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Flaws In A Fiduciary-Only/Best Practices Standard

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The resources cited in the White House paper do not support a fiduciary conclusion

Facts support continuing a Dual Suitability/Fiduciary Standard

An analysis of the DOL proposed fiduciary rule changes

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Summary

A brief history lesson: The build-up to the passing of SEC Rule 151a was not because, all of a sudden, index annuities did not meet the safe harbor exemption for non-securities outlined in the 1933 Securities Act. Instead, it was framed as a morality play where evil annuity agents were running amok and the only way to stop them was to force them to become securities registered, which would happen if index annuities were turned into securities. The industry was able to nullify the Rule and index annuities remained fixed.

If the DOL proposal becomes law all annuity sales involving qualified funds will require the agent to be held to a fiduciary standard. In addition to greater financial exposure and culpability for any supposedly "bad" sales, the agent will also need to disclose their commission and any other incentives, such as marketing dollars or trips from the carrier or others. Although fixed annuity commissions are permissible under a fiduciary-only standard, they are a problem since many feel a commission in and of itself creates a conflict of interest. If annuities follow the path of securities transparency the commission paid will keep decreasing, until at some point it makes just as much sense to stop commissions altogether and make annuity compensation solely fee-based.

The DOL proposal would only apply to qualified money, but that would be short-lived – how do you tell an annuity buyer that his IRA purchase is fully disclosed and his non-qualified annuity purchase isn't? The DOL proposal is only round one, but unlike last time, the fixed annuity industry is not alone. A fiduciary-only standard has even greater negative consequences for securities broker/dealers than it does for annuity players and they will rally hard against it. The fight is just beginning.

The paper is designed to provide ammunition to those that wish to see the current dual system of suitability and fiduciary preserved – key facts are in **bold type**. I hope the paper helps.

White House Memo Cites Do Not Support a Fiduciary-only Conclusion

A White House Economic Adviser memo (http://www.scribd.com/doc/253449711/WH-DOL-memo) finds two White House economic advisers making claims that using financial advisors or brokers (the memo uses the terms interchangeably) can lead to exploitation of clients and cost consumers either 0.35% to 0.5% – or maybe as much as 1% – in extra annual fees. The White House advisers attempt to buttress their conclusion by providing partial cites on papers and studies that allegedly support their position. However, I have read the main studies they use and find either that the studies don't say what these authors say they say, the support is weak, or the papers are opinion pieces with no statistical support at all.

A key example is the memo mentions a Friesen & Sapp 2006 study that allegedly supports the notion that brokers churn to drive up fees. I couldn't find any 2006 **Friesen & Sapp study**, but I did find a 2007 one on mutual fund trading and it didn't quite come to the same conclusion [Friesen & Sapp, 2007]. The 2007 study found that when investors tried to time the stock market by moving in and out of mutual funds they had lower returns than those investors that didn't try to time the market – this was true whether the funds used were through a broker or not. While it was true that the broker funds performed worse than the non-broker funds because of higher fees, **the point of the study was that investors shouldn't try to time the market, not that a broker shouldn't be used**. In fact, the Friesen & Sapp study concludes "a comparison of the performance of index fund investors to that of non-index fund investors shows that both groups substantially underperform due to poor timing decisions" but this duality is ignored in the White House memo.

Another major study mentioned is a working paper which the White House memo says shows that retirement plan participants using a broker had lower risk-adjusted returns [Chalmers & Reuter, 2012]. This study did show that the brokered group earned 0.9% less a year than the do-it-yourself group, but it omits an inconvenient truth. This retirement plan gave participants two options; they could meet and work with a broker, or they could pick their own investments and "here is an armload of reading material and a list of links to investment webinars, good luck". The participants that chose to use a broker were younger and less experienced. **When asked why they chose the broker option 70% said the ability to meet with and talk to a broker was important to them. This brokered group recognized they needed professional help and chose to pay for it.**

There is widespread financial illiteracy in the country. The solution academics and some regulators suggest is offering free or low-cost courses on finances, but that hasn't worked in the real world. There have been several studies where people were offered the courses, made to sit through courses, nagged by follow-up visits to remind them of what was taught in the courses, and the bulk of the people remained financially illiterate. The reason was seldom lack of intellect; it was usually because they were more comfortable relying on someone else even if they had to pay for it.

This White House memo is five pages long; roughly a third of it lists the countries in recent years that have banned the payment of commissions. **The White House memo** doesn't say whether these bans were arbitrarily put in place or were the result of studies and it **admits they can't identify any new studies showing that the commission bans have been beneficial**.

The memo itself does not demand a fiduciary standard. The point it really seems to be making is fees and especially commissions are always bad and that, apparently, everyone in the financial services industry should work for free (and I'm not being entirely facetious based on some academic articles I've read). Even so, this biased and faulty memo gives ammunition for those desiring a fiduciary-only standard. The White House has come out in support of a fiduciary standard [http://www.bloomberg.com/news/articles/2015-01-30/wall-street-gears-up-as-white-house-pushes-retirement-fund-rules].

Facts Support Continuing A Dual Suitability/Fiduciary Standard

The Department of Labor has released regulations that would effectively establish a fiduciary-only standard whenever qualified monies are involved (e.g. defined contribution plans, IRAs). The Securities & Exchange Commission is examining the standards that define what investment advice is and who should be permitted to give it. The current standard is that registered investment advisors may, when acting as a fiduciary, charge fees for investment advice. Registered representatives of a broker-dealer do not charge fees because they do not act as fiduciaries, but they are held to a suitability standard where they must know their customer. This "dual" system of advisors and representatives has worked successfully for three quarters of a century. However, there are special interest groups that wish to change the system to one that requires fiduciaries and an end game where only fee based compensation survives.

The reason usually mentioned to try to justify this change is that consumers are "harmed" by the current model that permits both a commission and/or fee based compensation model. If there was actual evidence showing consumers were being harmed by the current system, that would be one thing, but there is a paucity of data showing that the current dual system has caused any harm to consumers. Indeed, upon close examination most of the hue and cry surrounding this topic is opinion masquerading as fact. Even more startling, **when one examines actual enforcement actions taken by regulators a multi-state conducted study found a fiduciary advisor was 11 times more likely to have been subject to an enforcement action than a broker.**

Opinions Not Facts

On 26 July 2011 Department of Labor Assistant Secretary Phyllis Borzi, testified before the House Committee on Education and the Workforce, Subcommittee on Health, Employment, Labor, and Pensions in favor of a fee-only fiduciary standard. In support of her argument she mentioned four studies. It should be pointed out that three of the studies were only opinion pieces containing no actual results. The fourth study took place in Germany, using only German financial advisors, and the study population had roughly thirty pure commission or fee-only advisors – too small a sample to meet validity requirements. Even these selective results could only support saying that the method of advisor compensation might improve investment decisions. The studies mentioned in the testimony did not contain facts supporting the notion that a fiduciary-only standard was better or that consumers were being harmed by the current regulatory system. **Even Borzi was forced to admit that "none of this research evidence necessarily demonstrates abuse"** [Borzi, 2011].

