Doug's Insights

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Category: Regulations

Department of Labor "Fiduciary" Rule

"Delay or Implementation – Impact on You"

By: Doug Horn, CFP®

The financial services industry found itself in the news over the last several weeks as President Trump signed a Presidential Memorandum requesting the Department of Labor (DOL) to revisit the "Fiduciary" rule which requested the DOL 'to determine whether the rule may adversely affect the ability of Americans to gain access to retirement information and financial advice', an excerpt from the memorandum.

It has been reported the financial industry is against this rule because it is mandating the financial advisor should put the client's needs before the advisor's needs. While this may make great headlines, it is not the entire story, and in my opinion not the truth. The actual regulation is "Definition of the term Fiduciary; Conflict of Interest Rule–Retirement Investment Advice" (Vol 81 Fed. Reg. 20946) and covers far more than acting as fiduciary. According to the DOL's own summary, the rule covers many areas including communications, recommendations, compensation, fiduciary, and conflicts of interest and is fifty-eight pages in length. As with any regulation of this length, it is impossible to boil it down to a single phrase such as "Financial industry against putting client's needs in front of advisor's". This regulation contains many points which will impact how the public is provided financial advice and in some circumstances the lack thereof.

A recent article I read suggested the Obama administration estimated that retirement advice in which brokers recommended investments "that put their interest ahead of their clients" cost investors $17 billion a year. The implication is that if a commission is involved it must be bad for the client and that the broker is putting their interest ahead of the client. It was this assertion causing the last administration to push for the creation of the DOL *Fiduciary* rule, basically trying to outlaw commissions for retirement accounts and clearly ignoring the millions of investors who prefer and could benefit from paying a onetime commission rather than an ongoing fee for advice.

I am both a *broker* since I hold several FINRA security licenses and an *advisor* since I am also registered in Tennessee and Texas. I also hold the Certified Financial Planner™ certificate. As a broker, advisor, and CFP®, there are many regulations, rules, and principles which I must follow. As a registered investment advisor, I am already required to put the interest of my clients before my own, thus no need for the DOL rule. As a CFP®, I am required to adhere to the CFP Board's *code of ethics* which includes providing financial services with integrity. If the DOL rule was only about

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having all financial advisors adhere to the *fiduciary* standard it would not have taken over five years for this rule to finally become a regulation or fifty-eight pages to describe.

To help to understand why the industry does not favor the DOL rule, here is a little background. For decades, financial services have been offered through two different platforms, one compensating the broker via commissions and the advisor with fees. The first are those with NASD or now FINRA security licenses which permits the broker to offer products and be compensated through commissions. The broker generally receives a larger payment upon the initial placement and sometimes followed by a smaller servicing fee to encourage the broker to continue to provide advice and direction throughout the years of existence of the investment. For smaller accounts, the payment of a commission was often the way to fairly compensate the professional for the time and experience invested by the broker on behalf of the client. Many of the products offered by commission also provide reduced commissions for larger quantity purchases, referred to as breakpoints. Brokers follow the *suitability* standard whereby products presented to the investor must be suitable for the investor. There are those who argue while a product is suitable, it may not be the best one available or in the investor's best interest.

The second platform is advisors who are SEC or State registered investment advisors offering products and management and who are compensated via fees. While the fee rate is generally much smaller than initial commission rates, the fees continue as long as the service is being provided. These advisors followed the *fiduciary* standard for their investors, which means the service or product should be in the investor's best interest. There are those who question why pay an ongoing fee on every investment when for some there may not be a need for management or future decisions to be made. Is that in the best interest of the client?

In my opinion, both platforms have a place and investors should be able to chose between the two services and compensation structures. Some investors prefer to buy and hold, while others prefer active management of their accounts. Clearly someone who prefers to buy and hold would not want to pay an ongoing fee for assistance, thus the commission structure is a better solution. And conversely, someone seeking active management may opt for a lower fee service than paying commissions on each trade even though the fee is ongoing.

