Research

DOL's Proposed Fiduciary Rule: Not in the Best Interest of Investors

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Executive Summary

- If the Department of Labor's (DOL) proposed fiduciary rule is implemented, almost all retail investors will see their costs increase by 73-196 percent due to a mass shift toward fee-based accounts.

- Firms providing investment advice will see an average of $21.5 million in initial compliance costs and $5.1 million in annual maintenance costs.

- Up to 7 million current Individual Retirement Accounts (IRAs) would fail to qualify for an advisory account due to the balance being too low to be profitable for the adviser.

Introduction

On the five-year anniversary of Dodd-Frank, the comment period ended on DOL's controversial proposed "fiduciary rule." The rule sets standards for providers of financial advice, but its most likely impact would be to hurt retirement savers – especially low and middle income retirement savers – and many small businesses that provide investment advice. This short paper contains an explanation of the proposal, a survey of the literature on its likely impacts, and an assessment of two comparable rules abroad that DOL used in its proposal.

2010 Proposal

DOL first proposed a fiduciary regulation back in 2010. That proposal set new definitions for when an adviser was considered to be giving investment advice and when a person was acting as a fiduciary as those actions relate to employee benefit plans under the Employee Retirement Income Security Act of 1974 (ERISA). Specifically, investment advice would be held to a fiduciary standard (as opposed to a suitability standard) even if it was just a single recommendation given once, or if the adviser was a Registered Investment Adviser (RIA), among other relaxed provisions. That fiduciary standard is the highest standard of care under the law and would require investment advisers to act in the absolute best interest of their clients or risk being in breach of that standard of care and face harsh punishment under the law. On the other hand, a suitability standard requires only that the adviser recommend investments that are "suitable" to their clients' needs. In response to the proposal, DOL received over 300 comments which, in large majority, criticized the proposal, its costs and effects, and urged DOL to seek other means for implementing such a standard. Congress responded in turn with the Retail Investor Protection Act which would prohibit DOL from issuing any rules regarding fiduciary standards under ERISA until at least 60 days after the Securities and Exchange Commission (SEC) issues a final rule regarding fiduciary standards for broker-dealers. The SEC rulemaking was required by Dodd-Frank, but had to be issued after an in-depth study on its costs and benefit, which is discussed below. By September 2011, DOL announced that it would withdraw the proposed rule and go back to the proverbial drawing board.

2015 Proposal

In April 2015, DOL announced its new proposal which stipulates the types of advice that qualify as fiduciary in nature, carves out certain categories of investment advice that aren't subject to the rule, and amends several existing exemptions from the classes of prohibited transaction while adding two more.

Types of Advice Held to a Fiduciary Standard

This proposed rule differs from the 2010 proposal in two important ways: 1) no longer is advice considered fiduciary just because the adviser is a RIA – it now takes a "functional approach" and must meet both prongs of the definition; and 2) advice doesn't have to be tailored specifically to the *needs* of the advice-receiver; it only has to be directed to the plan, participant, or beneficiary. Specifically, under the new proposed rule, a person renders investment advice that is subject to a fiduciary standard by: "(1) providing investment or investment management recommendations or appraisals to an employee benefit plan, a plan fiduciary, participant or beneficiary, or an IRA owner or fiduciary and (2) either (a) acknowledging the fiduciary nature of the advice, or (b) acting pursuant to an agreement, arrangement, or understanding with the advice recipient that the advice is individualized to, or specifically directed to, the recipient for consideration in making investment or management decisions regarding plan assets. When such advice is provided for a fee or other compensation, direct or indirect, the person giving the advice is a fiduciary." Put more simply, an investment adviser would be held to this heightened standard if they give any investment advice under the mutual understanding that they are their clients' best interests into consideration and acting on those interests.

Carve Outs from the Fiduciary Standard

The proposed rule lays out several categories of "carve-outs" for "communications that the Department [of Labor] believes Congress did not intend to cover as fiduciary 'investment advice' and that parties would not ordinarily view as communications characterized by a relationship of trust of impartiality." It also specifies that "[n]one of the carve-outs apply where the adviser represents or acknowledges that it is acting as a fiduciary under ERISA with respect to the advice." These carve-outs fall into 7 broad categories:

1) Statements or recommendations made to a "large plan investor with financial expertise" by a counterparty acting in an arm's length transaction;

2) Offers or recommendations to plan fiduciaries of ERISA plans to enter into a swap or security-based swap that is regulated under the Securities Exchange Act or the Commodity Exchange Act;

3) Statements or recommendations provided to a plan fiduciary of an ERISA plan by an employee of the plan sponsor if the employee receives no fee beyond his or her normal compensation;

4) Marketing or making available a platform of investment alternatives to be selected by a plan fiduciary for an ERISA participant-directed individual account plan;

5) The identification of investment alternatives that meet objective criteria specified by a plan

fiduciary of an ERISA plan or the provision of objective financial data to such fiduciary;

6) The provision of an appraisal, fairness opinion or a statement of value to an ESOP regarding employer securities, to a collective investment vehicle holding plan assets, or a plan for meeting reporting and disclosure requirements; and

7) Information and materials that constitute "investment education" or "retirement education."

