One Step Ahead of a Rolling Boulder

By Kerry Pechter *Thu, Sep 29, 2016*

In Colorado Springs this week, members of the Insured Retirement Institute met to discuss the impact of the DOL fiduciary rule. 'It's not all doom and gloom,' said one industry observer, who expects demand for retirement income planning, and planning products, to emerge.

Pressured by the approaching activation of the Department of Labor's fiduciary rule in April 2017, the retirement industry—product manufacturers, distributors, and hundreds of thousands of financial advisors—finds itself in a state of uncertainty, convulsion and frantic activity.

At the Insured Retirement Institute meeting this week in Colorado Springs, preparation for compliance with the rule was a common concern, according to one person who attended:

"The tone of the meeting was one of collaboration—like, 'How will we all get through this together? But it's weird. The insurance carriers are waiting to hear back from the broker-dealers about what they should do about the rule. But the broker-dealers and the IMOs still don't know what they're going to do," he told *RIJ*.

"Tactically, people seem comfortable that they will be able to issue the required disclosures and 'Best Interest Contracts' by next April. But they haven't solved the problem that people can start getting sued after that for violating their fiduciary duties. The big question is: How can we limit liability? They're hearing that class-action lawyers are already creating billboard ads" to attract potential plaintiffs.

"The overall answer to that seemed to be: if you, as an advisor, intend to sell annuities, or even mutual funds, you'll need a full financial plan. The product-pushing days are over. You'll have to look at the client's whole situation. If you sell annuities, you may not be able to push them alone. If you're an RIA, you might have to start considering annuities."

The DOL rule was intended to, and will, dampen retirement industry profits. The rule is expected to reduce and standardize, though not eliminate, the non-transparent fees, such as commissions and so-called 12b-1 marketing fees, that mutual fund and annuity manufacturers pay to distributors (broker-dealers and their advisors) for marketing and selling their products.

"Intentional or not, the DOL fiduciary rule will change the landscape of the retirement market for decades," said a LIMRA researcher this week.

It's as if, with respect to tax-deferred accounts, the government had told powerful people, with equally powerful secret lovers—in this case, broker-dealers and makers of mutual funds and annuities—to go back to their legal spouses.

For monogamous people, as it were, not much will change. For Vanguard, or fee-only planners, or elite wealth managers at Morgan Stanley, business will go on largely as usual. But thousands of lives, and livelihoods, will be rearranged as the lovers either break up, agree to remain friends, or try to carry on their mutually enriching relationships despite the rule.

Darkness at noon

Broker-dealers, especially the smaller ones without economies of scale, are experiencing the most disruption. The conflicts of interest that the DOL rule targeted are endemic to them and their registered reps. Broker-dealers who've relied on manufacturer-paid commissions to compensate advisors may have to switch them to salaries or fees as a percent of client assets. Many broker-dealers expect some of their advisors to retire. (See related story in today's issue of *RIJ*.)

"Smaller broker-dealers who can't keep up with the new technology that BIC demands will be threatened," David Macchia of Wealth2k, who is trying to position his proprietary web-based advisor marketing and income planning software as the right tool for advisors in the fiduciary era.

An August 2016 **report** from consultant A.T. Kearney now estimates that by 2020 independent broker-dealers will have $350 billion (11%) fewer assets under management and $4 billion (11%) lower revenue. Such firms should think about merging with larger firms, the report said.

Wholesalers of annuities, especially indexed annuities, will also be hurt, Macchia said. "Career-type field forces that have relied on proprietary product sales will face a big disruption. Standardization will become a much bigger problem. The idea of the 'rep as portfolio manager' doesn't have legs. Most or many advisors will end up as salaried employees delivering packaged solutions. Everybody will be impacted," he told *RIJ*.

Several factors make the annuity business vulnerable. The DOL rule won't hurt fixed deferred or immediate income annuities, but those aren't the top sellers. Instead, it puts a new regulatory hurdle, the so-called BICE, in the path of indexed and variable annuities, which sell in much higher volumes. LIMRA predicts lower sales for both product types in 2017.

Annuity manufacturers are responding to the DOL rule's scrutiny of commission-driven sales by rolling out no-commission products. Jackson National recently introduced a fee-based variable annuity with a lifetime income option, and Great American introduced the first fixed indexed annuity. Yesterday, Nationwide announced its purchase of Jefferson National, a provider of low-cost investment-only variable annuities for clients of registered investment advisors who are seeking a tax-deferred trading vehicle.

But annuity sales have long relied on commissions to drive sales, and after the Great Financial Crisis advisors showed little interest in the no-commission or low-commission products that came on the market. If advisors choose to sell annuities, it's not clear if they would charge the same or much less than their usual asset management wrap fee on unmanaged annuity assets, or if removal of commissions would translate into higher product value for customers.

