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Regulatory brief

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DOL fiduciary rule: Beyond the headlines

After several months of industry speculation about a delay of the Department of Labor's (DOL) fiduciary duty rule, on February 3rd the Trump administration issued a Presidential Memorandum instructing the DOL to re-examine the rule but did not specifically recommend a delay as many expected.[1] Under the rule, investment advice given to an employee benefit plan or an individual retirement investor is considered fiduciary advice and therefore must be in the "best interest" of the investor. Although the DOL is still likely to delay the rule's upcoming April 10, 2017 compliance date,[2] we nevertheless expect the industry to move toward a fiduciary standard not only because consumers continue to demand transparency, but also because many firms realize the importance of removing conflicts of interest between financial advisers and retirement investors.

Despite expecting a delay or revision of the rule after last year's election,[3] multiple large firms affirmed their commitment to a fiduciary standard and have updated their marketing materials to signal their intent to put their clients' interests first. In addition to the competitive benefits of maintaining a fiduciary standard, many impacted firms do not intend to reverse their compliance efforts because of the service and operational benefits they have realized by modifying their business practices.

Still, some in the industry have supported efforts to delay, revise, or repeal the rule. These efforts saw a setback on February 8th, when a US district judge ruled against several industry groups seeking to block the rule. This ruling was unexpected not only because it came several hours after the Department of Justice requested the court to hold proceedings, but because the case was brought by several prominent industry groups and was heard in a district that was expected to be sympathetic to their arguments.[4] Opponents of the rule have primarily argued that it should be delayed until there is a uniform fiduciary standard for all types of investment accounts,[5] or suggested that the rule will increase costs or limit access to advice and investment options for retirement investors.

However, even before the DOL's rule was proposed, it had become apparent that many retirement portfolios contained high-cost products that underperformed relative to their market benchmarks. Accordingly, consumers have increased scrutiny of their portfolios and there has been an ongoing shift of assets toward passive investments (e.g., exchange traded funds) that track market performance at a low price point, and from commission-based to fee-based advisory accounts.

In our view, a fiduciary standard is here to stay. Although the DOL's rule only applies to retirement investment accounts, the associated rise in consumer education and engagement is likely to put pressure on other types of investment accounts. In fact, the DOL's second round of FAQs released last month provided investors with information and specific questions they should ask their advisers, including whether the fiduciary standard will be applied across all of their investments.[6] As such, firms that commit to putting their clients' interests first will be at a strategic advantage and will be able to differentiate their brands from competitors that choose to reverse their compliance efforts.

This **Regulatory brief** analyzes the effects of a delay on the DOL's fiduciary duty rule, describes steps that the industry has already taken to comply, and offers our view on how firms should proceed.

What happens next?

Now that President Trump has directed the DOL to re-examine the fiduciary rule, it is up to the DOL to take action. Typically, any action to delay the rule would be taken by the new Secretary of Labor, but the confirmation hearing for nominee Andrew Puzder has been delayed several times and a confirmation vote would now be unlikely before the end of February.[7] Although it would be unusual for a non-political appointee to take action on an existing rule, it is still expected that Acting Secretary Edward Hugler will at least announce a delay until the new Secretary can undertake the analysis directed by the President.[8]

A delay will give the DOL time to review and potentially modify or repeal the rule as instructed by the White House. However, in order to change or reverse the rule, the DOL would have to issue a new rule with a comment period because the rule became effective last year. Given the progress that the industry has made already and the fact that a number of firms have publicly come out in favor of the rule, the DOL is likely to receive a fair volume of comments in support of the rule's retention. In fact, Senator Elizabeth Warren (D-MA) recently released the results of a questionnaire she sent to firms that have made significant progress on compliance, and said the responses indicated that several of the firms support the fiduciary standard, have invested heavily in compliance so far, and are still planning to be ready by the April deadline.[9]

We do, however, expect the DOL to reconsider certain controversial aspects of the rule, but any changes would not be made quickly as they would require a public notice and an industry comment period. One particular area where we expect to see changes is the Best Interest Contract exemption (BIC exemption), which allows advisers to continue to receive commission-based compensation if they meet certain conditions. Firms are required to fully comply with some BIC exemption requirements (i.e., signing new contracts with clients and making certain web disclosures) by January 1st, 2018, so many have not yet made as much progress in these areas as they have with other aspects of the rule. We primarily expect the DOL to reconsider a provision that grants investors the right to join class action lawsuits.[10]

However, even if the right for class action lawsuits is removed from the BIC exemption, individual investors would still be able to continue their current practice of enforcing their contracts with advisers through arbitration. Additionally, firms that violate the requirements of the BIC exemption would be subject to IRS prohibited transaction excise taxes.

How has the industry adapted already?

Many of the changes precipitated by rule are already becoming evident throughout the industry. Although most of the following actions were taken by firms in order to comply with the rule, they have often resulted in business benefits beyond reducing risk of noncompliance, such as improvements to customer service and increased operational efficiency. Accordingly, we do not expect most of these widespread trends to be reversed even if the rule is modified.

