Financial Services Observer

October 2015

The U.S. Department of Labor's Fiduciary Rule for Advisors Could Reshape the Financial Sector

Contents

Executive Summary

We assess that the U.S. Department of Labor's proposed conflict-of-interest, or fiduciary standard, rule could drastically alter the profits and business models of investment product manufacturers like BlackRock and wealth management firms like Morgan Stanley serving retirement accounts. Based on our proprietary estimates, we believe that the rule will affect around $3 trillion of client assets and $19 billion of revenue at full-service wealth management firms. Additionally, we think that investors and business analysts looking only at the more studied implementation costs of the rule are vastly underestimating the rule's potential impact on the financial sector. Current government and financial industry reports have a high-end annual cost estimate of $1.1 billion, but even our low-end prohibited transaction revenue estimate, arrived at using Morningstar Direct data, is more than double that at $2.4 billion.

The rule's financial repercussions also extend far beyond wealth management firms. We believe beneficiaries will be discount brokerages, like Charles Schwab; companies tied to passive investment management, like State Street; and robo-advisors. Conversely, some asset managers, like Apollo Global Management, and life insurance companies, like Prudential Financial, will probably be challenged. Companies with economic moats will be the winners of the disruption to the investment product distribution landscape.

Morningstar's Top Financial Services Category Investment Ideas

Name/Ticker	Economic Moat	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Morningstar Rating	Credit Rating	Market Cap(Bil)
BlackRock BLK	Wide	Positive	USD	365	346.32	Medium	★★★	A+	57.41
Charles Schwab SCHW	Wide	Stable	USD	32	31.00	High	★★★	A+	40.71
Morgan Stanley MS	Narrow	Stable	USD	38	33.54	High	★★★	BBB	65.32
State Street STT	Wide	Stable	USD	84	69.78	Medium	★★★★	A-	28.71
TD Ameritrade AMTD	Narrow	Stable	USD	43	34.96	High	★★★★	A	18.95
Wells Fargo WFC	Wide	Stable	USD	61	55.09	Medium	★★★★	A	284.64

Financial Services Observer

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Key Takeaways

Background and Purpose of the Department of Labor's Conflict-of-Interest Rule

- The proposed Department of Labor conflict-of-interest rule seeks to extend fiduciary duties to financial advisors that are under a suitability standard via its authority to define prohibited transactions. Under the proposed rule, practically any advice to a retirement account that leads to third-party remuneration would be considered a prohibited transaction.
- Self-directed retirement account assets eclipse private defined-benefit plans. IRA assets are likely to exceed $10 trillion by 2020 as a result of market returns and rollovers from 401(k)s.

What Can We Learn From Other Countries That Have Adopted Similar Best-Interest Standards?

- While the Department of Labor rule may look more lenient than the United Kingdom's Retail Distribution Review or Australia's Future of Financial Advice reforms, it isn't. Many financial industry groups believe that the rule effectively bans receiving third-party payments, as the proposed prohibited transaction exemptions are unworkable.
- Following the U.K. Retail Distribution Review, there were changes at both the industry and company level. At the industry level, there was a decrease in the number of financial advisors, a marked increase in passive investment product market share, and higher usage of fund platforms. At the company level, there was an increase in explicit advice charging that generally didn't completely offset the loss in commissions and trail fees.

The Department of Labor's Rule Is a Wealth Management Industry Game Changer

- Based on our interpretation of the Department of Labor's conflict-of-interest rule, we see it as primarily targeting advised, commission-based IRA assets. Our estimate of full-service wealth management client assets affected by the rule is approximately $3 trillion, and we assess that publicly traded firms hold over $1 trillion of those assets.
- We believe that investors and business analysts should be more concerned about the industry revenue affected by the rule than the implementation costs that government and financial industry reports have focused on. Annual cost estimates are as high as $1.1 billion, but our proprietary, low-end estimate of $2.4 billion of prohibited transaction revenue, which we arrived at using Morningstar Direct, is more than double that. Additionally, our rough estimate of the total revenue affected by the Department of Labor rule is $19 billion.
- Combining revenue and cost estimates, operating margins on IRA assets could contract up to 30%.

Three Major Financial-Sector Trends Will Receive a Boost From the Department of Labor Rule

- Full-service wealth managers may convert commission-based IRAs to fee-based IRAs to avoid the additional compliance costs of the Department of Labor rule. As fee-based accounts can have a revenue yield upwards of 60% higher than commission-based, this could translate to as much as an additional $13 billion of revenue for the industry.
- Robo-advisors stand to benefit from the Department of Labor rule, as they pick up a portion of our estimated $250 billion to $600 billion of low-account-balance IRA assets from clients let go by the full-service wealth management firms. Capturing a fraction of these loose assets will bring stand-alone robo-

advisors much closer to the $16 billion to $40 billion of client assets that we believe they need to become profitable.

- We believe that over $1 trillion of assets could flow into passive investment products from the Department of Labor rule. The increase would be from higher adoption of robo-advisors, increased usage of passive investment products from financial advisors that formerly may have been swayed by distribution payments, the proposed "high-quality, low-cost" exemption, and the effect of advisors trying to balance out higher explicit financial planning charges.

Which Companies Will Benefit or Be Challenged by the Department of Labor's Fiduciary Rule?

- We assessed the overall impact of the Department of Labor's conflict-of-interest rule on financial industries by looking at five criteria: pay/receive third-party payments, client asset inflows/outflows, expenses/legal exposure, vertical integration conflict, and the potential for a moat-based market share/mix shift gain.

Exhibit 1 The Fiduciary Rule Has Positive and Negative Repercussions Throughout the Financial Sector

	Pay/ Receive 3rd Party Payments	Client Asset Inflows/ Outflows	Expenses/ Legal Exposure	Vertical Integration Conflict	Moat-Based Market Share/ Mix Shift Gain	Overall
Discount Brokerages	Mixed/ Neutral	Postive	Mixed/ Neutral	Mixed/ Neutral	Mixed/ Neutral	Postive
Index and ETP Providers	Mixed/ Neutral	Postive	Mixed/ Neutral	Mixed/ Neutral	Mixed/ Neutral	Postive
Active Asset Managers	Negative	Negative	Mixed/ Neutral	Mixed/ Neutral	Postive	Mixed/ Neutral
Full-Service Wealth Management Firms	Negative	Negative	Negative	Negative	Postive	Mixed/ Neutral
Alternative Asset Managers	Negative	Negative	Mixed/ Neutral	Mixed/ Neutral	Mixed/ Neutral	Negative
Life Insurance Companies	Negative	Negative	Mixed/ Neutral	Negative	Mixed/ Neutral	Negative

Postive Mixed/ Neutral Negative

Source: Morningstar

- We believe that beneficiaries of the rule will be discount brokerages, like Charles Schwab and TD Ameritrade, and index and exchange-traded product providers, like BlackRock, London Stock Exchange, MSCI, State Street, and Vanguard. Discount brokerages should be able to pick up a portion of our estimated $250 billion to $600 billion of low-balance IRA assets that will be let go by the full-service wealth management firms, while the index and exchange-traded product providers will gain market share from the accelerated movement to passive investment products.
- There will be a mixed effect on active asset managers, like AllianceBernstein, BlackRock, Cohen & Steers, Eaton Vance, Federated Investors, Franklin Resources, Invesco, Janus Capital Group, Legg Mason, T. Rowe Price Group, and Waddell & Reed Financial, and full-service wealth management firms, like Bank of America, Morgan Stanley, Raymond James Financial, Stifel Financial, UBS, and Wells Fargo. Both of these groups will be materially affected by the prohibition on third-party payments. That said,

we believe that firms with moats will gain market share from their less competitively advantaged peers or that they'll be able to adjust their business model to offset the negative financial effects of the rule.

- Some alternative asset managers, such as Apollo Global Management, and life insurance companies, like Ameriprise Financial, MetLife, Principal Financial Group, and Prudential Financial, will be challenged by the rule. As specific alternative investment products were excluded from the list of assets that the best-interest contract exemption can apply to, certain alternative asset managers will have a decidedly more difficult time distributing their products to retirement accounts than mutual fund firms. Given the often higher commission rates of particular annuities and vertical integration at some life insurance companies, certain life insurance companies will be challenged by the rule.

Background and Purpose of the Department of Labor's Conflict-of-Interest Rule

Key Takeaways

- The proposed Department of Labor conflict-of-interest rule seeks to extend fiduciary duties to financial advisors that are under a suitability standard via its authority to define prohibited transactions. Under the proposed rule, practically any advice to a retirement account that leads to third-party remuneration would be considered a prohibited transaction.
- Self-directed retirement account assets eclipse private defined-benefit plans. IRA assets are likely to exceed $10 trillion by 2020 as a result of market returns and rollovers from 401(k)s.

In April 2015, the Department of Labor released a notice of proposed rulemaking regarding who would be considered a fiduciary to a retirement plan or account. Many expect the rule to be finalized by the spring of 2016. The major extension of the rule is to impart a fiduciary responsibility to advisors of individual retirement accounts and considering most investment advice leading to third-party remuneration as a prohibited transaction.

The Department of Labor has taken this step for two primary reasons:

- Financial advisors that are currently under a suitability standard may be unduly influenced by conflicts of interest that would be lessened if they were subject to a fiduciary standard.
- The nature of retirement saving has drastically changed since the Employee Retirement Income Security Act of 1974, or ERISA.

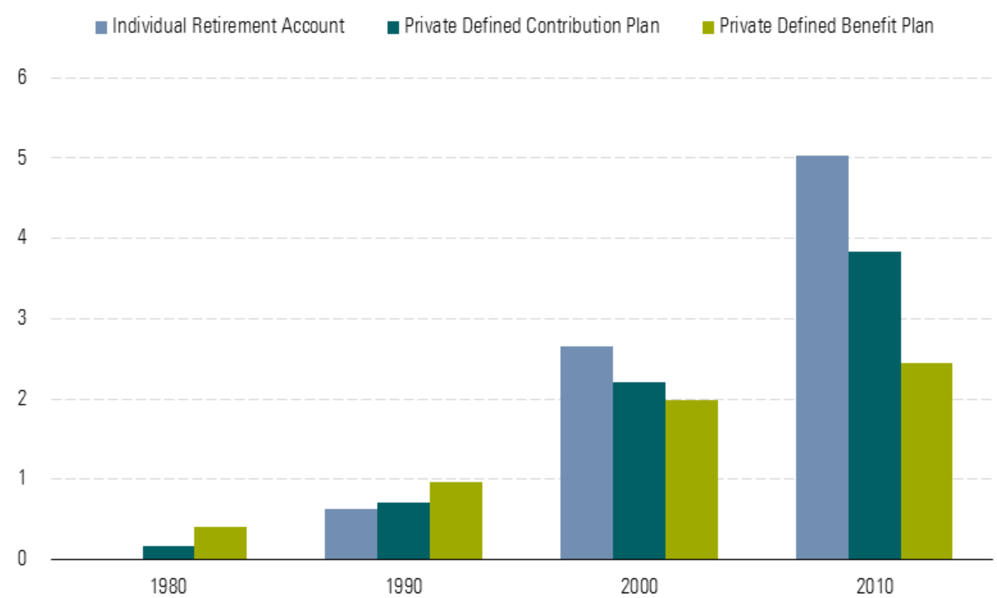
Financial advisors currently operate either under a fiduciary standard or a suitability standard. The fiduciary standard applies to investment advisors regulated under the Investment Advisers Act of 1940 and requires that investment advisors act in the best interest of their clients and manage conflicts of interest that could influence their recommendations. Managers of employee benefit plans are also fiduciaries under ERISA.

The suitability standard applies to broker-dealers regulated under the Securities and Exchange Act of 1934 and according to FINRA Rule 2111 requires that they "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer." In general, while FINRA and the SEC have determined that brokers violated the suitability rule by putting their own interests ahead of their customers', financial advisors that are regulated as brokers can recommend a product that pays them more over a product that pays them less, as long as the recommended product is still suitable for the client. This creates a potential conflict of interest. By extending the fiduciary standard to broker-dealer financial advisors when they advise IRAs, the Department of Labor hopes to reduce conflicts of interest via its authority to define prohibited transactions.

Important Retirement Investment Decisions Are Increasingly Falling Into the Hands of Individuals

When ERISA originally passed, retirement account assets were in employer-sponsored retirement plans supervised by a plan fiduciary. However, over the next 40 years, retirement account assets have shifted to more self-directed defined-contribution plans and IRAs from defined-benefit plans.

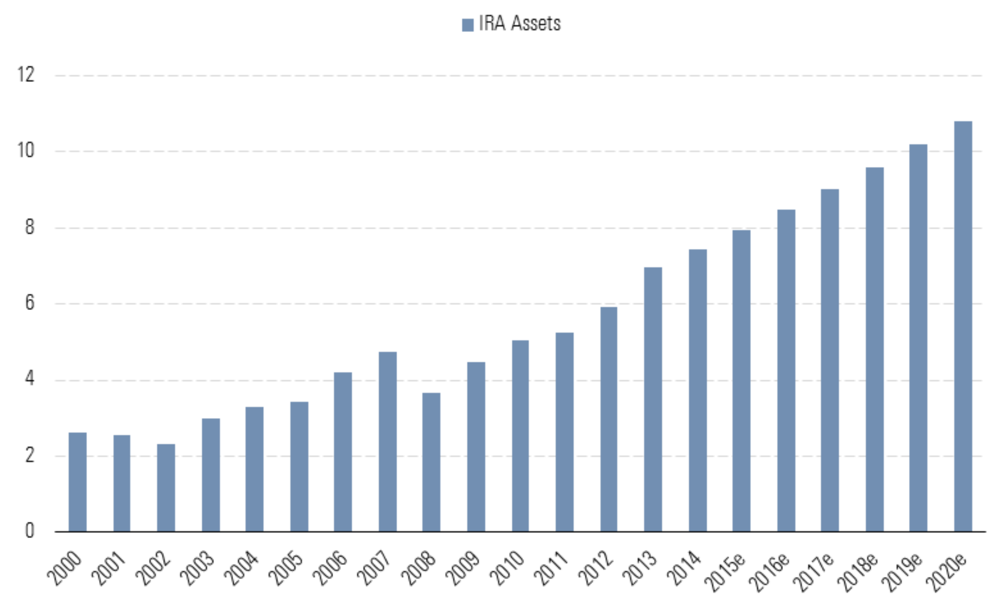
Exhibit 2 Self-Directed Retirement Assets Have Dramatically Risen Over the Last 40 Years ($ Trillions)



Source: Department of Labor, Federal Reserve

By 2020, IRA assets are likely to grow to in excess of $10 trillion from a combination of account returns and net inflows.

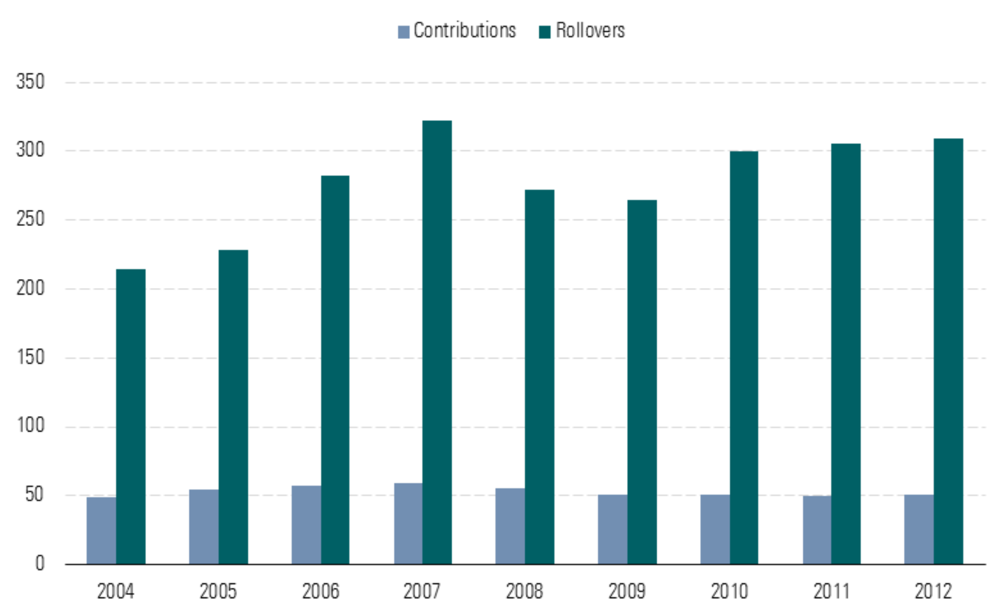
Exhibit 3 IRA Assets Already Exceed $7 Trillion and Are Projected to Grow to Over $10 Trillion ($ Trillions)



Source: Federal Reserve, Morningstar

Additionally, much of the inflows into IRAs are rollovers from employer-sponsored retirement plans, as individuals consolidate their retirement assets after leaving a job, rather than contributions.

