The View from the (DOL) Trenches

By Kerry Pechter *Thu, Nov 3, 2016*

'"Many of the broker-dealers are still searching for a light switch in a dark room," said James Lumberg of Envestnet, who, with Jeff Schwantz of Morningstar and Arjun Saxena of PwC, explained to asset managers in Boston how the DOL rule is impacting their distributors.

Just a few years ago, mutual fund companies happily anticipated the "rollover opportunity"—a windfall that would come from managing the trillions of dollars in Boomer savings that were pouring out of 401(k) plans and into retail IRAs. "Capturing Rollovers" was their mantra.

Asset managers' euphoria ended last spring, however, when the Labor Department released the final version of its conflict-of-interest rule. Starting in April 2017, the business of selling mutual funds to retail IRA clients will be held to nearly the same ethical standards as selling mutual funds to participants in qualified plans.

Financial services companies, especially the brokerage sector where employee-advisors earn commissions from manufacturers on the sale of funds and annuities, are now adjusting to the new rule. The actions of these distributors will have a big impact on the asset managers and insurers who rely on them to market their mutual funds, ETFs and annuities.

In Boston two weeks ago, hundreds of dark-suited mutual fund company executives gathered for the Money Management Institute's Fall Solutions conference. During one general session, they heard experts from Morningstar, PwC and Envestnet—firms that are helping guide asset managers and broker-dealers through the DOL transition—share insights from the front lines of the disruption.

Jeff Schwantz of Morningstar, Arjun Saxena of PwC and James Lumberg of Envestnet described a world where broker-dealers' product shelves will shrink, fund companies will condense their offerings, advisor compensation and revenue-sharing will be "levelized," holistic planning will replace investment selection as advisors' core competence, and compliance teams will call on IT departments to help them document and, if necessary, defend every step of the advisory process.

Shrinking product shelves

Saxena (right), a principal in PwC's New York office, predicts that a lot of actively managed funds with high expense ratios and rich front-end loads will simply vanish. "At broker-dealers using the BIC exemption and offering commission-based retirement accounts, here will be a constrained product shelf—mutual funds and annuities—for retirement clients, and the box of allowable financial advisor discretion on pricing will also get smaller," he said.

"If firms used to have 4,000 mutual funds available for retirement investors, in the future they will have one-fourth fewer funds," he added. "At the same time, the fund manufacturers will take a hard look at their own lineups, and they will merge or kill the so-so performers or the ones that had high fees or low take-up by investors. It's probably healthy. At one time, there were more funds than listed equities in the US market."

Commissions are likely to be standardized across products. "Broker-dealers are looking for BIC-friendly share classes. They are having discussions about mutual fund share class design with asset managers. Right now you have gradation in fund design. When one asset manager has a class A US mid-cap equities fund that pays a 3.5% front-end load, another has a 2.5% load and another has a 4.5% front-end load, it's hard for a wealth manager to say that there's no conflict of interest in choosing among them," Saxena said.

"The easy way for a broker-dealer to offset that conflict is to say, here's our new preferred standardized design, and have that new share class design uniformly apply to all asset managers who want be on the brokerage IRA platform MF product-shelf going forward."

Saxena added, "The reality is that the need for risk mitigation will force broker-dealers to lean more toward simpler products in retirement accounts, and their advisors will do the same. That's the direction we'll see over time. If you want to see the future, just look at the 401(k) world. Three, five or seven years out, the IRA space will likely look a lot closer to that."

Revenue-sharing will be levelized

Just as commissions that broker-dealers pay advisors will be standardized, so will the revenue-sharing dollars that fund wholesalers pay to broker-dealers, Saxena said. “Previously, a top asset manager might have paid a wirehouse a couple of million dollars in annual platform access fees. That payment might have allowed the asset manager to present at advisor sales conference or make a certain number of wholesale calls on the broker-dealer,” he said.

“There will be discussions and negotiations between broker-dealers and asset managers. The larger distributors that have critical mass will have the most negotiating leverage. They will be the market makers. That’s the process that’s underway now. There’s no easy way around it,” the PwC principal added.

Broker-dealers exercise control

Depending on their relationships with their advisors, broker-dealers may try standardize the processes that advisors use with clients, if only to simplify their new compliance responsibilities under the DOL rule.

“It remains to be seen how prescriptive around financial planning the [distributors] will get,” said Jeff Schwantz, head of Advisor Solutions, North America, at Morningstar. “Will there be one financial planning solution utilized for all clients? Some firms will go with full-fledged planning. Some firms will adopt a single sales process that they feel good about. If you’re a wirehouse wealth manager or a captive advisor, the sales process is already prescriptive and homogeneous. If you’re an independent advisor, you have historically had more autonomy to provide advice and a wider choice of products.”

Saxena noted, “Some advisors are used to running their own franchise, but that box has gotten smaller. Their employers will be saying, ‘I’ll take a more active role in deciding which funds get to stay on my product shelf or not for retirement clients.’”

‘Ripple effect’

Changes in one link of the fund distribution chain will inevitably force changes in other parts—in ways that no one can currently predict, according to Schwantz (below left). He wonders what will happen if advisors start charging by the hour or go on retainer instead of charging on the basis of account value.

