WHAT ADVISORS NEED TO DO TO COMPLY WITH THE NEW STANDARD

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THE DEPARTMENT OF LABOR'S Fiduciary Rule has been casting a long shadow over the financial services industry for nearly a decade, but now, after many twists and turns, it appears that it will finally be implemented. On May 23, 2017, Labor Secretary Alexander Acosta announced that there will be no additional delay of the DOL Fiduciary Rule and that it will go into effect starting June 9, 2017. The Department of Labor will continue to review the rule and may make changes to it, but for now, it will be implemented as written.

In a Wall Street Journal article, "Deregulators Must Follow the Law So Regulators Will, Too," Acosta explained, "We have carefully considered the record in this case, and the requirements of the Administrative Procedure Act, and have found no principled legal basis to change the June 9 date while we seek public input. Respect for the rule of law leads us to the conclusion that this date cannot be postponed."

"This is not a surprise as the Department of Labor had really run out of legal options to delay," explains Jamie Hopkins, Associate Professor of Taxation at The American College of Financial Services in the Retirement Income Program and Co-director of the New York Life Center for Retirement Income. "The only other two possible sources for a delay would be a court order or Congress passing a bill. At this point, with about two and a half weeks out, both seem unlikely. So, expect to see the DOL fiduciary rule go live, at least in part, on June 9th. However, remember that the full implementation date is not until Jan. 1, 2018, so the Department of Labor will continue working on a delay of this full implementation date and a new rule."

What now?

The Fiduciary Rule's definition of fiduciary advice -- which mandates that recommendations be made in clients' best interests – will go into effect on June 9. Starting on this date, advisors who sell products that do not meet these standards will need to begin asking clients for "best interest contract" (BIC) or Principal Transactions Exemptions, which will be available from the DOL.

During a transition period that will last from June 9 to January 1, 2018, requirements under the rule will be somewhat less restrictive, as many advisors need time to ramp up their compliance. However, during this period, advisors will be expected to comply with impartial conduct standards set by the DOL to give advice that is in the best interest of retirement advisors. Specifically, advisors will have to meet requirements including:

- **Prudence:** Providing a professional standard of care to clients, even if they seek a BIC exemption
- **Loyalty**: Basing advice on customer interests, rather than their own financial interests or those of their firm.
- **Fees:** Charging no more than reasonable compensation
- **Transparency:** Making no misleading statements about investment transactions, compensation, and conflicts of interest.

Steady for now but changes likely

That is the state of play right now, but it is important to note that just because the rule is taking effect does not mean it will not change in the future. Indeed, following two comment periods, the first regarding the delay, the second considering questions raised by the February Presidential Memorandum on costs and benefits, the DOL now has a considerable amount of fodder for continuing to tinker.

"Both comment periods have generated intense volumes of response. Among the responses have been additional financial impact information from industry and consumer advocacy groups covering the full spectrum of support and opposition to the Rule as currently written. The DOL as yet has probably not had time to fully analyze all of these submissions nor has it shared (nor is it required as yet) any information on any internal analysis it may have done itself," says Andrew Bresheer, project leader for DOL fiduciary rule solutions at Broadridge Financial Solutions, a leading provider of investor communications and technology-driven solutions for financial advisors.

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Of course, no one knows yet what these changes might be. However, Hopkins speculates that the most likely amendments might carve out more exemptions from the fiduciary standard. "You could see a full repeal of the expanded definition of fiduciary. However, I think that is less likely," he says. "Instead, you could see much more expanded prohibited transaction exemptions (PTEs). For instance, you could see one that excludes the sale of any insurance product from fiduciary advice or you could see indexed annuities moved out of BICE into PTE 84-24. Furthermore, you could see some limitations on the class action lawsuits under BICE. So, I would expect the rule to stay in some form, but to carve out a lot more exceptions and exemptions from the rule, freeing up some companies from liability and regulation. However, at this point, it's all guesswork as to what the DOL might do."

Also, still in the works is the SEC's proposed rule on advice standards, and there is no real clue when that rule will be unveiled or what form it will take. The SEC, like the DOL, is in political flux. Says Bresheer, "The SEC is currently still short two commissioners even with the Chairman recently confirmed. My feeling is that the Commission will likely take up the concept of a Uniform Standard of Advice (will it be a Fiduciary Standard as currently written, not sure), but not until they get to the full complement of members."

Hopkins adds that the SEC is under many of the same deregulatory pressures as the DOL, with the House already plotting a full Dodd-Frank repeal. "A potential repeal of Dodd-Frank could end the need for an SEC rule. However, the SEC status as fiduciary enforcers could remain, even after a significant Dodd-Frank rewrite, so really this all remains uncertain and up in the air today as many of the people pushing the SEC to control the fiduciary landscape are also against Dodd-Frank," he says.

The industry is already adapting

Despite regulatory uncertainty — which has been relieved but not removed by the DOL's decision this month — the financial services industry continues to move towards a fiduciary standard.

According to Cerulli Associates the fee-based RIA channel, which already adheres to a fiduciary best interest standard, continues to draw assets away from all other managers. In 2015, the independent RIA assets grew by 6.2%, compared to an average of 0.9%. The historically commission-based wirehouse channel shrank by 1.9% during the same period.

Moreover, even the wirehouses are jumping on board. Merrill Lynch made headlines late in November 2016, when it announced that its advisors would no longer sell commission-generating mutual funds to retirement

accounts. Then early this year, when the final rule was announced, Merrill created a special class of retirement IRA that required a client BIC waiver, but could hold commission-paying funds.

