While this transformation received a shot in the arm from the Department of Labor’s efforts to finalize the Conflict of Interest Rule, broker-dealers and financial professionals were already undergoing significant change. As a result, those who remain on the sidelines risk putting their business models at a competitive disadvantage moving forward.

Simply put, the Conflict of Interest Rule, while only one driver of change, has undoubtedly accelerated significant transformation that was already under way, and reaches well beyond the retirement investors the Conflict of Interest Rule sought to protect.

All of this is resulting in a refinement of the suite of products and underlying investments firms make available, enhancements to governance and oversight and a more rapid shift to advisory business.

At the firm level, there is greater scrutiny on the types of products made available to financial professionals, which ultimately impacts what products their clients can access. Furthermore, firms are making even more impactful decisions that will completely change their brokerage models. A “pullback” has occurred that takes various forms. Some firms are limiting the availability of brokerage-based solutions to clients, while others have limited the underlying investment offering as a result of re-evaluation and rationalization of their platforms. This has been driven by the compensation requirements of the Impartial Conduct Standards, as well as the potential liability inherent in reliance on the Best Interest Contract Exemption.

While not a new trend, the Conflict of Interest Rule has accelerated the transition to advisory business.

While not a new trend, the Conflict of Interest Rule has accelerated the transition to advisory business, and is driving further change. The result is that, in certain respects, advisory services are now more deliberately a larger part of the broker-dealer model than brokerage services. This is driven in part by complications created by the Conflict of Interest Rule and in part by efforts to retain those financial professionals that might consider walking away from their registered representative status all together.

This leaves broker-dealers needing to balance the demands of new risks associated with supporting dually registered professionals. As a result, significant changes are underway with respect to both the advisory programs they offer and the latitude they afford financial professionals in the Rep as Portfolio Manager Model.
The result is a streamlining of advisory programs, restructuring of advisory fees and compensation, and a reduction in the flexibility or even elimination of Rep as Portfolio Manager in favor of third-party strategists or more central control of models.

The Conflict of Interest Rule is also accelerating process change necessitated by a more broadly applied fiduciary standard. For this, it’s wise to look to best practices in the ERISA retirement plan space, and its penchant for “documentation, documentation, documentation.” A prudent process in the provision of investment advice cannot be demonstrated and proven without documentation, something firms are now placing a higher priority on and are therefore focused on improving whether it is a recommendation to roll over, to buy a particular security, or to invest through a specific advisory program.

This new focus on consistent process and greater documentation screams for improved oversight and in fact, will become central to upholding the warranties of the Best Interest Contract Exemption. Reliance on the Best Interest Contract Exemption goes as far as requiring the identification of an individual who is responsible for addressing material conflicts of interest faced by a firm. This focus has, in turn, led to a re-evaluation of processes that are barriers to effective oversight. One example of this is the operating model changes for firms with significant mutual fund business held direct to fund. To ensure the effective supervision of this business, firms are driving rapid change and migration of assets to their respective brokerage platforms. The byproduct of this move is the creation of increased efficiencies for broker-dealer processes, and improved controls around supervising their mutual fund businesses.

Moving forward, it is clear that the fiduciary mindset is not only here to stay, but it is also expected to have profound impact on how investment advice is delivered. Moving forward, it is clear that the fiduciary mindset is not only here to stay, but it is also expected to have profound impact on how investment advice is delivered. While some day-to-day, tactical compliance requirements may be removed if the Conflict of Interest Rule and its exemptions are significantly revised, it will nonetheless cause an overall transformation of firms.

Specifically, these changes will involve a reinvented business model that positions financial professionals to acknowledge, act and operate according to a fiduciary standard—a change that will extend well beyond retirement accounts. It will cause firms to look at potential conflicts in a new way and result in more transparent and conflict-free revenue generation. This will also translate into better alignment of financial professional compensation with the value they provide and more transparent pricing for clients.
Any discussion of wholesale industry change, especially when it involves a fiduciary standard, naturally raises questions of cost. The most likely scenario is that explicit fees to clients will rise over time, while implicit costs will fall. Indeed, it has been happening for some time. As we saw in the ERISA retirement plan market, this transition is not always easy. Financial Professionals must be prepared for difficult conversations if they are to navigate this transition. Those who are able to articulate and demonstrate value are well-positioned to navigate these changes.

For these reasons, a significant amount of thought should be given to how firms structure themselves in the future in order to most effectively align their value proposition with the services they provide.

Ultimately, what may or may not happen with the Department of Labor Conflict of Interest Rule is beside the point. Transformational industry change is already underway, and has been for some time. The only remaining question is how well, and how quickly, firms and their affiliated financial professionals can adapt.

---

We Can Help

Pershing’s open-architecture platform can help support your strategies to comply with the new Conflict of Interest Rule. Additional information can be found in Pershing’s DOL Resource Center in the Marketing Center in NetX360®.
The information provided in this document is general and educational in nature, and is not intended to be, and should not be construed as legal advice. Firms must evaluate their business models to determine how the DOL rule impacts their business and compliance models.

The information provided in this article is educational in nature, and is not intended to be, and should not be construed as legal advice. Federal and state laws and regulations governing broker-dealer and registered investment advisor conduct are complex and subject to change.