Exhibit 4 Rollovers From Employer-Sponsored Plans Constitute the Majority of IRA Inflows ($ Millions)



Source: Internal Revenue Service
*Data after 2012 is unavailable

The Department of Labor sees the movement of assets from the arguably more protected employer-sponsored retirement plans overseen by plan fiduciaries and the general increase in IRA assets, which may be self-directed or advised by a financial advisor subject to a suitability standard with potential conflicts of interest, as an issue.

What Can We Learn From Other Countries That Have Adopted Similar Best-Interest Standards?

Key Takeaways

- While the Department of Labor rule may look more lenient than the U.K.'s Retail Distribution Review or Australia's Future of Financial Advice, it isn't. Many financial industry groups believe that the rule effectively bans receiving third-party payments, as the proposed prohibited transaction exemptions are unworkable.
- After the U.K. implemented its rule, there were changes at both the industry and company level. At the industry level, there was a decrease in the number of financial advisors, a marked increase in passive investment product market share, and higher usage of fund platforms. At the company level, there was an increase in explicit advice charging that generally didn't completely offset the loss in commissions and trail fees.

The Department of Labor's proposed conflict-of-interest rule is part of a global rulemaking trend during the past several years that has sought to increase retail investor protection. Two countries that have enacted similar rules include Australia through its Future of Financial Advice reforms, which became mandatory in 2013, and the U.K., with its Retail Distribution Review that was implemented at the end of 2012.

Coinciding with Australia's and the U.K.'s reforms were material changes in investment product market share, investment product distribution channels, revenue mix of the wealth management firms, and wealth management firms' business models. We believe that a Department of Labor best-interest standard will similarly cause major shifts in investment product choice and financial-services business models.

Exhibit 5 On the Surface, the Department of Labor Rule May Look More Lenient Than Other Best-Interest Standard Rules, but It Isn't

	U.S. DOL Fiduciary Standard	**United Kingdom RDR**	**Australia FOFA**
Scope	Retirement Accounts	Retail Investment Products	Retail Investment Products
Increased Disclosure of Fees	Yes	Yes	Yes
Grandfathering of 3rd Party Commissions	Yes*	Yes	Yes
Ban on Future 3rd Party Commissions	No*	Yes	Yes
Increased Proficiency Requirements	No	Yes	No
Bi-Annual Fee Opt-In	No	No	Yes

Source: Australian Securities & Investments Commission, Department of Labor, Financial Conduct Authority, Morningstar
*Third party commissions can be grandfathered if the advisor ceases to provide advice on the underlying investment
*Future third party commissions can be received if it qualifies for a prohibited transaction exemption

The main legs of these reforms have been increased disclosure of the fees that are directly or indirectly being paid by the investor for investment products or financial advice and bans on payments from third parties for the purchase of investment products. Morningstar's 2015 "Global Fund Investor Experience Study" noted that fund expense ratios in certain countries have fallen in recent years because of the unbundling of the financial advisor advice fee from the fund expense ratio. Morningstar's Greggory Warren also noted in his piece "Pricing Already Under Pressure in the Canadian Fund Market" that increased fee and performance transparency from the second phase of the Client Relationship Model will cause changes in the Canadian asset management and wealth management industries. Additional measures taken by the U.K. include setting a higher level of professional qualification. Australia's rule also requires that a client explicitly renew its ongoing fee arrangement with an advisor every two years.

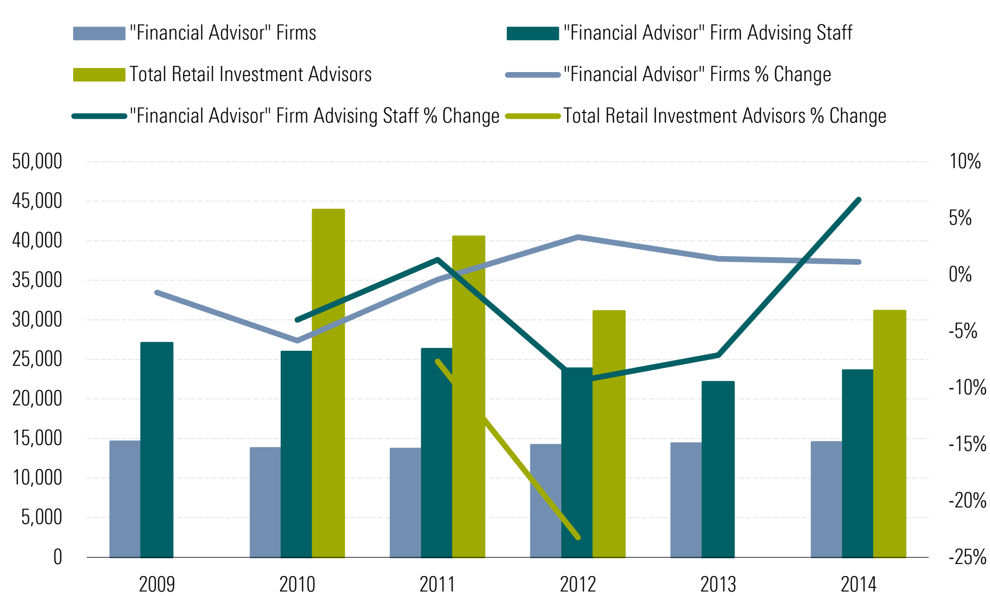
While it may seem that the Department of Labor rule is more lenient than other best-interest standards, since it has a couple fewer requirements and doesn't completely ban third-party commissions, it isn't, and the financial-services industry generally views its ability to make use of various safe harbors as unworkable. In order to grandfather pre-existing transaction compensation, the advisor and financial institution can no longer advise on the purchase, sale, or holding of the concerned asset. Broadly speaking, the financial industry feels that it would be difficult to monitor financial advisors to ensure that they don't accidently provide advice on the grandfathered asset. Additionally, not advising on the grandfathered asset when a financial advisor is trying to assess a client's whole financial picture is seen as not being in the client's best interest.

Future third-party commissions can be received if the underlying transaction qualifies for a prohibited transaction exemption. The prohibited transaction exemption rules rely on the advisor entering into a "best-interest contract" with the client. As the advisor has entered into a best-interest contract with the client that allows the client to bring legal action against the advisor if it's breached, the advisor is essentially a fiduciary that is required to manage conflicts of interest, such as receipt of third-party remuneration. Because of the cost related to the disclosures, monitoring, and potential for legal liability from using the best-interest contract exemption to receive third-party payments, many wealth management firms believe that this will make offering commission-based brokerage accounts to IRA clients uneconomical and force the firms to move the IRAs to a fee-based arrangement. Because fee-based account arrangements generally have higher account minimums, the wealth management industry also believes that this will cause holders of low-balance accounts to lose access to advice.

Both the Macro and Micro Investment Services Ecosystem Changed After the United Kingdom's Retail Distribution Review

Leading up to and following the U.K.'s Retail Distribution Review in 2012, there was a material decline in the number of financial advisors. Total retail investment advisor headcount across all channels decreased 29% from 2010 through 2012. Among firms whose primary business is wealth management, advising staff headcount decreased a somewhat more modest 8%.

Exhibit 6 Leading Up to and After the U.K. Retail Distribution Review in 2012, There Was a Material Decline in the Number of Financial Advisors



Source: Association of Professional Financial Advisers, Financial Conduct Authority, Morningstar, RS Consulting

Many have noted that a large portion, approximately 40%, of the decline in total retail investment advisors from 2011 to 2012 was concentrated in the bank and building society channel. While certain European banks may have already been undergoing a series of business restructuring unrelated to the

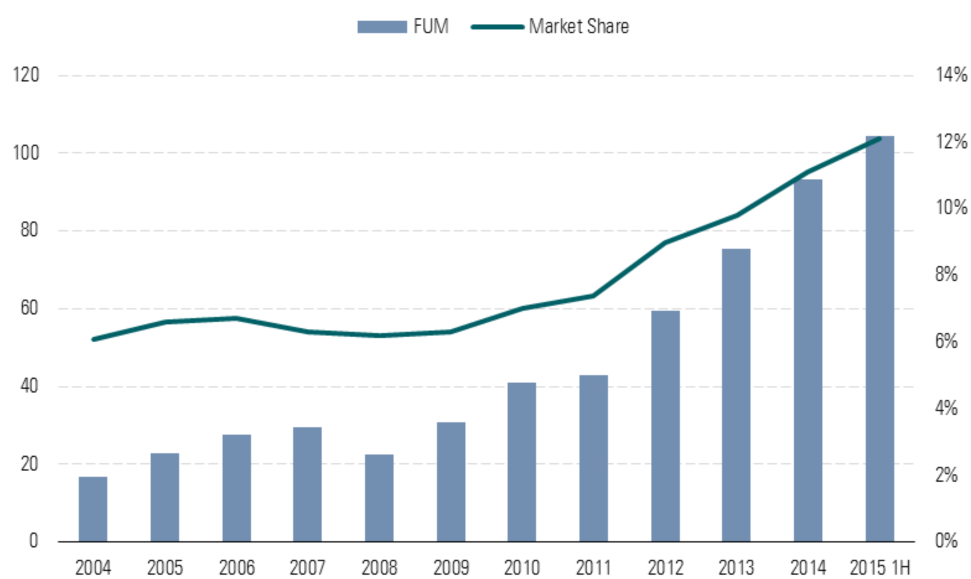
Retail Distribution Review, we believe that its potential negative effect on the profitability of their wealth management businesses must have been a factor taken under consideration when making the decision to reduce their wealth management service offerings and related headcount.

Besides headcount reductions decided at the company level, individual financial advisors may have chosen to exit the field of their own volition. According to an RS Consulting survey done on behalf of the U.K.'s Financial Services Authority, approximately 6% of the surveyed advisors would be classified as "early leavers" who planned on leaving the industry after the Retail Distribution Review was implemented at the end of 2012, with approximately 40% of those respondents saying that the professionalism requirement was a material factor. An additional portion of the 2% who gave an "other" response of their plans and some of the 15% who responded with a "likely to remain (a retail investment advisor)" cited that remaining one would depend on the economic viability of their practice after the Retail Distribution Review.

The Retail Distribution Review Also Coincides With a Change in U.K. Investment Product Market Share and Distribution

Passive-investment tracker fund assets and market share significantly increased around the time of the Retail Distribution Review. From 2011 through the first half of 2015, assets increased approximately 140%, and market share significantly increased from about 7.4% to over 12%. The increase is even more dramatic after considering that tracker fund market share was fairly range-bound from 2004 through 2010 at 6% to 7%. Some have attributed the higher tracker fund usage to the increased transparency in investment product fees, diminished influence of trail commissions from actively managed products, and the wider adoption of investment platforms.

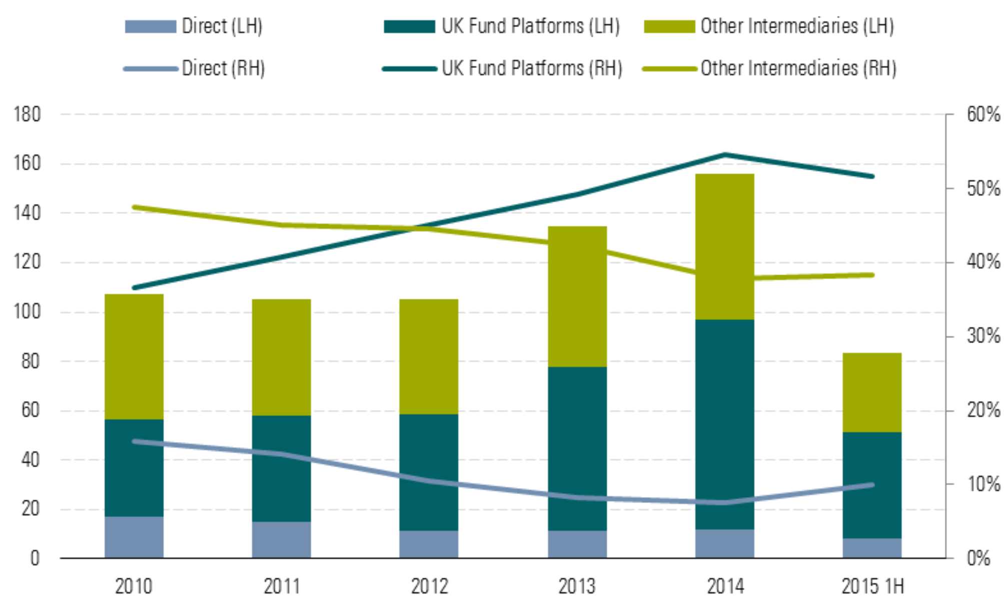
Exhibit 7 Passive-Investment Tracker Fund Market Share Increased After the Retail Distribution Review in 2012 (GBP Billions)



Source: Investment Association

While not solely attributable to the Retail Distribution Review, the United Kingdom fund platform distribution channel also gained material retail market share from direct distributers and other intermediaries, such as financial advisors, over the last several years. Platforms now have over 50% market share of gross retail sales of U.K.- domiciled funds and surpassed other intermediaries as the leading channel in 2012. Direct distribution market share has also halved to 7.5% in 2014 from 16% in 2010.

Exhibit 8 U.K. Fund Platforms Have Gained Market Share From the Direct and Intermediary Channels (Gross Retail Sales of U.K.-Domiciled Funds GBP Billions, % of Gross Retail Sales)



Source: Investment Association

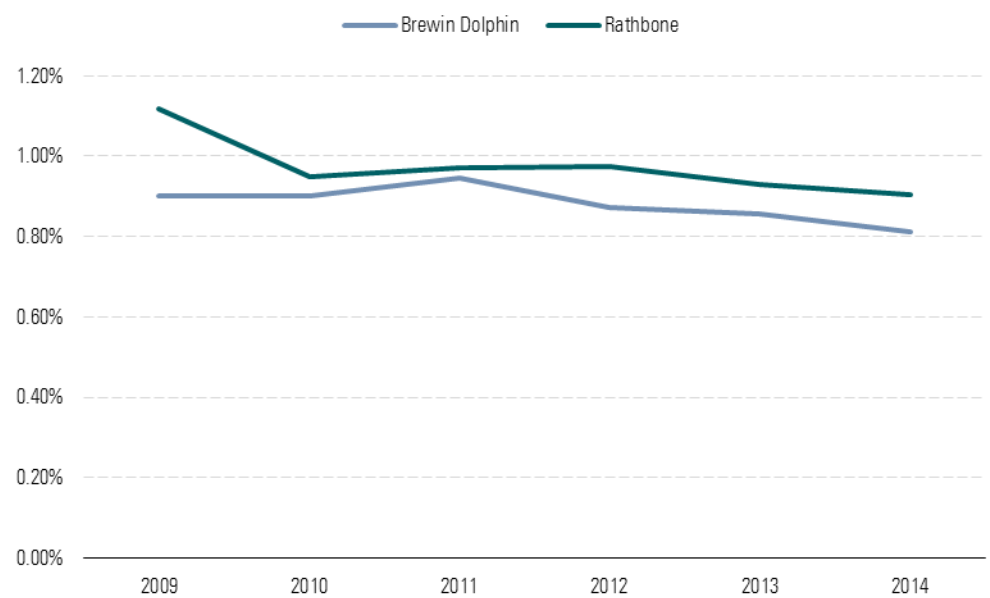
Investor and financial advisor choice of investment products and distribution channel have increasingly shifted toward lower-cost investment options after the Retail Distribution Review was implemented.

The United Kingdom's Retail Distribution Review Caused Firms to Change Their Business Model
Our overall impression from looking at three publicly traded U.K. wealth managers (Rathbone Brothers, Brewin Dolphin, and St. James's Place) is that they're making up for Retail Distribution Review revenue pressure, in lines such as commissions, by offering and charging more for providing financial advice.

We believe that looking at total revenue yield on funds under management is a reasonable measure of the effect of the Retail Distribution Review on wealth managers, since it controls for the absolute increase in revenue attributable to growth in funds under management. That said, overall revenue yield on funds under management doesn't take into account changes in revenue mix that may have a higher or lower revenue yield or a decrease in funds under management yield from more clients reaching asset-level fee breakpoints. Looking at the total revenue yield on funds under management at a couple of U.K.-

based wealth managers, there is a slight decrease, 7 to 9 basis points, at Rathbone Brothers and Brewin Dolphin after the Retail Distribution Review.