In a 12 October 2014 article in the *New York Times* a fiduciary-only proponent implied that "a fiduciary standard might protect people from brokers who are acting legally but who aren't recommending the best options for them" and went on to say that "evidence overwhelmingly suggests that investors suffer real financial harm" but failed to provide any evidence [Bernard, 2014]. Indeed, I contacted the individual asking her for any of this evidence and she failed to respond to my request.

One of the groups urging a fiduciary-only standard apparently had so little success in finding actual evidence that the current dual standard of suitability and fiduciary harmed consumers that they recently resorted to appealing to social media to find "horror stories" going so far as to say "our case will be more compelling to the Department and law makers when we have personal stories"[Knutson, 2014]. Sadly, **hereto they presented no evidence supporting their allegation that consumers were harmed when commissions were earned instead of fees.**

Actual Facts

The North American Securities Administrators Association (NASAA) released their report on securities enforcement actions for 2013 in October. Broken down by participants there were 357 enforcement actions against broker-dealer agents and 176 against investment adviser representatives. On the face of it, there are twice as many actions against broker-dealer agents as there are against investment advisors. However, the SEC and FINRA tables show there are roughly 629,530 broker/dealer agents and only 28,000 investment advisors currently registered. What this means is, **on average, there was 1 action per 1763 broker-dealer agents versus 1 action per 159 advisers.** In other words, on an individual basis, a fiduciary-standard adviser was 11 times more likely to have been subject to an enforcement action than a suitability–standard agent [NASAA, 2014].

This is not an isolated occurrence. The SEC *Study on Investment Advisers and Broker-Dealers* required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act found **over a six year period that investment advisers had a higher percentage of enforcement actions compared with broker-dealers** [SEC, 2011].

Conflicts of Interest

Many of those individuals and groups loudly demanding a fiduciary-only standard – which rewards a fee-based compensation business model – are those that use a fee-based compensation model. The irony here is although one of the claims made is that a fiduciary-only standard reduces conflicts of interests, the industry groups almost always fail to disclose that a fiduciary-only standard will lessen their competition and directly benefit their pocketbooks. As an example, a letter to the SEC dated 21 November states "Investors who expect to rely on advice from an objective, professional adviser may be misled into believing the sales recommendations offered by broker-dealers constitute such advice" [CFA *et al*, 2014]. However, at no point in this letter that often defames any non-fee based compensation model does their objectivity extend to stating that some of the signatories to the letter will financially benefit if a fiduciary-only model is adopted and that, over time, the annual imposition of fees can result in significantly higher costs to the consumer than a non-fee-based model.

These are cold, hard, facts. Not only do they not support a conclusion that a commission based compensation harms the consumer, but, if anything, suggest that a fiduciary standard is more problematic in protecting consumers. We should not use these genuine studies to conclude that fiduciary advisers represent a greater threat to consumers and thus require the SEC to allow only commission-only based compensation. Instead, the reality is the current system of two methods of compensation with any and all conflicts of interest fully disclosed has worked well for 70 years.

Analysis of DOL Proposed Fiduciary Rule Changes

Summary: The DOL Proposal contains an exemption from the fiduciary fee-only standard for the sale of fixed annuities. Technically it amends Prohibited Transaction Exemption (PTE) 84-24 to permit a ***Best Interest Contract Exemption*** for fixed annuities. This exemption permits the receipt of "reasonable" commissions for sales on fixed insurance and fixed annuity products. The amount of the commission must be disclosed. The exemption applies not only to insurance license-only agents, but allows insurance licensed brokers/advisors to also receive commissions on fixed annuity sales.

Comments are directed towards both the proposal published in the *Federal Register* and the corresponding *Fiduciary Investment Advice: Regulatory Impact Analysis* released 14 April 2015.

Background

On 20 April in the *Federal Register* (Vol 80, No 75, pages 21918-21960) the Department of Labor (DOL) published proposed changes to the definitions of what is a fiduciary, conflicts of interest, and what constitutes retirement investment advice. Written comments on the proposed regulation were to be accepted up through 6 July 2015, since extended. If the rule is enacted as written it will cause a colossal disruption for many securities broker/dealers. The disruption to the fixed annuity world will not be as apparent, but it sets in motion a process that, I believe, will eliminate the payment of commissions on fixed annuity and life insurance by 2020.

The Employee Retirement Income Security Act (ERISA) passed in 1974 put the Department of Labor (DOL) in charge of overseeing qualified (tax-advantaged) plans. At that time, the retirement plan world was effectively company pensions and it made sense to have the DOL oversee this. In the last 40 years the pension side has diminished and the employee/individual contribution side has exploded. It is a different world from 1974 and different rules are needed. The DOL is attempting to rewrite those rules, but a lot of people think they are getting it wrong.

I've read both the proposed changes and the *Fiduciary Investment Advice: Regulatory Impact Analysis.* The main problem one faces in opposing the DOL proposal is that it uses only facts and non-facts-presented-as-facts to support a predetermined position, rather than looking at the facts and seeing where they lead. After review here are three "facts" I can state:

- The DOL papers do not provide any direct data supporting the contention that current dual system of fiduciary and suitability standards harms fixed annuity consumers.

- The DOL position that their proposal will result in more asset growth for consumers than the current system ignores specific real world behavioral biases that impact investor decision making.

- The DOL position that their proposal will cause minimal impact and expense is Pollyannaish at best and generally not credible.

Conflicts of Interest

This is a good place to start because it illustrates a DOL non-fact. The DOL says "Research has shown that disclaimers are ineffective in alerting retail investors to the potential costs imposed by conflicts of interest" and then cites a study supposedly backing that claim. However, **the study cited has nothing to do with retail investors or costs**. It involves an experiment where undergraduates threw dice for chances to win $5 Starbucks gift cards [Lowenstein, 2011]. Yes, the college student study did try to test the effects of conflicts of interest, but this research <u>does not show</u> disclaimers are ineffective with retail investors.