These carve outs are a step in the right direction having taken into account many of the comments received after the 2010 proposal. Unfortunately, there are also exceptions to the carve-outs, which translate into an even greater need for compliance personnel and procedures for the individuals and businesses affected by this rule.

Prohibited Transaction Class Exemptions

ERISA contains a handful of "prohibited transactions" that are automatically considered to be in breach of a fiduciary duty along with several exemptions to those prohibitions. This rule proposes two new exemptions from the prohibited transaction provisions of ERISA along with amendments to exemptions that were already adopted. Per DOL's submissions to the Office of Management and Budget, "[t]he proposed exemptions and amendments would allow, subject to appropriate safeguards, certain broker-dealers, insurance agents and others that act as investment advice fiduciaries to nevertheless continue to receive a variety of forms of compensation that would otherwise violate prohibited transaction rules and trigger excise tax." The two proposed new exemptions are significant:

1) Best Interest Contract Exemption – One of the biggest criticisms of the 2010 proposal was that it would effectively ban commission-based and other indirect compensation. The Best Interest Contract Exemption (BIC) is DOL's response to that concern. BIC allows an adviser to receive otherwise prohibited forms of compensation in connection with the purchase, sale or holding of certain investment products provided that the adviser "contractually acknowledge fiduciary status, commit to adhere to basic standards of impartial conduct, warrant that they will comply with applicable federal and state laws governing advice and that they have adopted policies and procedures reasonably designed to mitigate any harmful impact of conflict of interest, and disclose basic information on their conflicts of interest and on the cost of their advice" with the investor. Such a contract isn't a "get out of jail free card" for an adviser should an investor later find the advice unsuitable. Rather, the BIC subjects the adviser to private actions under general contract law instead of fiduciary claims under ERISA.

2) Principal Transaction Exemption – Investment advisers often sell fixed-income securities out of their own inventory, triggering taxes and other legal sanctions, unless they are exempt. In DOL's eyes, these principal transactions raise conflict of interest concerns because the adviser is better able to manipulate the price. However, because the practice is so widespread, DOL decided to exempt these transactions from ERISA prohibitions provided they execute a contract containing the same provisions as the BIC as detailed above and further include precise terms related to the price of the security in the transaction. Specifically, the adviser would be required to obtain two outside price quotes for a same or similar security, then provide that security to the investor at a price "at least as favorable" as those two quotes. This exemption is similar to the SEC's principal transaction guidance for broker-dealers.

Possible Effects of the Fiduciary Rule

Although DOL's proposal is potentially months (or even years) from being implemented, several studies have been conducted to assess the potential impacts that such a rule would have on the market. A few of the most relevant are discussed below. Each of which is broken out, based on their findings, into two categories: 1) costs to retirement savers and 2) burden on businesses giving investment advice.

Costs to Retirement Savers

Section 913 of Title IX of Dodd-Frank required the SEC to examine the regulatory regimes covering broker-dealers and investment advisers. The SEC was directed to also examine the potential impacts on retail customers if those regulatory requirements are changed or eliminated and make appropriate recommendations as to what sort of fiduciary standards should govern the industry. This mandate has caused many to question why DOL is proposing this fiduciary rule instead of SEC. However, the SEC provides some useful analysis should such a rule be put in place.

The SEC study examined the impact on investors if the impact of the rule resulted in fee based accounts. The SEC study found that this could increase costs as well as impact the gains of their investment. The SEC analysis found that a1 percent increase in annual fees reduces an investor's return by approximately 18 percent over 20 years. The shift to a fee-based model would reduce cumulative returns to "small investors" (with $200,000 or less in assets) by $20,000 over the next 20 years.

Another study examined the impact on the U.S. retirement market, and quantif[ied] differences in investing behavior and outcomes between advised and non-advised individuals" by surveying over 4300 retail investors and 1200 small businesses.

The study found that DOL's proposed rule would likely reduce individual retirement savings. Other key findings include:

- 7 million IRAs would fail to qualify for an advisory account due to the balance being too low, as a result individual investors with small-balance accounts likely will lose access to retirement advice and support

- Almost all retail investors will see average increased costs of 73-196 percent due to a mass shift toward fee-based accounts.

- As many as 360,000 fewer IRAs would be opened each year as a result of the rule.