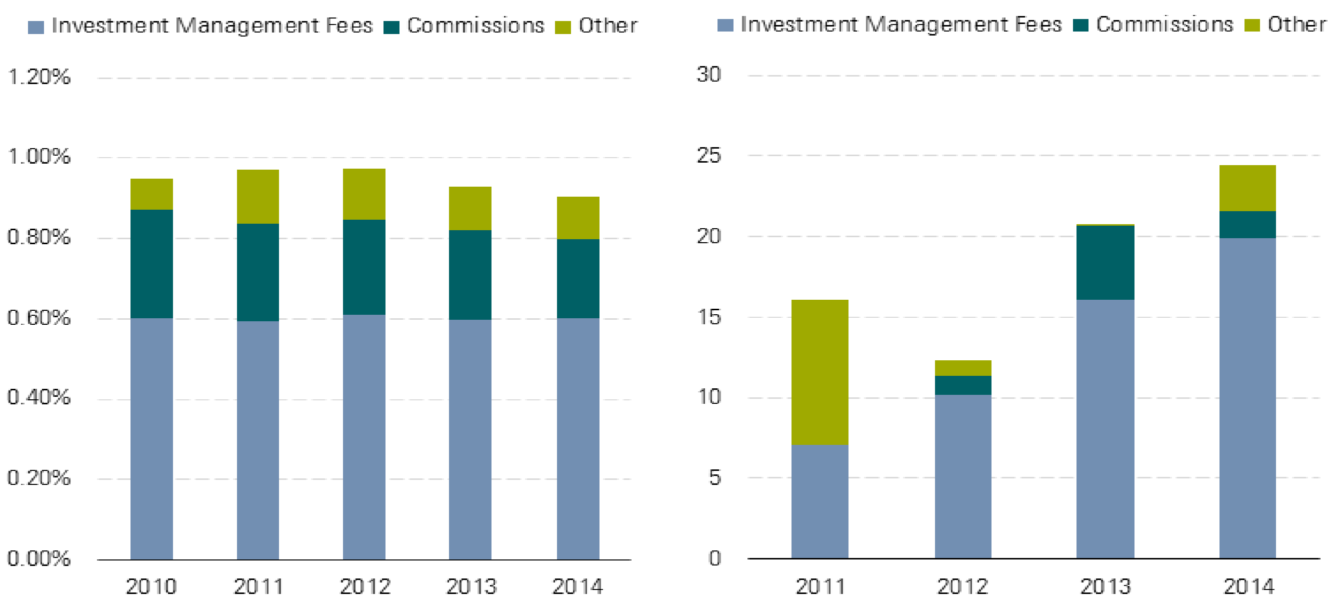
Exhibit 9 Revenue Yields Contracted After the Retail Distribution Review (% of Funds Under Management)



Source: Company filings, Morningstar

The modest revenue yield decline at Rathbone Brothers and Brewin Dolphin masks the change in their businesses.

Exhibit 10 Other Revenue Lines at Rathbone Brothers Couldn't Offset a Decline in Commission Yield (% of Funds Under Management, GBP Millions)

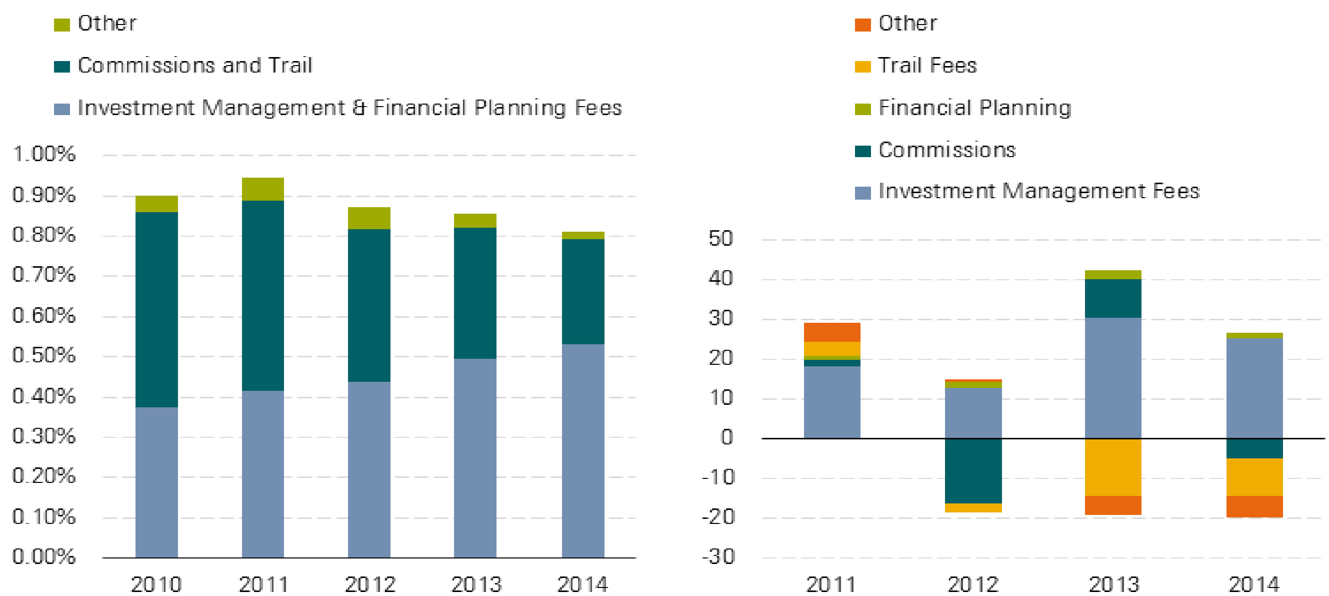


Source: Company filings, Morningstar

From 2012 through 2014 at Rathbone Brothers, overall revenue growth failed to keep up with asset growth. Net investment management fee income increased 37%, keeping pace with the 39% increase in funds under management. However, net commission income only increased 17% over that time frame, so its relative underperformance accounts for about half of the revenue yield decrease. The other half of the revenue yield decrease in "other" is from stagnant net interest income that is a function of the economic environment and not the Retail Distribution Review.

Brewin Dolphin's case is starker than Rathbone Brothers and is a prime example of how regulation can disrupt industries and force a change in business models. The company had a material decline in commissions and trail fees. Trail fees decreased 80% to just GBP 5.5 million in 2014 from GBP 29.2 million in 2012. However, largely offsetting the decline in commissions has been an absolute increase in investment management fees and an increase in the investment management fee yield on funds under management.

Exhibit 11 Higher Investment Management Fees Partially Offset a Drastic Decline in Trail Fees (Revenue Yield % on Funds Under Management, GBP Millions)



Source: Company filings, Morningstar
*2010 and 2011 financial planning and trail fees are Morningstar estimates

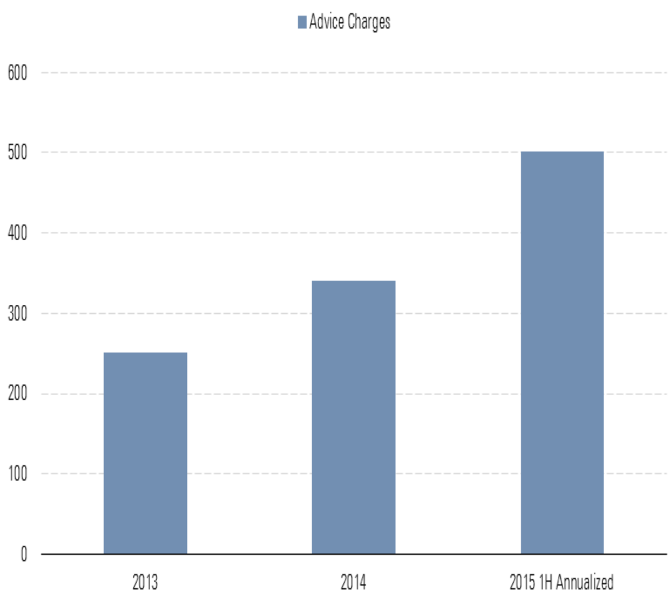
Underlying the investment management yield increase was Brewin Dolphin's business decision to generally stop offering its advisory managed and advisory dealing service. This prompted client assets to switch to full discretionary or execution-only services. The natural place for advisory managed assets to migrate is to full discretionary, where the company would pick up an additional 34 basis points of revenue yield. Advisory dealing assets are more likely to flow to execution-only, but the step-down is only 8 basis points. This planned shift in service offerings is what has bolstered investment management fees and led to the company maintaining its funds under management revenue yield despite the drop in commissions and trail fees.

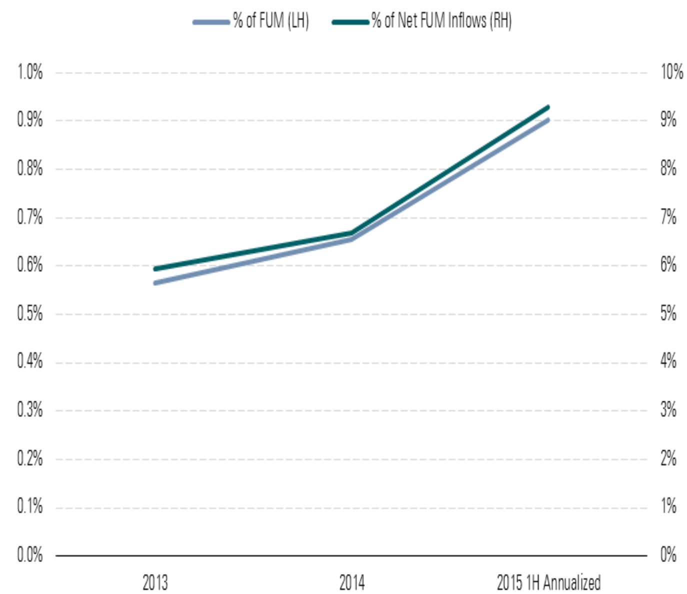
Exhibit 12 The Higher Investment Management Revenue Yield Resulted From a Business Mix Shift to More Profitable Discretionary Accounts (Funds Under Management in GBP Millions, Revenue Yield % on Funds Under Management)

Source: Company filings, Morningstar

St. James's Place is an interesting life insurance-wealth management hybrid in the U.K. that also shows a change in business model emphasis after the Retail Distribution Review. Because of recent changes in accounting rules, we can't calculate a clean revenue yield on funds under management going back several years. However, it is easy to see that the company has been materially increasing its "advice charges" on both an absolute basis and as a percentage of funds under management or net funds under management inflows.

Exhibit 13 St. James's Place Has Increased Its Charges for Financial Advice Since Retail Distribution Review (GBP Millions, % of Funds Under Management, % of Net Funds Under Management Inflows)





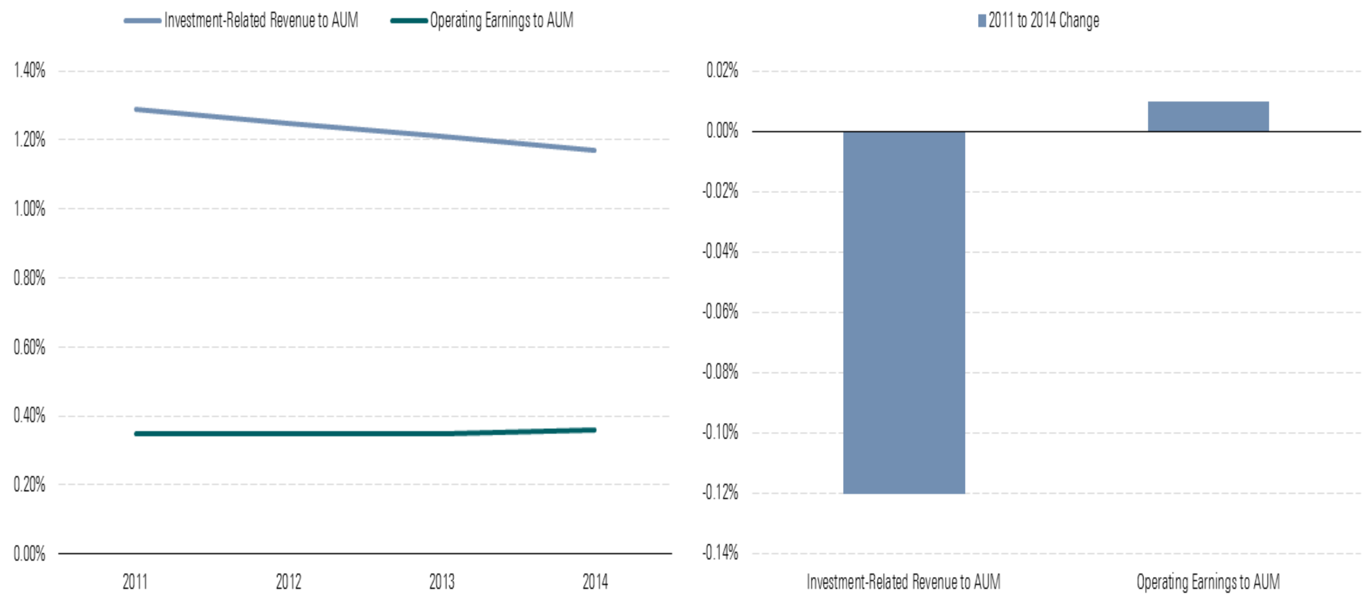
Source: Company filings, Morningstar

The Effect of Australia's Future of Financial Advice Act on Its Largest Wealth Management Firm Is Muddied by Other Legislation and an Acquisition

In Australia, similar to the United Kingdom, the near-term effect of the Future of Financial Advice has been muted by trail fee grandfathering. The immediate effect of the Future of Financial Advice on the wealth management business of narrow-moat AMP is made even more difficult to ascertain, as it began adjusting its business for the rule before the implementation date and made the material acquisition of AXA Asia Pacific Holding's Australian and New Zealand businesses.

There has been a noticeable decline in the ratio of investment-related revenue to assets under management over the past several years. However, much of the decline has been the result of changes in product mix—including the transition toward MySuper, the regulatory compliant default superannuation investment option in Australia, occurring between January 2014 and June 2017—and not necessarily because of the Future of Financial Advice. Arguably more important for AMP, despite the revenue yield decline, it's been able to maintain its operating earnings yield on AUM through cost efficiencies and scale benefits.

Exhibit 14 Despite a Revenue Yield Decline Caused by a Mix of New Regulations, AMP Has Maintained Its Operating Earnings Yield (% of AUM)



Source: Company filings, Morningstar

The Department of Labor's Rule Is a Wealth Management Industry Game Changer

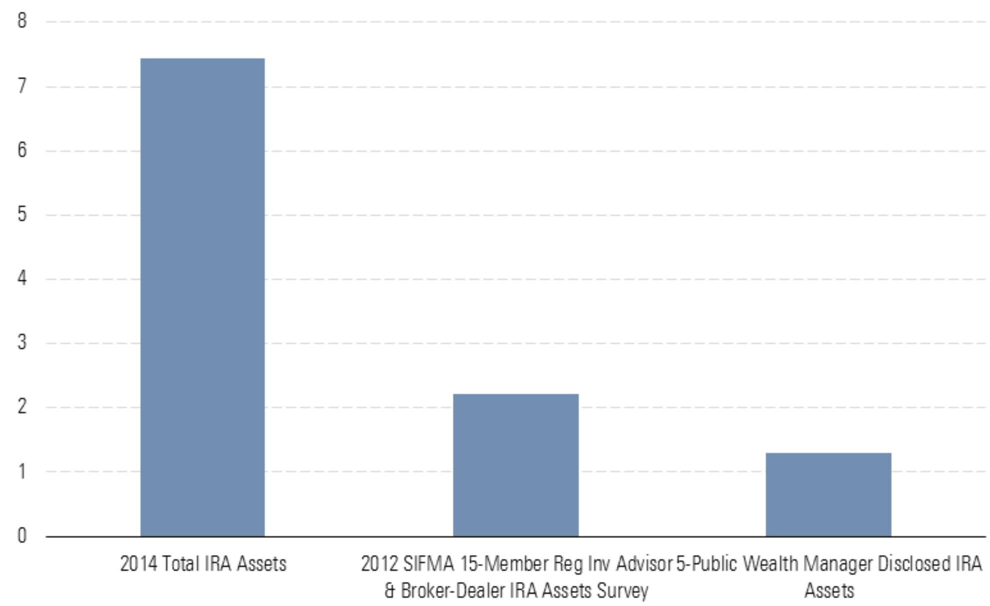
Key Takeaways

- Based on our interpretation of the Department of Labor's conflict-of-interest rule, we see it as primarily targeting advised, commission-based IRA assets. Our estimate of full-service wealth management client assets affected by the rule is approximately $3 trillion, and we assess that publicly traded firms hold over $1 trillion of those assets.
- We believe that investors and business analysts should be more concerned about the industry revenue affected by the rule than the implementation costs that government and financial industry reports have focused on. Annual cost estimates are as high as $1.1 billion, but our proprietary, low-end estimate of $2.4 billion of prohibited transaction revenue, which we arrived at using Morningstar Direct, is more than double that. Additionally, our rough estimate of the total revenue affected by the Department of Labor rule is $19 billion.
- Combining revenue and cost estimates, operating margins on IRA assets could contract up to 30%.

