How to prepare for the Department of Labor's Conflict of Interest Rule

Insights into what the rule means for financial advisors—and a five-step roadmap for creating a comprehensive fiduciary program before the December 31, 2017 deadline.

Philip Pyburn & Titus Bocseri

Slalom Cross-Market

slalom

The rule

The Department of Labor (DOL) Conflict of Interest Rule, which became effective on June 7, 2016, represents the single most profound change to retirement savings in the U.S. since the Employee Retirement Income Security Act of 1974 (ERISA). The rule is based on the department's belief that the investment advice provided to retirement investors is too costly, and that these excessive costs are largely the result of conflicts of interest that pit advisors[1] benefits against investors' best interests.

The rule requires that each advisor act as a fiduciary for their clients and give advice regarding account type, investments, rollovers, etc. that are **exclusively in the investor's best interest**. This advice must be prudent under the circumstances, provided for the sole benefit of the investor, and made without regard to the advisor's financial or other gain. Advisors must adhere to the Impartial Conduct Standard, which requires that they:

- Disclose the actual total cost of investment advice (not just pricing and fee schedules)
- Disclose how advisors are compensated
- Make no misleading statements
- Eliminate incentives that create conflicts of interest
- Implement policies, procedures, and systems to implement the Impartial Conduct Standard and prevent violations

While the rule doesn't explicitly define "best interest," it can be assumed that it must be determined relative to each investor's investment objectives, risk tolerance, financial circumstances, income requirement, etc. For example, a retired IRA investor will likely have a different best interest than a mid-career 401(k) plan participant. One of the challenges firms that wish to create a fiduciary program are facing, is determining each investor's best interest so advice can be targeted accordingly.

---

1. In this paper, we will use the term "advisor" to refer to any individual or firm that provides advice to retail retirement investors, including RIAs, brokers, and insurance agents.

Strictly speaking, the rule prohibits all "conflicted" compensation for investment advice, including commissions and other forms of compensation that have the potential to benefit the advisor at the expense of the investor. For example, a compensation program that pays the advisor a commission for securities transactions gives the advisor the incentive to keep each account fully invested even when the investor's best interest could be to maintain a significant cash position. Because the advisor is not compensated for cash in this example, there's an in-build conflict of interest.

Leading up to the final rule, the department received a number of comments indicating that eliminating conflicted compensation entirely would leave the vast majority of retail investors without a source of investment advice. Therefore, the department proposed a Best Interest Contract (BIC) Exemption to permit such compensation under certain circumstances. To rely on the BIC Exemption, the advisor must acknowledge their fiduciary status, adhere to the Impartial Conduct Standards, and receive no more than "reasonable" compensation. It's important to note that a Best Interest Contract does not relieve the advisor of its general fiduciary duties; it only permits certain forms of conflicted compensation that would otherwise be prohibited.

Compliance

Unlike many regulatory pronouncements, the DOL Rule offers little normative guidance on how the principles described in the rule are to be interpreted and implemented. What's an investor's best interest, and how should it be determined? How should the Best Interest Contract be worded, and how should it be communicated to the investors? What is "reasonable" compensation? How does our compensation compare to the rest of the industry? Is the compensation "reasonable" relative to our costs, relative to the industry?

Without normative guidance, it's difficult to know if you're in compliance with the fiduciary requirements. One man's reasonable cost is another man's excessive gouging. A recommendation that seemed prudent at the time may appear imprudent as events unfold. A suggestion to invest in a fixed indexed annuity may make perfect sense until the investor discovers that the agent made a hefty commission on the transaction.

And the winner is...the plaintiff's bar!

An interesting aspect of the DOL Rule is the near-complete absence of reporting requirements, fines, and other sanctions. Unlike almost all other regulatory pronouncements, the rule contains no significant reporting requirement, no fines or other sanctions for non-compliance, and no demand for independent audit and review. In other words, there's nothing in the rule that would compel financial advisors to comply.

