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04.12.16

The DOL's New Fiduciary Rule: They Got It Right (Mostly)

Recently, the Department of Labor released its finalized "*Fiduciary Rule*" – a regulatory package designed to address conflicts of interest in retirement advice. The rule was originally proposed a year ago and was met with a predictable chorus of criticism from the financial services industry. While some of the criticism was valid given the original rule's draconian mandates, much of the criticism was motivated by a desire to maintain the very lucrative status quo.

Twelve months later, the DOL has released a streamlined rule which genuinely appears to have incorporated the valid feedback that was given. In fact, despite all the hype about the potential damaging impacts of the rule and all of the effort spent trying to defeat it, the final rule is – dare we say – *reasonable*?

There is no question that the rule will have a significant impact on the retirement savings industry. Its impact will reach every American with a balance in a qualified retirement plan or an IRA, and it will fundamentally alter the way these investors receive advice concerning their retirement savings – and that's a good thing.

LAMCO has always conducted itself by the standards put forth in this rule, so we naturally believe it will be a positive change for investors. Any time regulation promotes or mandates one of our core principles of transparency and conflict-free investment advice, we believe investors will benefit. There are areas of the rule that LAMCO feels could have been strengthened even further, however in general we believe the rule struck a fair balance between the requests of the financial community and investor protection.

The majority of the burden from this new regulation falls on the financial professionals, not the investors or plan sponsors. As a result, little change will be necessary for our clients. It is important, however, that all investors understand the basic premises of the new rule. We have included an analysis and explanation below.

Highlights of the Rule

- The rule is primarily targeted at preventing conflicts of interest in the rollover market place, though there are some areas where qualified plans were impacted.
- All investment professionals who give investment advice to retirement plans, plan sponsors, participants, beneficiaries, IRAs or IRA owners must now act in a fiduciary capacity and must avoid payments that create conflicts of interest.
- Advisors must acknowledge this fiduciary role to their clients and disclose certain aspects of their compensation.
- The rule also clarifies the role of investment education made in conjunction with qualified retirement plans by drawing a clear line between what is general education and what is considered investment advice to an individual participant.
- The rule will be partially effective in April of 2017, and fully effective January 1, 2018.
- We anticipate a sharp uptick in rollover sales between now and April 2017, when the tightened requirements on advisors become effective.
- The rule should have little impact on sponsors and fiduciaries of large qualified retirement plans who already utilize the services of a fiduciary advisor.

The Motivation behind the Rule

The government's goal for this regulation is fairly clear – to protect Americans' retirement savings. Their motivations are so transparent that when they announced the rule to the public they launched the hashtag, "*#SaveYourSavings*".

So who and what is the DOL trying to protect our savings from? The short answer is that they are protecting investors from the harmful effects of conflicted investment advice, or advice that may be in the best interest of the advisor, but not the investor. The reason they are doing this now is because with 10,000 Baby Boomers retiring *each day*, we are about to experience the largest withdrawal of retirement savings in our history. As those assets are removed from the relative protection of employer 401(k) and pension plans and deposited into retail IRAs, the opportunity for conflict is massive.

How massive? It's currently estimated that the Boomers own between 65% and 70% of the United States' $24 Trillion in retirement savings. A recent government study determined that conflicted advice can result in higher fees and imprudent investments, which can lower investment return by between 0.5% and 1% *per year*. Even a conservative modeling of the potential impact of this results in hundreds of billions of dollars being lost by investors unnecessarily.

Given that Boomers have saved roughly $7 to $14 trillion LESS than they will need to live through retirement even before these potential losses are considered, the government has intervened in an attempt to prevent the hole from getting any deeper.

What is conflicted advice and how is it so damaging?

While most investors use the terms broker and advisor interchangeably, there are actually two very different standards to which financial professionals are held— the **Suitability Standard** and the **Fiduciary Standard**.

Under the Suitability Standard, a broker must:

- *Know their client and their financial situation.*
- *Recommend products which are suitable for that situation.*

Under the Fiduciary Standard, an advisor must:

- *Put the client's best interest first.*
- *Act with prudence; that is with the skill, diligence, and good judgment of a professional.*
- *Not mislead clients; provide full and fair disclosure of all important facts.*
- *Avoid conflicts of interest.*
- *Fully disclose and fairly manage, in the client's favor, unavoidable conflicts.*

To more easily explain the difference, I typically use an example from a job I had in college. I was working for a large electronics retailer selling TVs based largely on commissions. Each TV on the floor paid a different commission, with some TVs paying nothing. We were trained that unless the customer requested a specific brand, we should recommend the ones that paid us more because the store also made more money. This is a great example of a transaction executed under the Suitability Standard. The Customer wanted a TV, we sold them a TV. We were under no obligation to disclose the difference in compensation or avoid the inherent conflict. Had we been held to the Fiduciary Standard, we would have had to disclose the conflict we had because of the different commission levels, so that the customer could make a more informed decision. More importantly, we would have been held legally responsible for doing so.

