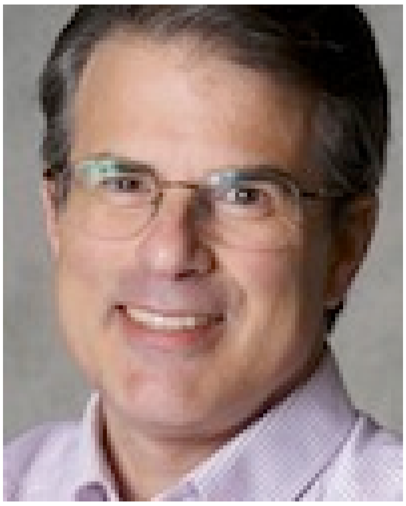
The Tell-Tale Brokerage Statement

By Kerry Pechter *Thu, Jun 22, 2017*

Judging by what I saw (and didn't see) in a friend's brokerage IRA statement, class action lawsuits for breach of the DOL Best Interest Contract might be a lot more common than anybody expects.



An acquaintance recently sent me a copy of his monthly brokerage IRA statement. One of the biggest financial services firms in the U.S. had issued it. In fact, it was a firm that has signed a Department of Labor "Best Interest Contract" (BIC) so that its advisors could sell indexed and variable annuities on commission without committing a "prohibited transaction."

But the details of the monthly statement made me wonder if the big brokerages might underestimate their vulnerability to lawsuits for BIC violations.

For instance, the brokerage statement showed that about 40% of the client's IRA savings was invested in about 20 actively managed funds. Nine of those funds had expense ratios over 200 basis points, and six had expense ratios between 150 and 200 basis points. Without those funds, the client would still be well diversified in much cheaper passive funds.

The acquaintance sent me the statement in part because he and his wife couldn't tell how much they were paying in fees for their investments. I looked through the statement and, without looking up each fund's expense ratio and multiplying it by the client's position in the fund, I couldn't tell either. The client also sent me the statement because his advisor had recommended a variable annuity with a lifetime withdrawal benefit.

I gave the person a list of questions to take back to his advisor. The advisor couldn't tell him how much he was paying in fees on the IRA holdings or how much the variable annuity would cost. When asked about the commission on the annuity, the advisor said he wouldn't have to worry about that because the employer paid the commission.

If a lot of the brokerage's statements looked like this one—I'm assuming it was typical, but maybe it wasn't—then this client's best interests were not being served. And, assuming that failure to disclose fees or to use expensive funds in an IRA was intentional—to maximize the interest of the company—then this national firm seemed to offer plaintiff's attorneys rich material for lawsuits for breach of the Best Interest Contract.

So, while financial industry compliance lawyers might be burning their legal desk lamps all night trying to make their firms invulnerable to specific violations of the letter of the fiduciary rule, they might be overlooking clear violations of the spirit of the rule—violations that the firms commit simply by having a certain business model.

For instance, the advisor in this story is an employee in a publicly held firm. The primary responsibility of the management of a stock company is to maximize shareholder value. The primary responsibility of an employee-advisor is to his or her manager. How can that advisor always act in the client's best interest?

It also turned out that this advisor was unfamiliar with certain important retirement income products, like qualified longevity annuity contracts. Without knowing all of the income options available, and without training in the use of these options, how could the advisor act in the client's best interest?

Although financial intermediaries call themselves "advisors" when working with clients, they are known within the industry by other names, such as "producers" (who are most valued by their companies for recruiting high net worth clients and enhancing assets under management) or "distributors" (whom product manufacturers rely to bring more money into their companies). It won't be easy to change the culture or the business model that this vocabulary signifies.

The Obama DOL was idealistic but naïve in its apparent belief that all financial intermediaries could meet the same high standard of conduct, regardless of the business models of their firms. It was always blindly unrealistic to expect employees of public companies, whose job is to produce or distribute or meet departmental goals, to be as loyal to clients as self-employed hourly-fee planners. But these conflicts of interest are not superficial or exceptional or easy to change.

If big financial services firms don't correct (or can't justify) the kinds of habits embedded in the IRA brokerage statement I saw, then there might be a lot of BIC lawsuits. On the other hand, if those kinds of habits can persist, then the fiduciary rule may be too weak to help retirement investors much.