"Schwarcz and Siegelman argue that insurance “agents can inefficiently withhold information and distort consumer choices by providing misleading information...though direct empirical evidence about the frequency of such misbehavior is limited.” (DOL comment)

Contrary to the above comment from the DOL, the evidence of actual bad agent behavior is far lower than limited; Schwarcz and Siegelman describe it as "scant", but even that overstates it [2015]. A few pages later **Schwarcz and Siegelman admit that "there are apparently no field experiments involving insurance intermediaries in the US" so there is no evidence.** Once again, the DOL conclusion is not supported at all. After running into this time and again it made me wonder whether DOL researchers are either really bad at research, because they never completely read their sources, or that they don't care what the source says because they're simply going to write what they feel like writing.

"insurance agents and brokers are compensated entirely or primarily by commissions resulting from product sales. This creates an incentive to aggressively maximize sales, which is likely to result in costly and economically inefficient efforts to attract new customers."(DOL opinion)

Every time I started to write a response to that DOL comment it came out snide or snarky, so I'll play it straight. I don't believe anyone in the DOL has ever had to prospect to find someone that wanted their services or to sell anything, so they are clueless about the sales process and look down upon those that do sell.

Who's Got The Numbers?

In the mutual fund segment of *Fiduciary Investment Advice: Regulatory Impact Analysis* the DOL says not implementing their plan could cost IRA investors alone $210 billion over the next 10 years....no wait, it could be $1 trillion over 20 years [page 7]. But on the next page DOL says they estimate it could save IRA investors $40 billion over the next 10 years....no wait, it could be $88 billion over 20 years....no wait, "If only 50 percent were realized, the expected gains in this subset of the market would total between $20 billion and $22 billion" [page 8]. The supposed "savings" to consumers is not the only area where the number are, to put it politely, a little squishy.

Industry Costs

The first line says the compliance cost will be $2.4 to $5.7 billion over 10 years. Industry groups say it will be $4.1 billion; at least DOL is in the ballpark.

The DOL admits the cost of Errors & Omission insurance will increase by an estimated 10% or $87 million a year, but says it doesn't matter because "this transfer could even be considered as contributing to a just outcome because those harmed are now compensated." They unbelievably take this idea further, essentially saying that **the increase doesn't really cost a thing because the lost profits have merely been transferred from the broker/dealer to the E&O insurer** and thus no one really incurred a cost.

Consumer Costs

The DOL admits that moving from a suitability based model to a fee-based fiduciary one could result in higher fees for the consumer. However, "the costs for any customers who do potentially convert to an advisory model would therefore be minimal as well, as they would be offset by the benefits from receiving additional advice." This is another tails I win, head you lose DOL argument without any backing. The DOL says they're going with the fiduciary fee-based model to reduce consumer costs, but also admit it will raise consumer costs. How does DOL deal with the contradiction? They say their fiduciary costs are good costs, but the suitability costs are bad costs.

"Transitional frictions may introduce some social costs"

If we assume $60,000 is the minimum annual income needed – and I'm just picking a number – a new annuity agent starting out might need to sell $1 to $2 million of fixed annuities a year (based on commissions of 3%-6%); a registered rep in a Broker/Dealer would need $2.5 to $4 million of trades (assuming a 60% payout and a 2.5% to 4% average commission) and a fee-based advisor would need $10 million of assets (at 1% fees assuming 60% net to the advisor). For the moment fixed annuity agents can still earn a commission, so they can survive under the change, but a new registered rep won't hit their minimum income level for roughly three years and may not be able to survive.

"Transitional frictions" is DOL-speak for being forced to take a pay cut and starve; "social costs" is code for industry layoffs and firm closings. The DOL plan discourages people from entering the financial services industry and will probably cause some smaller firms to close – but that the DOL says that's just the social costs of some transitional friction.

Kitchen Sink

"IRA investors are likely to be even more hard pressed to assess the quality of advice related to insurance products, mainly fixed and variable annuities. These products are notoriously complex..Their fees likewise are complex and difficult to interpret. "(p. 79)

- and then the report talks only about variable annuities

The DOL makes a point of saying that insurance product commissions are often substantially higher than securities commissions and says "Such high and variable commissions can encourage agents and brokers to recommend products that are not suitable". They also spend a paragraph going on about the evils of contingent commissions, before admitting that everything they read said these had nothing to do with retail annuities. However, as indicated previously, none of their sources can show where any consumer has ever been damaged by the current annuity suitability standard, and completely ignores the reality that fee-based advising not only results in higher costs over time, but creates a conflict of interest if the consumer's "Best Interest" is served by reducing the AUM and buying a fixed annuity.

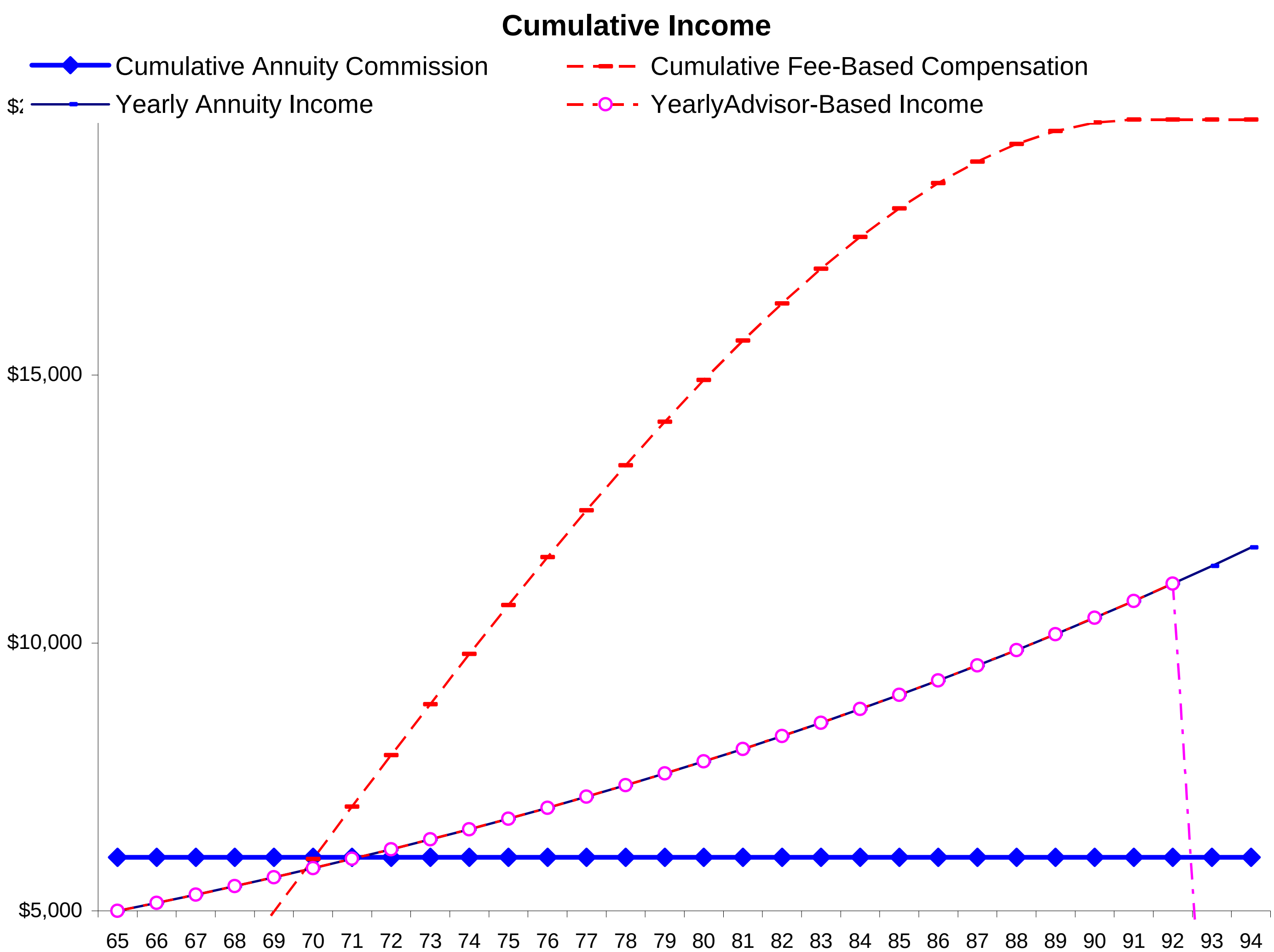
As shown, the fiduciary-only standard argument is weak on supportive facts, which is probably why they are making this a morality play between good and evil, with commissions as the devil. However, facts often don't prevail in Washington. The least bad news is that even though fixed annuity agents will have to disclose their commission they at least still get one. If the proposal passes this gives agents four or five years to transition to a fee-based annuity model (or apply for a government job).

