# Driving Competitive Advantage in Complying with the U.S. Department of Labor's Fiduciary Standards

## Table of contents

Executive Summary....1

The Fiduciary Rule – What Is It and What Does It Mean? ....2

What Should Financial Institutions Do in Response to the Fiduciary Rule? ....5

How Technology Will Help and How to Choose the Right Technology ....8

- Workflow system implementation ....8
- Choosing the right technology....9

Conclusion....9

# EXECUTIVE SUMMARY

When the U.S. Department of Labor issued its new fiduciary rule in early April 2016, requiring all financial advisors to provide conflict-free advice on client retirement accounts, officials touted it as a means to protect the average investor. That may be true, but it is equally true that the rule has the potential to disrupt and upend the business models that U.S. financial companies and advisors have depended on for years.

Once the rule kicks in next year, the business landscape will be starkly different from what advisors, annuity providers and financial firms are used to. Some industry players have made the drastic decision to exit rather than face the cost and potential risk of compliance. For advisors and firms, the key will be to provide individualized, client-specific advice—advice that is demonstrably in the client's best interest. This will cause a tectonic shift in how advisors position products with their clients, which in turn has far-reaching implications for all stakeholders in the investment industry.

There is general agreement that the rule will cause a shift from commission-based to fee-based accounts, leading advisors to move their clients toward lower cost products and bring financial planning to the forefront of the advice process. This advice process will further need to be connected end-to-end, with recommended investment programs and products directly tying to the investor's profiled financial needs.

At face value, as is the case with most market disruptions, there is an intense focus on new challenges and the potential downside associated with significant changes. However, the disruption can be positive. Firms that are forward-thinking and proactive can position themselves and their advisors as leaders in this new "best interest world"—if they take the right steps.

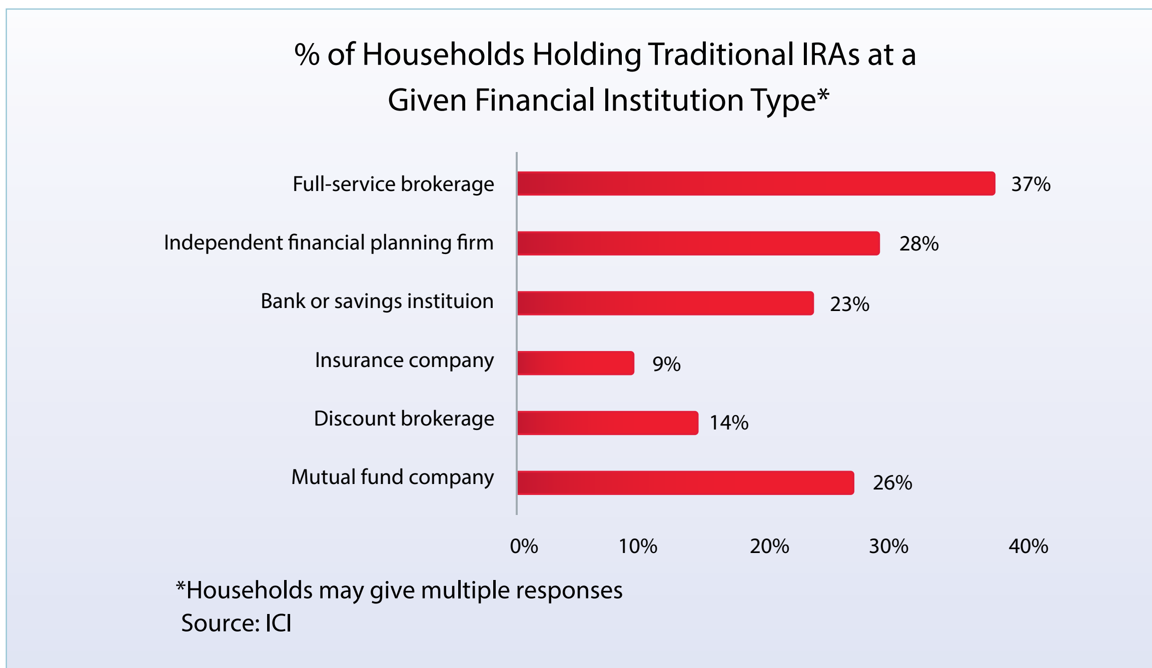
Those steps include changing product structures across both brokerage and managed product programs; adjusting the advisor payout grid and trailing compensation practices; implementing standards and processes around disclosures and client interactions; introducing robo-advisors and other digital technologies; and making many crucial improvements to technology platforms.

