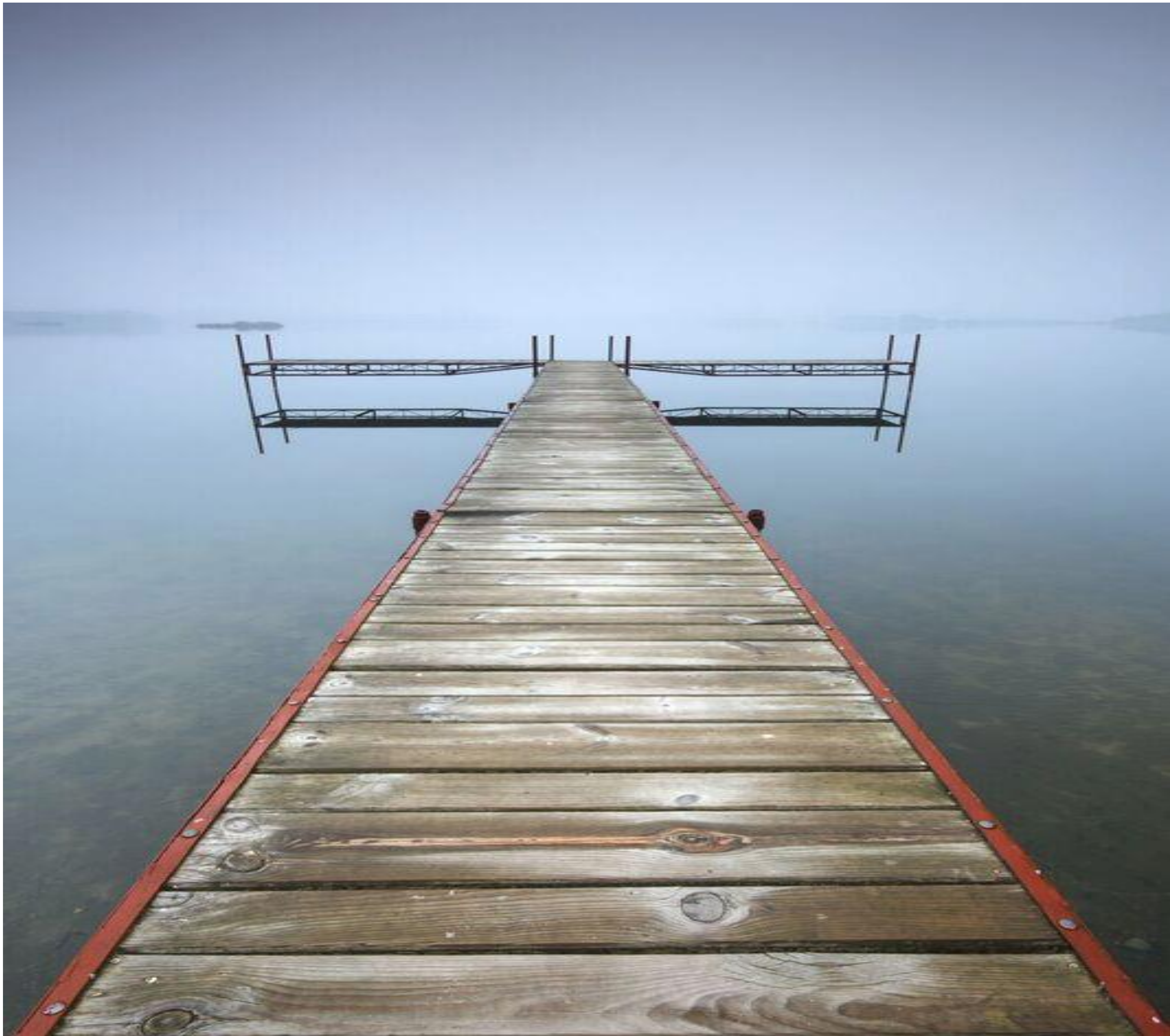


How to Thrive Under the DOL Fiduciary Rule

A guide to adopting the DOL fiduciary rule by joining an RIA.

