THE IMPACT OF THE DOL RULING ON FUND DISTRIBUTION

GEMINI COMPANIES

Since the February 2015 White House call-to-action for the Department of Labor (DOL) to update rules protecting retirement accounts against conflicts of interest, many articles, white papers and surveys have been created to rebut, dissect and foresee the impact of the DOL's ruling. Although, there is speculation as to the future of the DOL ruling - investment managers should continue to prepare for the stated April 10, 2017 regulatory compliance date that is swiftly approaching. To prepare for this new reality, investment managers should begin to **review their current business models, assess compliance policies and procedures, review current distribution fees, understand trends and develop an actionable plan** ahead of next spring.

THE DOL FIDUCIARY RULES

MEANINGFUL DOL RULES:

- Regulation over financial advice for retirement accounts.
- Compensation prohibited if it conflicts with a client's best interest.
- Best Interest Contracts (BIC) disclosure on exempt accounts.

COMPLYING WITH GUIDELINES:

- Commitment to provide advice in the best interest of the client.
- Adopting policies and procedures to mitigate conflicts of interest.
- Prominent and proactive disclosure of conflicts of interest.

EFFECT ON INVESTMENT MANAGERS

BUSINESS MODEL → SALES & MARKETING → COMPLIANCE

BUSINESS MODEL

THE INCREASING PUSH TOWARD A FEE-BASED MODEL

BACK TO THE FUTURE

Before the popularity of pooled investments with multiple strategies and a variety of share class options, professional investment management was delivered as a wealth management solution, with advice and education at the epicenter. Investment strategies were delivered in diversified or concentrated portfolios of individual securities, these separately managed accounts (SMAs) reigned supreme for decades, as the SMA offered both individual investment ownership and transparency. Whether a high-net-worth investor or an institution, clients understood how their assets were being invested and the cost of the investment. The new ruling is taking us back to 1940—allowing managers of the '40 Act structure to continue offering investment solutions through an SMA, in a simplified, transparent and potentially more cost-effective structure for the client.

Since 2008, the financial services industry has systematically shifted fiduciary responsibility to discretionary fee-based solutions. Whether these solutions are offered through an advisor, firm-driven models or turnkey asset management programs (TAMPs), the fee-based movement has transformed how the fund managers do business. The DOL will accelerate the trend, as seen recently with the shift to low-cost funds at Ameriprise, Charles Schwab & Co. and LPL. Such businesses are also fully supporting fee-based accounts such as wrap accounts or TAMPs with the intent of not only minimizing potential conflicts of interest, but also simplifying their operating model.

A SHIFT IN SHARE CLASSES

Furthering the case for fee-based advice is the shift in load-waived Class A and I share usage. Since load-waived A and I shares do not have high-end commissions, they are the most commonly utilized share classes in fee-based accounts (the A-share 12b-1 fees are often returned to end investors in fee-based accounts as a rebate, and I shares are no-load by nature). According to Morningstar, the past 12 months have seen A shares experience a net $102 billion outflow. The market share of Class A shares fell from 16.96% in March 2015 to 16.43% 12 months later. Our own fund data also supports the fee-based shift, showing dramatic year-over-year buys and sells for I shares (an increase from 50% of all share class transactions in June 2015 to 75% in June 2016) and A shares (which decreased from 41% of all share class transactions in June 2015 to 17% in June 2016). C shares, on the other hand, were flat year-over-year at 8%, further demonstrating the upward trend toward fee-based advisory solutions.

The intermediary platform community tends to lead industry trends for inflows and product placement. Smaller fund complexes will continue experiencing challenges in gaining platform placement as intermediaries continue leaning on larger fund complexes, resources and scale for product options and financial advisor support. Larger fund managers tend to lead industry trends, which they can sustain or build given their size. However, smaller independent broker-dealers (IBDs) may be unable to implement a shift to their business model, which will lead to an increase of IBD mergers and acquisitions. This year alone, the IBD space has seen a sell-off as transactional sales have plummeted, creating lower-than-normal margins. The upcoming DOL rules will cause the IBD space to further shrink, limiting IBDs' distribution opportunities. As the smaller firms are acquired by larger organizations, the onboarding process will become more difficult given greater due diligence requirements, a larger competitive universe and more expensive platform fees. In addition, increased product oversight may also impact the product universe as broker-dealers seek to decrease the number of available strategies, adding further compression for investment managers.

While fee-based business continues its momentum, it poses several critical questions: Should the investment manager continue to pursue transactional- or commission-based markets, and if so, for how long? Should managers restructure their existing back- and front-end load share classes? We can help you answer these questions in accordance with your unique firm or fund.

SALES & MARKETING

IMPACT ON DISTRIBUTION: PROS AND CONS

Since the DOL's new rules hasten a shift to simpler solutions and business models, they create widespread and complex ripple effects for mutual fund distribution, which impacts share class structures, shareholder servicing fees, distribution fees and marketing engagement.

PROS

COLLAPSE OF THE SHARE-CLASS ALPHABET SOUP

- With the move to fee-based solutions, we anticipate a parallel move to a common share class structure: Institutional (I or Y shares), Investor (N), A and R share classes. The streamlined share classes will offer investors simplicity, transparency and a better understanding of their investments.

SUB-ACCOUNTING

- The move to fee-based solutions offered through intermediaries has led to another trend: the move toward omnibus account operating environments, which enable managers and intermediaries to commingle securities for more than one beneficial owner. Omnibus accounts allow for simpler account trading, and offer streamlined execution and account allocation flexibility.

