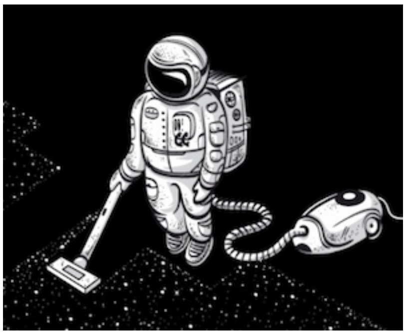
This Is Worse than the Fiduciary Rule

By Kerry Pechter *Thu, May 17, 2018*

Nature abhors a vacuum, and so does the retirement industry. Now that the Obama fiduciary rule is gone, some people are realizing that it actually served a purpose. The problems that the DOL addressed in the rule are still with us, and there's no promising new solution to them in sight.



With the Fifth Circuit Court of Appeals' decision to vacate the Obama fiduciary rule on May 7, the securities, life insurance and retirement industries had effectively thwarted a big threat to their product distribution model. But, based on what I've heard at industry conferences, they're not uniformly satisfied with their victory. That's no surprise. The Obama Department of Labor was the messenger, not the cause, of industry's problems.

"It's as if the rule never existed," attorney Steve Saxon of the Groom Law Group said last week at the Insured Retirement Industry conference. But, as he and others have conceded in public in recent weeks, the issues that inspired the rule still exist. As the thrill of victory subsides, they're reacquainting themselves with the headaches of playing a game without clear rules.

The incestuous, over-priced business model they defended is obsolete anyway. Brokers continue to migrate from the commission-based world to the fee-based advisor world. The law still requires intermediaries to be "prudent" and act in clients' "best interest." Technology continues to commoditize what they do and squeeze their margins. Index funds still crowd-out active funds. The conflicts of interest inherent in third-party payments for distribution still make investors distrust them.

At retirement conferences, discussions about certain elements of the Obama rule have bordered on the nostalgic. Some IT departments and business units who spent millions of dollars adapting their technology to the rule are said to resist reversing their improvements. The guidelines for marketing IRAs to 401(k) plan participants are said to be muddy again. Brokerages have to go back to using the obsolete "five-part test" to distinguish salespeople from advisors; but the test doesn't fit today's fluid, multi-licensed advisory practices.

So far, neither the DOL, the SEC, the federal courts nor the National Association of Insurance Commissioners has replaced the Obama rule with anything more palatable to the financial industry or as appealing to consumer groups. The Fifth Circuit Court of Appeals decision ignored 40 years of change in the way America saves for retirement. The Field Assistance Bulletin that the Department of Labor said it wouldn't enforce the Obama rule, but that created new confusion. The Securities & Exchange Commission's "best interest" proposal, now open to public comment, aroused little enthusiasm. New York and other states now threaten to create a patchwork of five or six different state fiduciary standards. In a May 14 podcast, attorney Fred Reish of the firm of Drinker Biddle said, "We're in the middle of a mess."

Where the rule came from

The seeds for the 2017 fiduciary rule, or at least some of them, were planted 20 years ago, when several major life insurance companies decided to demutualize, cut costs, demobilize their captive agent forces, and rely on third-party distribution. But third-party marketing and distribution was not cheap; fund companies had to pay for shelf space at brokerages and insurers had to pay competitive commissions to independent insurance agents.

Those payments posed a conflict of interest for the intermediaries. The advisors' interests naturally aligned with the parties who paid them—the product manufacturers. "A" shares were replaced by manufacturer-financed "B" shares. The manufacturers' subsequent recovery of those acquisition costs from clients had to be engineered into products. As a result, products became more complex and less transparent.

The Obama DOL didn't invent this problem, or the blurring of designations in the financial world. Brokers and insurance agents, supposedly limited to making one-off recommendations, taking orders and executing transactions for self-directed investors, have created a raft of titles designed to suggest that they provide trustworthy advice. More confusingly, one person, with the right licenses and designations, can switch hats and adopt the role that works best from a compensation or regulatory standpoint. Studies showed that investors are blind to these distinctions.

The DOL didn't invent the transition from defined benefit to defined contribution, which turned savers into investors and retirees into their own pension fund managers. It didn't create equity-linked insurance products, which straddle the insurance and investment worlds. Nor did it attach living benefit riders to annuities and create a new class of personal pensions.

Most importantly, no one foresaw the unintended consequences of rollovers, which allows trillions of dollars of tax-deferred savings to move into a regulatory grey zone between the DOL and the SEC. It didn't invent the blurring of education and marketing by recordkeepers when participants prepared to change jobs and became candidates for rollovers. It didn't invent the vast differences between the 401(k) world and the rollover IRA world.