Comparing Total Consumer Costs of Commission vs Fees

One of the many problems in the DOL proposal is assuming that those that get paid on commission automatically have a conflict of interest, while those that are fee-based compensated never do, but this example shows a hole in that thinking:

The earnings of a fee-based fiduciary are based on assets under management (AUM); the greater the AUM, the greater the income. When the goal is building assets the consumer and advisor's interest are parallel – they both benefit from higher assets. However, when the goal is producing income by removing assets their interests diverge – the more income the consumer takes, the smaller the AUM and resultant fee income. It becomes even worse for the advisor when the consumer wants an income guaranteed to protect against longevity risk. Buying an annuity provides the only guaranteed solution to longevity risk, but buying an annuity solves the life income problem and eliminates the need for the advisor. Granted, the annuity pays a one-time commission that averages 3% to 6%, depending on the annuity, but that pales next to the fee income that is lost in subsequent years.

The following chart compares the total fee income produced by selling a fixed annuity with a guaranteed lifetime withdrawal benefit (GLWB) or using a fee-based method of advisor compensation. The assumptions are that we start with $100,000 at age 65. The fixed annuity paid a one-time 6% commission, the advisor charges 1% a year, and both begin income at a 5% payout adjusted for 3% inflation (which is available on a few GLWBs). Although the consumer is protected against the annuity going bust, let's assume the advisor can generate a 5% net return. How much cumulative income does the advisor get with the annuity versus being a fee-only advisor?



The annuity provides a one-time commission of $6,000, the fee-based advisor matches that commission income by year six, has more than doubled it by year thirteen and more than tripled the commission he would have received from the annuity by year twenty-one. Why does the cumulative fee-based income stop increasing at age 92? It turns out the advisor's 5% return wasn't enough so the retiree ran out of both assets and income. Oops!

Would your Doctor prescribe a pill for you if that pill meant you'd never need their services again?

Your physician is undoubtedly a fine person. He or she has sworn to keep you from harm. However, what if, unbeknownst to you, your doctor had a pill available that would cure your illness or chronic condition and even make it so that you would never need the services of the medical world again. Would your doctor prescribe that pill for you?

Before you answer, look at the decision from the doctor's side. If she gives you the pill you will never pay her for another office visit and never pay her for future treatment or tests because you have been cured. Indeed, all of the pharmaceutical companies would also be affected because you would no longer need their products. And the hospitals would sing the blues because they too would lose any future revenue in treating you.

It is very possible the drug companies and hospitals and the doctor's interest in self-preservation would all work against prescribing you that pill. In fact, the entire medical community might try to keep knowledge of the pill under wraps, or if they did mention it, they might say that a patient really doesn't need the pill because they're not going to get sick or that the pill has a bitter taste. After all, they say, the patient has been managing more or less okay so far.

Unfortunately for the patients of the world there is no such solution. However, there is a cure for the financial illness *poorhousitis*, which is the condition of running out of money before you run out of life. The cure is a fixed annuity guaranteed lifetime income provided though a life contingent immediate annuity, a deferred income annuity or a fixed annuity with a guaranteed withdrawal benefit (GLWB), but the reasons the consumer may not hear of the cure are the same ones that would work against prescribing that magical pill.

The quandary in retirement is providing an acceptable level of income that does not end before the retiree does. The solution used by most fiduciary advisors, based on the surveys reported in financial planning media, is to use a variety of investment remedies to treat the symptoms. The retiree's problem is never cured, but the advisors provide managed care to keep the income flowing as long as they can....all the while collecting ongoing fees.

By contrast, the fixed annuity world offers three distinct solutions that each provide an income for as long as the retiree lives and, very possibly, at a higher income level than the Wall Streeters can deliver. The fixed annuity solutions do not provide a better treatment for *poorhousitis* – they cure it. Once the retiree uses the annuity solution their retirement income problem is solved...and therein lies the dilemma for Wall Street.

The fee-based advisor's business model is built on collecting a never-ending stream of annual fees to manage financial problems. However, if you solve the problem there is no longer a need for the advisor, and this is why there has been so much resistance from advisors to offering fixed annuities. Sure, the annuity provides an upfront fee, but the long-term revenue is much, much less.

The response from advisors to this threat has taken many forms. For the most part they have tried to keep from mentioning the existence of these fixed annuity solutions to their clients. A very few have developed their own version of lifetime income using contingent-deferred annuities so that they can continue the fee stream. And some have embraced fixed annuity income solutions as the right thing to do for their clients.

The world of medicine has not yet developed the magic pill that cures chronic illnesses, but the world of fixed annuities has cured the illness of lapsed retirement income. It requires vigilant fixed annuity practitioners to spread the word and let consumers know that there is a cure.

Shouldn't A Fee-Based Fiduciary Advisor Recommend A Robo-Advisor?