Client segmentation and new channels

It has been recognized for some time that the fiduciary rule makes it difficult for firms to serve low net-worth retirement investors at acceptable economics under a commission-based compensation model (in part due to the risk of litigation under the fiduciary standard).

Firms have largely gone in one of two major directions to address this difficulty. Some have taken the approach of requiring all retirement clients to transition from commission-based to fee-based adviser compensation structures (i.e., charging a flat or scaled fee for services). Other firms have chosen to comply with the BIC exemption in order to retain commissions for clients above a certain asset threshold, typically ranging from $25k - $100k.

Additionally, most firms have also accelerated their adoption of self-directed investment portal and/or robo-advisory offerings. These options are being positioned as an alternative channel for clients who could end up paying more under a fee-based account than they did when they were charged a commission. In fact, nearly all large and mid-sized full-service firms (including wirehouses, independent broker dealers, and bank brokerages) have over the last six months either (a) announced partnerships with third-party robo-advice providers or (b) expanded call center and web-based self-service options.

Product review and streamlining

In order to ensure that advisers are recommending products that are in their clients' best interest, many firms have been reviewing and streamlining their product offerings. In particular, firms are eliminating certain retirement products that have been deemed to be too complex or costly to be justified as being in an investor's best interest (e.g., proprietary structured products, equity syndicates, REITs, and market-linked CDs).

We have also seen significant streamlining of the mutual funds and annuities that are offered to clients, with some large firms removing up to a third of the over 3,000 distinct mutual funds typically available. Most often, the funds have been removed due to having high cost relative to performance and/or limited scale. Many firms are also using the prospect of product shelf streamlining to nudge manufacturers to make changes to share class structures (e.g., introduction of 'T' share class with fewer sales charges that could produce conflicts of interest).

Finally, beyond eliminating or reducing certain types of products, firms have also been reevaluating their due diligence procedures in order to make sure that advisers recommend products that meet defined price and performance criteria.

Pricing shifts

Many firms have taken the opportunity afforded by the rule to update and simplify pricing schedules. For several types of products (e.g., commission equities) many firms had complicated pricing arrangements which would have been difficult, if not impossible, to represent without inconsistencies in the client disclosures required by the BIC exemption. As such, these pricing schedules are now being updated with simpler, volume-based tiers. Firms have also simplified their discounting policy (which was clarified to be an allowed practice in the first round of DOL FAQs) in order to standardize rules and reduce adviser discretion for giving discounts.

In addition, firms have accompanied client segmentation changes with modifications to their advisory fees and minimum asset thresholds required to access certain products. In order to ease the transition to fee-based accounts for investors who may have paid less under a commission-based structure, some firms lowered their fees or allowed accounts with lower assets (e.g., under $100k) to access fee-based services that they may not have previously been able to access.

Finally, we are seeing overall lower effective pricing across mutual funds as firms introduce new share classes, reduce fund pricing, and make changes to revenue share arrangements (e.g., for sub-transfer agency services and platform).

Adviser compensation changes

Because adviser compensation is one of the main sources of potential conflicts of interest, many firms have already made significant changes to adviser compensation practices. For example, firms have scaled back employee forgivable loans or sign-on bonuses that were dependent on meeting sales targets. Further, in line with clarifications in the FAQs,[11] wealth management firms are also making changes to avoid or eliminate drastic increases in commission thresholds and retroactive adjustments (i.e., applying a higher payment rates to prior sales upon reaching a new threshold).

Firms have also taken steps to partially recoup some of the negative revenue impact and increased costs of compliance from the rule by re-examining the share of revenue that is allocated to adviser compensation. The fiduciary rule limits firms' ability to entice financial advisers to switch employers and bring over their clients, a practice which had increased leverage for financial advisers to negotiate higher pay. Accordingly firms are reconsidering the way they pay financial advisers, particularly with respect to which services are compensated and which are not (e.g., robo-advisory services).

Technology enhancements

Several firms have invested in new technology to ease compliance with the rule. For example, some firms have added automated due diligence systems for adviser recommendations in order to mitigate the risk of recommending products that are not in a particular client's best interest. These systems are designed to evaluate information on a client's investment and risk profile in order to sort through the high volume of products available and provide the adviser with a short list of products that are aligned with the client's profile. Additionally, firms have implemented tools to monitor adviser performance and provide reports to compliance executives. Finally, some firms that have begun to shift clients to robo-advice portals have invested in creating user-friendly online platforms. Such rule-driven technology enhancements have often had the added benefit of increasing efficiency and effectiveness of client interactions.

Consolidations and divestitures

In response to the rule, there has been recent consolidation in the wealth management industry, primarily driven by pricing pressures, and the high cost of technology developments and compliance projects. Additionally, smaller insurance broker-dealers, independent broker-dealers and regional brokerages have been consolidating and we expect that they will continue to do so over the next several years.[12]

How should the industry proceed?