For smaller investors this becomes a more significant issue under the DOL rule. An investor with $25,000 to invest might generate $1,250 of initial commissions which compensates not only the broker but also the product company and the broker's Broker/Dealer. If the commission structure is removed or made less favorable to utilize due to other changes by the proposed DOL regulation, under the fee format, even if the fee were two percent (2%) which would be consider high by most standards, the revenue earned in the first year would be $500. While someone may question what is wrong with $500, it could take the advisor two to four hours of time to put this product in place once meeting time, preparation and processing the application is considered and does not take into count the advisor and staff's non-

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productive time for education, compliance, annual client reviews/questions, and those prospect meetings which did not culminate in the placement of a product. Think back for a moment, was your first foray into investing with $25,000 like this example or more like $500 or even a $100 per month. Like all businesses, the advisor must evaluate whether a particular prospect will cost them to service or be profitable to service. In my opinion the DOL rule reduces the available options, especially for the smaller investor or beginning investor, and may contribute to this group of investors becoming uneconomical to service. Since this may occur, I hope this is an unintended consequence and not one by design of the DOL.

Just like in the legal services world, there are multiple types of fee structures. The client can agree to pay an hourly fee for the services they are seeking, or agree to a fixed fee. Lastly for some services, they could agree to a contingent fee whereby the client receives a reduction of the award with the attorney's compensation being a percentage of the award. I am certain it could be argued the contingent fee is not in the client's best interest, but due to the cost of some actions it could also be argued those without substantial funds might not see justice without this option being available. Similarly, without the option of commissions, those with few dollars might not receive the quality advice they need for their investments.

Another significant issue is how this rule impacts the services which can be provided due to the conflict of interest rules. It can be argued under this rule, when an advisor offers services to manage a retirement account, the advisor has violated the conflict of interest rule since they would benefit by receiving fees or commissions for the services being offered. There could also be a potential conflict of interest by recommending one product over another since commissions paid may differ between the products and it is feared the broker might recommend the product with the higher commission. The regulation could cause all products to be offered at similar commissions. I thought this was considered price fixing.

The regulation appears to favor fees over commissions despite certain circumstances whereby the payment of commissions may be the least costly method for the investor. Additionally, the regulation does not permit the broker to have discretion over retirement accounts. For my advisory clients who have accounts held at TD Ameritrade this is not an issue since QFC's service is offered under an advisory fee contract and meets the definition of fiduciary. However, several hundred brokerage clients who have given me discretion over their accounts subject to a restriction, that no trades/exchanges made create any revenue for me or my firm, may find the DOL regulation does not permit this service, even though it is offered free of charge and beneficial to my clients. For QFC to provide this service, it appears the investors must change their account to an advisory service account which would result in higher fees over the life of the investments.

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Another significant issue is the suggestion to do away with predispute binding arbitration agreements. For the industry this could open the door to significant litigation when select attorneys use "hindsight" or other means to claim alternative decisions could have avoided losses or made higher gains for their clients. Such litigation could bankrupt smaller financial advisory firms and most likely put a target on the back of the larger firms like other industries for which the late night TV legal ads hint. The industry's arbitration agreements have successfully allowed clients who were harmed by their broker/advisor to receive appropriate awards for their damages, therefore opening the industry to class action law suits fails to be necessary or beneficial to the client.

The unintended consequences of this DOL regulation could be far reaching and impact an industry with thousands of employees, brokers, and advisors who seek to serve millions of investors on a daily basis. Many of the financial professionals provide other services such as insurance, real estate, or tax advice in addition to investments. It is not known how the proposed DOL regulation would handle the client whose needs include investments, life insurance, and tax planning. In this case, the allocation of funds could create a conflict of interest when selecting the type and amount of life insurance, since commissions are paid on insurance products. By definition under the regulation, there may be an issue with the fiduciary rule as well. It is unfortunate for an industry with so many qualified and ethical professionals who make literally thousands of decisions and recommendations daily for their clients to only makes the news when one of the few "bad apples" takes advantage of an investor or when the industry is seeking fair treatment but is presented to be the big bad wolf.

At Quality Financial Concepts, we have always sought to do the right thing for our clients. We are duly licensed and offer both commissioned and fee based products and services. It has never occurred to us to put our own interests in front of a client's. We are running a business and make business decisions each and every day, like the one made in 1996 to add *advisory* services providing clients a choice in how we are compensated and the type of services provided. I would like to thank all of our clients who rely on our direction and advice. If you have questions on the DOL rule or your accounts, please contact us so we can respond.

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