If the regulators aren't going to compel firms to abide by the rule, why would anybody disrupt their fee structures, compensation plans, and client communications to comply? The answer, we think, is primarily the threat of a class action lawsuit.

With more than $25 trillion in retirement assets and $300 billion in fees, you can be assured that law firms all across America are gearing up for inevitable class action suits. In fact, one attorney we spoke with estimated that the cost of these suits could dwarf the tobacco litigation.

Creating a fiduciary program

The lack of normative guidance and compliance by litigation combine to suggest three things for a fiduciary program:

1. Cost and value

The rule makes it clear that an advisor need not be the lowest cost provider for fees and costs to be "reasonable." This suggests that fees and other costs can be reasonable if they're based on:

- The actual cost of services
- The value of those services to the investor
- An investment services agreement that clearly spells out the services to be provided (and not provided) and the cost of those services for the investor

2. Compliance is relative

Because the rule applies to any organization or individual that makes recommendations to retirement investors, it's important to construe the "retirement industry" broadly. When evaluating fees, compensation plans, and other aspects of an advisory program, it's critical to consider firms outside of your traditional competitors. An important aspect of a defensible position in a class action will undoubtedly be the ability to compare products, services, costs, and compensation across all advisor types.

3. Compliance is risk-based

Decisions about a fiduciary program, and especially about fees and compensation, should weigh the financial and reputational costs of an excessive-fees class action against the cost of proposed changes. For example, setting fees at the 25th percentile of industry standard may reduce the likelihood and severity of legal action but could have disastrous consequences on the firm's finances. Setting fees at the 95th percentile, on the other hand, will likely have the opposite effect. As part of a firm's decision-making, it may want to consider "de-risking" the book of business to eliminate those investor/product categories that are most likely to be problematic—e.g. product X for retired IRAs or all 401(k)s in a certain industry.

What may have to change

While the full extent of the rule won't be known for some time, implementing a fiduciary program will be a significant undertaking for most firms. At minimum, changes can be expected in products, distribution pricing, field compensation, advisor training, point-of-sale disclosure, and client communication. In addition, compliance and reporting systems need to be reviewed, and likely enhanced, especially for sensitive transactions like rollovers, replacements, and account-type changes.

The results of a recent survey[2] confirm the magnitude of the expected impact:

---

2. *The Proposed Fiduciary Rule: Advisors' Perspective, DOLviewpoints, LIMRA Secure Retirement Institute, 2016.*

Impact on advisors

- 60 percent believe the rule will have a negative impact on their businesses, and 54 percent say they will be forced to drop or turn away small retirement investors. At a time when older advisors are retiring or otherwise leaving the business, this can only make recruiting the next generation of advisors that much more difficult.
- 45 percent indicate that they will be more sensitive to product costs, and 37 percent expect to make greater use of passively-managed funds. 27 percent indicate they will sell fewer annuity products.

Impact on products

- 54 percent expect to either reduce or consider reducing the number of products offered. Only 8 percent expect to increase the number of products they offer.
- The biggest impact will be on the Qualified Variable Annuity market. 73 percent believe the rule will require moderate to significant changes in the sale of variable annuities.
- Indexed annuity sales are expected to fall by 30 percent or more in 2017 as advisors react to the DOL Rule, a revenue drop of more than $17 billion.[3]

Impact on fees and compensation

- 43 percent believe that the biggest impact of the fiduciary regulations will be required changes to incentives and field compensation practices. An equal number believe that excessive costs and compensation practices will expose the firm to litigation unless significant changes are made.
- 90 percent predict a moderate to significant increase in clients' interest in fee-based services.

3. *Indexed annuity sales projected to plummet 30% because of DOL fiduciary rule, Investment News, Greg Iacurci, 8/2/16.*

In other words, complying with the DOL Rule implies a comprehensive review of every aspect of your operating model that touches the retail retirement investor.