"How soon will the phenomenon of 'episodic advice' become the norm, and how will it affect others in the product chain? It's a challenging problem," he said. "If advisors start charging retainers, how will other service providers in the chain be affected? The other service providers might not be aligned to that model.

"For instance, today, financial institutions incur clearing and trading fees and today pass those fees along to the client. That creates friction points. If the client is paying the advisor a flat retainer, the way attorneys and other professionals are paid, but a service provider is aligned to fees that are expressed in basis points, the friction intensifies. How will that put pressure on firms that are wed to a basis-points model? How will they unwind that model and stay relevant as providers?"

Holistic financial plans

It's widely agreed that one-off product sales will be hard to defend under the DOL rule. To justify a product recommendation, the advisor will have to show that the product plays a logical role in a comprehensive plan, and then show that the plan is in the client's best interest.

"The focus has been moving from the product view to the portfolio view to the household view," said Schwantz. "Advisors will have to answer the questions, 'How does the product work in the portfolio? What purpose does it serve?'

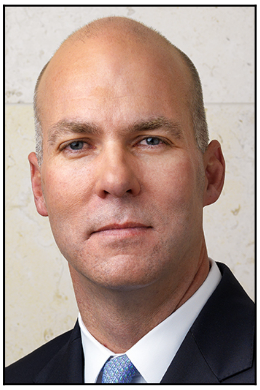
"The DOL doesn't see how 'best interest' can be delivered without a plan," said James Lumberg (below right), co-founder and executive vice president at Envestnet, the Chicago-based technology platform provider. "Knowledge of the client, the creation of a plan, the implementation of the plan—documenting each of these will be part of documenting best interest. Tying what you've done back to the client's specific situation will be an important part of showing due diligence."

A single standard for all accounts

Increasingly, industry members are predicting that the standards set by the DOL rule will eventually apply to all accounts, IRA and taxable. In a world where many clients have both kinds of accounts, and where advisors are trying to be more holistic, it's awkward to do otherwise.

“If the advisors put their “white hats” on for retirement accounts and take them off for non-qualified accounts, there’s a difference in client experience,” Schwantz said. “Morningstar surveyed broker-dealers in January through March. They were evenly divided in how they would deal with two different experiences. But a more recent survey showed that approximately 80% of the firms say the sales experiences will be similar and not differentiate between retirement and non-qualified accounts.”

This means signing the Best Interest Contract and accepting the liabilities that go with it. “Early on, we heard people saying, ‘We won’t use the BIC. We won’t put ourselves in that position,’” Lumberg said. “They were driven by a desire for risk avoidance and by ignorance about the BIC. But as they’ve become more comfortable with the rule, they’ve decided that they’d rather use the BIC [and take the risk of lawsuits] than risk being out of compliance [and vulnerable to DOL action]. We’re hearing more and more firms saying, ‘We’ll BIC everything.’”



“To have two stories is not workable long-term,” said Saxena. “You need a unified client experience. It’s more a practical problem for advisors than a regulatory requirement. It’s difficult for an advisor to tell clients that their advice on taxable accounts is different from their advice on pre-tax accounts. You will see many firms offering similar if not the same product offerings on taxable and pre-tax accounts. There’s an expectation that, perhaps in 2018, the SEC will act to harmonize its regulations with the DOL’s.”

Document your process

Because the DOL rule gives investors the right to sue for violations of their best interests, brokerages need to start preparing now for the class action lawsuits they may face in four or five years. That means integrating currently unconnected data sets and configuring information technology systems to do so.

“ERISA standards by their nature are prudent process-driven,” said Schwantz. “Financial institutions need to carefully scrutinize their decisions within their value chain and then document those decisions in writing. Show your investment committee process. Show all the analyses that you did. Show how you arrived at the recommendations you made to clients.

“That’s what most organizations are thinking now. They’re appointing BIC officers, and trying to show, ‘Here are all the processes within the value chain on how we use to show clients that our advice is in their best interest. That’s the risk mitigation process. And it’s likely to require new information technology to scale,” he said.

“Under the suitability standard, firms weren’t necessarily capturing the rationale for their advisors’ recommendations,” Saxena said. “Now the compliance departments will say, ‘You have to capture the data about the clients’ circumstances and the advisor recommendations starting at the point of sale, and then retain it for at least six years.’”

Simplicity is better

Financial institutions are racing to become compliant with the DOL rule by either the preliminary deadline next April or the hard deadline on January 1, 2018, but some have a lot of work to do. “Many of the broker-dealers are still searching for a light switch in a dark room,” said Lumberg. “They’re not as ready as they should be.

“I’m seeing two approaches to the rule among broker dealers. One approach is to say little about the DOL change, lie low, and promise nothing to clients. The other is to come out and offer a robust new value proposition. So it’s both a burden and an opportunity.”

He tends to look on the bright side. “The DOL rule is good for investors, and it offers opportunities for those who deliver more value and for the robo-advisors,” said Lumberg. “Digital innovation benefits investors. It’s an opportunity to simplify things. Over the long term, simplicity is better for the industry and for clients.”