Success, however, will boil down to providing individualized, client-specific guidance that is clearly and demonstrably in the client's best interest.

# THE FIDUCIARY RULE – WHAT IS IT AND WHAT DOES IT MEAN?

The new rule says that all retirement investment advice and recommendations must be made in the best interests of the individual client, rather than just being suitable for a client's general situation. The Department of Labor, which oversees individual retirement accounts (IRAs) and corporate retirement plans, issued the long-expected rule on April 6, 2016. Its provisions start to take effect in April 2017, but firms and advisors already are preparing for the changes.

The fiduciary rule applies to all registered representatives at FINRA-registered broker/dealers, licensed insurance agents overseen by the National Association of Insurance Commissioners (NAIC), and registered investment advisors (RIAs) under SEC supervision. Most clients at brokerage firms, banks, insurance companies, and RIAs have IRAs, meaning most client relationships now will be subject to these new standards.




What does "best interest" mean? It means providing advice that is specific to each individual client. Giving tailored advice will be vital—for compliance, for client satisfaction, and to justify the fees that clients pay their advisors. Further, the firm must be able to prove that the advisor's and firm's self-interest—including compensation, proprietary product biases and other conflicts of interest—have had no influence on their investment recommendations.

When it comes to compensation, the rule defines commissioned brokerage relationships to be inherently conflicted and not in the client's best interest. This effectively bans management of retirement accounts through traditional commission-based relationships, which will have a huge impact on a huge market. It is estimated that, of the $7 trillion held in IRAs, as much as $3 trillion is in transaction-based accounts—accounts that generate $19 billion in annual revenue for brokerage firms. The rule allows such transactions to continue, however, if the client and advisor sign a specific contract called a Best Interest Contract Exemption, or BICE.

Because of the costs and challenges associated with using a BICE, many firms are expected to accelerate their transition to a fee-based business model. So, those billions of dollars in commission revenue will need to be replaced with fee income. Fee-based revenue, however, will see changes too, with impacts to 12b-1 fees and marketing allowances. In addition, managed products also will need to be reengineered to eliminate conflicts.

Although many of the fiduciary rule's provisions were anticipated, collectively they undermine many of the methods that financial institutions have relied on to provide advice, service, and investment products to investors, and to drive profits as well.

And, no matter the business model, financial firms may face class-action liability for failing to follow best interest standards in both brokerage and advisory relationships.

Some companies, such as AIG, have been exiting the advisory industry ahead of the rule's issuance, saying the increased compliance costs and potential legal liabilities are not worth it. For those companies that stay in the industry, **the key is going to be changing the business model to achieve compliance without compromise; that is, meeting all of the rule's many requirements, while growing profitably.**

**Advisors will need to be sure they are delivering advice that is both "necessary" and "right," and that the product choices are appropriate and unbiased.**

To do so will require a significant amount of work and, in some cases, a thorough re-thinking of the fundamentals around how these firms do business. Beyond reengineering managed product offerings, firms and advisors will need to be sure they are delivering advice that is considered by clients and regulators to be both "necessary" and "right," and that the product choices that come from that advice are considered to be appropriate and unbiased. This will require taking a hard look at approved product list standards and pricing levels. Another consideration will be whether firms should add more advice into products to justify fee levels.