- As a result of the lack of a carve-out that would allow providers to market self-directed plans with fewer than 100 participants, financial advisers would be forced to stop providing workplace retirement plan set-up and support services to small businesses which would cause many small businesses to close existing plans or never establish a plan in the first place.

Lastly, several comments received by DOL questioned the regulatory impact analysis conducted by the DOL. One comment by the Financial Services Institute (FSI) relied on a study conducted in conjunction with Oxford Economics that quantitatively criticizes the regulatory impact analysis (RIA) conducted by DOL. In particular, the comments say that the RIA failed to take into account the impact of the rule on savers who have an IRA and who do not. For those savers that do have an IRA, the analysis failed to quantify whether the current system suits them well.

Second, FSI explains how the rule's resulting compliance costs outlined in the RIA are understated or, at times, absent entirely. Those costs include:

· Elimination of choice for investors as firms reduce their catalog of investment options

· Homogenization of investing strategies that will create greater risk for investors

· The push into "robo-investing" which will particularly hurt inexperienced investors

· Information overloads, most often in the form of the BIC, that will be faced by investors and inhibit their ability to properly comprehend their investment choices

· Loss of access to commission based accounts and products that are more appropriate for some investors

· Extensive disclosure requirements

· Recordkeeping costs

· Implementation costs of BICs for both new and existing clients

· Supervisors, compliance and legal oversight costs

· System interface development costs related to the need to accept new data feeds required by the proposal

· Training and licensing costs

· Litigation costs, including potential class action lawsuits stemming from the BIC

· Each of the above new costs to investment advisers will result in increased direct costs to investors in the form of pass-through costs

Costs to Businesses Providing Investment Advice

With regard to the impact of DOL's proposal on businesses that provide investment advice, the SEC study found that, as the rule decreases savings over time for retirement savers, the cost of services becomes prohibitively high for the advisers forced to deal with increased compliance costs, and as a result retail investors would face limited choices. It even goes so far as to say that "the increase in costs to broker-dealers could cause many to decide to no longer offer certain products and services to retail customers (e.g., due to risk of litigation under a new fiduciary standard or due to restrictions on principal trading), or would only offer them at increased prices, thereby limiting retail customers' access to the currently available range of products and services." The footnote to that section predicts that "middle class Americans – especially those unwilling or unable to pay upfront fees for guidance – will effectively lose access to competent financial guidance and certain investment products and services." In sum, as fiduciary duties are levied on advisers who previously were under a suitability standard, advisers will be hit with compliance costs that will eventually be passed onto low and middle income investors, thereby limiting their access to investment accounts and retirement savings.

Earlier this month Deloitte released a report which examined the operational expenses for companies complying with the new rule. The study yielded “five themes” which indicate that broker-dealers will face a great deal of operational and financial challenges in implementing the proposed rule. Those five themes are as follows:

1) It will be unfeasible or impossible to operationalize certain requirements.

2) Significant personnel, process and technology changes and investments to operations, business and compliance will be required to comply with the rule.

3) Rule requirements will create disruptions to business operations and customer experience.

4) Rule requirements may conflict with existing regulatory obligations.

5) The rule is ambiguous and broad in certain areas, which challenges the operationalization of the rule’s requirements.

The report also included the costs to firms as a result of the rule. The estimates follow broken down in terms of net capital: small (less than $50 million), medium ($50 million to $1 billion), and large (greater than $1 billion):

· Small firms: $3.4 million in initial compliance costs; $2.6 million in ongoing maintenance costs.

· Medium firms: $23.1 million; $5 million.

· Large firms: $38.1 million; $9.5 million.

Another study surveyed over 600 retirement plan decision makers at various small businesses in an effort to “how the rule could impact assistance provided to small businesses and their employees. HCC’s research examined three general topics: 1) the current environment of investment selection and monitoring, 2) how small businesses currently offering retirement plans feel about the proposed rule and its impact, and 3) how small businesses currently *not* offering plans but considering doing so feel about the rule and its impact. Like Deloitte’s study, HCC’s results were five-fold:

1) Thirty percent of small businesses with a plan indicated that it was at least “somewhat likely” that they would drop the plan if the rule were to be implemented.

2) Fifty percent of small businesses with a plan indicated that it was at least “somewhat likely” that the rule, if it were implemented, would cause them to reduce their matching contribution, offer fewer investment options, and increase fees charged to plan participants.

3) Fifty percent of small businesses *without* a plan, but considering implementing a plan indicated that the rule would reduce the likelihood of them offering a plan, with thirty-six percent indicating that it would *greatly* reduce that likelihood.

4) Forty percent of small businesses without a plan, but considering implementing a plan indicated that the regulation would be at least somewhat likely to cause them to charge higher fees to

participants and not offer matching contributions.

5) Over eighty percent indicated that they believed their current adviser did a “very good” or “excellent” job of investment selection and over ninety percent indicated that they were at least “somewhat satisfied” with the plan’s current investment options.

