

The Call of Duty

PROFESSIONAL INVESTORS HAVE STRONG VIEWS FOR AND AGAINST A NEW FIDUCIARY RULE

The Right to Receive Unbiased Advice

By L. Randolph Hood, CFA

I thank the editors for the opportunity to comment on the DOL EBSA rule on conferring fiduciary status on those providing financial advice for investors possessing retirement assets. Allow me to state at the outset that I personally am strongly in favor of such a rule.

In the last 12 years of my active working life (before I retired), I served as the chief investment officer for a corporate-sponsored US employee benefit plan that included a sizable defined-contribution savings plan, which of course was subject to ERISA. In other words, to be clear, I was a plan sponsor. Prior to that in my 37-year career, I was an

investment manager, seeking to be hired by plan sponsors. It's fair to say that I've seen both sides of this debate.

Numerous reasons favor the proposed rule:

Participants leaving a corporate-sponsored plan, perhaps for an individual IRA, expect and have every reason to expect the same level of protection they enjoyed under an institutional plan. Participants in those plans believe they are getting advice that is rendered in their best interest. They deserve to know—clearly—about any conflicts of interest, whether actual, probable, or possible.

Participants are generally anxious about their retirement investments, which often account for a substantial part of their savings, and they are ill

equipped to evaluate critically the cost and efficacy of advice being offered. Financial advice is not an efficient market by any means. Financial products are usually opaque and confusing. Mistakes made by uninformed participants take years to come to light, will be costly, and are irrevocable.

Participants not familiar with the investment industry—and that encompasses most of them—generally do not know how, to whom, or how much they are paying in fees. Whatever the motivations were for adopting Rule 408(b)(2) for sponsors of defined-contribution plans, they must apply to individuals. [*Editor's note:* Under the Employee Retirement Income Security Act (ERISA) of 1974, section 408(b)(2) defines responsibilities for fiduciaries

The Position of CFA Institute on Defining "Fiduciary"

CFA Institute submitted two comment letters in response to the US Department of Labor's proposal to define "fiduciary" for purposes of the Employee Retirement Income Security Act and the Internal Revenue Code. The first comment letter, submitted on 20 July 2015, explained the position of CFA Institute on the proposed change. The second comment letter, submitted on 24 September 2015, provided additional comments regarding claims that the rule would deprive investors of investment advice. Below is an excerpt from the supplemental comments that summarizes the position of CFA Institute and addresses other considerations.

The purpose of these supplemental comments is to offer additional views on the likelihood that, if implemented, the DOL Rule would deprive investors of needed investment advice. As discussed in our previous letter and testimony, we believe that the advisory industry, with the benefit of advances in technology, will be able to meet the needs of investors and fill whatever temporary void is created in the provision of advice for clients with small amounts of assets under management (AUM), should certain current providers discontinue their services. ... We reiterate our support here for the DOL's efforts to ensure that clients' interests are put first and that they receive impartial investment advice. We

also encourage the DOL, as it prepares to issue a final version of the Rule, to reduce the overall complexity of the Rule, and most importantly, of the Best Interest Contract Exemption in an effort to reduce compliance costs; to clarify the parameters of that Exemption (including when and how duties to comply first arise); to address in greater detail when legal liability will attach under the Exemption; and to address how to reduce investor confusion that will result from situations when advice providers under the Rule (and thus operating under a best interest standard) also provide advice under a different standard to non-retirement accounts.

We support the raising of standards in the industry and increasing investor protection. As consumers and the investing public question the integrity of our financial markets, we believe that constructive efforts to advance measures to enhance the fairness and integrity of financial services are critical. To that end, we strongly encourage the DOL and SEC to convene a summit of stakeholders in Washington sometime in the next six months to either advance this proposal in a cooperative and forthright fashion or to otherwise structure an alternate resolution.

The full comment letters are available at <http://cfa.is/2fcJyws>.

of defined-benefit plans. Rule 408(b) (2) was an amendment concerning fee disclosures, which took effect in July 2012.]

