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THE RULES ARE HERE

TIME TO ACT ON THE DEPARTMENT OF LABOR'S NEW FIDUCIARY STANDARDS

ABOUT THIS ARTICLE

This report is based on in-depth discussions with the following professionals from within the EY Financial Services Organization:

- **Daniel Bender,** Executive Director
- **Kelly Hynes,** Executive Director
- **Ranjit Jaswal,** Principal
- **Michael Patterson,** Principal
- **Nancy Reich,** Executive Director
- **Justin Singer,** Senior Manager
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- **Thomas Ward,** Partner
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THE DOL FIDUCIARY RULE (THE RULE) IS A GAME CHANGER for service providers and manufacturers of retirement products including broker-dealers, wealth managers and insurers. The new Rule and its tight deadlines relative to the scale of changes required pose significant challenges to the way business is conducted. The expanded fiduciary standards for firms and advisors providing products and services to retirement accounts will fundamentally change:

- The conversation between advisors and their clients in relation to important guidance offered regarding retirement accounts
- Fee structures associated with firm and advisor compensation
- Compliance requirements including significant new documentation needs, enhanced monitoring and heightened supervisory oversight
- How products are structured, marketed and offered to retirement plans, plan participants and IRA customers

The key change is the expansion of the definition of fiduciary investment advice with respect to retirement products and services offered to ERISA pension plans and IRA clients, and the absolute requirement to act solely in the best interests of the customer.

Key dates to be aware of include the following:

- **June 7, 2016**—the date on which the Rule finally becomes effective
- **April 10, 2017**—the "Applicability Date" is the date by which relationships that are currently non-fiduciary must conform to a fiduciary standard. By this date, firms must also begin to monitor their adherence to impartial conduct standards, as defined by the DOL. Finally, this date marks the beginning of a transition period for certain aspects of prohibited transaction exemptions (PTEs).
- **January 1, 2018**—full compliance must be achieved with the Final Rule and all PTEs.

Note that implementation of the Rule requires an assessment of compliance, operating and business models, product design, technology platforms, supervisory systems and customer experience; this is no small undertaking. Given the breadth of required changes to operating models, firms should resist complacency and begin planning and executing their transitions today.

SOME BACKGROUND

CONFLICTS OF INTEREST ARE A KEY focus of many regulators, including the U.S. Department of Labor (DOL), the U.S. Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA), a self-regulatory organization responsible for broker-dealers.

The DOL's focus on conflicts has played out most recently in its fiduciary rulemaking, which was first proposed in 2010. Similarly, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), signed into law in 2010, directed the SEC to study the appropriateness of adopting a fiduciary standard for broker-dealers when dealing with retail investors. Prior to Dodd-Frank, there were a number of studies suggesting that the majority of customers of firms dually registered as both broker-dealers and investment advisors had little to no understanding of the nuances of such relationships. That is, says EY's Nancy Reich, customers were largely unaware when their financial advisor was acting as a broker (subject to a "suitability" standard) versus as an advisor (subject to a fiduciary standard). Furthermore, neither did most customers understand the differences between each standard. Ultimately, says Reich, "recommendations arose suggesting a common standard be applied to both brokers and advisors when dealing with retail investors."

"Recommendations arose suggesting a common standard be applied to both brokers and advisors when dealing with retail investors."

—Nancy Reich
Executive Director, EY

The SEC's Dodd-Frank study recommended that the commission should "exercise its rulemaking authority to implement a uniform fiduciary standard of conduct for broker-dealers and investment advisors when providing personalized investment advice about securities to retail customers." However, the SEC has not yet engaged in formal rulemaking and is continuing to review the topic.

But with the DOL's fiduciary final rulemaking and much commentary from the industry on the difficulties of addressing a rule that applies to only a portion of the industry, matters are accelerating. For example, the SEC has announced a 2016 focus on retail retirement investing, and FINRA, though lacking the power to require a fiduciary standard for brokers, nonetheless wields significant influence over how brokers engage with customers. As Reich explains, FINRA is "driving a lot of the discussion around identifying, minimizing and managing conflicts of interest or otherwise providing sufficient transparency surrounding recommendations to retail customers." Moreover, FINRA has "issued guidance regarding its expectations on conflicts of interest and announced that it is an exam priority for 2016." The SEC is continuing to review the topic.