Some of the issues to consider

Area	Issues to Consider	Area	Issues to Consider
Pricing & Fees	• Determining reasonability • Industry relative pricing • Pricing based on service value • Simplified firm-wide pricing	Products	• Standardized pricing across products • Compensate for holding cash • Product justification by client segment • De-risk product/client segment
Compensation	• No variable compensation • No link between comp. & production • No progressive compensation • No contests, trips, etc.	Distribution	• Advisor policies & procedures • Agent/broker/advisor agreements • Training programs (ongoing) • Change management programs
Promotion & Client Comm.	• Ads & promotional material • Investor services agreements • Best interest contract • Disclosing fees & compensation • Client reporting	Operations	• Contemporaneous industry comps. • Compliance policies & procedures • Transaction monitoring & analysis • Disaggregated back-office data • "Best Interest" analytics • Compliance dashboards & reporting

Next steps: a five-part program

To prepare your organization for the implementation of the DOL Rule, you should consider the below five-part program. It will help you evaluate your current operating model, decide how elements of that model must change, and develop a fiduciary program to implement those changes by the deadline, December 31, 2017.

> *"60 percent believe the rule will have a negative impact on their businesses, and 54 percent say they will be forced to drop or turn away small retirement investors."*

1. Evaluate pricing and compensation

As noted above, the department created the rule to address the total price of advisory services paid by retirement investors. The first step in developing your fiduciary program is to document the total actual charges paid by your investors and compare them to those of other firms serving retirement investors. Your ability to demonstrate that the total amount paid was "reasonable" under the circumstances means that you need to determine the sum of all of the fees, commissions, and other charges paid by actual investors—not just review your fee schedules. Even a flat commission schedule can result in "unreasonable" costs if a portfolio has too many holdings or is churned often.

To conduct this price and compensation diagnostic, you should:

- Determine the total actual charges incurred by your retirement investors over the prior year. This analysis should be made at the investor level and should include the total compensation paid to advisors for all activity related to that investor. The department's concern is with the costs paid by the investor, so you may need to aggregate across multiple accounts if the investor has several. This data should then be aggregated by investor segments—small 401(k), retired IRA, etc.—and presented in a way that patterns can be visualized and evaluated.

slalom

- Compare your data to that of other firms offering investment advice to retirement accounts. This analysis should be conducted by investor segments to identify costs that are significantly higher or lower than the industry. For example, you may discover that while your average account costs are mid-pack, your account costs for retired IRAs with less than $250,000 are in the 95th percentile.

2. Revise the operating model

With the results of the pricing and compensation analysis, it's time to establish a design and decision-making process based on those facts. While the number and magnitude of these decisions will vary from firm to firm, it's important for the process to be well-documented so you can demonstrate that the decisions made were based on the facts at the time and were not arbitrary or self-serving. When it comes to pricing and compensation changes in particular, senior executives need to have a forum to discuss the issues at hand, the time to weigh the consequences, and the responsibility for making the necessary choices. While it may seem easiest to postpone the hard choices for now, it's important to keep in mind that the pressure to explain the rationale for the firm's pricing and compensation decisions is lower now than during the discovery phase of a class action lawsuit.

Depending on your circumstances and the facts uncovered in step one, you may want to establish separate teams to evaluate elements of the operating model and to create alternative designs to reduce the firm's exposure to excessive fee class actions. Given the department's central focus on retirement plan costs, it's likely almost every firm will need to make some changes to the way it prices its services and the way it compensates advisors (both captive and independent). You may want to consider:

- **Investor segments**—De-risking the book of business to reduce or eliminate certain retirement investor segments that pose a significant risk that cannot be mitigated by pricing or compensation changes.
- **Products**—Removing certain products from the menu of available options for retirement investors or creating new products (e.g. overlay strategies) to customize the desired risk and return profile for retirement investors at an overall lower cost.

- **Distribution channels**—Curtailing distribution through channels that will be difficult to control or channels where participants must pay to play with account or transaction minimums or other tiered incentives. You might also want to consider limiting the products that can be distributed through certain channels.

