Waiting for the DoL's Fiduciary Do-Over

By Editor Test *Thu, Jun 20, 2013*

If the retirement plan space were Dodge City, do you think that a fiduciary rule would A) Clean up Dodge City for the benefit of all or B) Sterilize Dodge City of all commercial activity, to the detriment of all? That may be the essence of the fiduciary debate. Is there room for compromise? Apparently not.

Anyone looking for conflicts of interest in the retirement world need look no farther than the conflict between the advisors who render advice to 401(k) plan sponsors and participants, on the one hand, and federal regulators like Assistant Labor Secretary Phyllis Borzi, director of the Employee Benefit Security Administration (EBSA), on the other.

Ms. Borzi, a regulator in a Democratic administration and a champion of ERISA (the Employee Retirement Income Security Act of 1974), has positioned herself as a defender of the interests of rank-and-file participants—and especially of their interest in achieving the highest possible income during retirement at the lowest possible cost.

[To hear and see Ms. Borzi's response to a question from Insured Retirement Institute President and CEO Cathy Weatherford at the IRI Government, Legal and Regulatory Conference in Washington, D.C. this week, see today's lead feature in *RIJ*.]

So since 2009 she's been pushing for a so-called "fiduciary standard" that would require the brokers and similar intermediaries who work with plan sponsors, plan providers and plan participants to set aside all interests except those of the plan participants when they render advice to either the plan sponsor or the plan participants.

The intermediaries, however, would prefer to work under the prevailing *caveat emptor* or "suitability" standard. Such a standard allows them to put their own direct (or indirect, if they work for a broker-dealer) financial self-interest ahead of that of the participants whom they advise and whose decisions they can easily influence—as long as it doesn't harm the participants.

But it does harm the participants. In the ERISA-governed retirement plan setting, such a standard leaves room for intermediaries to err on the side of enriching themselves or their firms at the expense of plan participants. It lets them rescommend that plan sponsors select investment options that shift costs to participants. It lets them encourage participants who are no longer employed by the plan sponsor to transfer money from the plans to rollover IRAs, where it can generate higher fees for the intermediaries or their firms.

Pragmatic differences

At first glance, this debate might seem to raise philosophical questions that are ultimately unanswerable. Can anyone, for instance, other than a saint or a Solomon be equally faithful to two masters at the same time, especially when those two masters' interests are not aligned? Or can a fair-minded intermediary

render a solution that maximizes everyone's interest?

But the question is not really that abstract. It's comes down to whether you believe that establishing, in the retirement plan space, a standard of zero tolerance for abuse of trust, zero tolerance for asymmetry of information between buyer and seller, and zero tolerance for any mis-labeling of sales pitches as "advice" will A) Clean up Dodge City for the benefit of all or B) Sterilize Dodge City of all commercial activity, to the detriment of all. (Or, as Woody Allen might put it: If you drive the money-changers out of the temple, how will you break a $20?)

Ms. Borzi evidently takes position A. The financial services industry (or the segment of the industry that's vocal on this issue) takes position B. It's the more pragmatic position. It says that if you try to create a marketplace where service-providers can't make a good living, then the intermediaries will leave and you won't have any services at all.

Reasonable people might eventually be able to compromise here—and perhaps they will. But only to a point. That non-negotiable point will probably involve the acceptability of sales commissions. The sales commission or load is as fundamental to financial services as alcohol is to the 6 p.m. networking sessions at industry conferences. And a strict fiduciary rule would have to outlaw all but capped commissions.

Commissions can't exist under a fiduciary standard, for at least three reasons. First, there's no clear relationship between the services rendered and the amount of the compensation. (Sales sessions, it should be universally agreed upon, do not qualify as advisory services. It's a canard to equate sales with financial advice.)

Second, commissions and similar arrangements like revenue-sharing can't tolerate sunlight. They deliberately obscure the influence of third-party interests. They rely on so-called asymmetrical information, and always to the disadvantage of the client. Third, manufacturers and distributors calibrate commissions explicitly to satisfy their own interests and not the customers'. Participants don't have a seat at the table.

It's been argued, by supposedly serious people, that commissions are good for people with smallish account balances. The idea is that intermediaries can't afford to spend time with them any other way. But this idea makes no sense. If the IRS, for instance, were to use the same logic, then income tax rates would be graduated in reverse, just as break-points on sales commissions are, on the grounds that the government can't afford to provide public services to low-income people any other way. You can make that argument—flat-tax advocates do—but it represents a mean-spirited brand of public policy. You can't claim with a straight face that it's *good* for modest earners. You'll certainly never get a Democratic Department of Labor official to believe that a bad sale is better than no sale.

A strange game

Nonetheless, the odds that the DoL will succeed in establishing a strict fiduciary standard for advisors are not very high. Ms. Borzi's initial regulatory proposal was withdrawn under a superstorm of negative feedback from corporate attorneys and financial industry lobbyists. Her office has been slow to offer a revision, and at the IRI conference this week she was vague about when it will do so. It's possible that a

new fiduciary rule with enough exemptions might satisfy the retirement industry and squeak through. But Ms. Borzi might as well try to reinstate Prohibition as try to establish a standard of conduct that prohibits sales commissions.

A very real problem for Ms. Borzi is the lack of solidarity within the government on the fiduciary question. The Securities and Exchange Commission, which regulates the activities of investment advisors *outside* of retirement plans, also needs to weigh in on the fiduciary issue. Its thinking isn't necessarily aligned with the DoL's, and its definition of fiduciary conduct is likely to be quite different. (Given the unique legalities of the ERISA world, the chances for a single, "harmonized" standard are nil, one lawyer at the IRI conference said privately.) Meanwhile, industry lobbyists are already working through sympathetic members of Congress to frustrate Ms. Borzi's designs. Republican legislators seem especially disinclined to let a mere bureaucrat dictate the rules of the $9 trillion 401(k)/IRA game.

Financial services itself is a strange and serious game. The fees and commissions, which look so small at first, produce mountains of tangible take-home pay for industry professionals. The gains for the amateurs, which loom so potentially limitless at first, can turn out to be insignificant, especially after fees, inflation, volatility, taxes, and unfortunate timing take their toll. In so many cases, only one of the two parties to an investment transaction fully understands how the game is played.