ACCEPTING THE NEW NORM

WITH FINALIZATION OF THE RULE, firms now need to be very focused and strategic in their compliance efforts. They need to conduct a thorough analysis across their organizations, to determine how the business is impacted and what compliance, governance, operations, technology and supervision changes are required to achieve compliance. The Rule impacts not only the manufacturing of retirement and other products, but also the distribution of those products to retirement customers.

The following business impacts need to be considered.

Distributors:

- Customer segmentation and associated customer experiences
- Product and service alignment, including differentiation between retirement and non-retirement accounts
- Distribution channels, including face-to-face, call center, digital platforms
- Which exclusions and prohibited transaction exemptions, including the Best Interest Contract Exemption (BICE—see below), the firm may qualify for or rely on and the related compliance obligations
- Training of brokers and investment advisors who provide retirement advice to retail customers

Manufacturers:

- Product rationalization and related fee and compensation structures
- New product offerings/new product pricing considerations
- Product selection
- If necessary, which exclusions and PTEs, including the BICE, the firm may qualify for or rely on
- Marketing and wholesaler training

Additional impacts to be considered:

- Compliance processes and reporting, including decisions around exemptions, exclusions and disclaimers
- Documentation requirements and supporting technology and processes
- Technology enhancements to CRM systems, websites and trading systems
- Data needed to capture client interactions and manage new compliance processes
- Profitability as a result of new business models
- Compensation changes
- Sales practices and marketing enhancements

The resulting implications for industry participants' business models, especially the ways firms interact with customers and prospects, are profound. For example, product and service costs for providers in general "may rise—in many cases significantly," says EY's Daniel Bender. Overall, he explains, "firms may need a wide range of adjustments across key elements, including target customers, channels, investment offerings, advice and guidance offerings, and overall fee structures, which compose a majority of their operating model."

MOVING TO THE NEW NORM

The Rule itself is the leading edge of a broader trend toward greater transparency in advisory relationships and investment product distribution.

Impact analysis of the Rule and the associated decision making may not be straightforward, as nearly all components of strategy, operations and infrastructure are likely to feel an impact. Any resulting strategy—or compliance-driven decisions in one area of the business—may also cause a ripple effect, creating the need for recalibration across nearly all other strategies and business processes. The work is complex; however, there are some key steps that should be taken into consideration, including the following:

REVISIT CORE BUSINESS STRATEGY

AS EXECUTIVES DEVELOP GREATER INSIGHT into the complex interplay of all of the issues, the need for fundamental transformation will become increasingly evident. Such thinking and decisions need to be considered sooner rather than later, because to delay will result in a reactive approach, potentially requiring rework and causing firms to be on their heels, playing catch-up to their competitors, impacting the ultimate success of their strategy.

As Bender points out, firms should explore strategic opportunities such as movements toward level fee discretionary advisory programs, enhancing customer segmentation and householding strategies to better define total relationship value and attract and retain assets; such strategies should also assess enhancing digitally enabled service models and advisor desktop utilities. This, says Bender, "is an opportunity to see more clearly than the competition and to benefit from disruption."

However, firms may elect, for example, to divest or outsource specific business activities. Alternatively, other firms may acquire certain capabilities or simply keep in place their transaction/commission-based platform to attract high-producing brokers who prefer that model and compensation structure. Nevertheless, says Bender, the bottom line is that no significant strategic planning or corporate development should be taking place today "that doesn't take into account the inevitability of some form of fiduciary standard impacting all customer relationships and engagement."

REASSESS CHANNELS

BENDER FURTHER EXPLAINS THAT INDUSTRY practices surrounding fiduciary status, as well as expanded focus on conflicts of interest, may have a significant impact on where and how firms engage customers. Channels and related "go-to-market" approaches, says Bender, "may require re evaluation."

Firms should begin by conducting comprehensive reviews of their business structures and operations, "mapping the touch points with customers." This includes everything from "pre-point of sale to point of sale, transaction, ongoing services, surveillance and reporting," says Bender. Firms should consider not only those interactions directly addressed by new regulations, but also those likely to be subject to increased regulatory or investor scrutiny. Start with internal processes and interdependencies, says Bender, but also look closely at interactions and synergies with external manufacturers, distributors or other parties.

