DOL Hearings: Wonkishly Stimulating

By Kerry Pechter *Thu, Aug 13, 2015*

"I believe the proposal is intended to eliminate the commission model," said Ron Kruszewski of Stifel Financial during the hearings on the DOL conflict of interest proposal. Scott Puritz of Rebalance IRA looks on.

There was conflict, and it was interesting.

Although not as entertaining as, say, Megyn Kelly and the first Republican presidential debate, the three days of testimony and debate on the Department of Labor's conflict-of-interest proposal this week proved to be much more absorbing than your average C-SPAN broadcast.

And why not. The terms and conditions of managing $7.2 trillion in rollover IRA money are getting hashed out.

The webcast hearings, which end at mid-day today, have involved the testimony of over 100 witnesses, including financial industry advocates, attorneys, law and finance professors, consumer rights activists, at least one martyred whistleblower and a couple of just-folks insurance agents from the farm-and-ranch belt.

The DOL grouped the witnesses into 25 panels of three or four each, often pairing natural antagonists in a way that prevented imbalance and monotony. There were boring patches where witnesses simply read written statements. But these patches were typically followed by a wonkishly stimulating Q&A period in which a panel of DOL officials, led by Deputy Assistant Secretary of Labor Tim Hauser, probed, prodded and sometimes provoked the witnesses.

The hearings made one thing clear: The DOL specifically wants its proposal to close a 40-year-old "loophole," written before the invention of 401(k)s and IRAs, that allows advisers considerable discretion in deciding when the legally-binding burden of "fiduciary" conduct applies to their conversations with and recommendations to clients. It was equally clear that advisers don't want to surrender that discretion.

Overall, the DOL maintains that its proposal—now more than five years in the making—aims to lower costs and raise transparency in transactions involving tax-deferred savings, without unnecessarily restraining trade. Those likely to be most affected by the proposal—those who earn commissions on selling variable annuities and mutual funds to IRA owners—say it won’t work.

Is the DOL naïve?

Will the proposal accomplish the DOL’s goal? It depends on the workability of the compromise at the heart of the regulation, which would allow brokers and agents to keep using the third-party commission compensation model as long as they sign a pledge to act “in the best interest” of the client “without regard” to their own compensation.

At the hearing, even the DOL seemed to have doubts whether such a compromise is practicable. At one point, Hauser asked Mark Smith of the Sutherland Asbill law firm if the DOL was “naïve” to believe that such a compromise could work. Smith said, “No.”

Yet most of the industry representatives who testified said brokers and agents couldn’t operate within the confines of this compromise. Tom Roberts of the Groom Law Group said, “The best interest standard is incompatible with any selling model that I have seen. It is exclusively in the interest of the [advice] recipient.”

Steve Saxon, also of Groom Law Group, said, as he has said before, that the proposal’s “without regard” clause, which requires advisers to promise to turn a blind eye to their own compensation when formulating advice, was too absolute, and would create too much legal liability for advisers.

One after another, industry representatives called the proposal “unworkable.” The changes in reporting responsibilities necessitated by compliance with the proposal would break their IT budgets, they said, and having a different standard of conduct for managing IRA money and taxable retail money would just confuse clients.

Addressing that last point, the DOL’s Hauser said, “Congress created a statute that said there should be a special regulatory regime created for tax-preferred accounts, and we’re it. We do not want to make the broker model impossible. We agree that not everyone needs an ongoing advisory or RIA relationship. We just want to tamp down the conflicts.”

As for the accusation implicit in the DOL proposal that the industry has problems that require new regulation, no industry witness acknowledged the existence of problems. Indeed, the industry advocates and attorneys offered no direct response to the assertions by consumer activists and academics who, in their testimony, claimed that brokers’ recommendations are often determined more by a desire to enhance their own or their firms’ compensation than by the clients’ needs or interests.

There was, in fact, considerable evidence to that effect. Mercer Bullard of the Business Law Institute at the University of Mississippi described in detail the way compensation dominates sales behavior in broker-dealers. His testimony was unique in laying bare brokerage compensation practices that appear designed to maximize sales.

