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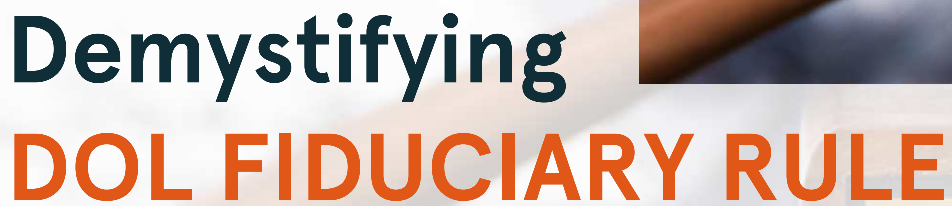

Demystifying DOL FIDUCIARY RULE

What it would mean to the broker dealer industry?

Over the last few years, the independent broker dealer industry in USA has seen a lot of churn. Many large broker dealers grew their book of business and registered representative base inorganically, by taking over their smaller counterparts. What came as legacy was a host of disparate systems and operational teams, all doing similar tasks.

The broker dealers were still grappling with the problem of integrating the systems of their new found entities, when the Department of Labor (DOL) threw them another curveball in April 2015. This curveball has since come to be called as DOL fiduciary rule and threatens to alter the entire dynamics of the industry, which has operated on a variable compensation model for decades. It will force the industry, which has long regarded its role as transaction facilitators, to wear the hat of the advisors and discharge all the onerous responsibilities that come with it. But what exactly is the DOL fiduciary rule and what will be its impact? There is a huge dark cloak over it, partially because the final regulations are still not out and partially because of the ambiguities present in the current directive. This white paper is an attempt to demystify the ruling and aims to propose what broker dealers should be doing to prepare for this seismic event.

DOL in Layman's Language

A real life example conveys a message more eloquently rather than an example filled with Industry Jargon. Therefore let us take a hypothetical real estate agent company called Joe realty dealers (JRD), to convey what exactly is demanded by the DOL fiduciary rule. JRD is a renowned chain of real estate agencies operating across the United States. Their sales team, fondly called as property advisors, understands the needs of prospective customers and accordingly advises them whether to buy a Townhouse or a Condo and which builder's property to buy. Customers, implicitly, trust the words of these advisors while buying new houses or selling their existing houses for those bought. Joe and company get compensated by earning a commission from the property builders on every property purchased. Various builders also reward them in other forms for their help in moving their inventory. JRD gives away a portion of these commissions to the sales team and keeps the balance for managing their overheads and another portion as their profits. One day, the real estate agency gets a letter from the government which reads as follows:

"All real estate agents are required to implement following directives to be able to continue selling properties

- You are advised that you can only earn a fixed annual fee on your book of business, i.e., on current value of property sold by you.
- To earn commission on the property sales, you and the builder will have to sign an agreement with the customer that you are acting in his best interest.
- You will also have to tell your customer the amount of commission you are making by selling a particular type of property.
- Additionally, you will have to report multiple other sales-related details to the government and report how you complied with the above directives."

As soon as the agency reads the letter, it breaks into a sweat. They had operated on the basis of commissions for last so many decades and now, the government wants to take away those commissions. They are afraid that this directive will totally change the dynamics of their operations. This will further increase their costs and reduce their revenue simultaneously.

Operational Impact of DOL

The above example in a nutshell summarizes the dilemma being faced by the broker dealer industry in USA today. The DOL fiduciary ruling threatens to fundamentally change the way industry has operated for years. So what are the main points proposed in the DOL fiduciary rule:

- For all the investment recommendations made to move or not to move assets to/from retirement accounts, such as IRAs, 401(K), the broker dealers are allowed to earn reasonable compensation, which for lack of clarity currently means Level Fee on the assets under management (AUM). Therefore, it applies to all product types that are bought or sold in the retirement accounts.
- To earn compensation in any other form, such as commissions or trails from the retirement accounts, broker dealer will have to satisfy the conditions laid down under BICE (Best Interest Contract Exemption), which states that the advisor will always have a fiduciary responsibility to act in the best interest of the client. This fiduciary responsibility will be established through
    - A contract with the client for the fiduciary relationship
    - Putting in place practices and checks which result in no conflict of interest
    - Specifically disclosing the amount of conflict compensation earned by the parties in the transaction, including guiding them to the website where the compensation disclosure will be made.
- There will be multiple other additional reporting requirements to prove that the advisor acted in the best interest of the client, failing which there can be stiff penalties and liabilities.