## The BICE Exemption

**The fiduciary rule makes an allowance for commission-based relationships to continue through the so-called Best Interest Contract Exemption (BICE). To utilize BICE, firms and advisors must enter into formal contracts with investors, disclosing all client costs and potential conflicts. It also imposes additional oversight and compliance requirements.**

**Under a BICE contract, the firm and advisor must still make sure the advice they give is in the client's best interest. But, it allows commission payments—which are still defined as conflicts of interest—as long as the advisor and the firm warrant that they have identified those conflicts and are taking steps to ensure they will not get in the way of the advisor looking out for the client's best interest. A BICE contract not only applies to traditional brokerage, but also to direct product relationships (e.g., direct mutual funds, annuities, alternatives).**

One specific change confronting firms will be to ensure that investment products are priced consistently based on each product's "value." Investment product options with outlying fees and compensation will need to be filtered to increase consistency and remove conflicting financial incentives. Lower cost share classes and fund products will need to be brought in as replacements. Enhanced due diligence will be required, particularly for more expensive products, to prove these products' superior value justifies their expense. Further, selling agreements will need to be renegotiated to remove inconsistent and non-transparent marketing payments and 12b-1 fees.

Beyond price and product, the most successful firms also will increasingly rely on wealth technology platforms to implement consistent advisory standards, control advisor recommendations, execute centrally-managed programs, and automate compliance oversight activities. Technology can help firms do all of this, and do it cost-effectively as well. In the past, these types of IT tools could be seen as a "nice to have." Post-disruption, they are a prerequisite to any type of successful transformation.

Technology also will be key for goals-based planning. Determining a client's goals is step one in delivering unique, client-specific advice; that is, advice that is in a client's best interest. Firms and advisors will need to identify the proper investment products clients should purchase to meet their goals. Using technology to do all of this efficiently, effectively, and without bias or conflict will help firms and advisors to differentiate themselves, as well as justify their fees.

Moving forward, all advisors should consider embracing a goals-based planning program for at least some clients. This not only can be a good way to strengthen an advisor's relationship with a client, but also may help the advisor to meet the requirements of the fiduciary rule. For example, if a client has a stated goal to save money for a new home, the advisor can recommend a particular investment product or asset allocation to help reach that goal. It is easy to prove that such advice, with a tangible goal in mind, was made in the client's best interest.

A final consideration for firms is whether they will make these changes only for IRAs and other ERISA qualified accounts, or across all accounts. Modeled profitability impacts will need to be balanced against disjointed client experiences, as well as increased training, compliance, and technology implementation complexity. A client's goals rarely are satisfied by a single account type, so in order to comply in a goals-based approach, firms will need to think beyond IRAs.

# WHAT SHOULD FINANCIAL INSTITUTIONS DO IN RESPONSE TO THE FIDUCIARY RULE?

Technology is going to be a crucial component of firms' efforts to meet the requirements of the fiduciary rule, but it will not solve every problem. Wealth management firms need to take many different steps to protect profitability and ensure their business model evolves.

**Product platform changes**: The fiduciary rule will spark a major shift away from commission-based accounts toward fee-based accounts. It also is likely to accelerate the move from actively managed products toward lower-cost passive products, and it will lead to other changes to product platforms as well. Financial firms need to take steps now to prepare.

Leading wealth managers are aiming to help their advisors build deeper, longer lasting relationships with their clients by standardizing their managed account product offerings. This includes creating a single advisory agreement that covers all managed account types, as well as implementing an advice process that is similar across managed account programs. This kind of consolidated arrangement allows advisors and clients to add or change managed accounts without having to go through a lengthy and disruptive transition processes.

**Firms should reengineer their managed products to provide structural consistency across features, prices, investments and compensation models.**

Firms also should reengineer their managed products to provide structural consistency across features, prices, investments and compensation models. This process, done correctly, will allow firms to identify and address any "gaps" in their managed account offerings to ensure a client at any stage in his or her life cycle can be appropriately served under the same advisory relationship. For example, ensuring that a client initially invested in a wrap program can be easily upgraded to a unified managed account (UMA) after receiving an inheritance. These steps will streamline sales, implementation and servicing processes, and help advisors realize the benefits of a lifelong relationship with each client.