Red Paper

REDHAWK WEALTH ADVISORS

As the industry awaits the Department of Labor's finalized fiduciary rule, advisors need to take heed and make sure that their practice is prepared for when the rule takes place. The rule is currently with the Office of Management and Budget (OMB) and has been there since the end of January. The rule can sit with OMB for as long as ninety (90) days before being released, so it is expected to be finalized by the end of April, 2016. Firms don't have to comply with the rule until the compliance date, which is currently slated in the proposal to take place eight months after the effective date and therefore likely to be sometime in the first quarter of 2017. So what should you be doing now?

Take the time to understand the rule

Advisors first need to understand what is in the proposal and what it means for them and their practice. Under the proposed DOL fiduciary rule, advisors will have two options for providing individual retirement account (IRA) recommendations.

Option #1: Advisor serves as a fiduciary under ERISA.
This option eliminates all conflicts of interest between the client and advisor. For example, commissions will no longer be an acceptable means of compensation. Advisors serving as a fiduciary under ERISA must either charge an hourly rate, a flat fee or a flat percentage of assets under management regardless of the asset class.

Option #2: Advisor chooses not to serve as an ERISA fiduciary and elects to work under the Best Interests Contract Exemption.
Under this option, the advisor can make IRA recommendations under the Best Interests Contract Exemption (BICE). This exemption is the DOL's attempt to allow for a compensation model similar to the majority that exists today. The BICE essentially allows for conflicted forms of compensation (i.e., commissions and revenue sharing) as long as the compensation is reasonable, adequately disclosed, and does not lead to biased recommendations in any way.

The BICE also requires a laundry list of disclosures around compensation and costs. In short, advisors will be required to disclose how much they and their firm will make on each specific recommendation along with the annual costs, in dollars, that will be incurred by the client. The advisor will have to execute a contract with each client, attesting to the fact that any recommendations will not be biased in any way. Any violation of this contract or omission of disclosure requirements of the BICE could lead to a breach of contract claim against the advisor and the firm.

While serving as an ERISA fiduciary is the more restrictive of the two options, it is also the clearest as to what is allowed and what is not. The BICE, while allowing advisors to make relatively minimal changes to their existing business model, comes with many uncertainties. Questions such as what is reasonable compensation, what fees must be disclosed and how, why is this particular investment best for my client, and what other forms of payment must be disclosed. I suspect many of the answers to these questions will not be known until the lawsuits are filed after the next bear market.

Impact on your practice

This rule reminds me of when retirement plans had to comply with 408(b)(2) back in 2012. Under this requirement, plan service providers had specific disclosure obligations to ensure that responsible plan fiduciaries provided the information they needed to make better decisions when selecting and monitoring service providers for their plans. This resulted in full fee transparency across the industry and led to a compression of fees for all parties including recordkeepers and retirement plan advisors. As plan sponsors saw all of the fees being charged to their plan, they naturally went out to the marketplace and conducted fee benchmarking studies to make sure the fees in their plan were reasonable. It forced advisors to substantiate their fees and better describe what services they were providing for those fees.

Because the DOL fiduciary rule will have the same impact on the IRA marketplace as 408(b)(2) had on the retirement plan space, advisors must assess how the new rule will impact their practice now and make the necessary adjustments to survive and grow in the future.

Advisors that currently either serve in a fiduciary capacity for retirement plans as an ERISA 3(38) Investment Manager or partner with a third-party firm that specializes in these services will have an advantage. The reason being is that they are already serving as a fiduciary under ERISA and already have the prudent processes in place to satisfy the new DOL fiduciary rule. All they have to do is transfer their processes and fiduciary practices over to the individual rollover side of their practice.

