NAVIGANT

INSURANCE AND INVESTMENT MANAGEMENT

navigant.com

About Navigant

Navigant Consulting, Inc. (NYSE: NCI) is a specialized, global professional services firm that helps clients take control of their future. Navigant's professionals apply deep industry knowledge, substantive technical expertise, and an enterprising approach to help clients build, manage and/or protect their business interests. With a focus on markets and clients facing transformational change and significant regulatory or legal pressures, the Firm primarily serves clients in the healthcare, energy and financial services industries. Across a range of advisory, consulting, outsourcing, and technology/analytics services, Navigant's practitioners bring sharp insight that pinpoints opportunities and delivers powerful results. More information about Navigant can be found at navigant.com.

THE DOL FIDUCIARY RULE – ARE YOU READY FOR THE CHANGES?

NO SMALL ISSUE

On April 8, 2016 the Department of Labor ("DOL") published its new fiduciary rule ("Rule") governing 401(k) plans and Individual Retirement Accounts ("IRAs") in the Federal Register and becomes law on June 7, 2016. Compliance with the new fiduciary definition will not be required until April 10, 2017, with exemptions phasing in through January 1, 2018. The Rule will drastically change how financial advice is provided in the United States. The Rule will place intense pressure on financial advisors to change the traditional advisory model from commission to fee-based compensation and will substantially change product fees and features. Some financial services institutions have decided to exit their retail broker-dealer business altogether to avoid the perceived risk, liability, and increased costs of compliance.

This article provides a high-level examination of the Rule and outlines how market participants can prepare themselves to address the shifts.

WHY THE CHANGE?

Based on its own studies, the DOL believes that the use of high-cost and commission-based products, together with the conflicts of interest that come along with them (advisors being paid by the products rather than the clients), are costing billions of dollars in lost retirement assets.[1] In its impact analysis, the DOL indicates that the under-performance of mutual funds acquired by IRAs in a conflicted model will cost retirement investors more than $210 billion over the next 10 years.[2]

1. Proposed Rules 29 CFR Parts 2509 and 2510 as published in the Federal Register April 20, 2015
2. Ibid.

WHAT DOES THE NEW RULE DO?

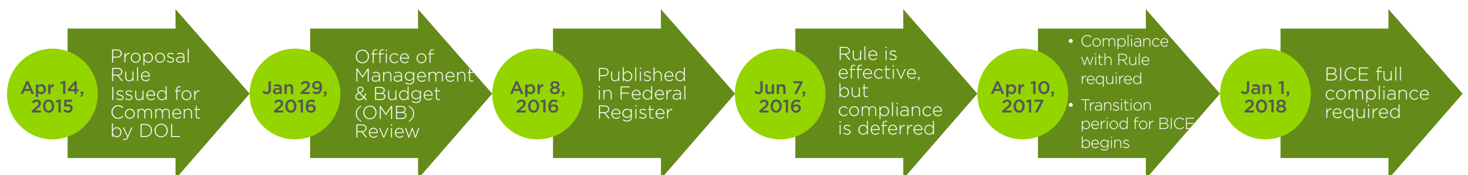
The Rule requires any financial advisor providing advice and guidance over 401(k) and IRAs to deliver that advice as a fiduciary. This means putting the interests of the client first, before the advisor's own interests or those of the advisor's firm.

The Rule mandates disclosure of conflicts of interest to the investor, particularly disclosures of compensation from third-parties to financial advisors and their firms, including hidden fees and revenue sharing agreements (generally compensation paid by product manufacturers or sponsors). Furthermore, it eliminates loopholes that permit broker-dealer reps to provide advice under the existing "suitability standard," which does not require the advisor to put the interests of the client first.

Lastly, the DOL will require advice to be provided to IRAs and 401(k) plans on a fee-based or flat-fee basis (similar to the existing model of Registered Investment Adviser ("RIA") firms).

Although the DOL rule will not cover assets outside of 401(k), IRAs, and certain other retirement accounts, the Dodd-Frank Wall Street Reform and Consumer Protection Act requires the Securities & Exchange Commission ("SEC") to develop a fiduciary standard which would cover all investments in securities. The SEC has publicly indicated that it will propose a fiduciary standard rule for comment in the latter part of 2016. We do not yet know if the SEC version will mirror the DOL Rule, but it is clear that it is only a matter of time before all investor assets will be covered by some form of fiduciary standard.

WHAT IS THE TIMING?



WHO WILL BE IMPACTED?

