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## Damage Assessment: Who's Hurt by New Fiduciary Rule?

By Kerry Pechter    *Wed, Dec 23, 2015*

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*Advisors who sell on commission, I-banks that underwrite securities and sell them through their own broker-dealers, and recordkeepers that capitalize on their access to participants should all beware the DOL's impending conflict-of-interest rule, says Cerulli Associates.*

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The perennial wave of rollovers from 401(k)s to IRAs won't be thwarted by the Department of Labor's soon-to-be-issued "conflict of interest rule," but the rule could foil some of the existing synergies in the IRA business, according to the latest issue of the Cerulli Edge, Retirement edition.

In the report, analysts at Cerulli Associates, a global consulting firm, said that they believe the proposed rule, which would extend the DOL's jurisdiction over retirement plans to include retail rollover IRA accounts, will "be implemented with only minor revisions in spring 2016."

And even though the DOL has made clear that it would rather see less money migrating from relatively low-cost, closely regulated 401(k) plans to potentially higher-cost retail IRA accounts, Cerulli doesn't think that's likely. The firm expects the rollover tsunami to keep rising. By 2020, it estimates the annual volume of rollovers will reach \$517 billion.

"Tsunami" in this case is justified hyperbole. As more Boomers reach retirement age or leave their employers, more of them roll their employer-sponsored plan accounts to IRAs. Rollover IRA assets, now at about \$7.3 trillion, exceed the assets in defined contribution plans.

Cerulli cited two reasons why the rollover wave will continue unabated: First, the big broker-dealers whose advisors have largely switched to a fee-based, fiduciary compensation model already, so their most important advisor-client relationships won't necessarily change.

Second, most 401(k)s aren't set up for flexible distributions, so retirees are virtually forced to roll assets over to IRAs. "Just 21% of large plan sponsors report having adopted an in-plan guaranteed income product," Cerulli reported. "Only 10% of plans allow participants to take ad hoc partial distributions."

## Uneven impact

The DOL proposal will hurt some financial industry players, leave some more or less alone, and have a mixed effect on others, according to Cerulli. It's difficult to isolate the likeliest points of pain, however. That's because advisors often wear multiple hats (insurance and investments), broker-dealers have mixed business models (commissions and asset-based fees), and properly licensed and certified intermediaries can act as planners at one moment, brokers at another and insurance agents at another. Here's how Cerulli expects the new "playing field" to unfold:

**Insurer-owned broker-dealers:** They could get hurt the most, Cerulli says. Their business model—where advisors often sell proprietary products like variable annuities on commission—is inherently conflicted. Insurer-owned B/Ds faced problems even before the DOL's campaign to reform the IRA rollover industry began.

**Firms with existing client relationships:** Plan participants tend to stick with the provider they know. Depending on the size of the plan, that provider might be a registered rep, an insurance agent, a recordkeeper, or a full-service provider like Fidelity or Vanguard. It's no coincidence that Fidelity, the largest plan provider, is also the largest IRA provider, with 14.7% (\$1.1 trillion) of the IRA market. (Fidelity's "Bring Us Your Old 401(k)s" ads seem to be everywhere.)

**Wirehouses:** As registered investment advisors, most wealth managers at wirehouses (Merrill Lynch, Morgan Stanley, UBS, Wells Fargo) are already fiduciaries, so they already comply with the DOL's anticipated new rule. Also, their high net worth clients (>\$250k in investable assets) tend not to purchase commissioned products, which DOL believes are inherently conflicted. "Cerulli believes that large-balance investors and rollovers will be the least impacted by the new rules because these investors will value holistic advice on their entire portfolio," the report said.

**Advisors at broker-dealers affiliated with investment banks that underwrite securities:** "To be a fiduciary, these B/Ds must ensure that investors receive best execution or the most favorable price on any securities they purchase. It should be noted that this largely applies to buying individual equities or bonds," the Cerulli bulletin said. In other words, investment banks might have difficulty pressuring their broker-dealers to push their issues.

**Advisors or broker-dealers that receive revenue-sharing payments from companies**

**that provide products on their shelves:** “A key source of revenue for many B/Ds is revenue sharing from product manufacturers, which is another potential conflict of interest, albeit for the B/D rather than the advisor. Seeking client acknowledgment of revenue sharing may be yet another pain point for advisors,” according to Cerulli.

**Recordkeepers:** “Many recordkeepers provide IRA education while participants still have assets within defined contribution plans to help facilitate rollovers,” Cerulli’s report said. “While investors may be getting the consultation they seek in these scenarios, the proposed Department of Labor Conflict of Interest Rule has the potential to change this dynamic with more stringent regulation of the IRA rollover process.” The DOL has said publicly, however, that generic rollover information by recordkeeper call center operators won’t be considered to be advice under the forthcoming rule.



**Editor’s note:** In the discussion over the details of the conflict-of-interest proposal and its disruptiveness for broker-dealers, the context of the rule is often lost or obscured. For instance, it’s been said, somewhat opaquely, that the DOL wants to “expand the definition of fiduciary.” Essentially, the DOL wants to change an antiquated definition of fiduciary status that allows some broker-dealer reps to be refs and players at the same time—that is, to serve as trusted, objective advisors to retirement plans and also use the plans as sources of retail rollover prospects.

The DOL hopes to end this game, especially when a client’s costs go up as a result. The ultimate goal is to reduce the costs that retirement investors pay. The DOL focus on costs rankles the retail financial industry because it appears to imply that their services add no value. Retirement industry leaders have also claimed that, as a practical matter, brokers will

sell far fewer 401(k) plans to small businesses if there's no potential for them to secure future retail business.

Some broker-dealers believe that the DOL rule will chill the sale of all commissioned products, including income annuities and the hot-selling fixed indexed annuities. If that happens, they have argued, the DOL initiative will backfire by eliminating services for middle-income clients (who are the primary purchasers of commissioned products) and reducing the availability of guaranteed income products.

The industry resents the "one size fits all" solution to conflicts-of-interest in the IRA world that the DOL appears eager to impose. Rather than make surgical changes to its rules, the DOL chose to use a blanket approach and require advisors who want to make inherently conflicted transactions—sell on commission, accept revenue sharing, or sell proprietary securities—to sign a legally-binding Best Interest Contract (BIC) and promise to act in the sole interest of the client. Many in the rollover industry have found the BIC requirement to be, in their words, "unworkable." But the IRA business is so varied and complex that anything other than a principles-based solution may have been impractical.

The DOL proposal does make at least one surgical change to the regulations. It distinguishes variable annuities from fixed annuities, making sellers of VAs on commission subject to the BIC pledge requirement while allowing fixed annuities to continue to be sold under an existing indulgence (i.e., "exemption from prohibited transaction"). As a result, selling VAs may be more difficult going forward. But it may not matter much: VA sales are shrinking anyway.

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