Based on our estimates, over $3 trillion of full-service wealth management client assets will be affected by the extension of a fiduciary duty to IRAs. Additionally, using data from Morningstar Direct, we calculate a low-end amount of prohibited transaction revenue of $2.4 billion, which is more than double other research reports' high-end annual compliance costs of the rule. Therefore, our view is that investors and business analysts looking only at the more studied costs of the rule are vastly underestimating the rule's potential impact on the financial sector.

According to the 2013 response from the Securities Industry and Financial Markets Association to an SEC data and information request, among only the 15 SIFMA member firms that responded with data, they held $2.217 trillion of client assets in IRAs at the end of 2012. Among just the five wealth management firms that we found that have disclosed IRA assets, they held around $1.3 trillion.

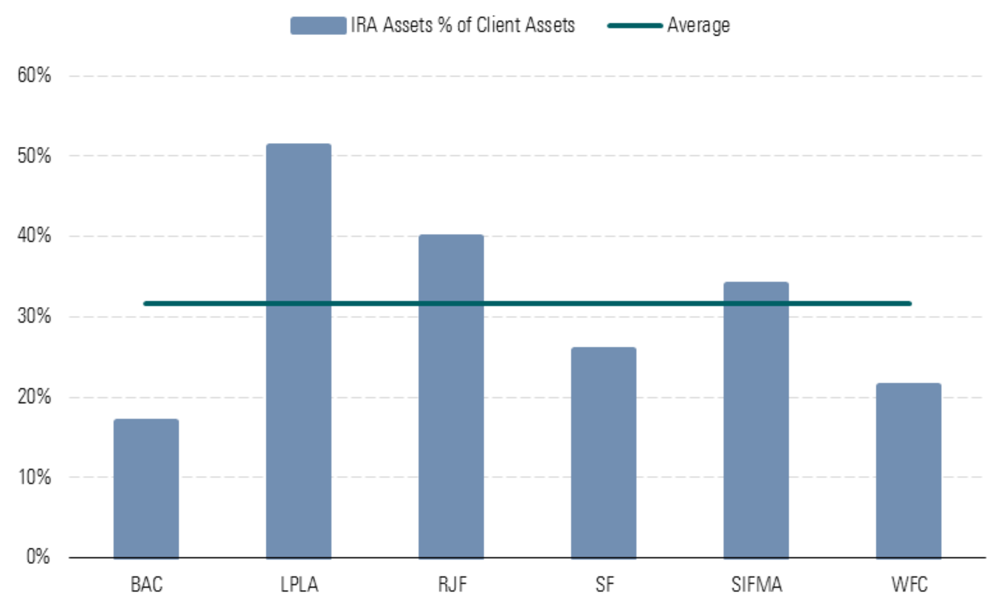
Exhibit 15 Wealth Management Firms Hold a Material Amount of IRA Assets ($ Trillions)



Source: Company filings, management comments, U.S. Federal Reserve, SIFMA

As a percentage of client assets, IRA assets are around 30% of client assets.

Exhibit 16 IRA Assets Compose Approximately 30% of Client Assets



Source: Company filings, management comments, SIFMA

While the proposed Department of Labor rule covers all IRA assets, one of its primary purposes, similar to Australia's and the United Kingdom's rules, is to reduce the potential conflict of interest created when a third party, such as a fund manager or insurance company, pays a commission to the financial advisor or the financial advisor's firm for putting client assets in its financial product.

This purpose leads to two important qualifications when looking at the potential assets affected:

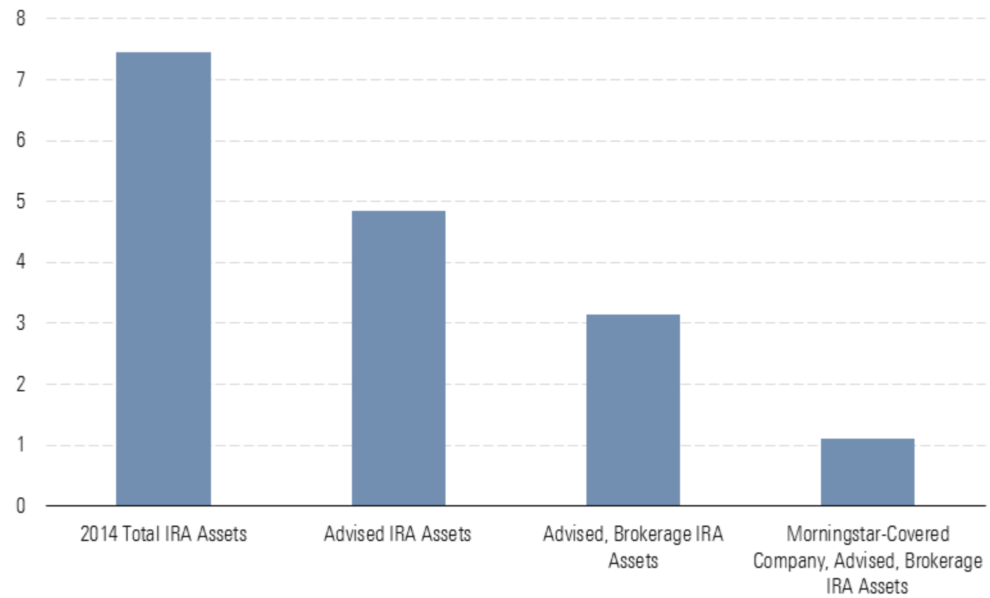
- They'll mainly be in commission-based brokerage IRAs.
- The assets are in an advised or full-service relationship instead of being self-directed.

The first qualification means that assets in fee-based charging arrangement accounts, with the fee typically determined as a percentage of client assets, should be little affected. Fee-based IRA assets that are managed by a Registered Investment Advisor, or RIA, on a discretionary-basis are already under a fiduciary standard. Because they're under a fiduciary standard, the advisor has a duty to manage and disclose conflicts of interest, and therefore, fee-based advisors typically use "unbundled" mutual fund share classes and similar products that don't have third-party commission payments or trailer fees. Even if they use a share class with a trailer, the trailer payment may be rebated to the client.

The second qualification means that the rule shouldn't affect self-directed IRAs. Firms with their historical roots in the discount retail brokerage space, such as Charles Schwab and TD Ameritrade, have much less to worry about than full-service wealth managers. One aspect of the rule that even the firms supporting self-directed IRA investors may need to contend with, though, is to make sure that the information they provide fits into the rule's education carve-out and isn't deemed financial advice. The discount brokerages, along with other record keepers, may also have rollovers from employer-sponsored retirement plans into IRAs stunted if the initial information provided about having an IRA is considered financial advice.

Even after using this more narrow scope for the assets that will be most affected, we estimate that the wealth management industry has around $3 trillion of advised, commission-based brokerage IRA assets. Among the financial-sector stocks that we cover with material wealth management operations, we estimate that they hold over $1 trillion of advised, commission-based brokerage IRA assets.

Exhibit 17 We Estimate That Around $3 Trillion of Client Assets Will Be Affected by the Department of Labor Rule and That Publicly Traded Wealth Management Firms Hold Over $1 Trillion ($ Trillions)



Source: Company filings, U.S. Federal Reserve, Morningstar

Aggregate Industry Cost Estimates Have a Wide Range, but Are Likely to Be Substantial

Expense forecasts for the fiduciary rule have been done by the Department of Labor using SIFMA data, Deloitte & Touche LLP on behalf of SIFMA, and Oxford Economics with the support of the Financial Services Institute. Aggregate first-year cost estimates range from approximately $740 million to $4.7 billion. Annual ongoing costs are from $390 million to $1.1 billion.

Exhibit 18 While Industry Implementation Cost Estimates Have a Wide Range, It Will Be in the Billions ($ Millions)

	Department of Labor		**Deloitte-SIFMA**		**Oxford Econ-FSI**
	Scenario A	Scenario B	DOL Methodology	Alternative Methodology	
1st Year Costs	1,440	744	2,200	4,700	3,870
Ongoing	669	389	563	1,100	

Source: Deloitte & Touche, Department of Labor, Oxford Economics

The lowest cost estimates are from the Department of Labor in its "Scenario B." The Scenario B costs are based on the cost survey that SIFMA submitted to the SEC relating to its uniform fiduciary standard data request. That said, the SIFMA costs are adjusted downward by nearly 80% to reflect, in the Department of Labor's opinion, SIFMA's sample consisting of primarily the largest U.S. financial institutions. While the Department of Labor believes that even its Scenario B estimates may be overstated, some have criticized the Department of Labor's cost estimates as too low on various grounds, such as it being based on SIFMA member estimates for a contemplated, much narrower in scope SEC fiduciary standard and not specifically the Department of Labor standard.

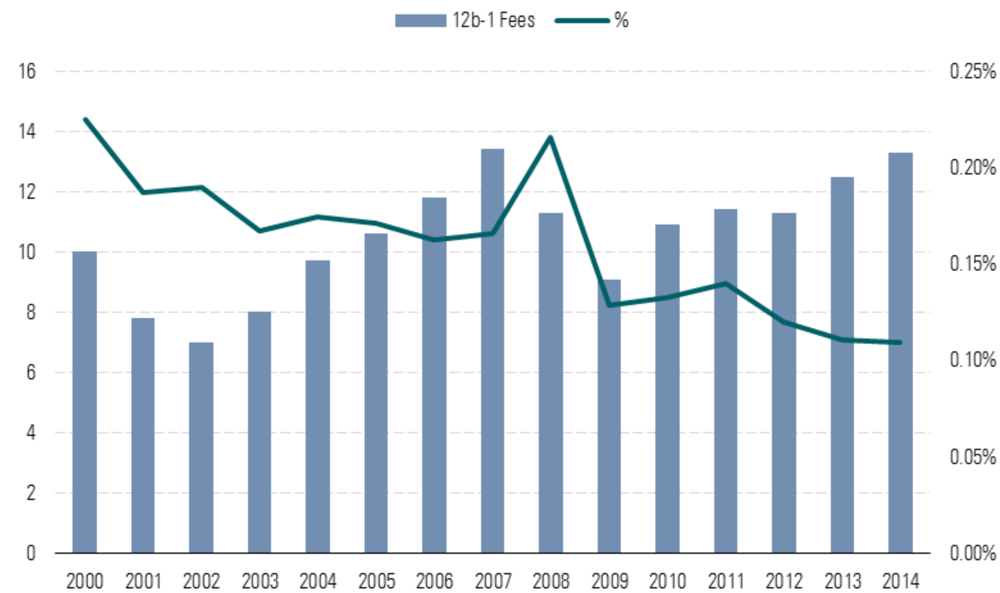
The highest industry cost estimate comes from the Deloitte study done on behalf of SIFMA using its "Alternative Methodology," which basically begins by grouping the 18 SIFMA firms that submitted cost estimates into buckets for large, midsize, and small firms. Then the average cost estimate in the large and medium buckets are multiplied using the number of firms of that size in the U.S. according to the Department of Labor. The Deloitte study didn't include the costs of small firms, as it assumed that its small-firm sample didn't represent the heterogeneous U.S. small-firm market. Additionally, the system implementation and compliance costs of the Department of Labor rule may fall just as much or more on the back-office and platform providers of the small firms as the small firms themselves.

The Oxford Economics study that relied on the Financial Services Institute membership, which is composed of independent broker-dealers, estimated first-year costs in between the Department of Labor and Deloitte's studies. For comparison purposes, it's important to note that the Oxford Economics aggregate estimate, similar to the Department of Labor but different than Deloitte, included small broker-dealers. It's quite interesting to note that the ratio of midsize and small broker-dealer startup costs to large broker-dealer costs in the Oxford Economics study are 55% and 44% greater, respectively, than the ratio that the Department of Labor used to do its cost estimates and that its industry startup cost estimate is over three times higher than the Department of Labor's. While this may substantiate the claim that the Department of Labor's cost estimates are too low, Oxford Economics' sample size is too small to draw a definitive conclusion.

The Potential Wealth Management Industry Revenue at Risk Dwarfs Industry Expense Estimates
While there have been multiple studies to figure out the costs to broker-dealers with wealth management operations, the revenue impact on the industry has been largely ignored in both government and financial industry studies of the rule. We believe that the revenue from commission-based account assets subject to the Department of Labor rule is even more important than cost estimates for investors, as our low-end prohibited transaction revenue estimate based on Morningstar data of $2.4 billion is more than double the $1.1 billion high-end cost estimate from industry reports. Our low-end estimate includes only mutual fund 12b-1 fees and front-end loads, but other sources of wealth management firm revenue affected by the rule would include annuity trails, general mutual fund revenue-sharing agreements, and alternative investment product commissions.

Using Morningstar's mutual fund database, we calculate that open-end mutual fund 12b-1 distribution and servicing fees or trails, which is one of the major categories of third-party commissions or compensation that the Department of Labor's rule targets, totaled over $13 billion in 2014.

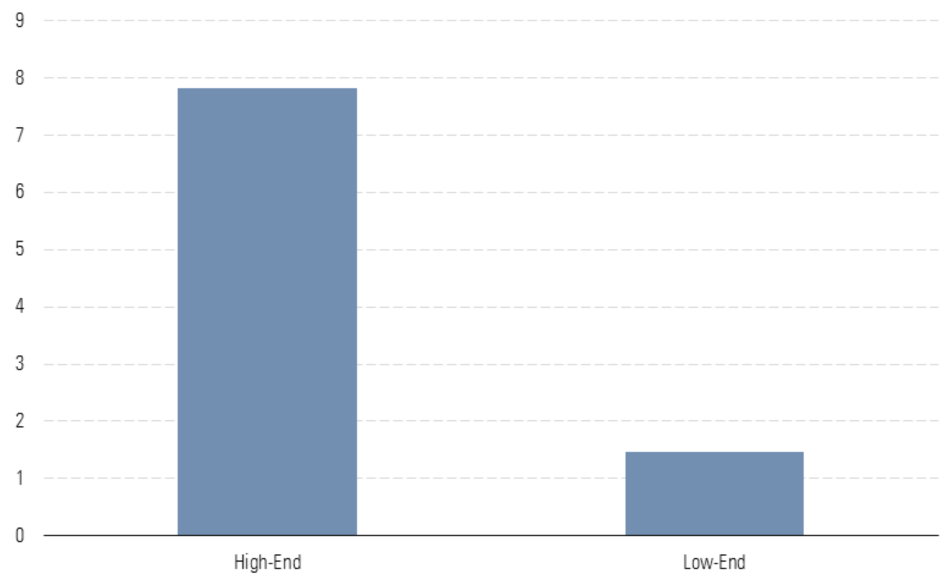
Exhibit 19 Mutual Fund 12b-1 Fees Total Over $13 Billion ($ Billions, 12b-1 Fees as a % of Fund Assets)



Source: Morningstar Direct

At the high end, $7.8 billion of 12b-1 fees may be annually collected from all IRA assts. This would be based on assuming the typical A-share or no-load 12b-1 fee of 25 basis points applied to the $3.1 trillion of non-money-market, mutual fund assets in IRAs. On the low end, we would estimate $1.46 billion of 12b-1 fees being affected by the Department of Labor rule. This is based on an 11-basis-point average 12b-1 fee for open-end mutual funds, our $3.1 trillion estimate for advised, brokerage IRA assets, and the fraction of IRA assets in mutual funds.

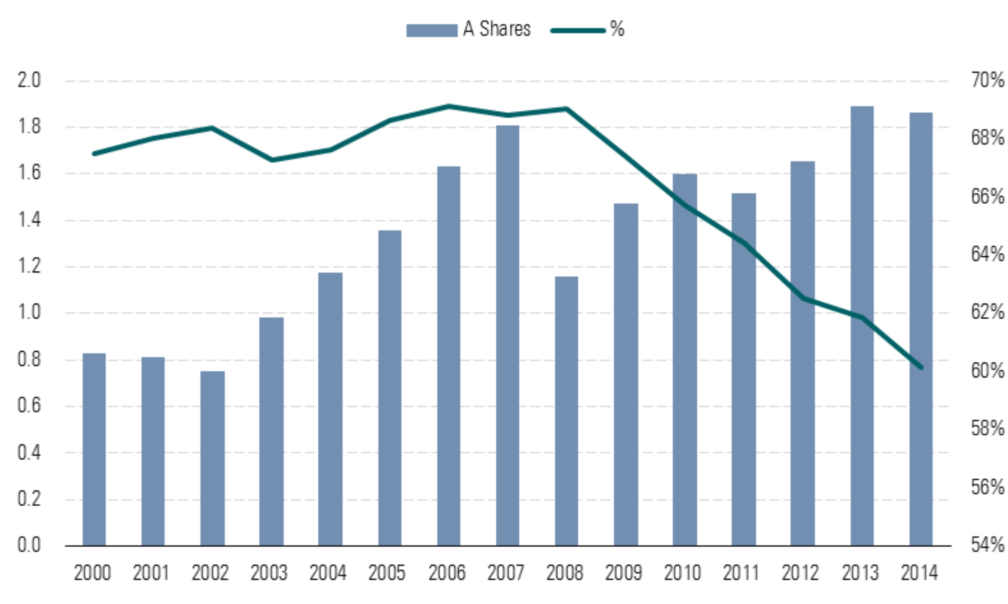
Exhibit 20 Our Estimate Range For IRA 12b-1 Fees Is $1.46 Billion To $7.8 Billion ($ billions)



Source: Morningstar

Another third-party payment that would constitute a conflict of interest under the Department of Labor rule is mutual fund sales loads. While its estimated portion of sales into the financial advisor channel has been on the decline in recent years, front-end sales commission or A-class load shares still constitute the majority of financial advisor mutual fund assets at approximately 60%.