The final draft of the above ruling is in progress and is like to come out in March 2016. When notified, the above ruling is likely to be the single biggest change to hit the broker dealer industry. Its potential impacts that we are likely to see are:

- The compliance costs for selling commissionable products in the retirement accounts is likely to increase manifold. Therefore, advisors are likely to steer clear of selling these products for retirement accounts.
- There will be a large scale movement of assets from commissionable model to the fee based model in which the broker dealers are compensated on the basis of Asset under Administration rather than upfront commissions. This is a massive change for some of the products, such as variable annuities, wherein more than 95% sales were coming from the upfront commissions' model rather than fee-based model.
- Broker dealers as well as their advisors will have to adjust to a world wherein their upfront commissions will be severely reduced. However, their overall compensation measured over the years will remain the same or rather increase because of yearly fees on AUM.
- Registered reps may focus more on the non-retirement accounts, as they do not come under the purview of the above ruling. However the huge corpus of funds that comes every year from rollover cannot be ignored for long.
- Many dually registered advisors may move their retirement business to the RIA (Registered Investment Advisor) world, as RIAs have always been in the purview of the fiduciary responsibilities albeit less restrictively.

Who will sink and who will swim?

Needless to say this is an equivalent of the meteor strike of the Jurassic age. There will be many broker dealers who will find themselves unable to come to terms with the changing world realities. Many will decide to sell out and get out of the business. American Insurance group (AIG) recently sold AIG Advisor group, one of the largest independent broker dealers, having about 5000 registered reps, to Lightyear capital and PSP investments. In the investor presentation made after the sale, AIG CEO, Peter Hancock said: "It's a business we are not the best owner of, in light of potential Department of Labor rules."

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There will be many other broker dealers who may follow the suit, because they are not agile enough to come to terms with the changed business realties. There will be others who will feel the pangs of increased cost and reduced revenue in the post DOL world. Many smaller broker dealers are likely to disappear as a result.

At the same time, there will be others who will recognize this as an opportunity to establish a new world order. These broker dealers will be able to run much faster on the curves and leave competition trailing in their wake. So, how can one judge which category a broker dealer will fall into.

The first step towards knowing that will be to know: How informed a broker dealer is? Does the broker dealer know its business well enough to understand how it will be impacted? For example, if it can answer following questions.

- What percentage of its total business comes from sales to the retirement accounts?
- What percentage of the business in the retirement accounts comes from the sales of commissionable products as opposed to fee-based products?
- Which of its sub-entities or its registered representatives will be most impacted when the new ruling finally comes into play?

A broker dealer, that effectively answers all the above sample questions, has cleared first level and would be a little better off than many of its industry counterparts. But, the sad reality of the broker dealer industry is that many of the existing broker dealer networks of the day have grown by taking over multiple smaller players and have still not been able to integrate their systems under one umbrella system. The technology and the processes used by some of the players are totally incapable of responding to such a fundamental shift.

Even if the broker dealer answer above questions, it is highly unlikely that their systems are geared towards the extensive compliance, audit and data retention requirements that new ruling mandates. As per the draft rule, the parties will have to retain data pertaining to non-conflict of interest for 6 years and will have to submit the same for review on demand to a host of regulators, such as DOL, Plan Administration, SEC, Department of Insurance, state regulators, FINRA and even IRS. Are the broker dealer systems geared towards readily handling the additional reporting overheads? If not, then people will have to scramble for data as and when such requests are made by the regulators.

Technology Impact

The broker dealer industry will have to honestly look in the mirror to answer these questions. They will have to bring their systems to a level where they can clearly get an integrated view of their business, where its stands now. They should be in a position to judge operational and business impact with hard numbers, rather than throwing darts in the dark. Secondly, they will have to significantly alter their current practices to be BICE compliant and ensure they place checks and balances to ensure contractual compliance. Lastly, they will have to upgrade their reporting capabilities to a level which can readily serve any regulator request without throwing people off their regular jobs.

"We are looking at increased costs in all aspects: E&O insurance, compliance, technology, legal."

The industry players will have to integrate their disparate transaction systems under single umbrella system or build out reporting warehouses, which can service regulatory data requests in a factory model. It is easier said than done. We are looking at increased costs in all aspects: E&O insurance, compliance, technology, legal. And all this coupled with revenue reduction in the immediate term.

Conclusion

When the DOL dust settles, the broker dealers left standing are poised to gain significantly because the assets as well as advisors will move to the broker dealers with much stronger practices and systems, and all the efforts spent to prepare for this tumult will be worth it.

Broker dealers should not think that they can, probably, focus more on non-retirement accounts and still expand their book of business. Regulatory tightening is an inescapable reality. There is every chance that SEC may also come up with a similar directive to cover non-retirement accounts. If the systems and practices are now put in place to weather a future storm, the broker dealers will be able to adapt much more easily when the next meteorite hits.

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- Focus and passion for innovation
- Flat organization structure – responsive engagement models
- Agile and flexible delivery and commercial models
- Focus on long term partnership with clients