After a lifetime of both watching and being part of the securities world (I was a stockbroker and also owned a broker/dealer) I believe it is accurate to say that most retirement (financial) planning is pretty much boilerplate. You listen to the consumer describe their goals and risk tolerance, ask their age, check out where they are financially, and pop-out an asset allocation model – and this allocation model will look amazingly similar to thousands of others, containing a mix of equities and bonds, with more bonds as the person ages. Occasionally you run into a special circumstance requiring a more involved solution – perhaps a special trust arrangement that you would do in conjunction with their lawyer – but normally it's a matter of "if the consumer's situation is a, b, c, suggest d, e, f". Boilerplate. It's the kind of thing that could generally be handled electronically by having the consumer simply input their data into a computer and have the software program spit out the answer.

Today, fee-based advisors typically charge 1.02% a year of the assets[1]. However, so-called robo-advisors, wherein the platform asks the same questions the advisor asks and then the platform algorithm produces an allocation model that is identical to the one the advisor would produce, charge as little as 0.15% to 0.25%[2]. Well, not exactly identical, the robo-advisors are more likely to recommend lower fee index funds – instead of managed funds – so the cost to the consumer is even less.

Another benefit is the robo-advisors minimum fees are much lower or nonexistent. Research I conducted last year found the typical fee-based advisor had a minimum portfolio size of $250,000 and/or minimum annual fees. Instead of lowering minimum fees, the talk in the fee-based advisor community is the need to increase minimum fees, perhaps requiring a $199 minimum monthly charge[3]. By contrast, robo-advisors may have no minimum portfolio requirement and usually no minimum fee requirement.

That raises a question. Since a computer could usually provide the asset allocation solution at a much lower cost, wouldn't it be the fiduciary duty of the advisor to recommend the lower cost solution?

1. Liz Skinner, Advisory fees show signs of a rebound, *InvestmentNews*, 5 April 2015
2. Ask the algorithm. 9 May 2015. The Economist p.11-12
3. Darla Mercado, Are low-cost subscription pay models even viable? *InvestmentNews*, 7 April 2015

A Fiduciary-only Standard Discriminates Against Minorities

Key Findings

- Requiring a fiduciary-only standard unintentionally discriminates against minorities because a disproportionate percentage does not have sufficient assets to be accepted as clients by most fee-based fiduciary advisors.

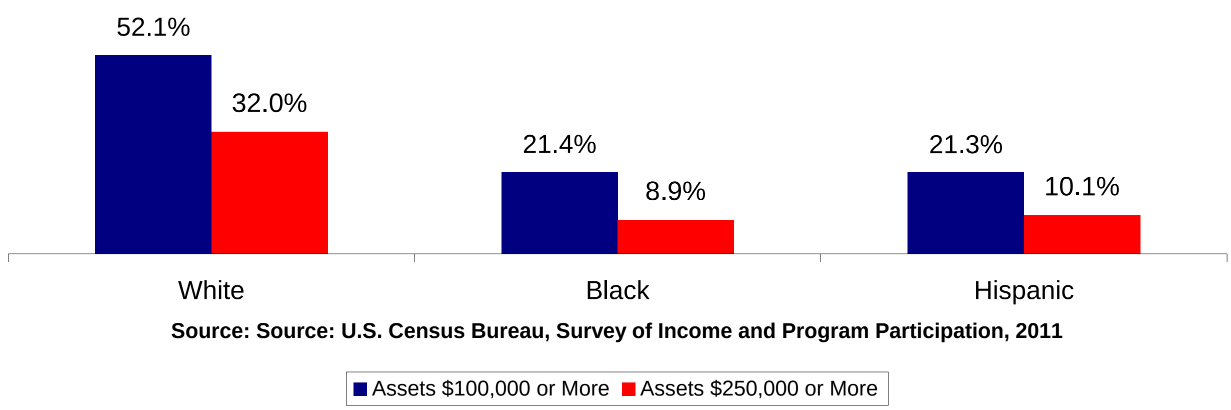
- The Department of Labor (DOL) should not revise current ERISA definitions because this would cause undue hardship on over 88 million households. **Since the median value of an IRA account is $34,000 and the median value of a 401(k) plan account is $30,000 a fiduciary-only standard for qualified accounts would effectively deny the vast majority of Americans access** to professional financial advice [Source: U.S. Census Bureau, Survey of Income and Program Participation, 2011].

- Insurance agents operate under higher standards than registered securities representatives thus eliminating the need for a fiduciary-only standard in the purchase of fixed annuities

Section 913 of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) called on the Securities & Exchange Commission (SEC) to evaluate the effectiveness of their current regulatory system. The SEC report was issued in January 2011. In the report the SEC said it believed that consumers did not understand the difference between a fiduciary standard used by advisors and the suitability standard used by broker/dealers and concluded "therefore, in the interests of increasing investor protection and reducing investor confusion, the Staff recommends that both broker-dealers and investment advisers should be held to a uniform fiduciary standard in providing personalized investment advice about securities to retail customers that is no less stringent than the existing fiduciary standard of investment advisers."

The SEC does not come out and directly say commission-based compensation should be eliminated, but it strongly hints it would end. As an example, under *Costs to Retail Investors, including Loss of Investor Choice* the report says, "it has been recognized that a commission-based, rather than fee-based, system of charges may pose a conflict" [SEC, 2011]. However, the report does acknowledge that, "to the extent that accounts were converted from commission-based accounts to fee-based accounts; investors would become susceptible to higher costs in certain circumstances". It also states the "underserved portions of the retail investor population...might be adversely affected." Even though the SEC understands that a fiduciary-only fee-based standard poses the threat of higher costs to consumers and a loss of financial services to certain sectors of the population it somehow manages to still conclude that, "the recommended uniform fiduciary standard would in and of itself, not adversely impact such populations' access to financial products and services."

Percentage of Households With Assets of $100,000 or $250,000 or More



Source: Source: U.S. Census Bureau, Survey of Income and Program Participation, 2011

The other agency that has pushed for a fiduciary-only standard is the Department of Labor (DOL). Although the existing definitions used by ERISA have proved more than adequate since they were enacted in the '70s, the DOL had proposed rules that would categorically ban the payment of commissions for all ERISA fiduciaries unless special permission is received in the form of a *Prohibited Transaction Exemption*; a pejorative title if ever there was one [DOL, 2015].