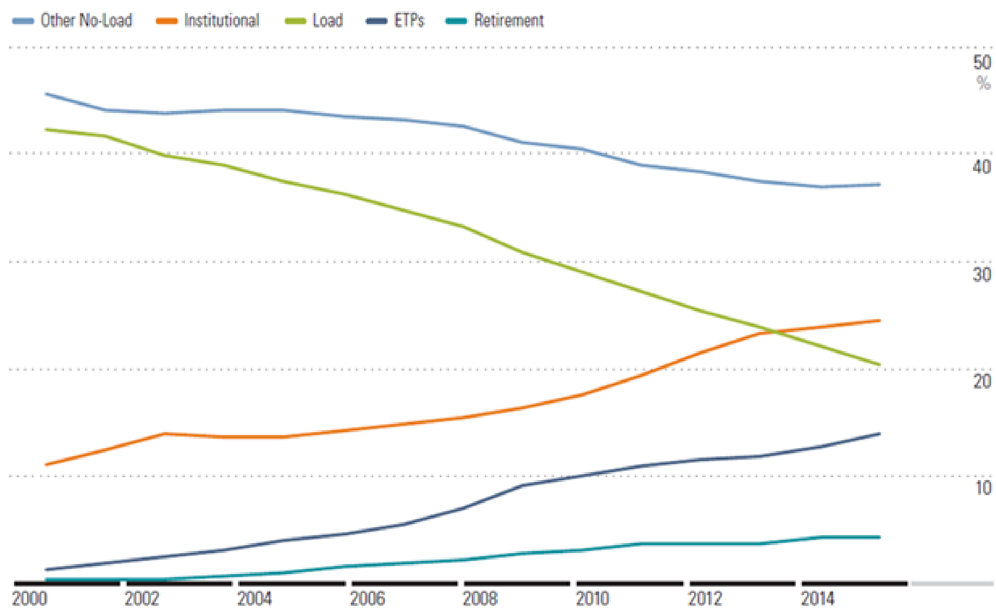
Exhibit 21 Front-End Commission A-Shares Are a Material Portion of Advisor Portfolios at Over $1.8 Trillion ($ Trillions, A-Share % of Nonproprietary Channel Mutual Fund Assets)



Source: Morningstar Direct

This decline in the advisor channel, mirrors, to a lesser extent, the decline in load-based mutual fund shares in the overall market noted in Morningstar's Michael Rawson and Ben Johnson's "2015 Fee Study: Investors Are Driving Expense Ratios Down."

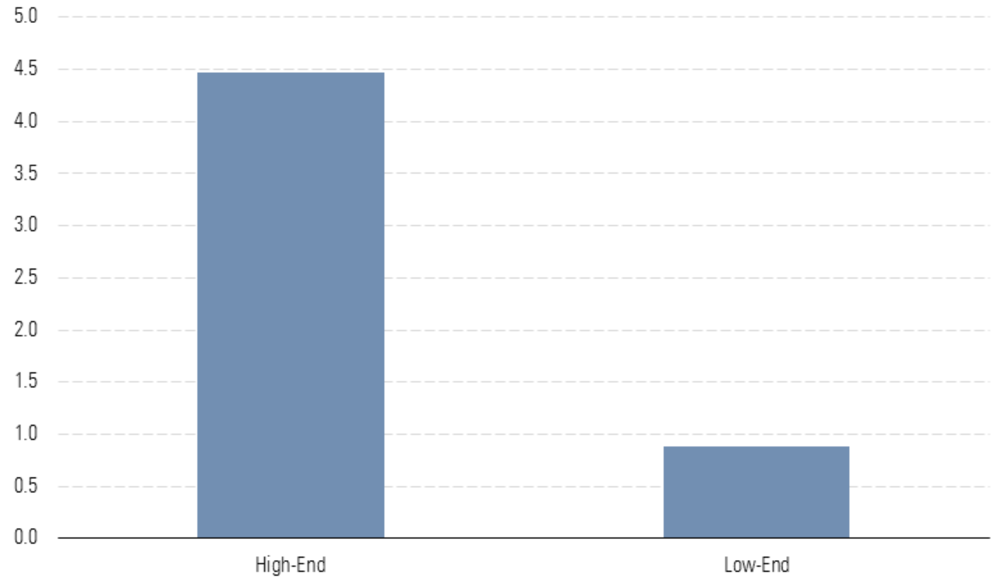
Exhibit 22 Load Mutual Fund Shares Have Been Losing Market Share



Source: Morningstar Direct

On the high end, if we were to assume an average mutual fund holding period of four years, approximately in line with historical overall mutual fund redemption rates, and a 2.25% front-end load, which is fairly typical for a $250,000 to $500,000 investment portfolio, we estimate that advised brokerage IRAs could be paying nearly $4.5 billion in front-end loads annually. On the low end, if we were to assume a holding period of nine years, based on the 8.9-year holding period for A-shares stated in the Capital Group Companies' letter to the Department of Labor, and a 1% front-end sales load, then load commissions would be approximately $900 million.

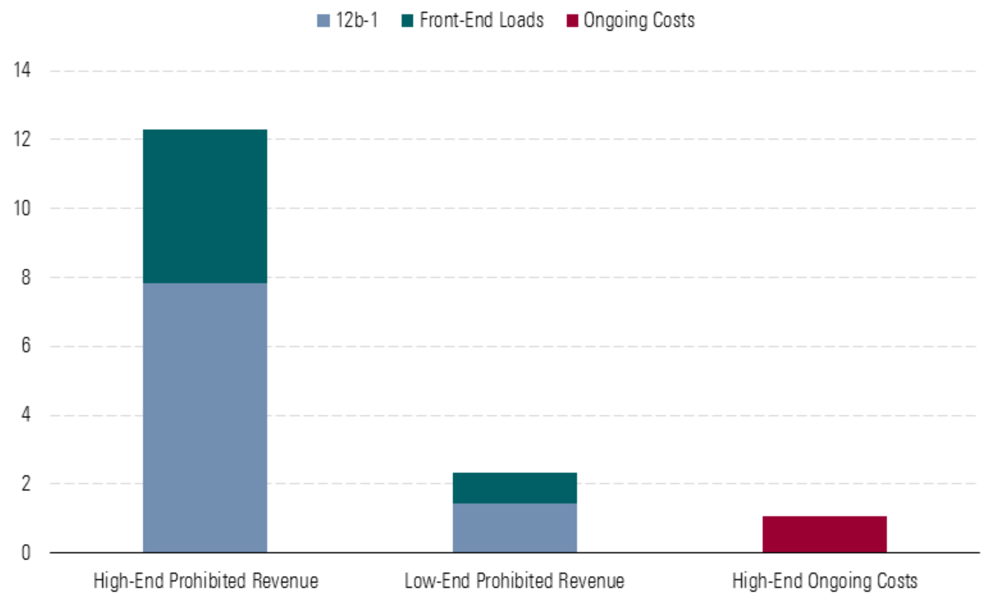
Exhibit 23 Our Estimate Range for IRA Front-End Loads Is $900 Million to $4.5 Billion ($ Billions)



Source: Morningstar

Even our low-end annual $1.46 billion of mutual fund 12b-1 fees and $900 million of front-end load commissions that could go away because of the Department of Labor rule totals to over two times greater than the highest ongoing cost estimate of $1.1 billion from the Deloitte-SIFMA study. If the true revenue at risk is closer to our high-end estimates, then we'll see a major overhaul of the financial-services industry in the near future. Mutual fund 12b-1 fees and front-end loads are just two of the myriad sources of revenue and advisor compensation that will be affected by the rule. Other sources of wealth management firm revenue affected by the rule would include annuity trails, general mutual fund revenue-sharing agreements, and certain alternative investment product commissions.

Exhibit 24 Potentially Banned Revenue Is a Multiple of Rule-Related Expenses ($ Billions)

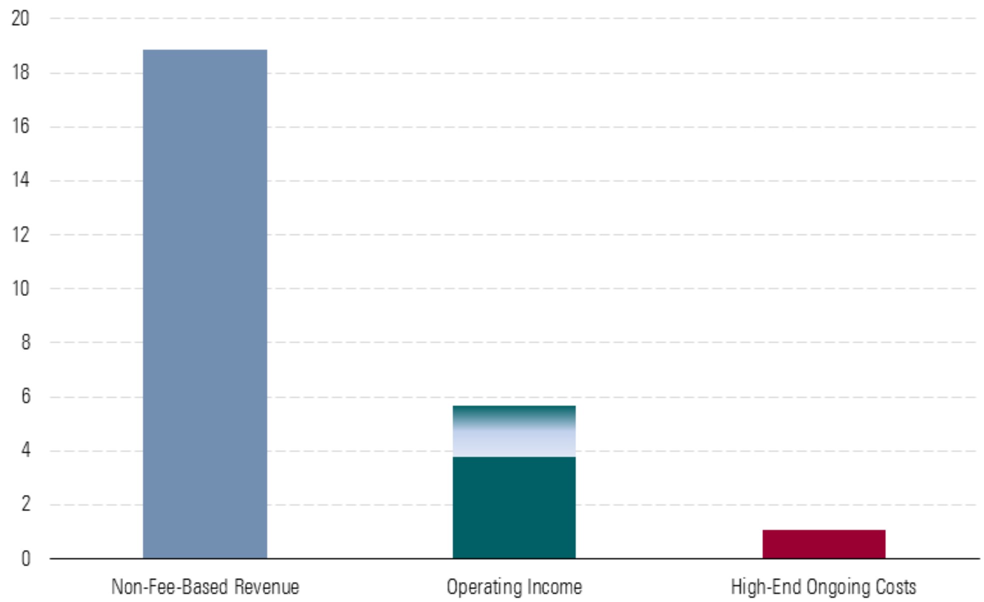


Source: Morningstar

The Additional Expenses Compared to the Revenue Affected Portends a Material Decline in Operating Margin

Operating margins on full-service wealth management firm IRAs could take a drastic 20% to 30% hit from the rule. We roughly estimate that the total amount of revenue related to full-service, non-fee-based IRA assets is $19 billion and that the related operating income is $4 billion to $6 billion.

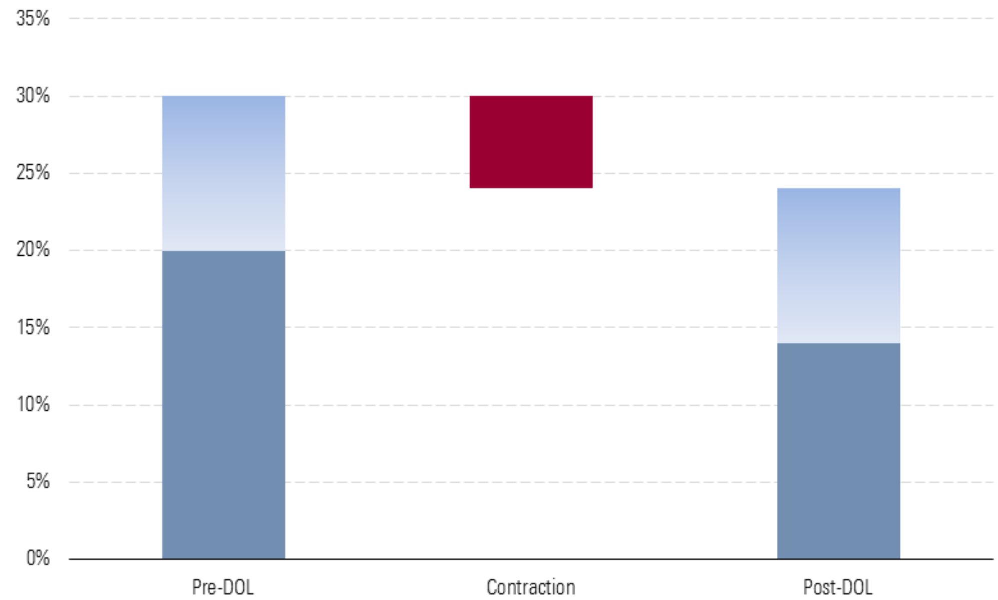
Exhibit 25 Department of Labor Annual Costs Are Relatively Small Compared to Non-Fee-Based IRA Revenue, but Material Compared to Operating Income ($ Billions)



Source: Deloitte & Touche, Department of Labor, Morningstar

This means that if the high-end ongoing cost estimate of $1.1 billion from Deloitte is correct, operating margins would decrease nearly 6 percentage points. Considering that most wealth management operating margins are in the 20%-30% range, a 6-percentage-point operating margin contraction leads to a 20% to 30% decrease in operating income.

Exhibit 26 A 6-Percentage-Point Operating Margin Contraction on Brokerage IRAs Would Lead to a 20% to 30% Decrease in Operating Income



Source: Morningstar

Three Major Financial-Sector Trends Will Receive a Boost From the Department of Labor Rule

Key Takeaways

- Full-service wealth managers may convert commission-based IRAs to fee-based IRAs to avoid the additional compliance costs of the Department of Labor rule. As fee-based accounts can have a revenue yield upwards of 60% higher than commission-based, this could translate to as much as an additional $13 billion of revenue for the industry.
- Robo-advisors stand to benefit from the Department of Labor rule, as they pick up a portion of our estimated $250 billion to $600 billion of low-account-balance IRA assets from clients let go by the full-service wealth management firms. Capturing a fraction of these loose assets will bring stand-alone robo-advisors much closer to the $16 billion to $40 billion of client assets that we believe they need to become profitable.
- We believe that over $1 trillion of assets could flow into passive investment products from the Department of Labor rule. The increase would be from higher adoption of robo-advisors, increased usage of passive investment products from financial advisors that formerly may have been swayed by distribution payments, the proposed "high-quality, low-cost" exemption, and the effect of advisors trying to balance out higher explicit financial planning charges.

We see the acceleration of three major trends in the financial sector from the Department of Labor rule:

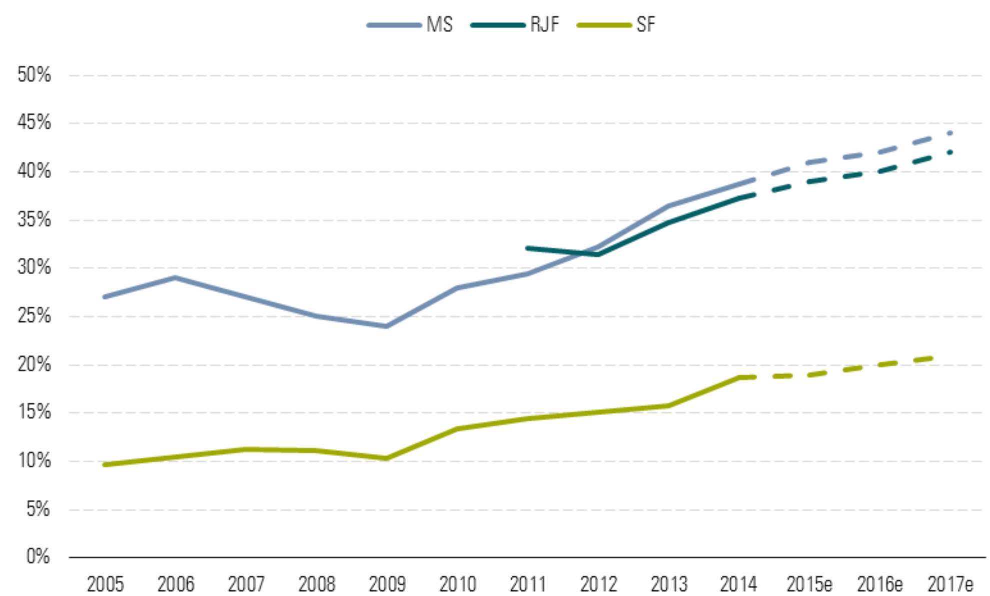
- The shift to fee-based accounts from commission-based accounts at wealth management firms.
- The emergence of robo-advisors as an investment-service offering and distribution channel.
- The increased usage of passive investment products compared with actively managed products.

