonable compensation, nowhere is it clearly or authoritatively defined. Distributors who provide investment advice will need to evaluate the value of this service and determine a reasonable compensation structure for providing it. An overall view of the complete service offering is necessary to reach such an estimate.

Today, many firms and advisors currently provide advisory services for which they are not directly compensated, such as educating customers on more complicated products. It is not clear how or whether the cost of such services could be included in calculations of reasonable compensation. Should the evaluation of reasonable compensation only consider services for which customers are directly charged, or should it also factor in the sophistication of planning, the level of product complexity and the value of underlying benefits such as mitigating behavior risks in bad markets by having access to advice?

Identifying what compensation to include in the reasonable compensation evaluation is another complicating factor, especially for proprietary products and captive distribution forces. When analyzing proprietary products, should all firm revenue be included in compensation or only the direct compensation paid to the advisor as a result of the sale? For captive distribution forces, should the value of all benefit programs and company support be included in compensation?

Ultimately, it is expected that the market will determine reasonable compensation. In the meantime, firms must be able to articulate the cost for each service they provide as if they operated in an unbundled model or risk becoming obsolete in a cost-focused regulatory environment.

3. How will agents and advisors handle conversations regarding rollovers, withdrawals and other distributions?

Today, conversations with customers on distribution options from retirement plans or IRAs are not considered fiduciary advice, even if accompanied by a recommendation as to where the distributions would be invested. Under the Rule, the DOL would reverse its prior position so that rollover and withdrawal recommendations would now be considered investment advice and thus need to comply with new fiduciary standards. This is a major change from the past and is important as more than 50% of annuity transactions involve qualified money, which would be subject to a fiduciary standard under the proposed rule. It is also perhaps the most undefined area in the Rule, and the ambiguity has been raised by industry stakeholders as an area for potential clarification.

Advisors can use the best-interest contract exemption to negotiate the issue, provided they can demonstrate and document their approach to best interest. But still, they must be very careful because the exemption only applies to non-discretionary accounts (i.e., accounts that require the client’s consent for each transaction), with limits on the types of assets that are allowable under the exemption.

Firms planning to use the education carve-out must ensure that all customer communications on the topic satisfy carve-out conditions, such as those requiring “investment-neutral” language. The conditions around education in the Rule are seen as restrictive for many in the industry. For instance, asset allocation advice referring to specific investments or products (such as annuities) is off limits. Again, much depends on the types of accounts and the type of advice involved in the rollover processes.

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1 DOL’s Advisory Opinion 2005-23A
The initial response and the way forward

The industry’s response to the proposed rule to date reflects these high-level impacts. Beyond engaging with the DOL to encourage mitigating the most burdensome effects of the proposal, affected companies across the retirement industry ecosystem have been performing impact analyses on their people and teams, processes and technology. If the Rule is adopted as is, many firms are estimating large up-front efforts and costs accompanied by significant ongoing costs to maintain modified business models and for compliance and supervisory systems. In addition to impact analyses, firms are researching alternative product structures and business practices to minimize the potential revenue impact of the Rule and find new revenue opportunities.

Looking ahead, in an effort to maintain client choice and quality for all client segments, distributors will need to assess and possibly adjust the following business functions to align with the retirement customer’s best interest:

1. The advisory and service delivery models
2. The advice models
3. The necessary product features and pricing structures
4. The supporting core operating model
5. The systems and technology infrastructure

Product manufacturers will need to work closely with their distribution networks to provide appropriate products and sales support, which will be necessary to meet customer needs and maintain shelf space in this new, more highly regulated environment.

By exploring important strategic questions related to these business functions and taking appropriate actions now, firms will be well positioned to take advantage of the market disruption and continue to provide high-quality solutions for retirement market customers.
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