Retirement Income
JOURNAL

Would the DoL Proposal Deny Advice to the Masses?

By Kerry Pechter *Thu, Jul 23, 2015*

Forcing commissioned brokers and agents to act like fiduciaries would deprive middle-class investors of access to financial advice, critics of Labor's proposal argue. Maybe. It would almost certainly deprive advisors of access to investors.

The financial services industry's most common criticism of the Department of Labor's conflict-of-interest proposal has been that middle-class Americans would lose access to valuable advice about retirement investing if the proposal were enacted in its current form.

Several financial services trade associations mentioned this possibility in the reports they submitted to the DoL during the public comment period on the proposal, which ended this week. The cost of all the disclosures required by the proposal, said the Bank Insurance & Securities Association:

"Will require enormous effort on the part of financial service providers, at great expense. Conceivably, this could force all but the largest financial institutions to leave the retirement plan and IRA business, inhibiting the ability of average investors to obtain the advice they require."

But is that true? Would the Labor proposal backfire, and ruin an imperfect but functional market for advice in a quixotic attempt to purify it? Or is the industry's concern for the average investor mainly just a talking point, tailored to neutralize the DoL message and gain public sympathy?

The jury's still out. A review of the comments on the DoL/EBSA website, and a look at related reports and studies, suggest that the proposal in its current form would be highly disruptive. In the UK, advisor numbers dropped by almost 25% after most commissions were banned.

But the proposal may not as disruptive to the delivery of *advice* per se as to the delivery of *products*. The advisors who will be most affected will be those who are directly involved in the sales and distribution of high-cost mutual funds and variable annuities; these are products that don't sell themselves, and which require the incentives that the DoL clearly targets. The proposal may or may not limit a client's access to advice; it would almost certainly limit an advisor's access to clients.

The economics of advice

Part of the economic argument against the DoL proposal is the assumption that vendor financing—mainly in the form of manufacturer-paid commissions on the sale of mutual funds and annuities—helps drive the provision of financial services to middle-class people who wouldn't actively seek or pay for advice alone.

According to this line of thinking, if you encumber the commission-model with over-regulation, advisors will move to the fee-based model that, almost by definition, caters primarily to people with enough wealth to make a percentage of assets-under-management arrangement attractive for the advisor.

"If, as we predict, the proposed rule will cause all compensation models to move to one-size-fits-all pricing, advisors are likely to determine that they cannot afford to work with small clients," wrote Scott Stolz, president of the Raymond James Insurance Group, in his comment to the DoL.

In support of that idea, he pointed to a hypothetical client with a $25,000 IRA. "Assuming a common asset charge of 1%, advisors are unlikely to enter into a fiduciary relationship that requires essentially a 24-hour a day, seven-day-a-week care for just $250 a year."

Even if the advisor charges a commission, it still wouldn't be enough, Stolz argued. First of all, "the compression of commissions and trails… will provide compensation to the advisor roughly equal to the $250 he or she would receive under a fee-based agreement," and the advisor "will most likely not serve the client because the costs and liability [entailed by the BIC standard] will likely exceed the compensation received."

Defenders of commissioned sales also argue that one-time commissions on product sales can be cheaper in the long-run than asset-based fees that are assessed every year. But it's difficult for a layperson to make apples-to-apples comparisons in such cases, because products often entail their own automatic annual fees, and an asset-based fee might cover financial planning services that commissions don't.

Will 'robos' fill the gap?

Even assuming that middle-class investors are disenfranchised by regulations that discourage commission-based sales, they increasingly have the option of seeking investment advice online. Robo-advisors like Wealthfront, Betterment and others, as well as traditional B2C providers like Vanguard and Fidelity, along with advisors who adopt a hybrid model that blends in-person and automated advisory services, are confident that they can pick up the slack.

In his official comment to the DoL proposal, submitted this week, Rob Foregger, the co-founder of robo-advisor NextCapital, wrote, “The emergence of low-cost, automated services will directly help alleviate the concerns of decreased access to advice.

“In general, digital advice firms target those investors who may be underserved by traditional advisors. With the increased adoption rate of new technology, access to automated financial advice will only continue to grow and ultimately benefit lower-income investors.”