Firms also should take the opportunity to update or create approved product list standards that cover all products—mutual funds, exchange traded funds (ETFs), variable annuities and underlying funds, and alternatives.

And, they should consider using one or more of the following tactics to reduce "fee to value" variance:

- Enhanced due diligence documentation to justify higher fees charged by certain funds
- Winnowing of options to "level fee" choices within asset classes
- Development of low-cost fund slates, including an increased reliance on passive fund options

Other considerations include active versus passive fee standards, as well as total cost-to-client standards, especially for alternatives, annuities and other offerings that have multiple embedded fees. Another crucial decision is whether to apply such standards universally, or to apply them solely to IRAs and qualified retirement plan accounts covered by a BICE.

**Changes to compensation**: The fiduciary rule bans the longstanding arrangement of advisors receiving commissions for investment products they sell. That means firms will have to adopt fee-based or self-directed compensation models. And, it will lead to necessary adjustments to the payout grid and to trailing compensation practices.

The rule includes exceptions to the ban on commission payments, most notably BICE, which will allow firms to pay their advisors through commissions or revenue sharing, although there is a trade-off.

Under a BICE, commissions are allowed as long as the advisor and firm meet stricter compliance and disclosure requirements. For instance, the BICE contract itself, which an advisor signs with the client, must state that the firm and advisor are committed to providing investment advice that is in the client's best interest; it must warrant that the firm has put in place policies and procedures intended to mitigate conflicts of interest; and it must "clearly and prominently" disclose any conflict of interest—such as fees in fine print or backdoor payments—that could prevent the advisor from giving "best interest" advice.

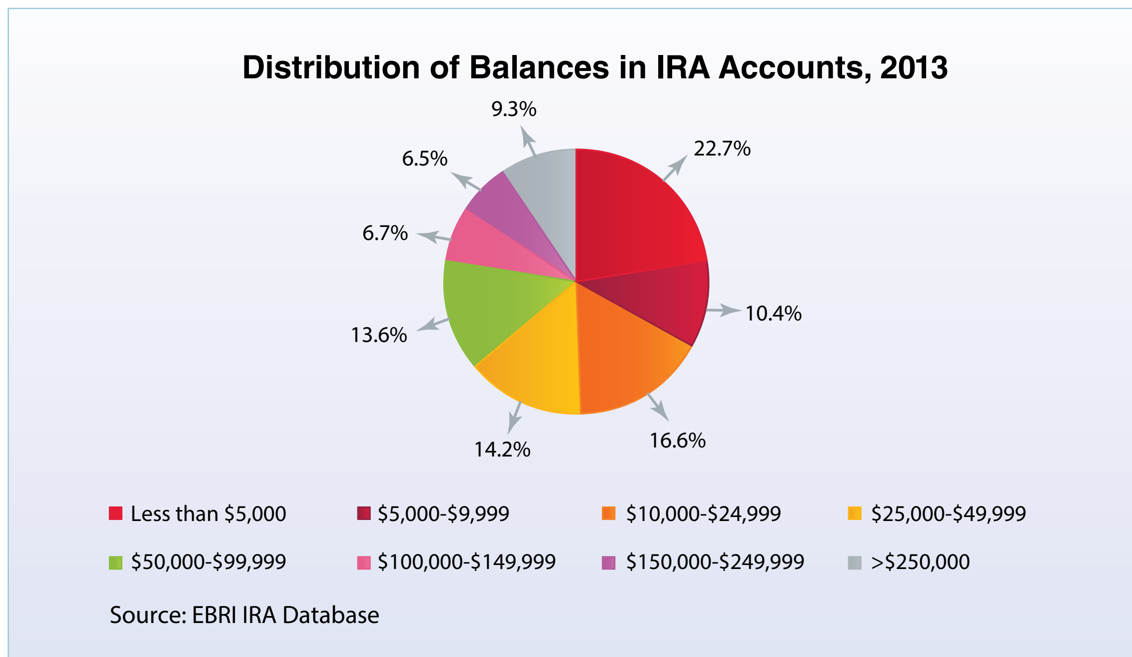
As with the standards discussed above, firms and advisors will need to consider whether they want the BICE contract to apply across the entire client relationship, or just to specific IRAs and qualified retirement plan accounts.