Even prior to the new Rule, many firms were conducting a strategic re-evaluation of how they interact with their customers. Minimizing or eliminating relationships or processes that could be construed as a conflict of interest will significantly improve reputation and customer satisfaction, as well as reducing regulatory risk and exposure to litigation and regulatory enforcement.

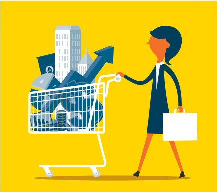
RE-EXAMINE THE ADVICE MODEL

MOST FIRMS HAVE A CONFIDENT VIEW OF what constitutes good advice, says EY's Ranjit Jaswal. But under the new Rule, firms may need to "re-evaluate their definition of 'good advice,' taking steps to make sure their processes are not only effective but also well-documented." This begins with presenting products that are not merely generally sound investments but also are the products in the best interest for specific customers. But firms may also need to "thoroughly document the qualitative and quantitative [and associated] justification[s] behind their determinations," says Jaswal.

A key problem the industry faces is the view by many that there is a difference between perception and practice. As Jaswal explains, many producers of investment products use independent advisors for distribution. Each individual advisor may, in turn, have his or her own views and methods for establishing and tracking customer risk profiles. Therefore, "firms need to assess the consistency of advice between advisors."

Undoubtedly, firms will need to do more to understand and justify how, where and why advice is presented. Moreover, they may need to provide more in terms of contemporaneous documentation, surveillance and related processes to receive sound and unbiased advice (see "Documentation" and "Technology" below).

Finally, the new Rule has the potential to accelerate the trend toward fee-based advisory models, which, Bender explains, may increase the transparency to the customer when obtaining advice or an investment product.



ADJUST PRODUCT AND SERVICE OFFERINGS

DEMAND FOR VARIOUS FINANCIAL PRODUCTS and services tends to vary with changes in financial environment, investor demographics and overall customer needs. Today, for example, there exists a proliferation of new products and alternative asset classes alongside an observable shift from active to passive or indexed investment products, and from transaction-based products toward fee-based discretionary advisory programs. In any marketplace, firms must discern:

(1) Which products are necessary to help their customers achieve their financial goals?

(2) Which of these products are profitable to the firm, in which channels and with which customers?

(3) What service model is necessary for customers to use products appropriately?

This requires keen insight into both fees and costs associated with product and service provision, not only product by product, but also channel by channel and even customer by customer.

But as fiduciary requirements expand, cost structures may change—significantly, in many cases.

Certain instruments and transactions may require more attention than others. For example, IRA rollovers are a key focus area of the Rule and both SEC and FINRA examinations. In addition, given that the Rule focuses on certain types of compensation earned by firms and advisors as the root of conflicts of interest, the supervision of investment product recommendations will need to more closely scrutinize compensation earned by firms and advisors and affirmatively determine that the payments don't constitute a conflict of interest, for a particular recommendation.

The new Rule also has a significant impact on annuity products. Specifically, variable annuities and fixed index annuities can be recommended to IRA owners and small plans only under the Best Interest Contract Exemption (BICE), a new exemption created by the Rule (see explanation below of what this constitutes). With added fiduciary responsibilities, insurance firms may find the cost of providing annuities to certain investors with limited assets prohibitive. As EY's Ben Yahr explains, "These are relatively complex instruments, and the fiduciary requirement may mean, in many cases, collecting more information about each investor and a lot of handholding."

This adds considerable cost as well as regulatory and legal risk to the process. Thus, many firms may decide the cost of compliance is too high for certain customer segments. As such, the increased regulatory requirements around informing the customer, documenting transactions and the like "may mean that those who could benefit most from an annuity may have less access than before."

In general, says Yahr, under higher fiduciary or conflict-of-interest standards, the more complex the product, the more expensive its provision. So in tandem with business models and distribution networks, firms may need to gather data and make choices about which products to keep, which to add and which to exit or avoid, all in light of the higher risks and costs driven by the new standards. Firms may decide to simplify or consolidate many of their product and service models in order to reduce the compliance burden and simplify the customer experience.

With added fiduciary responsibilities, insurance firms may find the cost of providing annuities to relatively lower-income investors prohibitive.

REVISIT THE REVENUE MODEL

AS THE NATURE OF INTERACTION EVOLVES—as business models, channels and products are reconfigured—firms may need to reconsider the form and amount of their fees.