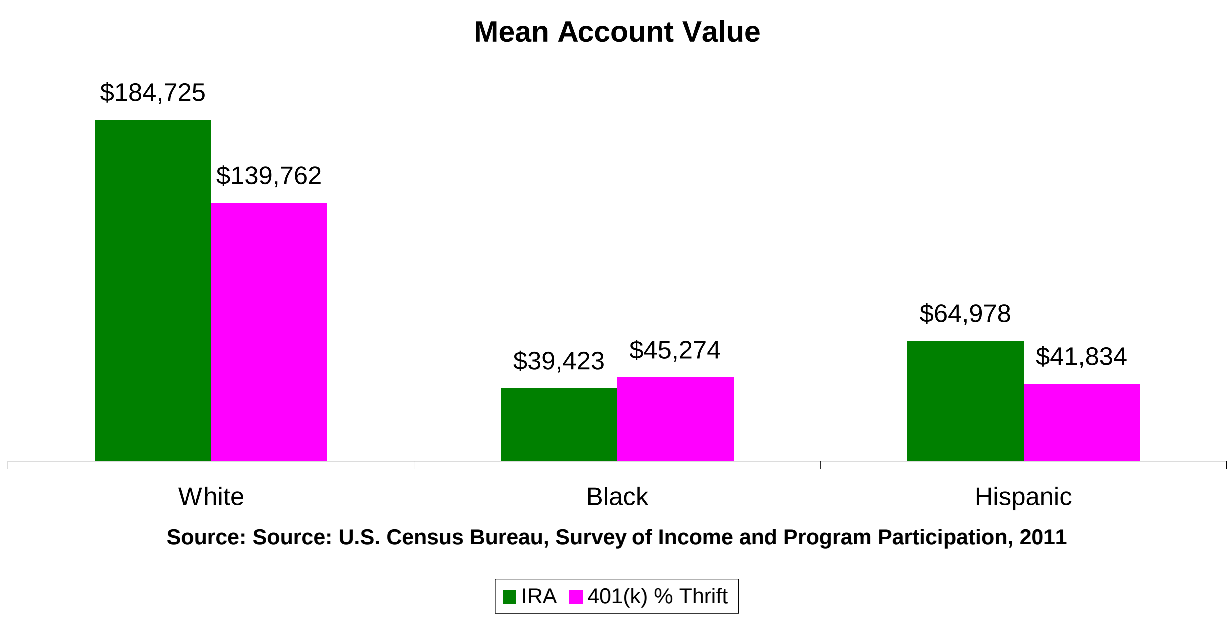
The bottom line is this. A fiduciary-only fee-based model disenfranchises every consumer except those that are affluent or mass-affluent, and a fee-only approach amounts to sanctioned discrimination against minorities who are the most affected.

Fiduciary-only Standard Creates Discrimination

More than 80% of fee based advisors define their core market as clients with a minimum of $250,000 [Franklin, 2011]. However, this fiduciary-only standard of $250,000 effectively means large numbers of less affluent Americans – especially minority Americans – would not receive any financial assistance from financial professionals. If the DOL model is enacted it would cause even more problems because the bulk of the middle and mass market financial assets are in qualified accounts where the median value of an IRA account is $34,000 and the median value of a 401(k) plan account is $30,000 [U.S. Census, 2011].

A fiduciary-only standard would typically require minimum investable assets of $250,000 before a consumer could receive help from a financial professional. This, in and of itself, means **nine out of ten African-Americans and Americans of Hispanic origin would have insufficient assets to meet the minimum requirements to receive advice from a fee-based advisor.** If fee-based advisors were encouraged to drop their minimums and accept consumers with investable assets of $100,000 this would still mean eight out of ten African-Americans and Americans of Hispanic origin would have insufficient assets to meet the minimum requirements and be unable to receive professional financial advice. The situation becomes direr if the proposed DOL fiduciary is enacted.

The proposed DOL fiduciary-only changes create a bar that keeps the majority of minorities from getting professional financial advice.



The proposed DOL fiduciary-only standard means commission-based compensation would be banned for all qualified accounts unless special permission was received to do a *prohibited transaction*. An African-American with an IRA has a mean account value of $39,423; if they participate in a 401(k) or thrift plan the mean value is $45,274. Americans of Hispanic origin participating in a 401(k) have a mean account value of $41,834 and those with IRAs have a $64,978 average value. Even if fee-based advisors were encouraged to drop their minimum account size to $100,000 a statistically significant percentage of African-Americans and Americans of Hispanic origin would have insufficient assets to receive financial help from advisors with their qualified accounts when compared with white Americans. What the DOL fiduciary-only plan effectively does is create a bar that keeps the majority of minorities from getting professional financial advice.

Creating Confusion & Double-Standards

If the DOL proposed standard was adopted and the talked about SEC one was not you could have a situation where the financial professional would be able to apply an annuity solution to the extra $25,000 sitting in a low-yielding savings account, but would not be allowed to discuss annuity solutions for the consumer's $125,000 IRA that is fully exposed to stock market risk of loss.

Not every fee-based fiduciary-only advisor has a minimum account size, but those that do not tend to have minimum fees. Doing a web search for fee-based advisor minimum account size I found minimum annual fees ranging from $1,875 to $6,500 [Marrion, 2013]. Consider a consumer with only $60,000 of additional financial assets; those first year fees would be equivalent to 3.1% to 10.8% of assets. Even if the consumer decided on a do-it-yourself approach thereafter those are still significant one-time hits.

By contrast, the typical minimum required to purchase a fixed annuity ranges from $5,000 to $25,000 and is often less for qualified accounts. Fixed annuity agents can and do provide the same professional service for consumers whether the annuity premium is $5,000 or $500,000. A fiduciary-only standard would effectively raise these minimums so that the use of the agent's time and expertise is justified. The net effect would be a dramatic increase in the minimum annuity premium required, with the result that millions of consumers would be unable to purchase an annuity and receive an income guaranteed for life.

The fiduciary-only standard effectively creates two classes – the affluent that have sufficient assets to justify the time and fees of the advisor and the much larger mass market that will be unable to get professional financial advice. The fiduciary-only standard places an excessive burden on African-Americans and Americans of Hispanic origin because far fewer meet the minimum threshold for financial advice. In practice, requiring a fiduciary-only standard is, essentially, discrimination against certain minorities.

<u>Fee-Only Can Generate Higher Compensation Than Commission-Based</u>

The justification often used for a fiduciary-only fee based standard is that is it less expensive for the consumer than commission-based compensation. Although that may be true for consumers with substantial financial assets it is not necessarily true for most consumers.

If a fee-only advisor accepts smaller accounts the annual fee is often 2% of the assets year after year after year [Franklin]. Let's compare the compensation paid with a consumer that has $100,000 that wants preservation of principal. In one case the consumer will buy a fixed annuity, in the other we will use an advisor with a 2% fee. In both cases we will assume the yield is 3% and the timeframe is 5 years.