3. Create the infrastructure for day-one compliance

In this step, the DOL team develops the infrastructure needed to implement the decisions that come out of step two, with an emphasis on day-one compliance. As I noted earlier, your response to the DOL Rules will be evaluated relative to the industry, so your approach will necessarily evolve over time. That said, given the April/December 2017 deadlines, your immediate attention should be focused on the things that must change between now and then.

This is the step where most of the heavy lifting occurs. High-level decisions about pricing, compensation, and client communication need to be translated into detailed actions by individuals throughout the organization. While many of these changes will have the biggest impacts on client-facing staff, it's important to consider the impacts on product development, agent/advisor appointment, and other operational functions as well.

The tasks in this step fall into three broad categories:

- **Policies**—Document policy decisions and validate with senior management.
- **Processes and procedures**—Revise level 3/4 processes as necessary to implement the policies and develop detailed operating procedures for those processes.
- **Technology**—For day-one compliance, identify the minimally-sufficient IT modifications that will be required to support the revised processes.

4. Employee-centered change management and training

Any program with broad impacts across an organization will require a significant change management effort to be successful. Given the breadth of changes identified in step three, a successful rollout of a fiduciary program requires addressing issues beyond just tactical training, to embed new ways of working while proactively mitigating negative productivity and employee engagement impacts that such change often creates.

Consider an employee-centered change management approach that seeks to help them understand how the changes affect them, give them the skills to address those changes, and teach them how to do their jobs with new procedures, guidelines, and systems.

5. Contemporaneous monitoring and management reporting

Ultimately, the success or failure of your fiduciary program will rest on the actions of the people in your organization. While it's difficult to monitor every communication that frontline staff and advisors have with investors, the consequences of those communications are observable in terms of the documents they exchange, the accounts created, and the transactions made. The final step in a comprehensive fiduciary program is to establish a monitoring and reporting system that:

- Identifies suspicious activities (and patterns of activities) that might reflect violations of the firm's guidelines as they occur
- Includes a process for analyzing the suspicious activities to determine whether there is real cause for concern
- Reports problematic cases to management for corrective action

Those with broader compliance responsibilities will see a parallel between these processes and those employed to detect, analyze, and report money laundering. There are different rules, analytics, and report recipients, but the same basic structure.

> *"Ultimately, the success or failure of your fiduciary program will rest on the actions of the people in your organization."*

While these activities represent the final logical step in the creation of a fiduciary program, they're not something that should be left to the last minute or treated as an afterthought. Given the volume of activity that must be monitored and the extent of data to be retained, this element of the program can require significant system development activities that take months, if not years, to complete. The IT organization should therefore be included in the fiduciary program from the beginning to provide as much lead-time as possible.

About Slalom

Slalom is a leading consulting firm that helps companies solve business problems and build for the future, with solutions spanning business advisory, customer experience, technology, and analytics. Slalom is passionate about helping its clients succeed, collaborating every step of the way to deliver amazing results—together. Founded in 2001 and headquartered in Seattle, WA, the company has organically grown to nearly 4,000 employees and has offices in 25 metropolitan cities near you, including London and Toronto. Learn more at www.slalom.com.

About the author

Philip Pyburn

Philip Pyburn is the Practice Area Director of Capital Markets and Compliance on Slalom's Cross-Market financial services team. Phil has over 25 years of experience serving clients in capital markets, asset management, insurance, and wholesale/corporate banking. He earned graduate degrees in Finance and IT at M.I.T. and Harvard, and he is a Certified Anti Money Laundering Specialist (CAMS). You can contact Phil at phil.pyburn@slalom.com.

Titus Bocseri

Titus Bocseri is a Managing Director in Slalom's Cross-Market Insurance Practice. He has over 20 years of insurance experience centered on Life, Annuities, Retirement Services, and Wealth Management. Titus has helped insurance carriers accelerate development and the introduction of products and services, lower costs, comply with changing regulations, and better align business and technology investments. He holds an MBA from Columbia Business School with a dual emphasis on Corporate Strategy and Finance. You can contact Titus at titusb@slalom.com.