The new rule will have a significant impact on your practice. First off there will be changes that you will have to make in order to comply with the new rule. Most importantly, the rule will make it more difficult for advisors to scale their business in a profitable manner. Initially, there will be an onslaught of information hitting your clients which will leave them wondering how this will impact their retirement nest egg. Anytime there is uncertainty in the client's mind, it will leave them vulnerable for other advisors embracing this as an opportunity to go after your clients. Clients will be open to listening to other advisors to make sure that they are in the appropriate investments and paying reasonable fees.

Once the dust settles, fees will compress and it will force those advisors that can't operate with diminishing revenues either out of the business or to consolidate.

Putting together a game plan

It's critical that advisors start to assess the impact that the new rule will have on their practice. It will make a difference as to whether you merely survive or thrive under the new rule. What can you do to prepare?

Audit your accounts
Advisors should figure out how the DOL fiduciary rule will impact their book of business. For example, if you are a registered representative, you have to look at your existing accounts and figure out what it will mean on an ongoing basis. For example, the BICE has a small grandfathering provision for existing accounts that lets firms set their own compensation practices

as long as they commit to putting their client's best interest first and disclose any conflicts that may prevent them from doing so.

Segment your clients
The new rule will have a major impact on smaller retirement accounts, mainly the ones under $25,000. Advisors should segment their clients into three parts.

1. Clients to be moved today.
   These are clients that are in commission-based products that an advisor can reposition or convert to an advice-based fee for service account.
2. Clients to retain.
   These accounts may be at a disadvantage if they were moved to an advice-based account. An example would be a client with an annuity that would have a large surrender charge if moved immediately.
3. Alternative clients.
   These accounts might be too small or unprofitable and may have to be "orphaned" or have to find a new home as the advisor cannot work with them anymore – or might not want to. These accounts may be ideal for a robo type of solution.

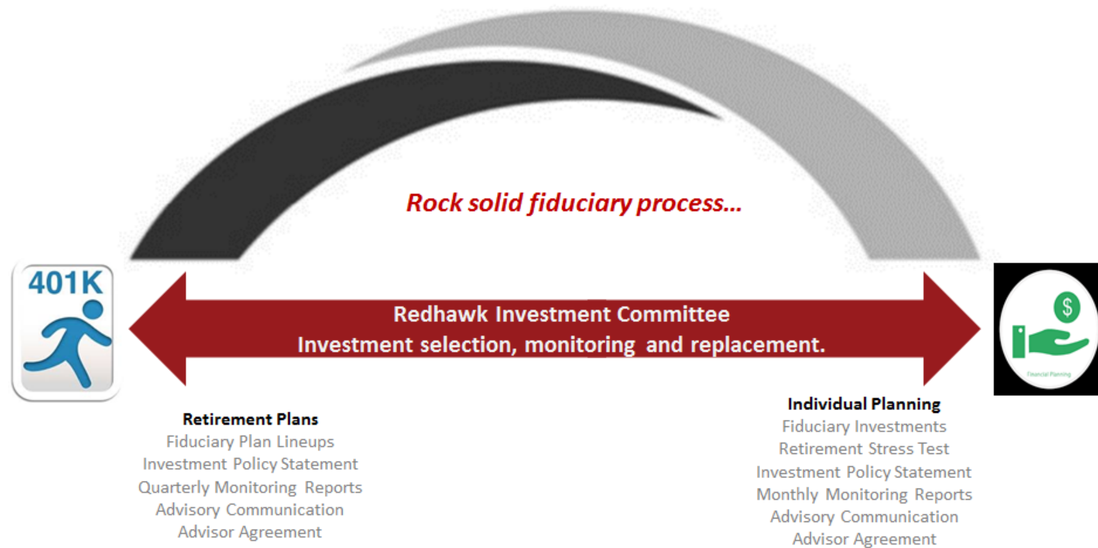
Tell your clients what's going on
Once advisors have clarity on the rule, have audited their books and segmented their clients, advisors should let their clients know how the fiduciary rule will affect them. Advisors should make sure clients are prepared so that when the fiduciary rule is finalized it's not a big surprise to them. It's possible that some clients may not be impacted at all, but given media speculation, some clients might be afraid of what's going to happen and it's best to keep them as calm as possible. By communicating with your clients, you are proactively letting them know what it means for them and if you aren't communicating to them, your competitor is.