The Rule is focused on advisors and product providers to primarily 401(k) plans, participants, and IRAs. This includes:

- RIAs and their firms;
- Product manufacturers such as insurance companies that provide variable annuities, and mutual fund sponsors and asset managers, to the extent these products are sold to 401(k) accounts and IRAs; and
- Registered representatives and their broker-dealer employers advising retirement assets.

WHY IS IT IMPORTANT?

- The Rule explicitly prohibits an advisor from receiving commissions or other compensation from products (mutual fund sales loads, variable annuity commissions, 12b-1 trails, etc.) in retirement accounts.
- There is an exemption to the prohibition on receiving such variable rate compensations called the Best Interest Contract Exemption ("BICE"). The BICE states that if the advisor or broker-dealer can document that they are acting in the client's best interests, a commission-based product can be utilized as long as the firm provides disclosures in a disclosure document (for 401(k) plans and participants) or contract (for IRAs). The disclosure must:
  1. State the advisor and firm are fiduciaries;
  2. Commit the firm and advisor will act in the client's best interest, including receiving no more than reasonable compensation;
  3. Warrant the firm has adopted policies and procedures that identify and mitigate conflicts of interest; and
  4. Clearly and prominently disclose conflicts of interest (like hidden fees or backdoor payments) and must direct the client to a webpage disclosing, among other things, product fees and costs, compensation paid to advisors by their firms, and the compensation arrangements between any third-party (e.g., the product provider) and the advisor and firm.

WHAT IS THE INDUSTRY IMPACT?

For fee-based advisors and their firms

- Ensure business models meet the fiduciary standard and other requirements of the rule; or
- Choose not to advise on assets covered by the rule.

For commission-based advisors and firms

- Decide whether to continue to using commission-based products going forward and comply with the BICE, which can impose multiple challenges including:
  1. Articulating and documenting that the use of higher cost or commission-based investment products — especially in cases where lower cost alternatives are available — is in the best interests of the client;
  2. Increasing compliance surveillance to ensure the advisor and firm are adequately implementing the exemption;
  3. Implementing policies and procedures designed to identify and mitigate conflicts of interest and detect and correct violations; and
  4. Identifying, collecting, disclosing, posting on a website, and maintaining all compensation arrangements between the firm and its advisors and product sponsors and any other third-parties compensating the firm and its advisors;

or

- Provide products that do not contain any direct or indirect compensation.

WHAT SHOULD YOU START DOING NOW?

If you are an advisor to or distributor of products to 401(k) plans, plan participants, and IRAs:

- Assess whether the cost of compliance and risks of non-compliance affect how you want to meet the requirements of the Rule (move to fee-based, continue to use commission products, or exit the business);
- If not exiting the business, inventory and assess your conflicts of interest and develop the mechanisms to report them in accordance with the Rule and BICE (if applicable);
- If you choose to use the BICE, update your regulatory compliance policies and procedures and provide training to all personnel to ensure that you comply with the requirements. This involves providing advice in accordance with the fiduciary standard, ensuring that you are capturing, disclosing and reporting all conflicts of interest and fee arrangements, and designating individuals to review and monitor transactions with 401(k)s and IRAs;

and

- If you are a product manufacturer, you will need to provide multiple solutions for both your fee-based and commission-based distribution channels. Even if firms continue to use commission-based products, there will likely be pressure to lower commissions and fees on products so that they are reasonable and there is not a wide disparity across products, and among product types. You will also need to prepare to assist distributors with fiduciary education and support for identifying and disclosing all of the conflicts of interest.

HOW NAVIGANT CAN HELP

- Strategy development, business model assessment, and business options assessment;
- Target operating model design;
- Compensation model analysis, assessment, and design;
- Compliance program design and implementation;
- Assessment of existing programs and development of gap analyses (risk-based or rules based);
- Gap remediation;
- Integration of multi-regulator regimes;
- Compliance program testing and reporting;
- CCO support (annual report preparation, formulation of policies and procedures, implementation of new disclosure standards);
- Data governance and data management; and
- Large scale project management.

The opinions expressed in this article are those of the author and do not necessarily represent the views of Navigant Consulting, Inc. Neither Navigant nor the author assume responsibility for legal advice nor make any representations concerning interpretations of either the law or contracts.

©2016 Navigant Consulting, Inc. All rights reserved. 00005600

Navigant Consulting is not a certified public accounting firm and does not provide audit, attest, or public accounting services.
See navigant.com/Licensing for a complete listing of private investigator licenses.