Other big players are muscling into fiduciary services. For example, Fidelity has announced that it is taking on fiduciary responsibility for both plan-level and participant-level advice in DC plans with assets under $50 million, in some instances to the chagrin of the financial advisors who are selling the plan and who are also acting as fiduciaries.[1]

And, finally, new share classes are emerging to satisfy the DOL rule's transparency and fee containment provisions.

T shares charge the same commission for all asset classes. Normally stock funds have higher sales charges than bond funds, giving advisors an incentive to put clients in equities. By leveling the fee schedule, the theory goes, T shares should encourage advisors to invest according to their clients' needs and risk tolerances.

Clean shares completely eliminate distribution costs, such as 12-b-1 fees, from the pricing structures, allowing advisors to charge a separate fee for their a dvice and other services. Similar shares have been sold in the U.K. since commissions were banned in 2013.

In a FAQ written to provide guidance on fiduciary compliance during the transition periods, the DOL encouraged financial services firms to explore clean shares, writing, "Assuming the compensation is reasonable, such an approach is a potentially powerful means of reducing conflicts of interest with respect to mutual fund recommendations and correspondingly reducing the need for heightened surveillance around adviser conflicts of interest."

Bresheer says he thinks that clean shares, in particular, will have a significant impact on business practices. "First, I think that you're going to see a lot of share class consolidation and effectively extinction as the market moves to T and then Clean share classes. Second, I think that T shares are likely to be short-lived, and that the so-called 'Clean' classes become the direction longer term. Finally, I think this is all part of the more over-arching demand by the end consumer to understanding more transparently what the cost of their investments really is (whether it's in a retirement account or not)."

The next few months will likely be a period of experimentation, as firms and advisors look for ways to comply with the DOL rule while continuing to run their businesses profitably. "Costs will change. Products will change. Planning will change. A Fiduciary is all about getting paid for expert advice. This means you want low cost and high performing products as a fiduciary," says Hopkins.

Costs will change. Products will change. Planning will change. Fiduciary is all about getting paid for expert advice

[1] "Fidelity's approach to DOL fiduciary rule rankles some 401(k) advisers," by Greg Iacurci, Investment News, May 17, 2017.

The new normal

The DOL's decision not to delay the rule again only confirms what many industry observers have been saying all along, that the fiduciary standard is here to stay. "The genie is out of the bottle on this one and there's no putting it back. The reality is that being able to say that you're operating in a fiduciary manner and putting your client's best interests first is now something that's become a competitive advantage," says Bresheer. "If I were to look into my crystal ball, I'd bet within 12-18 months it becomes table stakes for retail wealth management. There are operational issues that the industry has real concerns about with respect to how the Rule is currently written, but I think the majority of the industry thinks that the concept itself is the right direction."

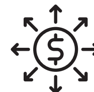
And for advisors who have not already started preparing, the time to get going is now. "Ever since this rule became law back in 2016, advisors have needed to start preparing for life as a fiduciary," says Hopkins. "First, it's the right thing to do, that being, act as a fiduciary. Now, you might not agree with how the DOL defines it, but you should agree that acting in the client's best interest is key."

He adds, "Today, advisors need to worry about documenting and making sure they have a solid process in place. This starts with gathering and documenting the correct client information. The next step will be providing good advice and good products at a reasonable fee. To me, that step requires re-education or in some cases, just education about best practices. Advisors need more education. That is a reality. To perform as a fiduciary, many will need to learn more in order to do the comprehensive planning required under the rules."

Here are some important steps that advisors can take right now to navigate the transition:

STEP 1: Review your book of business

Identify clients with IRAs, SEP-IRAs, Roth IRAs and other qualified retirement plans. Make sure you know which clients have purchased commissioned product from you in the past -- and plan to begin a discussion with them about your new requirements as a fiduciary.



STEP 2: Decide how you want to structure your business

Your clients may have already heard about the fiduciary rule, but most likely do not understand exactly how it will work. Emphasize that the new rule provides additional protection for them and that while you have always tried to do the right thing for them, you will be providing additional transparency and disclosure for their benefit.

STEP 3: Communicate with clients

Your clients may have already heard about the fiduciary rule, but much likely don't understand exactly how it will work. Emphasize that the new rule provides additional protection for them, and that while you have always tried to do the right thing for them, you will be providing additional transparency and disclosure for their benefit.

STEP 4: Get ahead of new rules on retirement plan distributions

The DOL rule substantially increases advisors' responsibilities regarding retirement plan rollovers. Advisors will be asked to ensure that the investments they select for a rollover are comparable or superior to the ones that are available in the corporate retirement plan. In some cases, it may even be advisable to suggest that your clients stay with their existing plan if the fees and investment options there are more attractive than the ones available outside the plan.

STEP 5: Familiarize yourself with new share classes

You may wish to introduce your clients to new share classes like T shares or clean shares. T shares have the same fees for all asset classes, while clean shares strip out distribution costs (and provide a mechanism for advisors to charge separately for their services). Currently, asset managers including American Funds and Janus offer versions of these share classes.

STEP 6: Educate yourself

The American College of Financial Services offers a DOL fiduciary training program, drawing on experts from law firms, industry groups, and financial planning experts to teach advisors how to comply with the rule and what a fiduciary process will look like in the future. You can access at the American University's website: https://www2.theamericancollege.edu/dol

STEP 7: Stay informed

The DOL has signaled that changes are likely ahead for the fiduciary rule, so you will need to keep current with any new amendments during the months ahead. Says Bresheer, "Align yourself with the pattern of the change and ensure that you're on track to comply with fundamental requirements of customer best interest. If you position yourself in that way, you will be able to pivot quickly to meet any unexpected changes, revisions or rescissions to the current Rule or any other changes (SEC Uniform Fiduciary/Advice Standard, etc.) that might occur in the near to medium term."

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