As such, HCC found that DOL’s proposed rule, if implemented as-is, “could have a negative impact on the number of employees who got offered plans and a profound negative impact on the quality and generosity of those plans.”

Finally, in terms of the impact on small businesses, the aforementioned FSI study explains that there are about 240,000 broker-dealers and investment adviser firms in operation today. Of those, approximately 60,000 are the big, national companies. The other 180,000 are smaller firms whose business is comprised mostly of $30,000-$50,000 accounts of low to middle income investors. FSI estimates that if DOL’s proposal is implemented, the costs required to comply would be significant enough to make those $30,000-$50,000 accounts unprofitable for the firms, and those firms would be forced to drop the investors as customers, which, for many small firms, would put them out of business entirely.

Results of Comparable Regulations Abroad

DOL’s own RIA uses examples of recently-implemented regulations in the United Kingdom and in Australia that it says mirror its proposal. In doing so, DOL argues that the United States should take a lesson from each of these countries since their regulatory regimes were comparable to the DOL proposal, and, at least in the case of the United Kingdom, there had been positive results. That contention is simply not true.

Australia’s Future of Financial Advice (FOFA) Reforms

FOFA does closely resemble DOL’s proposal: it prospectively banned conflicted payment structures including commission and volume-based payments; it imposed a “best-interest” duty on advisers on behalf of their clients; and it required various disclosure and client agreement duties while giving the Australian government more power over broker-deals and investment advisers. However, Australia’s retirement system looks nothing like that of the United States. FOFA did in fact dramatically reduce the size and accessibility of the investment adviser industry, but Australian retirement savers were not harmed because of a mandatory 9.5 percent employer retirement contribution. Those contributions go into a “Superannuation Fund” that can then be designated into various products with differing assets and diversification levels. Even if an employee is not advised as to which product they should choose or if he fails to choose at all, those deposits go into what is called a “MySuper” product which is required under the law to hold appropriate diversified assets. Because Australia’s retirement system offers a backup plan for those investors who are unable to access an investment adviser, it does not offer a meaningful comparison to DOL’s proposal and should not be a part of its RIA even though it highlights the negative effects on the businesses providing investment advice.

United Kingdom’s Retail Distribution Review

In 2006 the United Kingdom introduced its Retail Distribution Review (RDR) which, at its heart, requires advisers to: 1) explicitly disclose and separately charge clients for their services; 2) disclose to clients whether they are providing independent or restricted advice; 3) subscribe to a code of ethics; 4) hold an appropriate qualification; 5) complete at least 35 hours of continuing professional education annually; and 6) hold a

“Statement of Professional Standing” from an accredited institution. DOL states in its RIA that “the results [of RDR implementation] were positive and show material improvements” and that “[a]s a result, clients should be in a better position.” However, a 2014 Europe Economics “post implementation review” of RDR finds just the opposite.

At over 100 pages, the review quantifies several downfalls of RDR, but most alarming – and one of the biggest worries about the DOL proposal – is the effect it notes on low and middle income investors. Per Europe Economics: “Pre-RDR there was a concern that the ban on commissions and introduction of more transparent adviser charging would lead some firms to remove previous implicit cross-subsidies between customer groups. As a result, customers with low levels of investable wealth and simple ongoing advice needs may no longer be profitable for some firms, at least not at fee levels which customers would be willing to pay…Post-RDR there is evidence that firms are indeed segmenting their client books…There is also evidence of a move among some advisers towards higher net-worth customers. Although sources suggest minimum thresholds vary by firm, some firms have moved to minimum wealth levels of between £50,000 and £100,000.” The review also cites to decreased options for investors, not only as a result of minimum wealth thresholds, but from firms and banks exiting the market altogether. “This exit appears to have been driven by a mix of factors. Barclays, for example, cited ‘a decline in commercial viability for such services over recent years’…HSBC, RBS, Lloyds and Santander also re-structured their advisory businesses, leading overall to a partial withdrawal from the advice market – and a decline in adviser numbers.” It’s hard to imagine a scenario in which the same or similar negative effects would not occur in the United States as a result of DOL’s proposal.

Conclusion

Many experts agree in their concerns that DOL’s proposal will do more harm than good by way of reduced choice and limited access for investors. While most everyone involved is in favor of some sort of fiduciary standard, DOL should take into account what many experts are warning will be the impact of the rule and, at the very least, modify the proposal.

Ideally DOL would leave the setting of broker-dealer and investment adviser fiduciary standards to the SEC. DOL will conduct public hearings on the issue the week of August 10, after which it will accept further comments and possibly modify the proposed rule. Implementation is still a long way off, and hopefully DOL will use that time to provide a more appropriate proposal.