In our view, the DOL's fiduciary rule has merely accelerated an existing trend toward more transparency and consumer engagement in the wealth management industry. Consumers are unlikely to forget what they have learned about potential conflicts of interest in investment advice, and are increasingly likely to seek out investment options that justify their costs. Therefore, even if the DOL's fiduciary rule is delayed or modified, we believe that it will be a competitive necessity for firms to demonstrate that they put their clients' best interest first (particularly for millennial consumers, who traditionally distrust financial institutions).[13] Given the likely delay of at least the rule's first compliance date, we recommend that firms take the following steps:

Triage current compliance efforts: As many DOL programs have a number of decisions and changes planned through the year, it would be prudent to divide the remaining actions into three buckets with respect to level of desirability and business necessity:

1. The first category contains changes that firms should implement regardless of whether the rule is delayed or modified because of their operational and strategic benefits (e.g., simplifying complex pricing schedules, product shelf rationalization, client segmentation, and establishing lower thresholds for certain services). Many firms have already completed or have made significant progress on these actions.
2. The second category contains actions which will benefit firms' business and customer service models over the long term, but for which firms would prefer to have time beyond the currently scheduled rule deadlines to implement (e.g., changes to advisor compensation, rollout of self-directed and robo-advice channels). Many firms are already in the process of completing these types of actions.
3. The third category should contain actions that were primarily designed to meet specific rule compliance requirements, but could likely be put on hold until the final form of the rule is clear (e.g., technology enhancements designed to meet disclosure requirements, client communications for transition disclosures, changes to contracts).

Stay the course for priority actions: Many of the industry adaptations discussed in the prior section have already led to improvements in firms' product ranges and customer service models. We recommend that firms leverage the significant investments already made in their DOL programs, and continue with plans to complete first and second category actions in order to drive further beneficial business model changes. Continuing on a course towards a fiduciary standard will help firms strengthen their long-term competitive positioning by differentiating their services as meeting a higher standard of care.

Ensure client awareness: Many firms have already overhauled their marketing materials to avoid providing information that would be considered advice under the rule. However, firms should also take this as an opportunity to align their brands more explicitly with a client-centric approach. While consumers continue to receive new information on their investment options from the DOL and advocacy organizations, it is critical for firms to ensure that the public is aware of the changes they have made.

Endnotes

1. The White House Memo instructed the DOL to examine the fiduciary rule and determine whether it would (i) harm investors by limiting their access to advice, (ii) disrupt the industry in a way that would harm investors, and (iii) cause an increase in litigation or prices for financial advice, as well as to provide an updated economic analysis.
2. The rule was finalized in April 2016, and has a second compliance date of January 1st, 2018. See PwC's *First take, Ten key points from the DOL's fiduciary duty rule* (April 2016).
3. See PwC's *First take, Donald Trump's victory: Ten key points* (November 2016).
4. This was a ruling on the lawsuit bought by SIFMA, Financial Services Institute, the Chamber of Commerce and six other plaintiffs in the US District court for the Northern District of Texas. The Judge's ruling primarily upheld the DOL on administrative grounds (i.e., that the DOL had not exceeded its statutory authority) but did potentially impact the direction of the analysis ordered by the White House in ruling that the DOL's original economic cost-benefit analysis was not insufficient.
5. A uniform fiduciary standard is unlikely to be passed anytime soon. The Securities and Exchange Commission's (SEC's) version of the fiduciary rule (which would be applicable beyond retirement accounts) was not proposed during former SEC Chair Mary Jo White's tenure, and it is currently unclear whether this will be a priority for President Trump's nominee to lead the SEC, Jay Clayton.
6. The DOL also released a set of technical FAQs to guide firms in their implementation of the rule. For details, see PwC Tax Services' *Insight,* DOL issues second set of FAQs relating to investment advice fiduciary regulations (January 2017). For details on the first round of FAQs, see PwC's *First take, DOL fiduciary rule: Election impact and FAQs* (November 2016).
7. After the hearing, Puzder's confirmation would still be pending until he is voted out of committee, after which a full Senate confirmation vote would still need to occur. For other cabinet appointments, this process has taken over two weeks from the time of the hearing. Puzder's confirmation hearing was most recently rescheduled for February 16th.
8. While it is not a common action, the new administration could also direct a delay by appointing certain Assistant Labor Secretary positions that do not require Senate confirmation (e.g., Legislative Affairs, Public Affairs, and Management).
9. Under the Administrative Procedures Act, the DOL is required to issue a notice of proposed rulemaking for any new rules or substantial changes to existing rules, which could include a delay of the fiduciary rule compliance date.
10. 21 out of 33 firms responded to Senator Warren's letter, which included a series of questions to gauge the firms' support for the rule, their level of progress and spending so far, and potential actions if the rule is rolled back or repealed. Senator Warren sits on the Senate Health, Education, Labor and Pensions Committee, and she will likely use the letter responses in her questioning of Labor Secretary nominee Andrew Puzder during his confirmation hearing.
11. The right to join class action lawsuits would be implemented along with other BIC exemption provisions by January 1st, 2018.
12. See note 6.
13. See PwC's *Regulatory brief, Insurers: Retirement plans look less golden* (December 2015).
14. See PwC's *Financial services digital publication, Customers: What will they need tomorrow?* (March 2016).

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