The Shift to Fee-Based Accounts at Wealth Management Firms Imparts Significant Upside

The Department of Labor rule isn't completely dire for wealth managers, as it could spur a $13 billion industry revenue gain.

There is already an established trend toward fee-based accounts from commission-based.

Exhibit 27 There Is A Trend Toward Fee-Based Accounts (Fee-Based Client Assets as a % of Total Client Assets)



Source: Company filings, Morningstar

The Department of Labor rule encourages wealth management firms to move commission-based IRAs to asset-based fee IRAs. By moving commission-based IRAs to a fee-based arrangement, the wealth manager should be able to save on compliance costs. Fee-based accounts, such as separately managed accounts, are often under discretionary management and already subject to a fiduciary standard. Many of these fee-based accounts also largely don't collect third-party payments, so the financial advisor can avoid having to deal with all of the prohibited transaction rules.

Besides cost savings, fee-based accounts can have revenue yields as much as 60% higher than commission-based accounts. If all of the assets in advised, commission-based IRAs were to move to fee-based, it could increase industry revenue by $13 billion.

Exhibit 28 There's $13 Billion of Upside From a Move Toward Fee-Based Accounts ($ Billions)

Source: Company filings, Morningstar

The Department of Labor Rule Could Mark the Positive Inflection Point for Robo-Advisors
We estimate that as much as $600 billion of full-service wealth management assets may switch investment-service channels after the Department of Labor rule, and that robo-advisors will benefit. Individual robo-advisors capturing just a fraction of these assets would speed up their growth by several years and substantiate their business model, as they may finally be able to report operating profits.

The increased compliance and legal liability cost of small-balance IRA accounts would make a portion of them unprofitable to full-service wealth managers. This would cause the full-service wealth managers to let go of those accounts. As these investors presumably aren't comfortable with do-it-yourself investing, robo-advisors are a reasonable landing place.

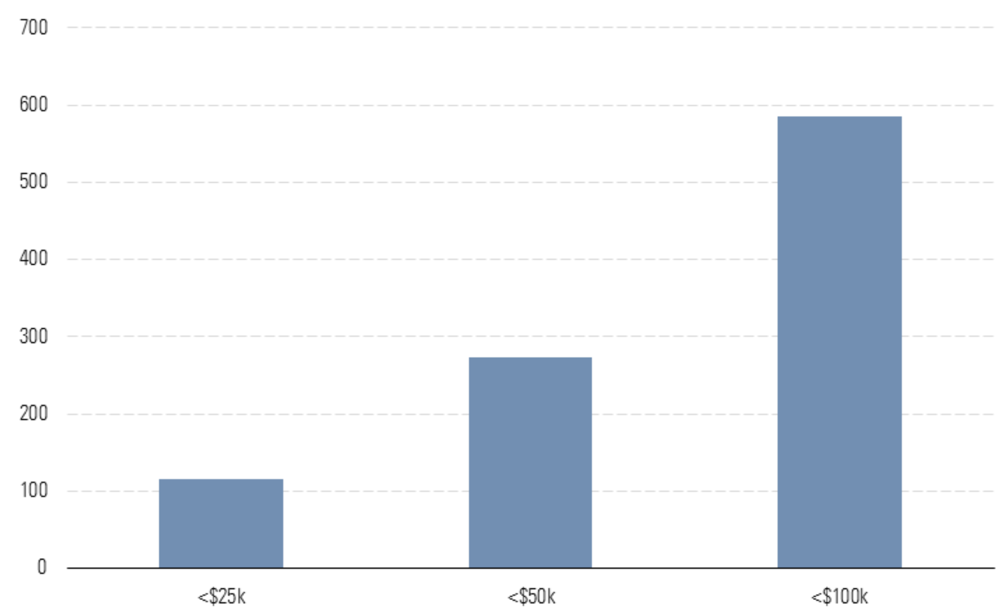
As we explored in our report "Hungry Robo-Advisors Are Eyeing Wealth Management Assets," robo-advisors have a distinct value proposition and address a specific niche of investors. We believe that robo-advisors are most appealing to relatively cost-conscious investors who would prefer to delegate their investment portfolio.

Exhibit 29 Robo-Advisors Potentially Fill Niche Between Discount Brokerages and Traditional Wealth Managers

Source: Morningstar

At the individual IRA level, we estimate that the full-service wealth managers hold nearly $600 billion in IRAs with a balance of less than $100,000.

Exhibit 30 Hundreds of Billions of Client Assets May Be up for Grabs From Full-Service Wealth Managers (Client Assets $ Billions, IRA Account Size)



Source: ICI, Morningstar

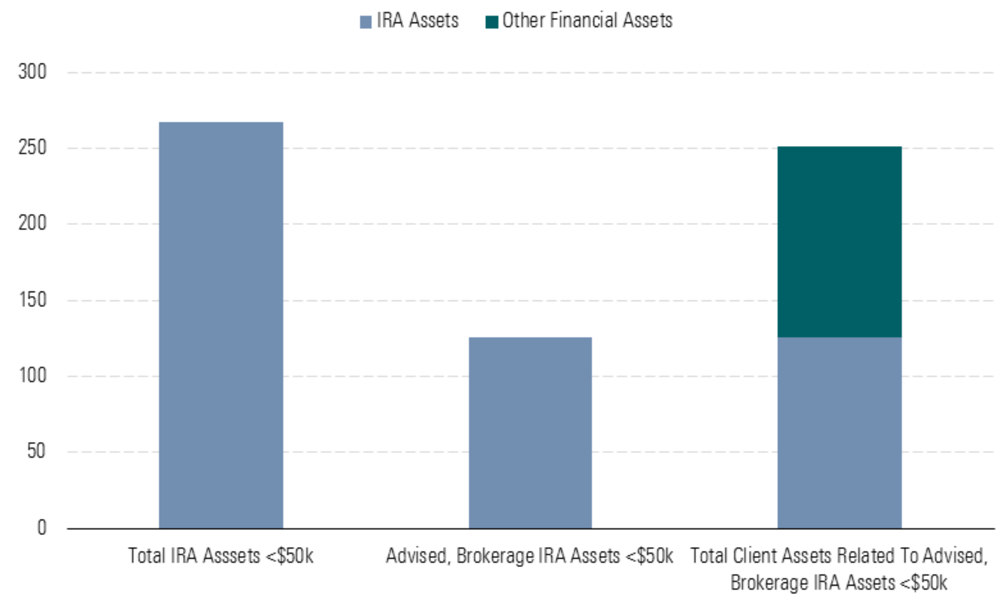
If we were to use a more conservative measure of the total client asset level to meet the minimum requirement for full-service wealth management, our estimate would be $250 billion. The more conservative measure would be looking at the total investable assets at the household level: This would include multiple individuals, such as the head of household and spouse, and assets in taxable accounts in addition to IRAs. This measure excludes nonfinancial assets like equity in real estate, as the financial advisor wouldn't receive any fees on these assets.

The Investment Company Institute and the Advanced Analytical Consulting Group-Deloitte Financial Advisory Services study of the Federal Reserve Survey of Consumer Finances support the view that households with approximately $50,000 in IRA assets will have enough total financial assets to meet the $100,000 full-service wealth management threshold and that these households hold over $500 billion of financial assets. In a letter to the Department of Labor, the Investment Company Institute assessed that 50% of household IRA holders wouldn't meet the $100,000 of investable asset threshold for full-service wealth management firms. As the median household owning IRAs has a balance of $50,000 according to the Investment Company Institute, this implies that the ratio of household financial assets to IRA assets is 2/1.

While the Advanced Analytical Consulting Group-Deloitte Financial Advisory Services summary data isn't directly comparable to the Investment Company Institute's, as many of its statistics are aggregated by ranges and are based on total households and not just households owning IRAs, it roughly corroborates its assessment. Based on the $50,000 to $100,000 income bracket that the median IRA household is in, the ratio of household financial assets/IRA assets, excluding defined-contribution plan assets, is 2.5/1 and the ratio of total financial assets/IRA assets, including defined contribution plan assets, is 3.3/1. These ratios likely overstate the true ratio, as we calculated them based on an income bracket and not IRA balances and because they're based on all households instead of only IRA-owning households. Therefore, a moderate downward adjustment would put them in line with the Investment Company Institute's assessment of a 2/1 ratio.

Based on the Advanced Analytical Consulting Group-Deloitte Financial Advisory Services data, the total amount of assets held by households with less than $50,000 in IRAs in 2013 was $267.7 billion and constituted 4% of total IRA assets. Multiplying our estimate of the total advised, commission-based IRA assets of $3.1 trillion by 4% and then adjusting it for the 2/1 ratio of total financial assets to IRA assets leads to our estimate of about $250 billion of assets being held at full-service wealth management firms that wouldn't meet the $100,000 in household financial asset threshold to receive service.

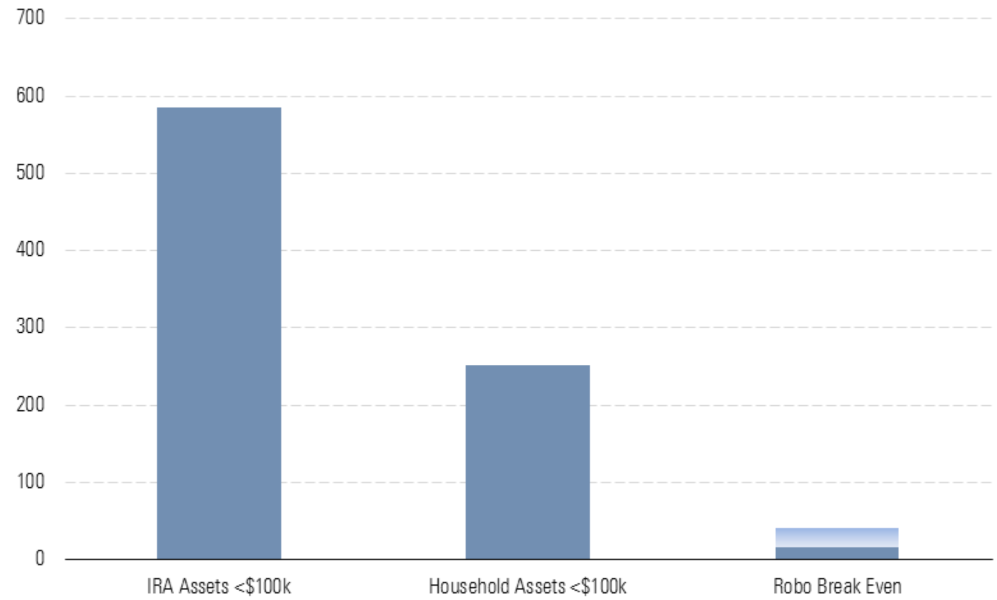
Exhibit 31 Based on Total Household Financial Assets, We Estimate That $250 Billion of Client Assets May Switch Channels From Full-Service Wealth Management Firms ($ Billions)



Source: Deloitte, Morningstar

With our estimate of $250 billion to $600 billion of full-service wealth management assets that may switch channels, individual robo-advisor firms capturing just a fraction of these assets that are up for grabs will go a long way toward them achieving our estimated client asset break-even level of $16 billion to $40 billion. Leading stand-alone robo-advisors currently each have client assets around $3 billion.

Exhibit 32 Just Capturing a Fraction of Client Assets Shaken Loose From Full-Service Wealth Managers by the Department of Labor Rule Could Put Robo-Advisors in the Black ($ Billions)

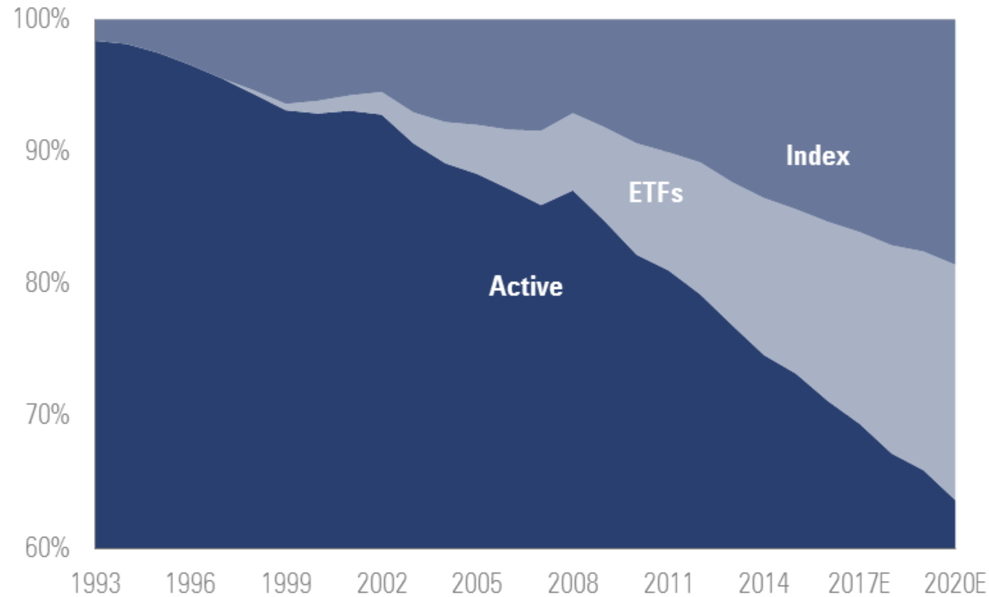


Source: Deloitte, Morningstar

The Department of Labor Rule Is a Definitive Boon to Passive Investment Market Share

One of the most prominent trends in the financial sector has been higher usage of passive investment products, such as index funds and exchange-traded funds, and less money going into actively managed mutual funds.

Exhibit 33 There Is a Trend Toward Lower-Cost Passive Investment Products Over Actively Managed Products (% of Total Open-End and ETF Assets Excluding Funds-of-Funds and Obsolete Funds)



Source: Morningstar Direct

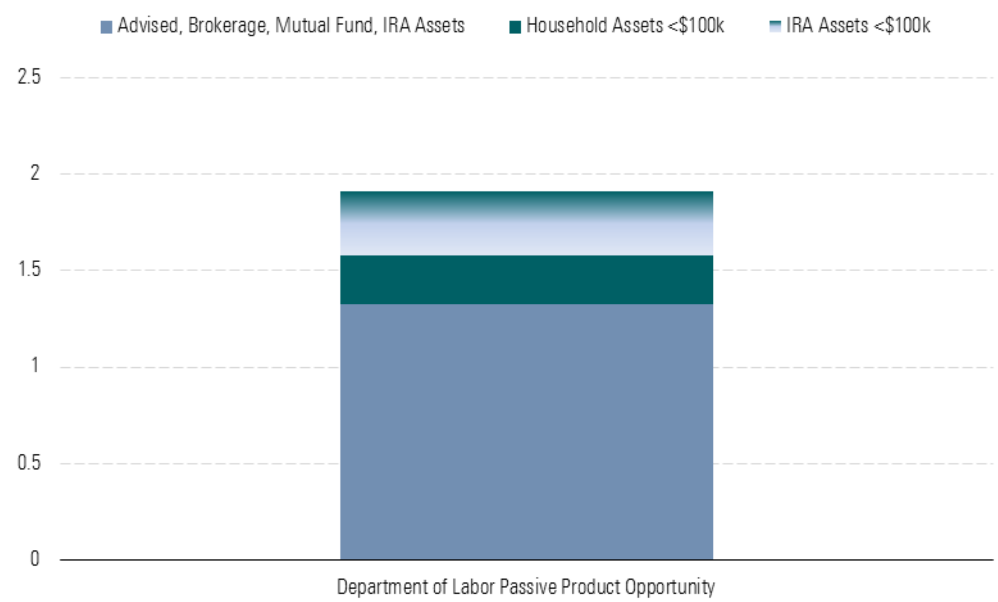
There are four reasons why the Department of Labor rule will accelerate market share gains for passive investment products:

- Robo-advisors: Because we believe that robo-advisors will capture part of the $250 billion to $600 billion of full-service wealth management assets that are in small-balance accounts, they'll funnel those assets into largely passive index products.
- Reduction in potential conflicts of interest: Prohibiting third-party payments would reduce potential conflicts of interest. If an advisor had been allocating more client assets to actively managed funds that pay a distribution fee compared to equally suitable index funds or exchange-traded funds that pay a lower distribution fee or none, the prohibition of third-party payments would conceivably shift the advisor into using more passive products.
- "High-quality, low-cost" exemption: There's a proposal for a streamlined "high-quality, low-cost" exemption for prohibited transaction payments. Examples of these types of products would be certain target-date and index funds. If this exemption were to be approved, advisors would likely use it to avoid having to use the other higher-hurdle prohibited transaction exemptions.
- Total-cost balancing: If advisors begin charging more for their financial planning services to offset the loss of third-party payments, they may begin to use lower-cost passive investment products over actively managed products to balance the total cost. One of the main reasons that mutual fund 12b-1 or trailer fees exist is to compensate financial advisors for providing ongoing financial planning advice to their clients. If this payment were to stop, financial advisors might increase their explicit financial planning charge to their clients to recoup the lost payments; there is some evidence of this occurring in the United Kingdom after the Retail Distribution Review. With the increase in their explicit charge, financial

advisors may choose passive investment products with a lower operating expense ratio to partly balance out the new all-in cost to the client.