Fiduciaries need to be clear. Salespeople needn't.

Certain practices common in the asset management industry, such as the solicitation of rollovers from 401(k) plans to individual IRAs, are currently labeled as "education," not "advice." All one needs to do is freeze the ending screen of a televised commercial on the subject to read the three-second disclaimer in fine print to see this. In written solicitations, the qualifying fine print is usually quite small—though, to their credit, some institutions are more candid about their motives. Aggressive canvassing by agents of asset-gathering firms of those nearing retirement or those recently retired is not only commonplace but also suggestive of the lucrateness of the practice. It is fair to ask what safeguards exist for these investors.

To be fair, those objecting to the rule offer a number of reasons, although of a common thread:

Some objections focus on projected changes to adviser compensation in its current form, the cost of implementation, the disruption of current business practices, and the gravity of unintended consequences. People making this kind of argument often present their concerns under the guise of being concerned about protection for investors.

One of the most common predictions is that middle-class clients with smaller accounts will be forced out of the advice marketplace due to the increased cost of compliance that advisers will have to bear under the new rule, making the servicing of such accounts too costly. This claim does not withstand realistic scrutiny. Most advisers are aligned with a major investment house that routinely recommends generic composite portfolios based on various criteria. No one seriously doubts the resources of these firms. Refining these portfolios with an eye toward implementation of the proposed rule would not be a Herculean task. Continued consolidation of the brokerage industry might occur, subject to regulatory oversight, but this trend has been going on for decades

due to a relentless focus on marginal costs by these houses. (When I entered the business, one of Wall Street's finest trading firms was Bache Halsey Stuart Shields. Today, not a trace of it exists.)

There are a number of reasonably priced, fee-only advice services available in the marketplace, and smaller-balance clients could use these. No one is suggesting advisers should not be paid. I am suggesting that advisers should clearly disclose how and to whom payments are made and the amount of those payments. I am suggesting that their allegiance should be solely to their clients.

The objection concerning the disruption to business practices of the brokerage industry is fanciful. The business is less than a generation old. This is not to belittle the industry of advisers broadly defined, but barriers to entry are low. In the case of advice, where the stakes are high, should not the standards be high as well? The advice industry is full of clever people accustomed to accommodating competitive obstacles. The ideas in the rule have been around for quite some time. The DOL originally proposed changes to the rule in October 2010.

The related objection to unintended consequences also works both ways. The unintended consequences of the current rules have resulted in uninformed investors paying for products they do not fully understand and paying fees and costs of which they are not aware with no one being overly concerned with their welfare. *All* rules have consequences, unintended or not.

Last, the better advisers already know that their long-term success hinges on putting their clients' interests first. Why not codify this best practice?

For informing clients of the impact of the Rule, may I suggest instead a variant of the Miranda warning? I'll call it the "Hood Warning." I suggest the warning be spoken by the adviser and a written copy be provided to and signed by the client:

You have the right to receive unbiased investment advice rendered solely for your benefit. You have the right to receive a schedule of total fees you will pay, including how these fees are charged. The disclosure of these

fees will include how much I personally will receive. You have the right to receive such a schedule for all variants of advice I propose. You have the right to choose any adviser you wish, but no advice rendered by a professional adviser is costless. Any advice I propose and you accept is not and cannot be guaranteed to achieve any or all objectives you may have. Do you understand these rights?

Is such a statement too much to ask? Personally, I don't think so.

L. Randolph Hood, CFA, is a retired managing director and CIO of Prudential Financial's pension plan based in New Jersey.

Using Disclosure to Empower Investors

By Bill Matson, CFA

All persons in the business of giving investment advice, including all sellers of investment products, should be required to prominently disclose two things in all written communications with clients and prospective clients (including account statements):

(1) what it means to be a fiduciary in 500 words or less, and

(2) whether or not they are currently or propose to be acting in a fiduciary capacity with respect to the specific clients and/or prospective clients with whom they are communicating. (A simple yes or no should suffice.)