When they execute a rollover, all those newbie investors who grew up in the captivity of the 401(k) plan have to learn how to survive in the (relative) wilderness of the brokerage world. They'll have more options, but they will be slow to discover that the prices will be higher and standards of conduct lower. Prior to the fiduciary rule, the brokerage world openly celebrated the rollover trend as a "bonanza": Trainloads of dumb money were coming to town.

For consumerist policymakers in the Obama administration, this was not a bonanza; it was a train wreck. The DOL recognized that the 401(k) had replaced DB and risen in importance for retirement security, that the tax-deferral subsidy has helped fatten 401(k) accounts, and that the 401(k) system was in danger of becoming a mere incubator for rollover IRA brokerage accounts whose higher fees would devour the beneficial effect of tax deferral.

Tax-deferral was in danger of becoming an industry subsidy, not a saver's subsidy. This is what prompted the creation of the rule. The DOL's attempt to clarify these problems was flawed. It was also a deep threat to the manufacturer-financed product distribution system. But it was not, as the Fifth Circuit judges labeled it, "arbitrary and capricious."

E unum pluribus

A problematic vacuum now exists. The conflicts and ambiguities are still there but there's still no promising remedy in sight. Neither the Fifth Circuit Court of Appeals, the Securities & Exchange Commission, or the Trump DOL has so far brought the kind of clarity to the situation that businesses and legal departments need.

In the Fifth Circuit Court of Appeals, which vacated the DOL rule on May 7, the two majority judges either didn't know or didn't care that the financial world has changed. They asserted that "only in DOL's "semantically-created world do salespeople and insurance brokers have "authority" or "responsibility" to "render investment advice" and that the Fiduciary Rule "improperly dispenses with [the] distinction… between investments advisors, who were considered fiduciaries, and stockbrokers and insurance agents, who generally assumed no such status in selling products to their clients."

This statement contradicts my first-hand knowledge of the industry. The two judges did not seem to recognize that the DOL was addressing, not imagining, the disappearance of that distinction. In discussing commissions, the judges seemed to think that they're used only in one-off transactions of little consequence.

They didn't appear to recognize that an insurance agent can recommend a $100,000 indexed annuity contract with a long surrender period, a lifetime income benefit and a $7,000 commission that's hidden in the annuity payout rates and still pretend that he's not giving long-term advice. Abuses in the commissioned sales of annuities to IRA owners are real, not "semantically created."

The long-awaited SEC staff's **proposal** for a "best interest" standard, released on April 18, doesn't represent much progress either. It said little if anything about insurance products. I watched the hearing where the commissioners reviewed it. Even the four (out of five) who approved it did so with reservations or without enthusiasm. Commissioner Michael Piwowar criticized its vagueness. "This proposal imposes on broker-dealers a new 'best interest' standard. This sounds simple enough."

But "the devil is truly in the details," he added. "This 'best interest' standard is wholly different from the well-established Investment Adviser's Act fiduciary standard and FINRA's suitability standard. Unfortunately, after 45 days of reviewing and commenting on this release, I am not convinced that we have clearly and adequately explained the exact differences. This lack of clarity is worrisome."

At the IRI conference, attorney James F. Jorden said that as a litigator who defends financial services companies, he saw potential legal vulnerability in the SEC's suggestion that advisors must use "prudence" in dealing with clients.

In the law, he said, prudence usually implies fiduciary responsibility, and not the weaker definition of best interest that the industry hopes for from the SEC. Meanwhile, the SEC will soon lose two of its five commissioners, which will stall action. The Trump administration is not expected to be quick to replace them.

The Trump DOL's recent Field Assistance Bulletin created more questions than it answered. In advising brokerages that it would not enforce the fiduciary rule, it implied that the rule still exists. "The FAB is somewhat difficult to understand," said a Wagner Law Group assessment of the bulletin. At the IRI conference, Drinker Biddle attorney Brad Campbell, a former assistant Secretary of Labor, said, "Labor is not the primary ball carrier. There's nothing on the DOL **agenda** about the rule. It's kind of embarrassing. There's almost nothing on it that’s new in the retirement space. I would have hoped that we would see a more robust policy agenda in the second year of the Trump administration.”

To the dismay of many in the retirement industry, individual state regulators are jumping into the regulatory vacuum where the DOL fiduciary rule used to be. The potential for the emergence of a patchwork of many fiduciary standards is a source of industry concern. The State of New York “has proposed a standard that is very tough on annuities and life insurance,” said Seth Harris, a former Acting Secretary of Labor, at the IRI conference. “The likeliest outcome is that you will get an SEC rule, and then you will have six or seven different state standards of conduct. That will be a big problem for carriers.”

Nature abhors a vacuum, it is said. And so does the financial services industry. But by defeating the Obama fiduciary rule, it has created a vacuum, and there’s no telling what might happen next.