Consider joining an RIA that's already compliant with the rule
Let's face it, over the next two to three years; advisors will earn less revenue under the new rule. It will happen gradually, but it will happen. Everyone is concerned about implementing the new rule, but no one is focusing on the changes that advisors will need to make in order to become more efficient. This will become more of a volume play as fees are reduced and it will force advisors to place an emphasis on acquiring more clients. It will be more about lead generation and getting in front of more clients. When looking at an RIA, you need to consider the following:

1. Are they already compliant with the DOL rule?
   When performing due diligence on an RIA, you'll want to make sure that they have already anticipated the DOL fiduciary rule and have made the necessary changes to be compliant with the rule. Make sure they have fiduciary oversight over every part of your practice that covers both retirement plans and financial planning.

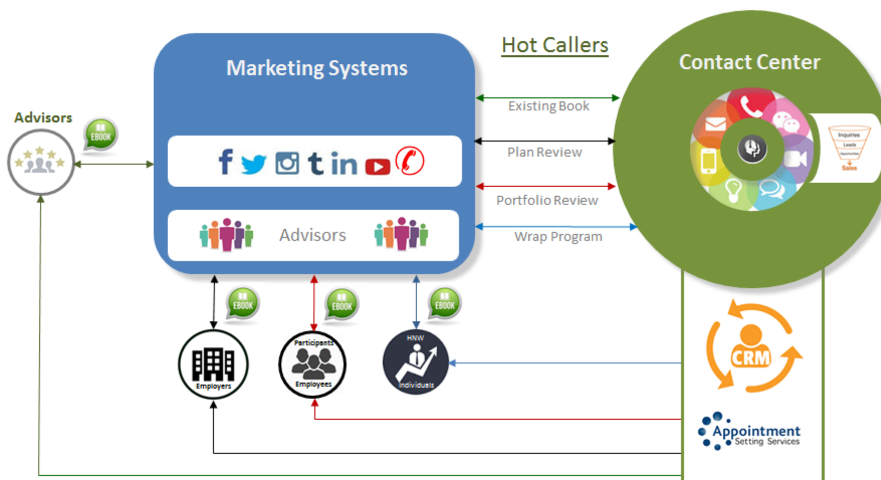
   Make sure the RIA has an approach and well defined processes that satisfies whether an advisor wants to be a fiduciary under ERISA, or they don't want to act as a fiduciary and utilize the BICE.

The diagram below depicts an RIA that has a comprehensive fiduciary oversight service model for both retirement plans and financial planning.



2. Do they have the right technology and support for you to scale efficiently?
When the DOL rule take place, fees will compress and you need to partner with an RIA that has the right technology and support that will allow you to scale. Advisors will need to focus on acquiring new clients and servicing existing clients efficiently and not spend valuable time on back-office activities that do not produce revenue. The chart below shows some of the key areas that an RIA must provide advisors.

3. Do they have marketing programs that will get you in front of more people?
   As fees compress, the only way to grow your firm will be to acquire more clients. In order to acquire more clients, you need to get in front of more people. This key element is mostly overlooked by advisors, yet it's a fundamental necessity to grow your practice. Only consider an RIA that has proven marketing programs for you to use. The diagram below shows a marketing program that puts the advisor front and center with prospects.



Conclusion

The DOL fiduciary rule will forever change the advisor landscape. It's critical that advisors start to assess the impact that the new rule will have on their practice. Advisory fees will compress and margins will tighten. Advisors must look to partner with an RIA that is already compliant with the new rule, allows for the advisor to scale their business efficiently, and provide access to get in front of more prospects.

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For more information, please contact Redhawk at either retirement@redhawkwa.com or (952) 835-4295.