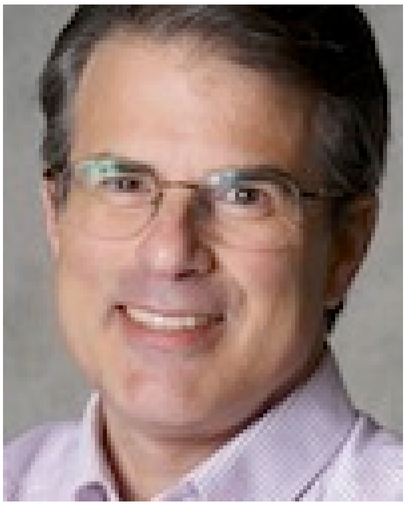
On Background: An Insider Talks about the DOL Proposal

By Kerry Pechter   *Thu, Oct 29, 2015*

What do broker-dealer executives really think about the DOL proposal and it's potential impact on their business? One executive spoke with RIJ recently.



A broker-dealer executive spoke with *RIJ* a few weeks ago about the Department of Labor's fiduciary or "conflict of interest" proposal. He expects the proposal's final version to resemble the current one, and that his industry will have only about eight months to comply with the terms of the proposal, starting after its publication in early 2016.

The executive believed that DOL officials might yet yield to some of the industry's requests for changes in the current version. But he seemed resigned to the idea that the proposal's most disruptive element—the Best Interest Contract Exemption (BICE), which stops advisors from taking commissions on sales involving IRA accounts unless they pledge to act in their clients' best interest *without regard* to their own—will survive in some form.

Unless that "without regard" wording is massaged, the BICE could be costly for the broker-dealer business model. A good chunk of broker-dealer revenue, besides asset-based fees, consists of sales commissions paid by manufacturers of mutual funds and annuities. Signing a BICE would make it hard, if not impossible, for advisors and firms to protect and enhance that revenue stream. But if the advisor and firm don't sign the BICE (in its current form), the $7 trillion rollover IRA market would be off-limits to many commission-sold products. This is what all the ruckus is about.

If advisors were denied third-party commissions, they'd probably sell a lot fewer load funds or B-share variable annuities. Product manufacturers would suffer. Broker-dealer revenue would drop by hundreds of millions of dollars. Advisors who couldn't switch to salaries or asset-based compensation could lose their jobs. Advisors who currently earn both commissions and asset-based fees might lose the freedom to toggle back and forth between the two. The DOL proposal, intentionally or not, threatens to throw a major wrench in a complex multi-trillion dollar product distribution system.

Still, there's hope in the broker-dealer world that the DOL will give in on some points. "There are elements of the proposal that are still in flux," the executive told *RIJ*. "The DOL is still considering changes that might make the transition easier and the proposal more acceptable. They are giving consideration to further product exclusion under the BICE. And they are giving more thought to grandfathering existing positions. But they are definitely going to require a signed contract.

He thinks the contract might change in the final draft. "The DOL admits that the disclosures under the BICE are too extensive and they will try to confine them to what is meaningful and doable. They admit that they've been too strict about drawing a line between investment recommendations and education. They will clearly move the bar there. They have heard loud and clear that our paperwork can't be done in eight months or even in several years. They hadn't consider that at first.

"They're more concerned about conflicts-of-interest at the advisor level than at the home office level. They're okay with firms getting revenue-sharing (payments from mutual fund companies to distributors to help pay for fund marketing) if it's disclosed and if the firms have procedures in place not to promote one product over another. They believe that it's not worth it to try to stop proprietary products sales. That's a fight they don't want to take on, as long as they can manage the conflicts at the advisor level. They have said that their intention is not to say 'You must sell the best investment and get rid of all conflicts.' The intention is just, 'Manage the conflicts.'"

The executive was asked if the DOL has been candid in saying that it wants broker-dealers to be able to maintain their current business models.

"If you were to go to DOL officials and ask them if they want to stop commissions, they will say, 'No, we have no issues with people taking commissions. We wouldn't have created the BICE if we didn't want to allow commissions.' But at end of day, they clearly don't like commissions," he said. "They believe that if you are paid a commission, then you'll make the wrong recommendations. They *say* they're not against commissions; but, of course, they have to say that. The only conclusion I can draw is that they want to make it difficult to sell any product with a commission."

Broker-dealers are acutely worried that signing the BICE would expose them to suits from disgruntled clients who lose money in a downturn. So, even if advisors sign it, they'll stop selling commissioned products. "If I decide as an advisor that I'll take on the legal liability of the BICE, I will be careful to make investment recommendations that are least likely to get me sued down the road. Those will be the opposite of commissioned products. So I'll make sure it's all fee-based. Why take the risk? I won't sell actively managed funds. I'll sell index funds, and low cost ETFs and TDFs," the executive said.

"I definitely agree that commissions cause advisors to recommend one product over another," he conceded. "But I don't agree with the conclusion that clients will end up doing worse." On the contrary, he said, clients could end up worse-off in accounts with annual asset-based fees of one percent or more than if they bought products with one-time front-end loads.

The executive also conceded that many variable annuity sales are driven by the desire for commissions. After the financial crisis, when annuity manufacturers introduced low-load "client-friendly" VA contracts, registered reps widely declined to sell them. The products went nowhere.

The VA industry has long struggled with the problem that advisors prefer to sell mutual funds, which pay an attractive commission but are simpler and easier to sell than VAs. This has led, perversely, to upward pressure on commissions and, in a self-reinforcing spiral, makes VAs even more complex and expensive and therefore harder to sell. "It's a chicken-and-egg thing," the executive said. "Annuities started paying a higher commission because it was a longer sale, and advisors had to be paid more. That led to more oversight and more paperwork, which reinforced the problem."

"No [broker-dealer] wants to be the first to lower commissions," he added. "This might make the DOL's case, but because VAs are commodities, if your firm is not in line, commission-wise, it will sell less. When I got into this business, VAs paid a 4% commission without a trail. The VA is the only product where commissions have almost doubled in the last 20 years. If the manufacturers could sell the same amount of VAs they sell now to fee-based accounts, and not have to carry the CDSC [contingent deferred sales charge] on their books, they would.

But it doesn't make much sense to put a variable annuity in a fee-based account. "There's a no-commission Pacific Life VA, on which the client saves 75 basis points a year. But the client is paying a one-percent management fee on a fee-based account. So there really is no savings." In any case, he added, it's difficult to justify charging a client to manage the money inside a variable annuity subaccount. In short, the DOL proposal won't be good for variable annuities or load mutual funds.

“Clearly, the VA companies are worried,” he said. “The fixed annuity companies are fine. They can just use PTE 8424 [an exemption for such sales in the current regulations]. They realize that broker-dealer and bank sales will be impacted, however, and that’s where the growth happens to be coming from.”

The executive, like many of his peers, believes that the current system, though not always consumer-friendly, provides a lot of ordinary people with valuable financial products—products they wouldn’t seek out on their own and that they are better off owning. “This is a solution in search of a problem,” he said about the DOL proposal. “It involves a large amount of disruption to the system in return for a relatively small improvement.”