A SEISMIC SHIFT
HOW THE DOL’S FIDUCIARY RULES WILL UPEND FINANCIAL ADVICE AND WHAT ADVISORS SHOULD BE DOING RIGHT NOW TO PREPARE

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On October 7, Merrill Lynch announced the end of commission-based products in new retail retirement accounts, radically altering a retirement planning business central to the practices of some 14,000 advisors. After April 10, 2017, all new retirement accounts at Merrill Lynch will be fee-based rather than commission based, and existing accounts must be converted to the fee-based Merrill One platform (at reduced fees) or be frozen. Customers who have accounts that are frozen can retain commission-based retirement accounts, but they will not be able to buy or sell securities within them.

The move came in response to the Department of Labor’s new ruling that redefines the meaning of the term “fiduciary” and sets in motion sweeping new changes in how retirement accounts are sold, serviced, and managed. The new ruling, which takes effect on April 10, 2017, extends ERISA protections to individual retirement products like IRAs.

That is a vast market. As of September 30, 2016, the Investment Company Institute reported that there were $7.5 trillion in individual IRA accounts, slightly more than the $7 trillion in 401(k) plans. Morningstar analyst Peter Wong estimates that approximately $200 billion in assets are transferred to IRAs every year by individuals working with professional advisors, a business that will change dramatically when the new rules are implemented.¹

WHAT’S IN THE RULE?
The DOL fiduciary standard dispenses with an outdated five-part test to determine whether advisors are fiduciaries and defines anyone who provides advice on retirement plan investing as a fiduciary.

It states, “The Financial Institutions and Advisors must adhere to basic standards of impartial conduct. In particular, under this standards-based approach, the Advisor and Financial Institution must give prudent advice that is in the customer’s best interest, avoid misleading statements, and receive no more than reasonable compensation…. Additionally, Financial Institutions generally must adopt policies and procedures reasonably designed to mitigate any harmful impact of conflicts of interest, and disclose basic information about their conflicts of interest and the cost of their advice.”

Doug Baxley, Vice President of Compliance for independent broker dealer Securities Service Network (SSN) adds, “The new test expands who is considered a fiduciary to anyone making a recommendation.”

“That’s not only a recommendation to buy, sell or hold a security, but a recommendation to use an outside asset manager, specific investment strategy, or distribute or roll over assets. Really, anything more than saying, “hire me” will make an advisor a fiduciary.”

That means that all advice and recommendations must benefit the investor alone, not the advisor, and that any conflicts of interest have to be clearly communicated. At a minimum advisors need to tell their clients about any commissions they are earning for selling products and get them to sign a BICE or best interest contract exemption allowing them to do so. Just having to disclose that conflict is giving investment firms like Merrill Lynch pause, hence the halt on commission-based product in retirement accounts.

“Certainly this rule will change the industry, which has been rife with conflicts of interest, including allowing brokers to call themselves ‘advisors’ when their advice is subject to a mere ‘suitability’ standard rather than a ‘best interests’ fiduciary standard,” says Wally Head, Principal and Vice Chairman at Gresham Partners, a Chicago-based independent investment and wealth management firm with $5 billion under management, primarily serving family offices. “It is important to keep in mind that the DOL rule is final. The pro-posed new rule impacts only retirement accounts and as a result will tend to have more impact on investors with modest amounts of investments, all or most of which are in retirement accounts.”

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—WALLY HEAD, PRINCIPAL AND VICE CHAIRMAN AT GRESHAM PARTNERS
ACCELERATING THE SHIFT TO FEE-BASED BUSINESS

The new rule is likely to augment a movement already in progress away from sales-oriented, commission-based business towards a fee-based model that emphasizes advice. Cerulli estimates that assets in fee-based accounts have grown from $987 billion in 2003 to $2.7 trillion in 2013. Analysis from CLS Investments suggests that advisors already source more of their income from fees than commissions (46% versus 45%).

Compliance with the new rule is significantly easier for fee-based advisors, who are called level-fee advisors in the final language. “If you’re a fee-based advisor, you’re still going to have to make changes—nobody’s going to survive completely unscathed—but fee-based advisors are going to be okay,” says Jamie Hopkins, the Larry R. Pike Chair in Insurance and Investments at the American College of Financial Professionals and a co-director of the New York Life Center for Retirement Income.

Under the new rules fee-based advisors are required to create a written statement of fiduciary status to comply with the standards of impartial conduct, that is, act in clients’ best interests, and to document their reasons for the level fee arrangements they make with clients.

THE IMPACT ON ROLLOVERS

The new rule goes beyond making it difficult to sell commissioned products to retirement investors, says Hopkins. “The rule also expands the definition of investment advice for the first time ever to things that have nothing to do with investments. That’s a big thing that I don’t think a lot of people have focused on,” Hopkins explains. “It covers advice on how you invest your IRAs, but also includes the type of account you have, whether or not to do a distribution, whether you do a rollover. It’s really more about the tax consequences and how you efficiently hold assets.”

That means that advisors are just as liable for recommending that a client rollover assets as they are for investment decisions that follow. “In the past, there was always this general assumption that of course you rolled assets over,” says Hopkins. “If you’re talking to an advisor, that’s going to be the first thing they say, roll your money over and I’ll help you manage it.”

Under the new rules, though, advisors have to justify a rollover — which often comes out of a large, institutionally-priced 401(k) into a pricier individual account. Hopkins says that advisors are going to have to make a more nuanced case, setting positives against negatives.