Under the fee-based advisor method, the total advisor fees paid over five years would be $10,190. However, an examination of 37 multiple-year guarantee annuity policies with a 5-year rate guarantee shows the average agent commission would be a one-time payment of $2,400 (annuityratewatch.com, 06/26/14).

Assuming the consumer could even find a fee-based fiduciary-only advisor willing to take a client with only $100,000 the advisor earns $7,790 more than the fixed annuity agent in compensation over the five years.

Fixed Annuity Agents Are Already Acting Under Rigorous Standards

Those pushing for a fiduciary-only standard fail to understand the difference between advisors, stockbrokers and fixed annuity agents. First, neither registered investment advisors nor securities representatives are licensed by the states they do business in, but merely registered with those entities. Just as a business must register with the state to open a shop to sell goods and services, a securities or financial advisor salesperson must also register with the state. Securities salespeople have an additional requirement in that they must also register with a federally recognized self-regulatory organization, which, anymore, means FINRA. This allows these securities vendors to collect commission and/or fees on mutual funds and other products and services they provide to consumers. However, neither these advisors nor securities representatives are agents of the mutual funds; they are simply registered.

By contrast, fixed annuity agents have been licensed by the states they do business in to act as agents for insurance companies and are bound to act in accordance with the common law requirements of agency. These agents do not register with a state, but must pass tests of both competence and character before they are granted a state license.

As an example of this important difference, under Missouri Revised Statutes Chapter 409, Regulation of Securities, Section 409-004.412 the registration of a securities representative or investment advisor may be denied if the individual (d)(3) has been convicted of a felony or misdemeanor involving a security, a commodity future or option contract, or an aspect of a business involving securities, commodities, investments, franchises, insurance, banking, or finance. These are very specific black & white rules relating only to criminal conviction and, more narrowly, criminal convictions of financial crimes, that could bar initial registration.

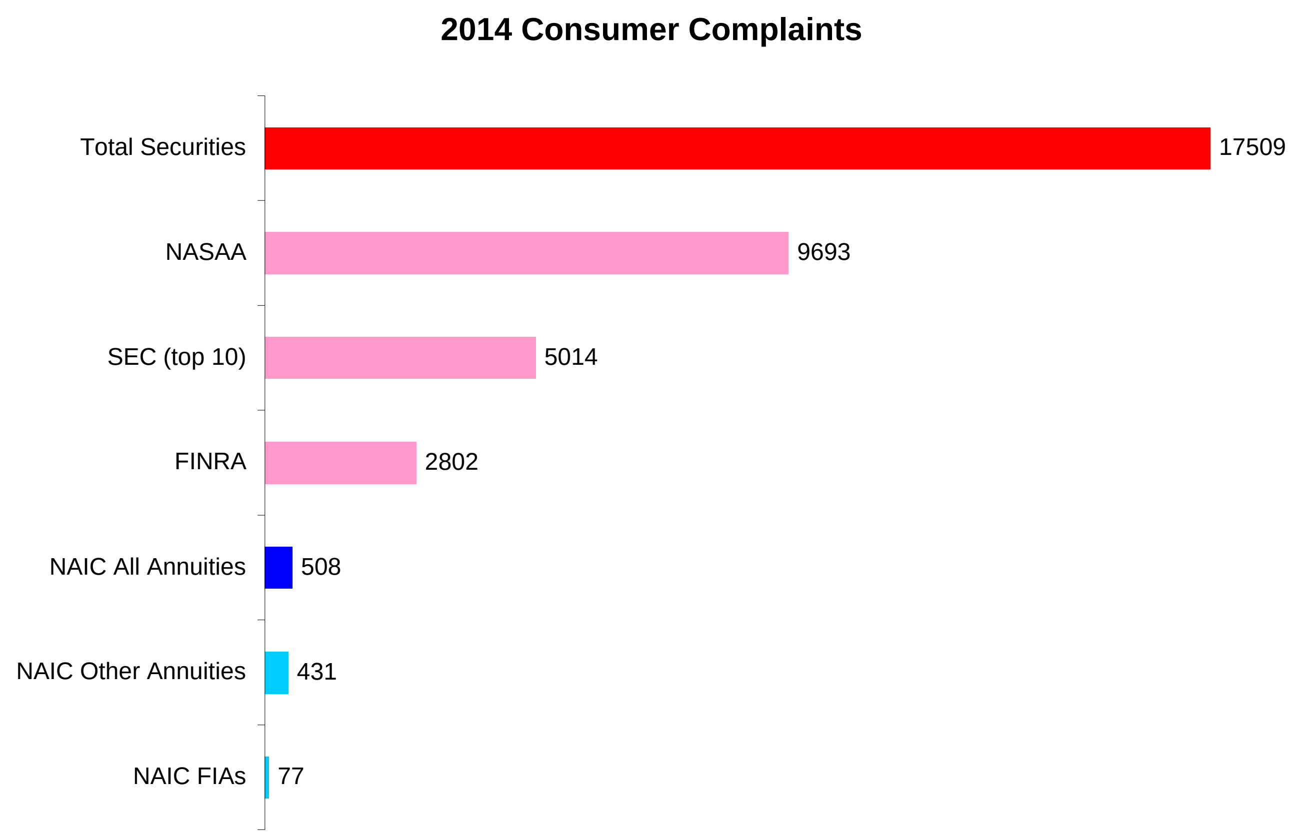
By contrast, under Missouri Revised Statutes Chapter 375, Provisions Applicable to All Insurance Companies, Section 375.141 the insurance department may refuse to issue a license if the individual has been convicted of a crime (1)(6) involving moral turpitude; or has used (1)(8) fraudulent, coercive, or dishonest practices, or untrustworthiness in the conduct of business in this state. To become licensed as an insurance agent the person must demonstrate that they have never behaved in a way that "violates the moral sentiment or accepted moral standards of the community" (http://www.merriam-webster.com/dictionary/moral%20turpitude) or been dishonest in any business dealings even if no formal crime occurred. The bar to become an insurance agent is significantly higher than that to become securities registered.

In addition, even after an insurance agent has been licensed by the state they must find an insurance carrier that will appoint them, supervise them, and permit them to act as their agent. Insurance carriers review each and every application for appointment and sometimes agents are denied the opportunity to be become an agent for that carrier. This review process occurs every time the agent applies to work for a new carrier. By contrast, I was president of a securities broker/dealer for over seven years and not once did a mutual fund company ever ask to see the credentials of the representatives selling their products.

In the fixed annuity world agents are required to pass a test of both their competence and moral character before they are licensed by the state. And this is only the first step. They then must go through an appointment process with each and every insurance carrier they wish to work with and must be found not wanting. Even after the agents has passed muster for the state and each carrier, they then will have each and every annuity application reviewed for each of 12 points to determine that the sale is suitable for the consumer and to determine the consumer will benefit from the annuity [NAIC, 2010].