Translating this analogy back into the investment world – imagine that instead of selling TVs, we were selling IRAs and mutual funds. Like TVs, each mutual fund, and share class of those mutual funds, pay the broker/advisor a different amount. Prior to this regulation, brokers acting under the Suitability Standard were not required to disclose or avoid this conflict, nor were they required to put the client's best interest before their own. The client needed a mutual fund, so they were sold a mutual fund.

Investors with smaller account balances are more likely to encounter this situation, because most advisors who work with smaller accounts follow the Suitability Standard. Larger investors, including large retirement plans and institutional investors, have the resources to be working with a Fiduciary Advisor already.

Let's look an example of how this could play out:

A new retiree walks into a retail branch of a big investment firm and sits down with an "*advisor*":

- *The retiree has $300,000 in assets saved in their employer's 401(k) plan.*
- *The money is all in the 2020 Target Date fund, so the participant is paying roughly 0.75% in expenses per year.*
- *The advisor tells them that the best course of action is to withdraw the assets from the plan, and put them into a free Rollover IRA. In fact, they will even receive an additional $500 credit for opening the account.*
- *Best of all, they can stay in the 2020 Target Date fund. It won't be the same brand, because that type is not available outside 401(k) plans, but it's still a 2020 fund.*
- *Client signs the paperwork and is on their way.*

While this sounds great, and the client thinks they made $500 just for moving the account, it is possible that the client just lost $13,000. Here's how:

- *The IRA is in fact free to open and they will receive $500 – so that part is true.*
- *What the Advisor didn't tell the client is that the 2020 fund they are transferring into has a 4.5% front end load.*
- *A front end load is a sales fee that is paid at the point of purchase. It is typically shared by the investment professional who sold the fund and their investment firm. They can range anywhere from 1% to 9% and are fairly common in retail investment relationships.*
- *So when our retiree's money is invested in the new 2020 fund, they will instantly pay a $13,500 fee.*
- *In addition, they will pay 0.89% each year for the management of the fund.*

Despite the availability of lower cost 2020 funds and funds without front end loads, the "*advisor*" recommended a fund that was in his interest, rather than the best interest of his client. And because the 2020 fund was a suitable investment for the client, the advisor has met the Suitability Standard and the client has little recourse.

With 10,000 Baby Boomers retiring each day, the DOL envisioned this happening a lot and they acted to prevent it. They did so by requiring that any investment professional that gives advice on retirement assets follow the Fiduciary Standard, rather than the Suitability Standard.

In our example above, the advisor would have been legally obligated to prove that they put the client's best interest before their own, to disclose their compensation, and to avoid the conflict of interest associated with the high up front compensation. If they did not adhere to this standard, the client now has legal recourse against the advisor.

While the actual regulation is more complicated and filled with the typical requirements, exemptions, and caveats, conceptually this is what the new rule is about. In their own words, the DOL states that the rule *"imposes basic standards of professional conduct that are intended to address an annual loss of billions of dollars to ordinary retirement investors as a result of conflicted advice."*

Realistically, what will the impact of this rule be?

The impact of the rule will be different depending on what your role is:

Plan Sponsors

One of the more interesting aspects of this rule is that unlike most DOL regulations, this rule places almost no additional burden on the sponsors of retirement plans. Almost all of the new requirements are the responsibility of the investment professional. For plans working with an advisor who has acknowledged their fiduciary status already, the rule will change very little.

If you are the sponsor of a plan and your agreement with your advisor does not outline their fiduciary status, or if you do not have an agreement, it would be in the best interest of the plan to clarify what that advisor's actual fiduciary role is in the plan.

Plan Participants

Until a participant is eligible to remove their funds from your retirement plan, this rule will have little impact. When they do go to remove their funds, the rule should level the playing field between them and their potential new advisor. Investors should still do significant diligence on the selection of their advisor and demand disclosure of all compensation and conflicts of interest.

Will there be any impact before April 2017?

We anticipate that rollover sales will increase dramatically over the next 12 months. The rule includes a grandfathering clause which will allow advisors to continue to receive compensation on any investments made prior to April of 2017. Therefore, we believe that there will be an aggressive push to rollover assets prior to this time. Sponsors and participants should be diligent for any such efforts, and should be prepared to ask a variety of questions before executing the rollover.

Nothing in the current law prevents an investor from asking an advisor about conflicts of interest or their compensation. Investors simply don't know that they should ask. LAMCO will be producing a rollover guide, along with other materials for participants in the coming weeks.

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