“The advisor might say, ‘You need more diversification, more investment products, and we can provide you with more investment options.’ Or ‘Your 401(k) only has two distribution options. We have a lot of different annuity and distribution options,’” Hopkins thinks that most advisors are eventually going to have to offer more comprehensive planning, such as integrating the IRA with social security planning, developing a tax-efficient withdrawal strategy, or working out whether Roth IRA conversions make sense for their clients. Advisors who do not currently offer these services might require additional training and certification.

“There are a lot of advisors who are doing planning that right now don’t have the right skills to provide the advice that they’re providing,” says Hopkins. “They say that one of their value-adds is that they integrate Social Security and they help with tax efficiency. Do they have any training on social security or tax efficiency? If something goes wrong and there’s a lawsuit, you’re going to have to show that you were qualified to give that advice.” He notes that some firms are already requiring the retirement income accreditation, RICP, for all advisors who give rollover or distribution advice, and he believes more will add these standards as the regulation takes effect.

SHARING RISK, PROMOTING TRANSPARENCY

The new rule is likely to change the products that advisors recommend as they work to avoid the liability and risk that comes with high-fee, high-risk investments, like hedge funds and other alternatives. At the same time, the focus on fee transparency may accelerate the move into low-cost passive investments like index funds and ETFs. The DOL does not mandate that advisors recommend lower fee, lower risk investments, but it does insist that they disclose risks and costs fully and explain why investments are appropriate.

“In the past, higher risk always meant higher risk for the client,” says Hopkins. “I think higher risk today probably means higher liability for the advisor.” The new rule will probably cause some advisors to re-evaluate high risk investments like non-traded REITs. “Could you do it? Maybe,” says Hopkins. “But can you get pretty close to the same type of diversification elsewhere and not have to worry about it? Sure, why not do that?”

Wally Head says that the new rule won’t affect his clients’ use of alternative investments, since his firm has always acted in a fiduciary capacity, choosing investments that are in their best interests. “However, the performance of many high-fee alternative strategies on the large bank and broker/dealer platforms appear to have disappointed investors in them over the last several years,” he notes. “As a consequence, we believe it will be difficult for those platforms to continue to justify
**PREPARING FOR THE NEW RULE**

**THE DOL’S FIDUCIARY RULE** does not take effect until April, and there are still a number of lawsuits pending which challenge the regulation. However, given the complexity of complying most advisors should start to prepare. Here are five steps to help you get ready for the change in regulatory climate:

1. **Evaluate your business:** Now is a good time to look at your book of business. How much do you manage in commissioned product? How much in fee-based business? Are commission-based portfolios actively traded, or relatively dormant? Do you provide a lot of IRA rollover advice? Do you make heavy use of alternatives like hedge funds, private equity, or real estate? The impact that the DOL rule has will vary substantially from practice to practice. The more fee-based business you do now, the less you’ll have to adapt to the new regulation.

2. **Talk to your clients:** Your savviest clients are already hearing about the new DOL rule so there is no advantage in putting off a frank conversation with them about what this means for their accounts. If you have always acted in a fiduciary capacity, now is a good time to reinforce this idea. If you have run a primarily commission-based business, you will need to discuss strategies for transitioning (or grandfathering) existing accounts with your clients.

3. **Decide which accounts to grandfather:** The DOL ruling provides some flexibility for existing commission-based accounts; so that investors who have already paid commissions on funds do not have to pay again for fee-based investments. Retirement assets can remain in commission-based accounts as long as the advisor does not give investment advice, and as long as the investor does not buy or sell additional assets (automatic monthly investments set up before April 2017 do not count). If you have clients in high-cost, front-loaded vehicles, like variable annuities, it will probably make sense to keep them there.

4. **Prepare BICE documentation:** You will need a best interest contract, or BICE, for every client you serve. The BICE will include a written statement of fiduciary status and a written rationale for why each recommendation is in the client’s best interest. Streamlined BICE’s are available for fee only or level-fee advisors. There is a transitional BICE for firms that will not be able to comply with the full BICE by April 2017.

5. **Think about training:** A fiduciary model requires additional expertise, not just in investments, but retirement income planning, social security integration, and tax-sensitive distribution strategies. Advisors who want to offer this kind of holistic advice should consider certifications like RICP (Retirement Income Certified Professional) or CRC (Certified Retirement Specialist).

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and place these high-fee strategies, which would be a positive result for the investors the new rule is designed to protect.”

**Turning disruption into opportunity**

There is no question that the new DOL fiduciary rule will be disruptive. Some analysts suggest that it may cost more than $10 billion for the industry to comply, but for forward-thinking advisors it may also represent opportunity.

Hopkins thinks that younger millennial advisors may be poised to benefit as older ones retire, rather than transitioning their practices to a new model. He points out that fee-based businesses consistently earn higher valuations than commission-based ones because of their more predictable income stream. Most important, he says, the new rule will improve the way that financial advice is delivered.

“Comprehensive planning is better and this is going to give people the opportunity really to do better planning,” he explains. “When we’re giving customers better planning and we’re protecting the customers’ assets and making them more financially secure – that’s good for the advisor. We don’t want them to run out of money. If they run out of money, the advisor doesn’t get paid either. It’s a better system for consumers if we can provide better, more comprehensive advice. That’s ultimately good for the advisor, too.”

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**“WHEN WE’RE GIVING CUSTOMERS BETTER PLANNING AND WE’RE PROTECTING THE CUSTOMERS’ ASSETS AND MAKING THEM MORE FINANCIALLY SECURE – THAT’S GOOD FOR THE ADVISOR.”**

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