The Fiduciary-Only Standard Is Not Only Unnecessary But Harms Consumers

Those that desire a fiduciary-only standard are well-intended, but they fail to prove the case that the suitability standard used by broker/dealers and fixed annuity agents is not serving consumers well and this is especially true with fixed annuity agents. Indeed, in 2014 consumer complaints involving securities and advisors represented over 97% of combined annuity and securities complaints. The reason that 99.97% of annuity owners have not complained – based on annual sales – is because fixed annuity agents are already acting under a higher standard of conduct.



Data Sources: *NASAA only has compiled complaints for 2013
FINRA: http://www.finra.org/newsroom/statistics
NAIC: https://eapps.naic.org/documents/cis_aggregate_complaints_by_coverage_types.pdf
SEC: http://www.sec.gov/news/data.htm
NASAA: http://www.nasaa.org/regulatory-activity/enforcement-legal-activity/enforcement-statistics/

If a fiduciary-only standard is adopted by either the SEC or DOL the effect will be catastrophic on all but the most affluent Americans. The suitability standards currently in place are effective and permit mass and middle market Americans to work with a financial professional, regardless of the modesty of their assets. The adoption of fiduciary-only standard, especially by the DOL, would effectively bar 80% to 90% of African-Americans and Americans of Hispanic origin from receiving professional financial advice. A fiduciary-only standard is not needed and would harm the very people it was designed to protect.

Benevolent Paternalism: Fiduciary-Only Standard

In this context benevolent paternalism means when the government takes the ability to make a decision away from the consumer ostensibly for the good of the consumer. An example would be former New York Mayor Bloomberg's decree banning eateries from offering a soda pop serving larger than 16 ounces. The "Big Gulp" ban was overturned by the courts, but benevolent paternalism has not gone away. It is active in the annuity world.

<u>Annuity Agent</u>

An agent is just that – one that works under the laws of agency as an appointed representative of the insurance company. The agent sells products of the carrier and is compensated by the carrier for those sales. A fiduciary standard requires one "to act in the best interest of the customer without regard to the financial or other interest of the [party] providing the advice" [PriceWaterhouseCooper, 2010]. Although the two are not mutually exclusive, there are those that take the position that unless you are a fee-based compensated fiduciary that you are harming the consumer.

Agent: One who agrees and is authorized to act on behalf of another, a principal, to legally bind an individual in particular business transactions with third parties pursuant to an agency relationship.

- West's Encyclopedia of American Law, edition 2

The SEC study found no evidence that the lack of a fiduciary standard harmed consumers (it appears neither the DOL nor current fee-based groups have even bothered to look for evidence). The fiduciary model is a major threat to the fixed annuity distribution model that is currently structured to fairly compensate agents that work with less affluent consumers. A change to the model would make it cost prohibitive to provide annuities to those that may need them the most and would dramatically reduce sales from existing providers.

<u>Action</u>

Both carriers and industry groups need to show the discriminatory and disenfranchising effects of a fiduciary-only standard. Regulators, politicians and the media need to be reminded from time to time that fixed annuity agents already operate under rigorous standards.

Consumers Aren't Confused; They Simply Want Fairness

A recent study that gets mentioned quite a bit by fiduciary proponents is "Fiduciary – Do investors know what it means?" by the Spectrem Group [http://spectrem.com/Content_Whitepaper/fiduciary.aspx] What the fiduciary-only proponents honed in was the finding that over 80% of investors believe their financial professional is a fiduciary. This finding caused quite a bit of clucking with the implication that these poor consumers were being misled, because in many cases their professional was not a fiduciary and they thought he was. However, if one reads the entire study you may take away a different understanding.

The study found roughly three-quarters of those **consumers surveyed think a fiduciary is someone that manages assets and has a legal or ethical relationship with the consumer**. This broad definition would include all annuity agents, brokers and advisors, unless one wishes to argue that the actions of entire group are unethical or that a consumer has no legal recourse if harmed by one of these groups.

Roughly half of the high net worth and two-thirds of the millionaires define a fiduciary as a professional looking out for the client's best interest and this appears to imply the majority want a fiduciary relationship. However, what is missing is the definition of what "looking out for client's best interest" means to the consumer. It would have been helpful if the survey had asked if a fiduciary "recommends suitable products" and then noted if there was a difference in responses between these questions, but that wasn't done. Only half of the individuals thought that a fiduciary was a "relationship based on confidence, good faith and trust".

Perhaps consumers aren't that confused; slightly over 40% feel that their financial professional is more concerned about selling them a product, but they appear to be okay with that. Although getting rid of commissions is a cornerstone of the Department of Labor Fiduciary Standards proposal **over half the mass affluent prefer that their financial professional be compensated though commissions and not fees** – over 40% of millionaires also prefer commission-based compensation to the paying of fees.

The reality of the study is not that consumers are being confused and misled because they want a fiduciary standard, but that consumers want someone that is going treat them ethically. The reality is not that consumer want commissions to go away – half of them prefer paying commissions instead of paying fees. The reality of the study is that regardless of whether the person across from them is acting as a fiduciary or not, the consumer realizes the other party has biases affecting their advice and takes that into account when making any financial decisions.

Resources

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12 November 2014 letter to Mary Jo White, Chairman, Securities and Exchange Commission from Consumer Federation of America, Fund Democracy, Inc., Certified Financial Planner Board of Standards, Financial Planning Association, National Association of Personal Financial Advisors

Advantage Compendium Ltd. (www.advantagecompendium.com) provides research and consulting service and is led by Jack Marrion. He has conducted a broad scope of research ranging from the behavioral economic reasons on how consumers make financial decisions to industry impact models. He also serves as a Research Fellow for Webster University.

His insights on the annuity and retirement income world have appeared in hundreds of publications including Best's Review, Business Week, Kiplinger, The New York Times, The Washington Post, and The Wall Street Journal. In 2006 the National Association of Insurance Commissioners asked him to address their annual meeting and teach regulators the realities of index annuities. In 2009 Dr. Marrion was asked to speak at the Washington regulatory meeting on how seniors make decisions. Best's Review said he was likely to affect the course of the industry.

Prior to forming Advantage Compendium Dr. Marrion was president and owner of an NASD broker/dealer with offices in nine states, and formerly vice president of a life insurance company and previously vice president of an NYSE investment banking firm. He has a BBA from the University of Iowa, an MBA from the University of Missouri and his doctorate from Webster University in the area of cognitive bias in decision-making formed a new paradigm in understanding how biases affect decision-making. Neither Jack Marrion nor Advantage Compendium sell or endorse any financial product.