Firms also should re-examine their recruiting standards, so that they can continue to attract advisors, even in the wake of compensation changes. These standards should include recruiting incentives for fee-based business.

**Training programs**: All companies—brokerages, annuity providers, RIAs, and everyone else in the industry—should update their training programs for agents, agencies, advisors and call center representatives to ensure that anyone who comes into contact with a client, no matter how brief, understands the difference between "educating" about retirement principles and savings—that is, activities that are non-investment specific—versus activities that could be considered "giving advice." Key points of any revised training program should include the following:

- Defining permissible activities without a BICE or advisory relationship agreement
- Guidance on when to begin the BICE agreement process and how to broach the subject with prospects when a relationship may still be nascent
- Monitoring and audit programs to determine education and advice provided prior to the execution of a BICE contract

**Orphans and robots**: It is expected that, under fiduciary rule standards, smaller retirement accounts—those with less than $25,000 in assets—may be "orphaned" by firms who feel that, without commissions, such accounts are too small to cost-effectively service. Forward-thinking firms, however, are finding ways to service such accounts and potentially win more of them. One approach firms are using is a flat fee across all types of programs. Another innovative way firms are handling smaller accounts is through the use of robo-advisors, also known as "automated investment advisors."



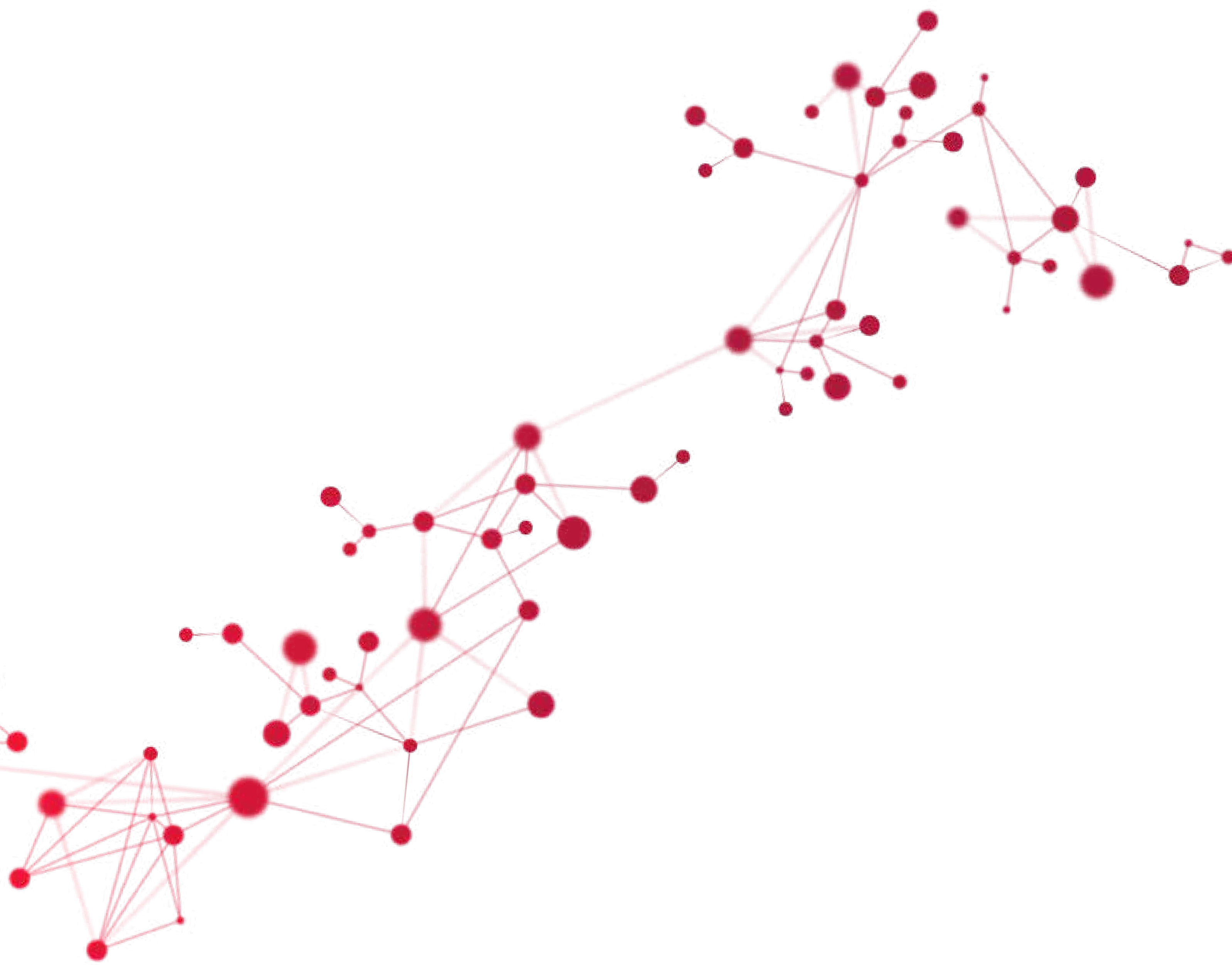

These algorithm-based platforms provide investment recommendations based on an investor's profile, risk tolerance and other factors, often using a goals-based methodology. They also can handle tasks like rebalancing, dollar-cost averaging and tax-loss harvesting.

Robo-advisors should not be viewed as a threat to existing advisors, especially in the post-fiduciary rule world. Instead, they should become a key part of a firm's service offerings, able to offer customized advice and other services to smaller accounts at a fraction of the cost and personnel hours.