Broader industry trends are already leading more firms "to unbundle financial advisory from asset management," says EY's Justin Singer. The new rule requires a reassessment of how fees are charged for providing education, guidance, discretionary and non-discretionary advice, and other ancillary services such as financial planning.

Regarding IRA rollovers, the DOL is concerned that advisors are too heavily influenced by commissions paid by various providers of investment products. So the DOL's Rule seeks to prevent advisors or their firms from receiving differential compensation based on product sales unless they avail themselves of a particular exemption that, as Singer explains, "drives transparency and consistency" across the industry.

Specifically, if an advisor or his or her firm wishes to continue receiving commissions and differential compensation from product sponsors, it may do so only after signing a "best interest contract exemption," or BICE, with each affected customer. A BICE, explains Singer, stipulates that the advisor is indeed "acting in the best interest of the customer." Accordingly, says Singer, "the advisor must be able to prove—to document and defend—why recommendations made under a BICE relationship are in the customer's best interests."

Note that all of this is taking place during a period in which financial services firms are facing significant fee pressure. As a result, leading firms are taking a hard look at the fees received for various products and services versus the resulting expense, which is leading to clearer choices about customers, channels and products.

Firms may need to reconsider the form and amount of their fees.

RECALIBRATE THE OPERATING MODEL

NEW RULES AND BROAD INDUSTRY TRENDS are driving firms to rethink the nuts and bolts of their operations. Key elements requiring attention include the following:

- **Documentation, disclosure and transparency.**

From a regulatory perspective, firms will need to do more to obtain the right data necessary to provide objective and effective advice to their customers. This will include providing greater transparency regarding the nature of their relationship with customers, including greater disclosure regarding commissions, fees and any potential conflicts of interest. They need to also simultaneously take steps to simplify their customer communications, particularly for retail customers.

Firms will need to consider to what extent the rule reflects underlying, nascent public preferences. Firms may wish to evaluate the impact of mere compliance with new regulations versus a more expansive response to the spirit of such reforms. The latter may deliver marketplace advantages in the form of a more positive brand image and stronger client relationships.

- **Customer service.**

Firms may also need to rethink their fundamental customer strategies, beginning from a standpoint that greater transparency is essential not just because of Rule requirements but because it leads to a better customer experience. The best approach is to create products and services that minimize or eliminate any impression of conflict of interest in the first place.

- **Compensation model.**

Financial advisor compensation plans are critical to attracting high-quality professionals and driving strategic firm growth. From a risk management perspective, under the new Rule, says Yahr, "firms may simplify compensation plans and focus on creating appropriate behavioral incentives to align advisor compensation with a customer's best interest. For example, some firms may decide to tie variable compensation to specific activities instead of basing it on sales." This may prove challenging, as most firms tend to design compensation plans to incentivize advisors to grow firm revenue and to promote front-office efficiency. With the new Rule in place, firms must realign the targets while still incentivizing top producers to grow their book of business. Further, to operationalize these changes, firms may need to enhance or replace existing compensation platforms.

Firms may also need to review and update marketing processes, including call center scripts, printed collateral and related informational materials such as prospectuses, websites or advertising. Firms will also need to pay particular attention to the sorts of training and disclosure information shared with intermediaries. Updating these materials and procedures may prove challenging, depending on specific segments.

The best approach is to create products/services/processes that minimize or eliminate any semblance of conflict of interest in the first place.

- **Compliance/surveillance.**

It is not enough to announce new procedures. As Yahr explains, firms may also need the means to monitor employee behavior over time to make sure they comply. "Each time there is an interaction, a discussion, a transaction, that information needs to be observable and auditable." Moreover, "systems should be able to detect noncompliance, generating an exception notice within an appropriate time frame for the firm to respond."

- **Customer/channel education.**

With advice unbundled from transactions, firms may need to evaluate how they provide, and whether to charge for, general investment education. With services thus decoupled, executives may have greater visibility into the margins generated within each phase of each relationship. Note also that much of the education process takes place through intermediary channels. Broker-dealers, for example, may likely need to take greater steps to make certain that financial advisors are thoroughly briefed on each product or service and how it can impact end-customers. All this will likely lead to rethinking the approach to educating various customer segments. Many firms may find new ways to standardize education processes, including the adoption of technology-based tools. The shifting and more visible cost of education may drive changes in products, channels, documentation, information systems, fee structures and other key business elements.