At the recent InVest conference in New York, executives from robo-advice firms praised the DoL proposal. One even suggested that the DoL timed its proposal to take advantage of the robo-advice phenomenon. Secretary of Labor Tom Perez mentioned the availability of Wealthfront and other robo-advisors when asked in a House subcommittee hearing about the potential for an advice-gap to open up in the wake of a hard-line DoL rule.

No advice gap in fiduciary states

In one of the few academic studies on this topic, Michael Finke of Texas Tech University and Thomas Langdon of Roger Williams University looked for evidence that holding agents to a fiduciary standard changes the composition of their client base—shifting it away from the middle-class—but they couldn’t find any.

“The [financial services] industry is likely to operate after the imposition of fiduciary regulation in much the same way it did prior to the proposed change in market standards that currently exist for brokers,” they wrote in their 2012 paper, “The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice.”
Exploiting the fact that some states already impose a fiduciary standard on advisors, Finke and Langdon surveyed advisors in states with and without the standard to see if there was a significant difference in the average incomes of their clients.

“We find no statistical differences between the two groups in the percentage of lower-income and high-wealth clients, the ability to provide a broad range of products including those that provide commission compensation, the ability to provide tailored advice, and the cost of compliance,” they wrote.

Those findings are compromised, however, by the fact that the research was sponsored in part by the fi360, the Financial Planning Association and the Committee for the Fiduciary Standard, all of which have come out in favor of tougher standards for brokers and agents. But the data speaks for itself.

Impact of RDR in UK

In the UK, a similar proposal did in fact have a disastrous effect on advisors. After the 2008 financial crisis, authorities in the UK conducted an examination of brokerage practices, called Retail Distribution Review (RDR), and a few years later the government outlawed third-party commissions on many annuity and investment products.

At the time, many observers feared that middle-class people would be "disenfranchised" in terms of access to financial services as a result. In a sense, it did. A June 2013 study by consultants at the Cass Business School of City University London found that between 2011 and 2013, the number of advisors in the UK dropped to 31,000 from 40,000.

"The overwhelming view of most of our interviewees was that… RDR would lead to a polarization and fragmentation of the advisory market," the Cass report said. "The consequence of this will be a reduction in the number of mass-market IFAs [independent financial advisers], which may create a 'guidance gap' where many consumers may find themselves without independent financial advice, despite still having a demand for it."

But, the report continued, "Despite the concerns raised by some or our interviewees about the unattractive nature of the market for financial advice in an RDR world, 69% of the advisers in our survey suggested that they would be retaining 75% to 99% of their clients, while 17% stated that they would retain 100% of their clients."

People were already moving away from the commission-based model anyway, the report said: "Sophisticated, computer- and financially-literate investors are already gravitating to internet solutions where fees are transparent and low. The awareness of ETFs, fundamental indices and similar 'economical' products is increasing exponentially."

Metered advice

Few commenters on the DoL proposal have asked a fairly obvious question: Why can't registered reps simply charge middle-class clients an hourly fee for advice, like fee-only planners, and avoid the conflict created by third-party compensation?

One advisor did in fact raise this issue in a comment to the DoL. "There is much talk in the media that registered reps believe that small clients, and some have even said mass-affluent clients, will not have access to advice if reps are not allowed to charge commissions on IRA," wrote Jonathan Phelan of Algonac, Michigan.

"Apparently their feeling is that RIAs will not service such clients and the reps have no other way to earn money on a client's IRA than a commission. Why couldn't the reps or the RIAs simply charge an hourly or flat fee for services for such clients instead of a commission or percentage of assets under management? I know there are plenty of RIAs, including myself, that are willing to charge hourly fees. Why are registered reps unable or unwilling to do that?"

One often-heard answer is that investors would rather have a commission deducted from their purchase premium or an expense ratio deducted from their account value, than write out a relatively modest check for an hour of advice or pay a flat fee for the creation of an investment plan. Indeed, investors generally don't question an advisor's right to earn a commission. But surveys show that they don't necessarily know when the advisor is receiving a commission, or whether the commission might be distorting the advice. Therein lies the problem that the DoL hopes to address.

Clearly, the government and the financial services industry have divergent ideas about what's best for middle-class savers. Industry advocates say that the DoL proposal is a solution in search of a problem. The government says that too many investors—IRA owners in particular—are over-paying for financial products and services. The search for a shared vision of the future has proven elusive.