There are two different robo-advisor models. The first is a "pure robo," where clients are largely self-directed and handed off to a call center for servicing. A fundamental challenge firms are having with this model is managing the handoff and ensuring advisors do not feel like they are losing control of clients. The second model is an advisor-supporting robo, where significant portions of the relationship are automated (for example, risk profiling and rebalancing), but where the advisor is still in charge of servicing the clients. Each of these models has potential benefits and downsides, and firms are still deciding which works best for their unique business strategy.

These platforms are still relatively new, and questions remain around scalability, profitability and how they may perform in a bear market. Still, their use is expected to grow substantially across the industry. A growing number of financial firms have been acquiring robo-advisor platforms, such as BlackRock with FutureAdvisor, while others like Charles Schwab are offering their own robo-advisor platform to RIAs on a white-label basis.

For these firms, the underlying managed account platform can be looked at as a way to effectively manage multiple management styles, including robo and traditional advice.



# HOW TECHNOLOGY WILL HELP AND HOW TO CHOOSE THE RIGHT TECHNOLOGY

Many advisors and financial firms are looking to technology to meet the numerous challenges created by the new fiduciary rule. Technology certainly will help, but it has to be positioned in the context of changes to the business model, segmentation and compliance functions. Disclosures and recordkeeping are not enough—advisors need technology to consistently deliver best-interest advice in a way that conforms to the firm's policies, is cost-effective and also allows for the justification of fees.

Whether it comes from a robo-advisor or a human, the best-interest advice given to a client needs to tie directly to product recommendations. Those recommendations cannot conflict and must still be in the client's best interest.

**Technology will be the linchpin that helps hold together financial firms' operations under the fiduciary rule regime.**

Indeed, it is no exaggeration to say that technology will be the linchpin that helps hold together financial firms' operations under the fiduciary rule regime. It will keep track of advisor interactions with clients, and it will help ensure they have made proper investment recommendations—and that they can defend those recommendations should the need arise. It does not matter if an advisor is operating under a BICE or the fiduciary rule itself; technology will be essential.