DECREASED FUND FEES/HIGHER PARTNERSHIP FEES

- Clients will benefit from the decreased fund expenses offered through fee-based solutions, as these accounts do not allow for sales charges.

MORE FOCUSED TARGET MARKET

- Investors (end clients) are not the only ones to benefit from fee-based business offerings. Fee-based business provides financial advisors with a more efficient practice—moving them away from "selling" to establishing deeper relationships with their investors, increasing their revenue and offering a broader roster of investment options.

SHARE CLASSES DEFINED

- **Institutional shares:** Do not have sales charges, are low-cost, tend to have higher minimums and are the preferred share class for large-asset accounts.
- **Investor shares:** No front-end or back-end sales charges, and are most often offered through an intermediary.
- **A shares:** Have a front-end sales charge and have been utilized for asset-based accounts; could serve as substitutes for C shares that have back-end load charges if the shares are sold within one year. A shares are often offered with a front end load waived.
- **R shares:** Designated for retirement accounts, and typically do not carry any front-end or back-end charges. However, operating expenses may vary greatly from one fund family to another. Generally may only be purchased through 401(k) and other employer-sponsored plans.

CONS

BIG CHANGES REQUIRED

- Pooled investment managers need to review and may need to change their current share class lineup to stay up-to-date with industry trends.
- Compliance with industry trends and new regulations could be costly.

LESS TRANSPARENCY & HIGHER COST

- Omnibus accounts allow for simpler trading, but managers can't see the underlying sale on a per-account basis, unless they contract through a third-party provider to enable this transparency for monitoring purposes.
- Fees for omnibus accounts are significantly higher than per-account network trading.

POTENTIAL OUT-OF-POCKET FEES

- Share classes with 12b-1 fees would typically offset the cost of intermediary platform fees. In response to the potential diminished use of 12b-1s, the investment manager would need to pay the fees out of pocket if the fund does not have sufficient operating expenses to cover such fees.
- Fee compression may lead to the emergence of marketing partnership agreements with intermediaries, which may also be a direct expense for investment managers and can be costly for smaller fund managers.

REALIGNMENT POSES CHALLENGES

- For investment managers, the depth of the broader product offering poses competitive challenges. Finding new ways to stand out amongst your peers will become a top priority in this environment.
- Client realignment will change financial advisors' conversations with investment managers as they seek to meet their fiduciary responsibility and further understand and document the recommendations they are providing clients. Financial advisors may rely on third-party recommendations or firm-driven models, or conduct deeper due diligence on investment managers, thereby prolonging the sales process.
- The move by financial advisors from commission-based to fee-based business will affect smaller independent broker-dealers that have yet to transition to fee-based solutions. IBDs may look to outsource their fee-based solutions, which decreases potential traction for smaller investment managers while increasing the time required to on-board strategies at outsourced provider programs, such as TAMPs, or recommended platforms.

COMPLIANCE

MONITORING AND ENFORCEMENT

One of the key issues facing investment managers' compliance with the coming DOL fiduciary rule is the creation of policies and procedures, and upgrading or implementing account technology, to minimize litigation exposure. These business changes may cause investment managers and financial intermediaries to incur significant costs to be fully compliant with the new rules.

PROS

STREAMLINED TECHNOLOGY CAN HELP

- Creation of proprietary technology solutions, or outsourcing arrangements with third-party technology providers, can assist managers with establishing a streamlined process for monitoring and staying in compliance with the new rules.

CONS

BIG CHANGES REQUIRED

- Those firms that decide to continue offering commission-based products and/or employ third-party advisors must disclose BIC conditions. Firms will have to upgrade their technology and make other operational changes while facing greater exposure to the risk of client litigation.
- Use of digital advisory (also known as "robo-advisory") solutions for smaller investors will open the advice-driven market.
- Investment managers utilizing robo-advisory solutions will likely move away from retirement account advice, as it may become too expensive to go after retirement accounts due to higher costs for lower-net-worth investors. This will likely in turn force the smaller investors to rely on robo-advisors for retirement advice because they cost less than traditional advisors. However, the investors will wind up with access to fewer investment options.

COUNTING DOWN

The countdown to the April 10, 2017 implementation of the DOL fiduciary rule is fast approaching. Investment managers should seek to outline a DOL readiness plan to ensure that their businesses are capable of navigating their industry's post-DOL terrain, which includes:

- ☑ Working with distribution partners to gain a deep understanding of how the intermediary is preparing to implement the DOL rules and how that would affect the mutual fund structure.
- ☑ Determining the needs of the financial advisor and client in order to craft a communication and education plan to help them adjust to the new regulations.
- ☑ Consulting with key partners on the legal, fund administration and distribution sides to review and make changes to current policies and procedures, and to discuss low-cost offerings that meet the needs of target markets.
- ☑ Understanding how to place strategies on robo-advisor platforms and determining what would be needed to support that aspect of the business.
- ☑ Gaining a deeper understanding of how to engage with third-party advisory solution providers, such as TAMPs.
- ☑ Reviewing sales and marketing content, and creating educational materials for new fee-based accounts.
- ☑ Determining if the organization is adequately staffed to manage the requirements of the new DOL fiduciary rule.
- ☑ Monitoring the Trump administration's position on the DOL fiduciary rule.

Don't hesitate to reach out to us with questions as the compliance date draws near.

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