The DOL rule is also expected to stifle efforts to solicit rollovers by separated employees from defined contribution plans to retail IRAs, and that could reduce the broker-dealer assets. But their loss would presumably help 401(k) plan providers.

"There will probably be fewer rollovers than there are today, but it's hard to know how much the volume will change or how long it will take to see a difference," said Srinivas Reddy, senior vice president, Full Service Investments, Prudential Retirement.

"On the other hand, while we strive to provide the best institutional solutions, we recognize that one size doesn't fit everybody for their entire lifetimes. On the positive side, we're seeing more interest among plan sponsors in lifetime income solutions than we've seen in several years. More sponsors are saying that their retirees are looking for those solutions."

The four wirehouses, Morgan Stanley, UBS, Wells Fargo and Bank of America—are expected to weather the storm more easily, in part because the final DOL rule allows their advisors to go on recommending "proprietary" products—investments underwritten by other parts of the company. Even so, the wirehouses will lose $300 billion in assets (5%) and $4 billion in revenue because of the DOL rule by 2020, according to A.T. Kearney.

Sunshine at midnight

“It’s not all doom,” said Wealth2k’s Macchia. “If there’s a saving grace, it’s about retirement income planning. Getting expertise in that area is the obvious way for an advisor to move up the value chain and avoid commoditization.”

Macchia is describing the narrow shaft through which the retirement income industry—the sect of the retirement industry whose members believe that annuities and investment products, in the context of the “household balance sheet,” work best for retirees—might escape its dilemma.

In a webinar on Wednesday, Macchia gave his version of an argument that the income industry keeps repeating in hopes that it will come true: That no advisor can claim to act truly in the best interest of an older client without a) assessing the client’s longevity risk, b) considering an annuity product to mitigate that risk, c) incorporating guaranteed income into the financial plan, and d) using software to document the process.

“If there’s a saving grace to the DOL rule, it’s about retirement income planning. Getting expertise in that area is the obvious way for an advisor to move up the value chain and avoid commoditization,” Macchia said.

The major technology providers, like Fidelity’s eMoney, also see opportunity in providing planning tools and documentation tools for advisors and broker-dealers who want to protect themselves from lawsuits. Its **website** says: “See how eMoney is bridging the gap between planning tools and compliance software to help fiduciary-focused advisors in a post-DoL world.”

Other software providers are getting legal opinions that their product will help advisors do that. One is Manish Malhotra, founder of Income Discovery, who obtained a **letter** from Wagner Law Group, an ERISA specialist, asserting that “in our view the use of Income Discovery’s retirement planning software, coupled with a Rep’s comprehensive data collection process, and the software’s ability to compare investment or annuity products, would assist an RIA in satisfying its duty to act with the care, skill, prudence and diligence of a prudent person under ERISA’s Prudent Man Standard of Care.”

The letter continues, “For this reason, even if an RIA is not subject to the BICE or the BICE’s Best Interest Standard of Care, the RIA may still wish to consider utilizing the Income Discovery retirement planning software when advising any retirement clients that are subject to Title I of ERISA.”

Malhotra hopes that all advisors will feel compelled to consider annuities for retirement clients in the future. “As a fiduciary you are responsible for developing multiple options. But if you’re an RIA who gets paid a percent of AUM [assets under management], you have a built-in resistance to recommending an immediate or deferred income annuity, even though those products might be good for your client. So you need at least some process in place to explain why you’re excluding that product. RIAs will be in a bind. I don’t know if they realize it,” he said.

“We are making the point that this software can be used to justify the advisors’ decisions and improve the clients’ outcomes,” Malhotra told *RIJ*. “The letter says that if you used Income Discovery that, in the attorney’s opinion, you would have demonstrated a high standard of care. The bigger advisory firms may have their own legal departments, but the smaller firms can go by this opinion.”

Independent, self-employed advisors, for whom being fiduciaries is nothing new, assume however that their own integrity matters more than any software they use or an attorney’s opinion of it.

“A tool is just a tool,” said Mike Lonier, an Osprey, Florida, advisor who uses his own proprietary planning tool, the **R-MAP**. “Any financial tool, and any legal opinion of it notwithstanding, can be used by a non-fiduciary agent acting in an irresponsible way contrary to a client’s best interest. The fiduciary responsible lies with the advisor, regardless of the tools the advisor uses.

“Nothing about a tool assures that the advisor is acting according to the fiduciary standard. Further, the responsibility to act as fiduciary remains rooted in the advisor’s behavior, and cannot be transferred or waived away by the use of a tool. No magic bullet makes you a fiduciary. That’s my view.”