- **Technology.**

The challenges related to implementation of the Rule requirements present profound implications for technology. According to Thomas Ward of EY, firms today often use a simplified approach for customer onboarding, gathering the minimum data required by applicable regulations and necessary to execute a transaction. Going forward, says Ward, firms may need to build systems able to "gather and manage much more data up front." That means "a lot more technology [aimed at] improving point-of-sale and supervisory systems to reduce regulatory risk," says Ward.

Such systems are needed to aid in the supervision of fiduciary compliance, and be able to generate customer-specific alerts such as significant changes in market conditions, prices or other key drivers of a customer's risk tolerance. In essence, says Ward, firms may need technology that not only "captures interactions contemporaneously," but that "also issues alerts commensurate with fiduciary standards."

A particularly noteworthy aspect of such change is the way in which this will likely drive more firms to invest in technology-enabled advice. Capabilities could include IT-enabled "direct to customer" and "self-service" capabilities (i.e., "robo-advisor" and similar digitally enabled utilities) as well as technology improvements to enable advisors to more efficiently work with clients, thereby lowering account minimum thresholds. As Bender explains, unless firms are able to harness technology, "the cost of servicing complex products and customer relationships" may, in many cases, become prohibitive. Certainly, firms may devote significant resources to addressing the needs of their most valuable customers. However, for lower-balance accounts, says Bender, "robo-advisory and customer-directed, self-service capabilities, where more elements of the relationship are automated, will likely become more prominent in the industry."

- **Cost structure.**

As reviews progress, firms may begin to recognize how any likely new environment will result in significant changes to their cost structures. For those customer interactions and processes likely requiring more elements of a fiduciary status, costs will tend to rise—in many cases, significantly. Not only may representatives in such positions require greater training themselves, but firms overall may need to provide significantly more in the way of process and IT support to capture, document and track—and produce to regulators as evidence of compliance—more information about each customer and each transaction (see sections on "Talent" and "Technology").

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UPDATE THE TALENT MATRIX (STAFFING AND COMPENSATION)

NEARLY ALL WEALTH AND ASSET MANAGERS, broker-dealers, asset managers and related industry executives agree: there is already a war for the top talent. But stricter fiduciary rules and related changes, as Yahr explains, means "more firms may need even more staff on hand with the appropriate training and certifications."

Accordingly, firms need to review their operating models—products, technology and related issues—in light of their likely talent challenges. Any talent gaps resulting from the coming changes may require attention to everything from training and certification to recruitment and retention.

A closely related point: as staff from different parts of the firm perform more fiduciary-level duties, firms may need to revisit compensation structures and, in particular, vouch for the absence of any incentive-driven conflicts of interest.

Finally, firms may also need to update their training programs to align with new regulations and industry trends. Leading firms will likely emphasize a culture of doing what's best for the customer.

Any talent gaps resulting from the coming changes may require attention to everything from training and certification to recruitment and retention.

CONCLUSION: THRIVE IN THE NEW NORM

The Fiduciary Rule is here, and immediate action is required to meet the implementation deadlines.

CONSEQUENTLY, EY RECOMMENDS that firms should begin taking a comprehensive look at all of their strategies, technology and operations and begin making adjustments that align to the spirit—consistent with the industry trend—of greater fiduciary obligations and conflict mitigation.

Companies now face greater regulatory and customer scrutiny relating to conflicts of interest. Together, this will drive significant change across business models and processes. Sales and servicing costs will no doubt rise for many products and services. Data collection and documentation burdens will increase, placing pressure on IT and reporting systems.

All firms need to take a comprehensive look at the whole of their product lines and sales and service channels to recalibrate based on new risk and cost structures. For many, the new requirements will accelerate the trend to fee-based advisory services or restructuring fees, commissions or other key business elements.

In conclusion, according to Jaswal, "the new Rule is a major source of disruption in the industry." Further, this is an opportunity to ride the coming wave of regulation to build competitive advantage. Firms should take steps to look further afield, looking for opportunities to expand, grow and protect their business, with the goal of "optimizing the mix of channels, products, fees, costs and revenues." In addition, strategies should consider aspects such as information technology, talent management and corporate development.

Those firms moving proactively and decisively to meet the implementation deadline will be in a stronger competitive position. A robust and strategic implementation plan will allow firms to consider all regulatory, operational and technical aspects of adapting to the requirements of the new Rule, rather than taking missteps that will need to be revisited later.

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