Because of the complexities of the fiduciary rule and the BICE exception, most firms' existing software packages are not adequate. Solutions to be evaluated include financial planning programs, client relationship management, risk assessment and portfolio management. Crucially, firms must make sure that, whether the software is new or existing, the programs can communicate with each other, or at least provide data that other programs can use. To comply, the workflow between these solutions needs to span the entire technology platform.

Firms should start with a review of their current business model, and then think through the strategic changes required to comply with new fiduciary standards. Issues to consider include the following:

- Will clients with less than $25K in assets be directed to a robo solution?
- How will products be reviewed, approved, and enforced?
- Will goals-based financial planning be implemented?
- What would goals-based planning look like for the firm?

A next step is reviewing the technology currently in place to see how it aligns with this new strategy. This review should be conducted with an eye toward ensuring top notch online security, upgrading existing software packages as needed, identifying gaps and flaws in data collection systems, and building out the right IT framework. This will prepare a firm for additional technology changes down the line and also puts its advisors in the best position to serve clients.

The new rule requires many more disclosures to clients than before. Technology can help here, too. Software can calculate costs and fees and automate the process of disclosing those costs and fees to the client. It also can automatically keep records to assist the firm and advisor with new compliance requirements.

## Workflow system implementation

Providing best-interest advice—and advice that leads to the sale of appropriate products—is critical, and technology can be a huge help here. Having a solution that can walk advisors through the processes of goal identification, risk tolerance, asset allocation, product recommendations, sales, rebalancing, and model management, all while ensuring fiduciary rule requirements are met, will be important.

For advisors with middle-market clients, these systems can be set up to lead advisors through a defined series of steps and client interactions, culminating in the recommendation and sale of a fund or other product. The system also can be customized for use with high net worth clients, allowing more flexibility while still remaining compliant with regulations.

In either case, ideally the workflow system will be integrated with client relationship management (CRM) software, so that an advisor can know at all times what is going on with a client.

Other system enhancements firms should consider include the following:

- Deploying new compliance rules engines to automate the monitoring of BICE activities and prohibited transactions
- Enhancing CRM systems to capture advisor interactions with clients, not only to document prudent practices but also to easily provide documentation in case of an audit or lawsuit
- Improving trading systems, including links to client profiles to ensure that advisors are not recommending products that are not allowed under the fiduciary rule

## Choosing the right technology

Without robust technology, financial firms are going to struggle, or even fail, under the new fiduciary rule regime. From product platforms to disclosure tracking, technology is key—but it is also vital that firms pick the right technology from the right vendor.

When it comes to portfolio management, some wealth management firms will look at turnkey asset management programs (TAMPs). TAMPs can be an easy solution that handles nearly all portfolio management functions, including portfolio construction, rebalancing, performance reporting and tax optimization, and such programs have surged in popularity in recent years.

But, firms considering a TAMP need to make sure it is flexible, so that they are not simply replacing one set of biases—the firm's proprietary financial interests—with a new set—that of the TAMP's own investment advice. This could happen because, whatever conflicts and biases are present in the TAMP's managers will be essentially passed along to the client.

**Technology-only solutions give a better opportunity to eliminate biases and contribute more value through a firm's own investment ideas.**

An alternative to this would be a technology-only solution—a platform that handles many of the tasks but not asset management itself. Such an option not only is less expensive, but it also allows a firm or advisor far greater control over how investments are selected for the platform, thus giving them a much better opportunity to eliminate biases and contribute more value through their own investment ideas.

# CONCLUSION

While at first the changes required under the new Department of Labor regulations may seem daunting, they present an opportunity to firms that are successful in adapting to the rules and could generate a significant competitive advantage. Many firms are looking to strategies such as goals-based planning to clearly tie clients' financial objectives to specific investment solutions, as well as enhanced monitoring and client interaction recordkeeping.

Technology is widely viewed as the best method to support these strategies at scale; however, the ability to execute will determine the clear market leaders. Those firms that select technology solutions strategically and effectively integrate them into a cohesive ecosystem will be well prepared to drive additional business and outpace the competition.

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