Adding up our estimate for mutual fund assets held in advised, brokerage IRAs and the total amount of full-service client assets that may shift to other investment-services channels, such as robo-advisors, the potential shift to passive investment products total over $1 trillion.

Exhibit 34 Passive Investments Could Gain Over $1 Trillion of Assets From the Department of Labor Rule ($ Trillions)



Source: Morningstar

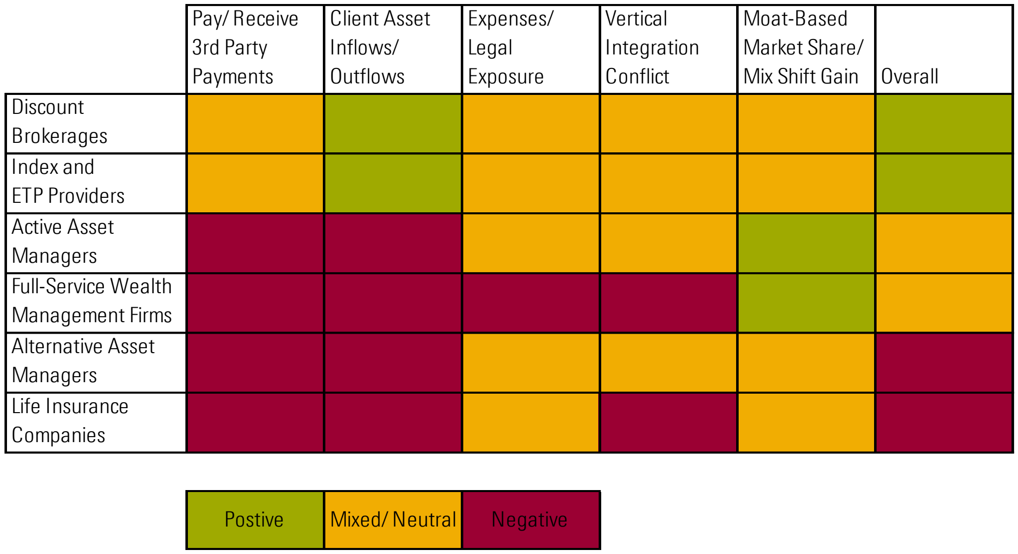
Which Companies Will Benefit or Be Challenged by the Department of Labor's Fiduciary Rule?

Key Takeaways

- We assessed the overall impact of the Department of Labor's conflict-of-interest rule on financial industries by looking at five criteria: pay/receive third-party payments, client asset inflows/outflows, expenses/legal exposure, vertical integration conflict, and the potential for a moat-based market share/mix shift gain.
- We believe that beneficiaries of the rule will be discount brokerages, like Charles Schwab and TD Ameritrade, and index and exchange-traded product providers, like BlackRock, London Stock Exchange, MSCI, State Street, and Vanguard. Discount brokerages should be able to pick up a portion of our estimated $250 billion to $600 billion of low-balance IRA assets that will be let go by the full-service wealth management firms, while the index and exchange-traded product providers will gain market share from the accelerated movement to passive investment products.
- There will be a mixed effect on active asset managers, like AllianceBernstein, BlackRock, Cohen & Steers, Eaton Vance, Federated Investors, Franklin Resources, Invesco, Janus Capital Group, Legg Mason, T. Rowe Price Group, and Waddell & Reed Financial, and full-service wealth management firms, like Bank of America, Morgan Stanley, Raymond James Financial, Stifel Financial, UBS, and Wells Fargo. Both of these groups will be materially affected by the prohibition on third-party payments. That said, we believe that firms with moats will gain market share from their less competitively advantaged peers or that they'll be able to adjust their business model to offset the negative financial effects of the rule.
- Some alternative asset managers, like Apollo Global Management, and life insurance companies, like Ameriprise Financial, MetLife, Principal Financial Group, and Prudential Financial, will be challenged by the rule. As specific alternative investment products were excluded from the list of assets that the best-interest contract exemption can apply to, certain alternative asset managers will have a decidedly more difficult time distributing their products to retirement accounts than mutual fund firms. Given the often higher commission rates of particular annuities and vertical integration at some life insurance companies, certain life insurance companies will be challenged by the rule.

The Department of Labor's fiduciary rule will have repercussions far beyond just wealth management firms, disrupting certain business models and providing opportunities for others. We assessed the impact of the rule on financial industries based on five criteria.

Exhibit 35 The Fiduciary Rule Has Positive and Negative Repercussions Throughout the Financial Sector



Source: Morningstar

- Pay/receive third-party payments: The most obvious effect of the rule will be prohibiting transactions that lead to third-party payments. This disadvantages the third-party payment providers because it decreases the incentive for advisors to distribute their product. Prohibiting third-party payments will also directly reduce the revenue and compensation of the firms and financial advisors that were formerly on the receiving end.
- Inflows/outflows: There will be a spectrum from firms that will either gain new client assets, have lower net new inflows than if the rule was not enacted, or will actually have outflows of assets.
- Expenses/legal exposure: The rule will increase compliance costs in the investment-services industry and open firms up to more litigation from usage of the best-interest contract.
- Vertical integration conflict: Firms that are both investment product manufacturers and distributors will probably face increased scrutiny in fulfilling their best-interest obligation when distributing their proprietary offerings.
- Moat-based market share/mix shift gain: Within certain industries, firms with a stronger competitive advantage should be able to pick up market share or adapt their business model to offset the negative effects of the rule.

Beneficiaries

- Discount brokerages: Charles Schwab, TD Ameritrade

We believe that discount brokerages, such as wide-moat Charles Schwab and narrow-moat TD Ameritrade, will be net beneficiaries from the rule. In our upside case based on the rule, our fair value estimates for the firms would increase 5% to 10%. First off, discount brokerages are largely insulated from the potential negatives of the rule. The vast majority of their retail brokerage business is self-directed, so they should escape from the conflict-of-interest proposal that targets advised IRA assets. Even their institutional business should be less affected than other wealth managers, as they primarily support RIAs, which are already under a fiduciary standard.

They should also experience higher net client asset inflows after the rule. Similar to robo-advisors, IRAs that are too small, and thus unprofitable, for full-service wealth managers to keep may find a new home at the discount brokerages. Given that these accounts formerly entrusted their assets to full-service advisors, the assets should largely flow to the top discount brokerages with strong reputations. If we assume that TD Ameritrade captures 10% of the assets dislodged from the full-service wealth managers and that Charles Schwab captures 20%, the client asset gain will be material to their retail segments.

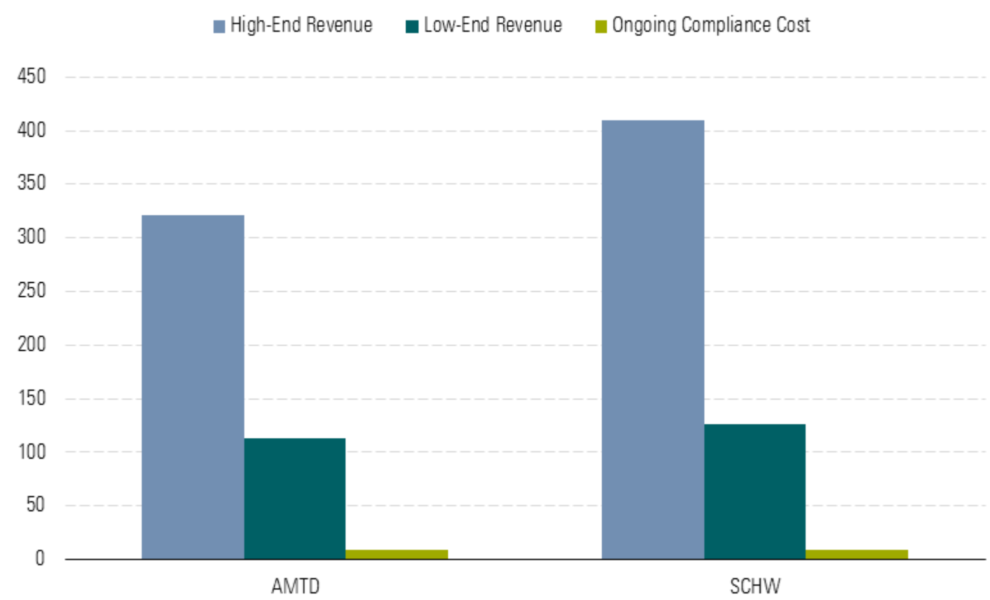
Exhibit 36 The Potential Net New Client Assets Captured From Full-Service Wealth Managers Can Be Material to TD Ameritrade and Charles Schwab (% Increase in Retail Segment Client Assets)

Source: Company filings, Morningstar
*assumes that half of TD Ameritrade assets are retail

The discount brokerages also offer solutions to investors who want more investment guidance. For those who want a comparable service to what they were receiving at their broker financial advisor, they may find their way to the RIAs that Charles Schwab and TD Ameritrade support. Another option for those seeking a more delegated approach would be separately managed account offerings, which generally have lower account balance minimums at the discount brokerages than other investment service firms. Additionally, Charles Schwab, with its Intelligent Portfolios line, and TD Ameritrade, through its evolving Amerivest product, should be able to compete with stand-alone robo-advisors such as Betterment and Wealthfront in the automated advice space. As we concluded in our "Hungry Robo-Advisors Are Eyeing Wealth Management Assets" report, we continue to believe that firms with integrated robo-advisor solutions, such as Charles Schwab, BlackRock, and Vanguard, will earn the majority of economic profits from this emerging investment-service and product distribution channel.

The rule-related additional revenue from inflows of client assets should more than offset the associated higher compliance costs from the rule or potential friction created with onboarding rollover assets.

Exhibit 37 Revenue From Client Assets Migrating From Full-Service Advisors Will More Than Offset Compliance Costs ($ Millions)



Source: Deloitte, Morningstar

Based on the high-end estimate associated with IRAs less than $100 thousand being unprofitable for full-service wealth managers, our fair value estimates for Charles Schwab and TD Ameritrade would increase approximately 5% to 10%.

- Index and exchange-traded product providers: BlackRock, London Stock Exchange, MSCI, State Street, Vanguard
  The index and exchange-traded product providers will profit from our belief that the rule will lead to passive investment product market share gains. ETP and index fund product manufacturers such as BlackRock and State Street and index license holders such as MSCI and London Stock Exchange, with its FTSE and Russell indexes, should be primary beneficiaries. Other financial exchanges, such as CME Group through its S&P/Dow Jones Indices ownership stake, Deutsche Boerse, and Nasdaq, also have beneficial, though relatively small, exposures to index-related fees. Given that these firms have high incremental margins and that upwards of $1 trillion of assets could shift to passive products, there could be a material uplift in their valuations.

In regards to MSCI, Morningstar analyst Peter Wahlstrom provides this analysis of the upside.

To frame the potential annualized revenue upside for MSCI, our estimate for the total amount of advised, commission-based wealth management assets is $3 trillion. Mutual fund holdings (as a percentage of IRA assets) are approximately 40%. If 40% of the $3 trillion addressable market converts to passive, and if MSCI captures 40% of these assets while charging 3 basis points (on average), this would bump the firm's annualized revenue by nearly $150 million (approximately 13%). Here, we assume high incremental margins (above 70%). When applying a normalized tax rate (35%), the per-share cash flow impact is approximately $0.65. This alone would boost MSCI's annualized free cash flow by more than 30%; if sustainable, this results in a $10 (or 15%) increase to our discounted-cash-flow-based fair value estimate.

Mixed

- Active asset managers: AllianceBernstein, BlackRock, Cohen & Steers, Eaton Vance, Federated Investors, Franklin Resources, Invesco, Janus Capital Group, Legg Mason, T. Rowe Price Group, Waddell & Reed Financial

Asset managers with true competitive advantages should profit at the expense of no-moat asset managers. Moat sources, such as intangibles stemming from strong brands and solid investment performance records, will become an increasingly important determiner of net inflows when potentially conflicted distribution payments drop out of the equation, as demonstrated by Morningstar's "2014 Global Asset Flows Report."

Exhibit 38 Strong Risk-Adjusted Performance Funds Attract More Net Inflows ($ Billions)

Morningstar Rating	Estimated Net Flow 2014	Total Net Assets 2014	Market Share of Assets 2014 (%)	Organic Growth Rate 2014 (%)
5-star	338.3	3,192.4	11	12.4
4-star	255.6	8,218.0	28	3.4
3-star	(75.4)	6,331.0	22	(1.2)
2-star	(132.9)	1,695.3	6	(7.2)
1-star	(32.6)	345.8	1	(8.4)
NR: 2+ Years	271.9	8,315.3	29	3.3
NR: 1-2 Years	274.3	807.4	3	57.4
NR: <1 Year	450.6	504.7	2	

Source: Morningstar Direct.

Exhibit 39 Better-Run Mutual Funds Attract More Net Inflows ($ Billions)

Morningstar Analyst Rating	Estimated Net Flow 2014	Total Net Assets 2014	Market Share of Assets 2014 (%)	Organic Growth Rate 2014 (%)
Gold	187.2	3,144.3	12	6.9
Silver	67.6	2,889.3	11	2.5
Bronze	(105.2)	2,563.9	10	(4.1)
Neutral	(77.5)	1,518.4	6	(4.8)
Negative	(3.1)	48.1	0	(5.8)
Under Review	(24.2)	54.7	0	(32.3)
Not Ratable	6.6	43.0	0	19.3
Not Rated	1,298.3	19,148.2	73	7.4

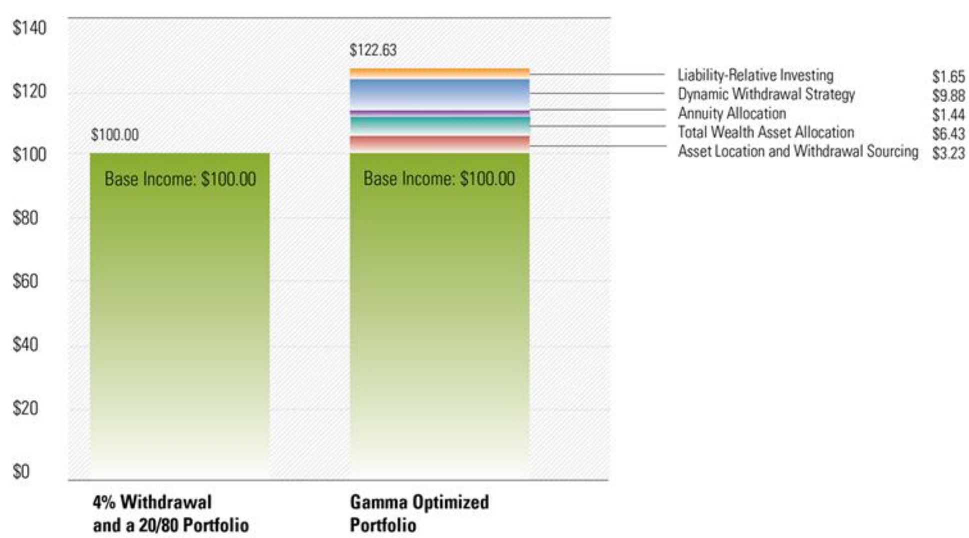
Source: Morningstar Direct.

We would be wary of asset managers that source a large portion of their assets from the full-service financial advisor channel or that subadvise to variable annuities. As the Department of Labor rule targets potentially conflicted payments to financial advisors, asset managers that primarily distribute to institutional investors, such as pension funds, or direct-to-retail investors won't be materially affected. It appears that variable annuities are receiving more scrutiny than other annuity products, so asset managers that subadvise on variable annuity assets could have their growth rates slow down along with variable annuities.

► Full-service wealth management firms: Bank of America, Morgan Stanley, Raymond James Financial, Stifel Financial, UBS, Wells Fargo
While the net effect on full-service wealth management firms is difficult to tell, it will probably be neutral to negative. It will be difficult to move all commission-based IRAs into a fee-based arrangement. The small accounts that aren't part of larger relationships have a distinct probability of being let go, as the cost to serve them becomes economically challenging. Wealth management firms with moats will weather the landscape change better than others, as their brand and product offerings should make clients reluctant to leave.

There are definite benefits to receiving advice from a full-service wealth management offering, such as the advisor "Gamma" that Morningstar's Head of Retirement Research Paul Blanchett, CFA, CFP, and Canada Director of Research Paul Kaplan, PhD., CFA, quantified in their research paper "Alpha, Beta, and Now…Gamma," which could be lost by holders of small accounts.

