Out of Commission

By Kerry Pechter *Thu, Sep 19, 2013*

Wondering what life under a strict fiduciary standard might be like? Just ask investors in the U.K. (also known as 'the nanny state') where sales commissions were banned from financial services last January.

Imagine a financial marketplace without manufacturer commissions.

It's not easy—unless you live in the United Kingdom, where commissions have been outlawed since last January 1 under Retail Distribution Review (RDR), a set of rules instituted by Britain's Financial Conduct Authority, the successor to the Financial Services Authority.

In practice, RDR is intended to make fees transparent, align the interests of the client and the intermediary, and make advice the only thing that people who call themselves advisors can charge for.

Advisers can't provide advice or recommend a product until they've explained to the client exactly what the advisory charge will be. The client pays the advisor directly or by deducting the fee from an investment or premium. Advisors can be either "independent," which means they must be product agnostic, or "restricted," which means they sell from a limited shelf of products or specialize in a type of product.

Either way, commissions are out, except in sales of pure protection products like term life and long-term care insurance. The new sunshine rules leave little or no room for B-share compensation, deferred acquisition costs or distribution fees that are simply bundled into an annuity's rate of return or payout rate.

"The focus of RDR was really on two things," Andrew Powers, Deloitte's RDR expert in the U.K., told *RIJ* this week. "Priority number one was to make sure advisors are appropriately qualified. Number two was to make sure that advisors described their services correctly.

"They have to say whether they are 'independent' or 'restricted'. They must be transparent in charging. They can no longer be paid a commission by the product provider. Before, people thought the advice they were getting was free. Now the regulators are saying no to that."

A 15-20% sales drop

RDR's impact so far has been far-reaching but uneven. Independent financial advisors who have already switched over to fee-based compensation and who already have a high-net-worth clientele may be the least affected. Their business is even expected to grow. For banks, whose advisors serve the mass-affluent in the U.K. as in the U.S., it's a different story. Banks have reportedly withdrawn from advisory services. Clients who are accustomed to "free" advice from a broker are suffering from sticker-shock.

Eighty percent of investment products, and many insurance products such as annuities, were sold by commission in Britain before 2013. Sales of those products have dipped by 15% to 20%, according to

Powers.

Insurance companies that used to pay commissions directly to advisors are adjusting to a new system of “facilitated charging.” With a client’s consent, the insurer can deduct the intermediary’s fee from the investment or premium and send him or her a check. Adapting to RDR has cost them the equivalent of about $50 million in systems changes alone, Powers told *RIJ* this week.

It’s not clear if what happened in the U.K. under RDR could happen in the U.S. under a so-called fiduciary rule. Under Section 913 of the Dodd-Frank Act, which instructed the SEC to look into tighter regulation of financial advice, commissions are not deemed to be inherently non-fiduciary. But that’s not to say that SEC or the Department of Labor, which is working on a second draft of a fiduciary rule proposal, couldn’t put pressure on the commission model.

Although many brokers in the U.S. have switched from commission-based to fee-based or mixed-compensation practices since the financial crisis, broker-dealers and their registered reps still rely heavily on commission-based business. Young brokers who haven’t established a personal book of business are especially dependent on commissions for compensation.

The Securities Industry and Financial Markets Association (SIFMA), which represents brokers, recently wrote that a fiduciary standard and commissions can co-exist. The brokerage business model might raise “conflicts that need to be appropriately managed, but they do not preclude a broker from fully satisfying a fiduciary standard,” wrote Ira Hammerman, SIFMA’s general counsel.

In an email, Scott Stolz, senior vice president, PCG Investment Products at Raymond James, told *RIJ*, “We have followed [RDR]. My boss [Chet Helck, CEO of Raymond James Global Private Client Group] is volunteer chairman of SIFMA so he has a front row seat to this. He’s not discounting the possibility that this will occur in the States.

“It’s our opinion that it would leave the small to mid-level investor out in the cold. No one is likely to take on a client with $100,000 or less in assets if they are going to generate only $1,000 per year in revenue. These are the very people that need the most help. As I understand it, a big difference between the UK and the US is the fact that the average US investor has more assets to manage, while in the UK it’s more about retirement income flow. That’s a very different model that requires a different solution.”

How a fee-based advisor sees it

How do U.K. advisors feel about the switch to RDR? Not surprisingly, fee-based advisors aren’t too ruffled by it. But commission-based brokers who sold products rather than advice have seen their revenue model all but criminalized.

Expressions of bitterness have appeared in the comment-chains at the end of online articles about RDR on Citywire’s New Model Advisor website. But there is also a scattering of *mea culpa* comments. Some advisors concede that the U.K. financial services industry was due for a clean-up after the financial crisis.

Anna Sofat, a principal at Addidi Wealth Limited in London, is a fee-based independent financial advisor. The new law requires her to comb the entire financial landscape for the best solutions for her clients.

Sofat, not unlike certified financial planners (CFP) in the U.S. in their comments about a fiduciary standard, believes RDR will be good for her firm and other well-established firms. Now that people are aware that they're paying for advice, the theory goes, they'll demand higher quality.

"The good advisors will survive, but RDR makes life a lot harder for mediocre or bad advisors," she told *RIJ* in a phone interview. "There's much more emphasis on the advisor's qualifications, the bar has been raised. And there's much more transparency around cost."

People in lower wealth brackets and people who resist advisor fees will have other options, she added. Some will opt for packaged solutions. "Companies are beginning to create more structured investment propositions for the middle-class. A number of insurers and investment companies, for instance, are coming up with risk-adjusted portfolios. The advisor can in effect outsource the proposition to them. In reality, that's already been the case. There have never been bespoke solutions for people with £20,000 ($32,000)," she said.

The 'disenfranchised'

Other people will seek out direct providers. "There will also be a lot more do-it-yourself investors, although it takes a certain type of consumer for that. It takes a certain set of skills and attitudes. Our firm finds plenty of takers among the middle-earners. What's happened is that they begin to appreciate the value of quality advice. We might start out by charging by the job, and after that they can sign on to an ongoing service," Sofat said.

RDR will "disenfranchise" millions of British investors, Power's research showed. These are people who got sticker shock when they learned how much advisors cost or, conversely, people whom financial service firms don't have any incentive to pursue. Deloitte estimates the number of disenfranchised at about 5.5 million, of whom about 600,000 are "affluent." The disenfranchised represent a potential market for providers of low-cost, packaged, direct, online or workplace-delivered advice solutions.

Research by NMG Consulting for the FCA last spring showed that it may take some time for Britons to grow accustomed to the differences between commissions and fees and what RDR means for them. An NMG survey found that many people are skeptical that they will ever see how exactly how costs are calculated.

"I think because they can't call it commission, it's going to be dressed up as a fee," one survey participant told NMG. "I'd be thinking they're getting a commission out of whatever the product is."

The many potential consequences of RDR—intended and unintended—may take some time to surface. It's a work in progress. "I think [RDR] is a step forward. There had been a lot of cases of mis-selling driven by high commissions in the U.K. To deal with it, regulators thought they had to draw a line," Powers told *RIJ*.

“But you could say that it’s a bit of a baby-and-bathwater situation. Some people have begun to say, ‘Look, there’s the potential for a bunch of do-it-yourself investors to invest in higher risk assets without understanding the risks, and their savings might get destroyed.’ There’s a debate going on about that right now. The regulators originally took the position that ‘no advice is better than bad advice.’ But now some of them are waking up to the idea that no advice isn’t the answer.”