Arthur Raby of Rutgers, Jonathan Reuter of Boston College, Michael Finke of Texas Tech and others cited various studies that showed that commissions lead advisors to recommend sub-optimal investments or insurance products.

“Economic incentives matter. When a person or firm has chance to get much higher compensation, the allure of the higher compensation nearly always wins, to the disadvantage of consumers,” said Ron Rhoades of Western Kentucky University. Antoinette Schoar of MIT described a 2012 study where mystery shoppers sent to brokerages were steered away from index funds and encouraged to believe in the wisdom of chasing returns.

Several consumer advocates opposed the plank of the DOL proposal that sends client-broker disputes into mandatory binding arbitration. Joe Peiffer, president of the Public Investors Arbitration Bar Association, argued that the arbitration system is biased in favor of advisers. Consumer advocates also pointed to the ineffectiveness of disclosures in providing the transparency that clients need from brokers and financial advisers.

Variable annuities as lightning rod

In the hearings, variable annuities received special attention. At least two consumer advocates cited instances where an adviser recommended that clients roll over 401(k) assets from low-cost institutional funds to high-fee variable annuities, to their detriment. At the same time, several industry advocates cited instances where buying a VA protected clients from market volatility and longevity risk.

VAs, perhaps because of their opaque fees, multiple moving parts and high commissions, have been singled out for special treatment in the DOL proposal. The proposal selectively requires commissioned sellers of VAs to take the “best interest” pledge that the industry finds unacceptable, while allowing fixed annuities to continue being sold under the long-standing and more flexible Prohibited Transaction Exemption 84-24.

Another contentious area involved the question of whether the proposal would backfire by reducing the access of small investors to advisory services. From the industry’s perspective, third-party commissions incentivize brokers to serve people who don’t have enough assets to interest fee-based advisers or who are unwilling to pay out-of-pocket for advice. In other words, these low-balance clients benefit from what might be called vendor financing.

Consumer advocates rejected this as illogical. Since clients pay indirectly for such vendor financing without knowing it, they said, they clearly can afford to pay for advice in a more transparent framework. Sheryl Garrett of the Garrett Planning Network dismissed the idea that the proposal would deprive the middle-market of advice, pointing to advisors in her network who currently provide conflict-free advice to thousands of middle-income clients.

She and others refuted arguments that taking away brokers' incentives to advise the middle market meant the middle market would go without advice, or pay much more because the only alternative was wrap accounts. "We would categorically reject the idea that conflicted commission-based advice is always cheaper than non-conflicted fee-based advice," said Christopher Jones, chief investment officer of Financial Engines, which provides web-based managed account services to retirement plan participants and retirees.

What happens next? After the hearings, the DOL will invite further comment, and then incorporate the new comments into the next draft—perhaps the final draft—of the proposal. Although Hauser said that the DOL wants to accommodate industry concerns, one witness, Caleb Callahan, representing the Association for Advanced Life Underwriting, made a surprise comment that the DOL's mind is already made up about what it will do next.

Callahan referred to a letter from Secretary of Labor Tom Perez to Missouri Congresswoman Ann Wagner stating that the DOL is ready to move to a Final Rule. RIJ obtained a copy of the letter from a Wagner staff member. At one point, the letter says: "We will move forward towards issuing a Final Rule that balances the input we have received."

The letter concludes, "We continue to welcome input on how to refine and streamline this Proposal so that when we publish a Final Rule, we can all be sure it is reflective of relevant input and achieves its desired goals."

Two advisors have suggested to *RIJ*, somewhat darkly, that the Obama administration is deliberately circumventing Congress with the DOL proposal in order to achieve some narrow or partisan gain.

"The idea of using the Department of Labor to regulate our entire industry is a strong-arm tactic by the current administration," one advisor told *RIJ* in an email yesterday. "I can't stand this overreach of government regulation, just because some people are angry about how other people get paid. That's honestly what this entire thing is about."