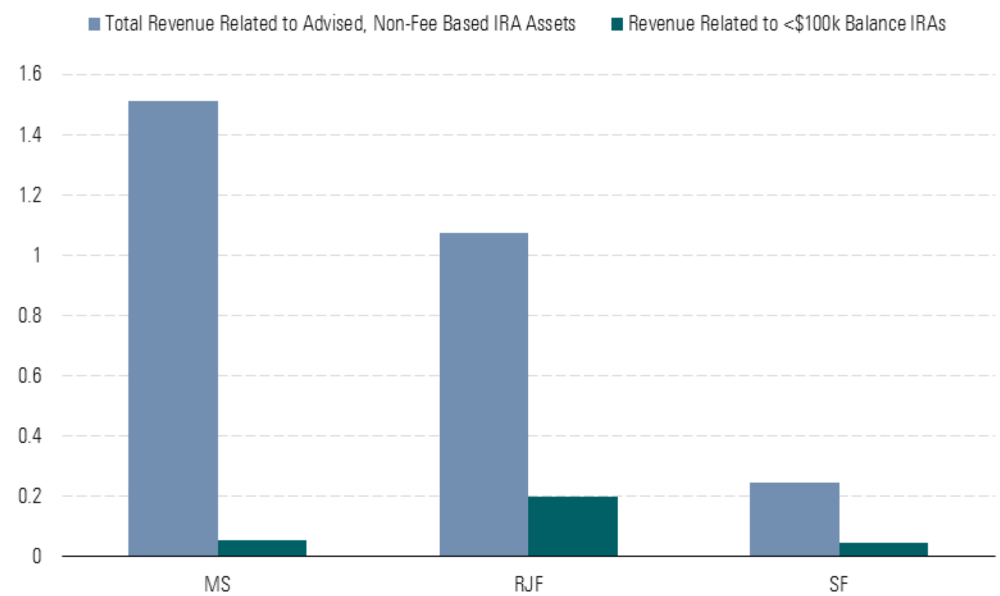
Exhibit 40 Effective Financial Planning Has Quantifiable Benefits



Source: Morningstar

Even if shedding small-balance accounts improves near-term profitability, they are often the seeds of future desirable accounts and their culling could come back to haunt the company.

Exhibit 41 We Estimate That Individual, Large Wealth Management Firms Have Over $1 Billion of Revenue Related to Advised, Non-Fee-Based IRA Assets ($ Billions)

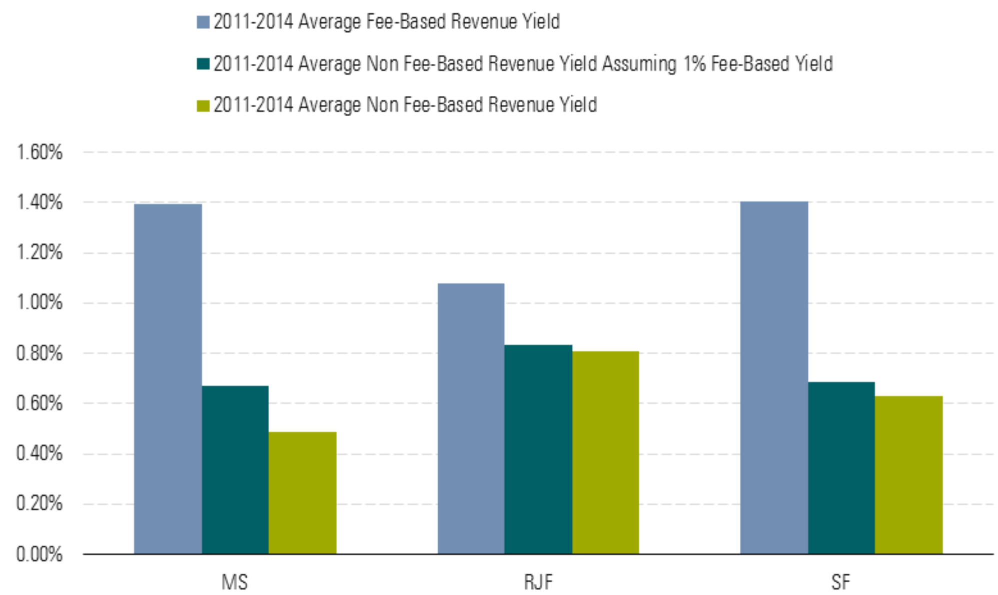


Source: Morningstar

We see the wirehouses and more regional wealth management firms as having different commission-based IRA client issues to deal with. We believe that the regional and independent wealth management firms have a larger exposure to low-account-balance IRAs that may be let go. This is because the wirehouse wealth management firms typically have higher account minimums. On the other hand, we postulate that the larger commission-based IRAs have a commission-based account because of preference, as opposed to smaller accounts where a fee-based offering isn't typically an option. If their advisor were to suddenly only offer a fee-based service, they would have the flexibility to find a firm willing to deal with the best-interest contract exemption elsewhere.

As the revenue yield on fee-based accounts is higher than commission-based, full-service firms can afford some client attrition and still maintain prerule levels of profitability, similar to the case with Brewin Dolphin in the United Kingdom.

Exhibit 42 There's Upside From the Movement of Accounts Into a Fee-Based Arrangement (% of Fee-Based or Non-Fee-Based Client Assets)

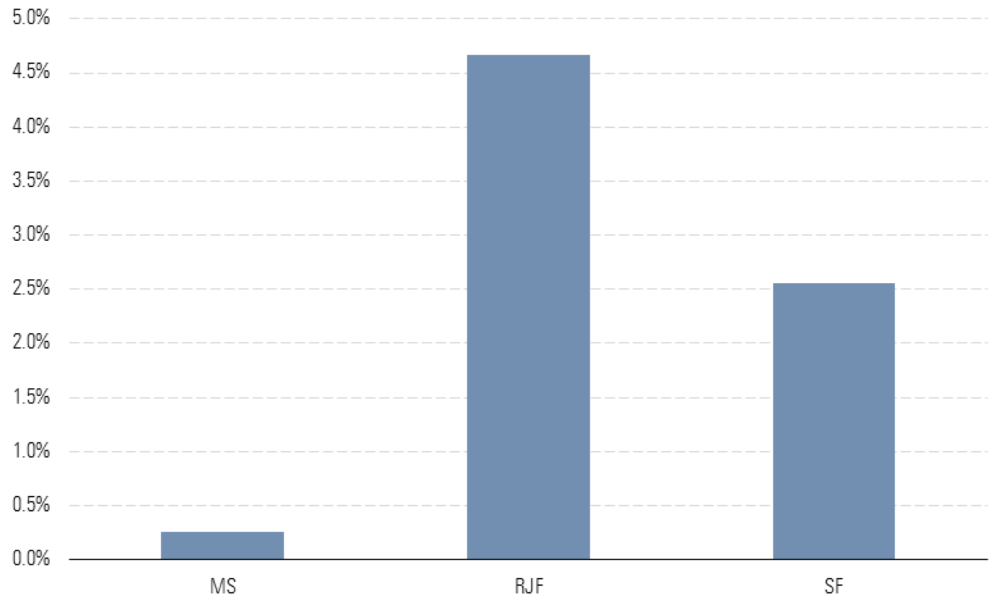


Source: Company filings, Morningstar
*The Raymond James' revenue yield is calculated by combining the wealth management and banking segments to be more comparable with peers. As the numerator for "fee-based revenue yield" may contain items that aren't solely attributable to fee-based accounts, such as traditional banking and account service fees due to how the wealth management firms group their revenue, we also calculated a non-fee based revenue yield using the 1% fee-based revenue yield convention.

Using our calculation of the non-fee-based revenue yield assuming a 1% fee-based yield, a full-service wealth manager could lose approximately three commission-based accounts for every two formerly commission-based accounts that it moves into a fee-based arrangement.

Another perspective is that under the scenario that Morgan Stanley, Raymond James Financial, and Stifel Financial let go of the IRAs where the account balance is less than $100,000, they would have to increase their higher revenue yielding fee-based account assets as a percentage of total client assets by 0.3 to 4.7 percentage points to make up for the lost revenue.

Exhibit 43 A 1.4- to 4.7-Percentage-Point Mix Shift to Higher Revenue Yielding Fee-Based Assets Would Offset Any Lost Revenue From Low-Account-Balance Commission-Based IRAs (% of Client Assets)



Source: Morningstar

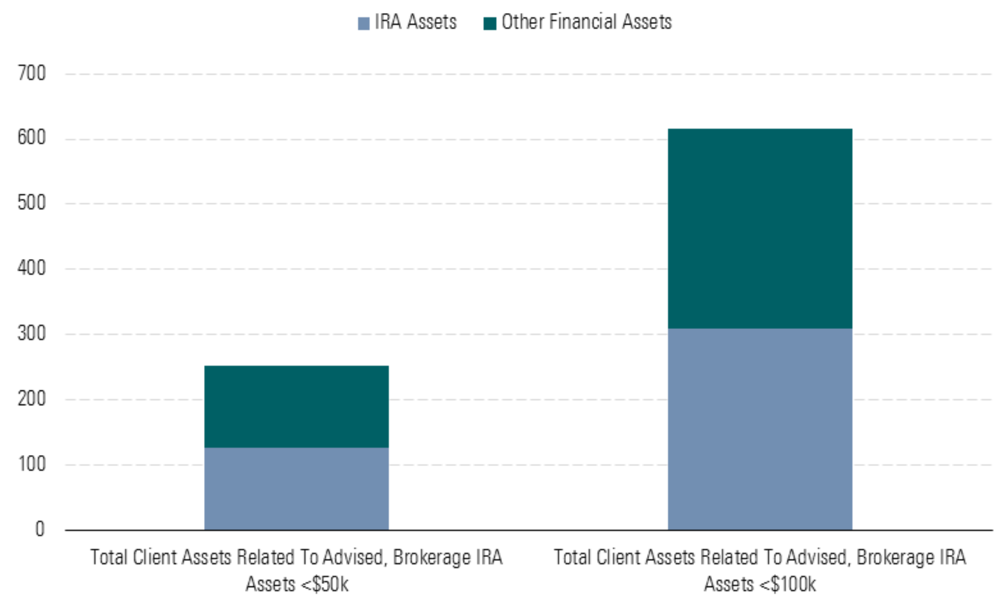
Full-service wealth managers going to all fee-based may not be a panacea, though. For vertically integrated product manufacturers and distributors, the specter of a conflict of interest would likely arise if their own asset management products are being used by the financial advisor. Reverse churning, where a client that trades infrequently is put into a fee-based account, could also become an issue.

In the end, we believe that the wealth managers will have to find some way to make the best-interest contract exemption work. This will mean additional investments in compliance systems and dealing with the headaches of increased litigation. For large firms, defined as having net capital greater than $1 billion, ongoing compliance costs range from a low estimate from the Department of Labor of $436,000 to a high-end estimate from Deloitte of $9.5 million.

Moaty full-service wealth management firms such as Bank of America, Morgan Stanley, UBS, and Wells Fargo will weather the Department of Labor's proposal better than others and might even benefit from it. Their intangible brand, capabilities, or products can create switching costs that retain client assets through the changes in business model. Therefore, offering up a fee-based arrangement to a prior commission-based account holder will more likely lead to acceptance rather than departure.

Being a household's provider of choice can also lead to asset inflows. As full-service wealth management firms rationalize their smaller account holders, small-account holders that have their assets dispersed among multiple financial institutions may choose to consolidate them at one institution. This would allow the household to meet the minimum asset level threshold and continue receiving service. While we estimate that there could be $250 billion of household financial assets at full-service wealth managers below $100,000, some wealth management firms require significantly more than that, such as over $500,000 to receive personalized service. Potential market share shifts of higher-net-worth households would be a multiple of the $250 billion.

Exhibit 44 Moaty Wealth Management Firms Can Gain Market Share From Household Account Consolidation Activity to Meet Asset Level Minimums ($ Billions)



Source: Deloitte, Morningstar

Smaller firms that are unable to deal with the new compliance regime could spur industry consolidation. Raymond James Financial and Stifel Financial would be likely consolidators, as they have more pockets in their geographic footprint to fill in than the wirehouses. Additionally, Raymond James and Stifel offer an independent contractor financial advisor option along with an employee advisor option, which certain firm principals would find attractive.

Challenged

- Alternative asset managers: Apollo Global Management

  Certain alternative asset managers, such as Apollo Global Management, may have one of their channels for distribution cut off. Their situation is distinctly less favorable than the traditional mutual fund managers in that certain alternative asset investments, such as nontraded real estate investment trusts and nontraded business development companies, aren't even listed in the definition of assets that could qualify for the best-interest contract exemption. The Department of Labor purposely tried to limit assets that could qualify for the exemption to those that are "relatively transparent and liquid." One consolation is that mutual funds that use alternative assets and strategies may qualify for the exemption, even if the underlying assets and strategies wouldn't be permitted.

Morningstar analyst Stephen Ellis has this to say about Apollo Global Management:

Apollo Global Management recently purchased 60% of AR Capital and RCS Capital's wholesale distribution arm, adding a leading asset manager as well as a wholesale advisor distribution network in the nonlisted REIT and business development company niche. AR Capital, with about $19 billion in assets under management is the industry leader by far and has historically attracted about 20%-35% of industry inflows, which ranged between $8.5 billion in 2013 to an estimated $3.3 billion in 2015. These investments typically yield 6%-8%, thus making them attractive for nontaxable IRAs, and we estimate about 30%-40% of nonlisted products are held within IRAs that would be affected by the new ruling. Given the nonlisted and private nature of the investments, advisors must be encouraged to push the products to retail investors through trail fees and hefty commissions, which would be eliminated.

Given that the deal was announced in August, well after the Department of Labor announced its proposals, and under consideration for all of 2015, we believe Apollo was aware of the implications and structured the deal accordingly. The upfront consideration is $378 million in cash and stock for net profit contributions of around $20 million annually by our estimates, with a further $500 million payable (in cash or equity) that is fully earned if AR Capital (which is now part of AR Global) raises $40 billion within five years. The $40 billion implies more than $8 billion in annual inflows, suggesting that AR Global could more than double historical peak levels of inflows (around $3 billion by our estimates) despite the loss of 30%-40% of historical demand. We believe Apollo is likely to focus on distributing nonlisted products to non-IRA taxable accounts, while adding Apollo-branded liquid alternatives, closed end funds, and annuities among other products that meet the new rule's guidelines, potentially using different types of fund classes. The opportunity to broaden the appeal and recognition of the Apollo brand with retail investors and advisors perhaps gives Apollo an edge on breaking into retail 401ks, another substantial area of upside. Overall, the transaction makes up about $1-$2 of our $35 fair value estimate for Apollo, and while we see a wide range of outcomes going forward, we do think the deal was structured in a way to position Apollo with a fairly small loss if the endeavor is not successful and substantial upside if the business can successfully manage the transition.

- Life insurance companies: Ameriprise Financial, MetLife, Principal Financial Group, Prudential Financial
  Morningstar analyst Vincent Lui provides this context and analysis of implications for life insurance companies:

For decades, insurance agents have operated on a commission model in which they get paid a fee when customers buy insurance and retirement products, including annuities. Because of the investment options that are built into an annuity, insurance agents often give advice and make recommendations on fund selection and allocation. In this role, insurance agents are similar to financial advisors, so would have to adhere to the same standards under the proposed Department of Labor fiduciary rule.

The proposed fiduciary rules have serious implications for the life insurance companies, and we believe that companies that rely heavily on annuity sales and investment services will feel the greatest impact. The proposed rules will make it very difficult for many investment agents and professionals to continue offering investment services and retirement products to clients for two reasons:

First, under the proposed rules, insurance professionals are deemed fiduciaries to qualified plan clients, including 401(k) and IRA investors, and because of this specific status, insurance professionals are prohibited from varying their compensation based on their investment recommendations, which generally includes commission-based and revenue-sharing compensation. The proposed rules essentially abolish the commission-based compensation model that has been in place in the industry for decades. As a result, insurance professionals and advisors may be unwilling or unable to provide basic information about investment options. At the end, clients will have less access to professional financial services and much-needed investment education.

Second, the proposed rules require insurance companies to offer a broad range of assets and funds to serve the best interests of investors, given their different objectives and risk-tolerance levels. In other words, life insurance companies, particularly the companies that write variable annuity, are in violation of these rules if they offer mostly their own proprietary funds for the annuity products they develop—a common practice in the industry. We believe top annuity sellers, such as MetLife, Prudential Financial, and Principal Financial, will either have to open up their platforms for other funds or use the exemptions in the rules to demonstrate that their current offerings are complete. In either case, insurance professionals are still not allowed to receive commission fees that are based on investment recommendations unless they comply with prohibited transaction exemptions. M

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