In addition, prior to the execution of any investment transaction, every client should be given a summary of all anticipated commissions, fees, markups, bonuses, and awards (such as sales contest prizes) to the seller that are associated with the transaction. These summaries should then be subject to regular audit by regulators.

It's about time we considered empowering investors with the information they need to make sound decisions rather than continuing to create ludicrously complex regulations with a multiplicity of possible interpretations and myriad unintended consequences.

Bill Matson, CFA, is CEO of BrainFutures.com and a freelance finance writer based in Florida.

Are Regulators Overlooking Unintended Effects?

By Ralph Wanger, CFA

The Department of Labor (DOL) has issued new regulations governing retirement funds, such as IRAs and 401(k) funds. The DOL rationale is that it is merely extending fiduciary standards to various advisers who have a less exacting standard (e.g., brokers, who operate under a suitability standard). The actual effect will be to prohibit the use of actively managed funds in retirement accounts. The DOL rule will force retirement plans to shift from portfolios of actively managed funds to low-fee indexed exchange-traded funds (ETFs), which will wreak havoc on the mutual fund industry and damage the investment management industry.

THE DOL ARGUMENT

“A careful review of the evidence, which consistently points to a substantial failure of the market for retirement advice, suggests that IRA holders receiving conflicted investment advice can expect their investments to underperform by an average of 50 to 100 basis points per year over the next 20 years. The underperformance associated with conflicts of interest—in the mutual funds segment alone—could cost IRA investors between \$95 billion and \$189 billion over the next 10 years and between \$202 billion and \$404 billion over the next 20.” So, fees must come down.

Will the end result be that “conflicted investment advice” gets interpreted by regulators to mean any fee higher than the cheapest indexed ETF?

The advisory community will switch from transaction fees to annual fees. Retirement plan owners will be asked to sign BICE (best interest contract exemption) agreements so their advisers can get paid. But the net result will be lower revenue for the investment advisory community and, therefore, fewer jobs.

What do you do when a major new regulation is initiated? I still remember 1974, when the DOL created ERISA to regulate pension funds. Pension funds

have boards of directors, just like the companies that the pension funds serve, and in many cases, some of the senior officers and directors of the parent company served on these pension fund boards. ERISA threatened penalties against the pension fund directors if something bad happened—for example, fraud or a conflict of interest that damaged the fund. As a result, the trustees had personal liability for damages if the pension fund lost money.

Because the damages could be millions of dollars, the trustees, understandably, were panicked. They called their lawyers and asked for guidance. The lawyers replied that no one knew the answer; the new law was complex, and until there were legal cases establishing precedents, no one could know.

So, every company that could do so converted its defined-benefit pension plan into a defined-contribution—that is, 401(k)—plan. The companies that could not convert were mostly unionized companies that could not end their defined-benefit plan because the union refused consent. Most of these unionized companies have vanished over the past 40 years, so few defined-benefit pension plans still exist. In order to solve a few problems in the pension system, the Department of Labor produced onerous regulations that had the unforeseen consequence of destroying the funds it was trying to protect.

The Roman historian Tacitus described the overregulation of the Roman Empire 2,000 years ago when he wrote, “Where they make a desert, they call it peace.”

Closer to our own time, John Marshall (chief justice of the US Supreme Court in the earliest years of the United States) wrote the majority opinion in the famous case of *McCulloch v. Maryland* and famously argued “that the power to regulate is the power to destroy.” So, there are impressive precedents to warn us of impending trouble.

THE RIA

Every professional has an inventory of investment choices to offer the

retirement plan owner. If the number of choices is large, an investor will accept a substantial fee, but if the inventory shrinks to a handful of ETFs, the job of advising the plan will seem too simple to be worth much. As a metaphor, consider three different games: chess, checkers (draughts), and tic-tac-toe.

Chess champions are reasonably famous people (or machines). You can likely recall Garry Kasparov or IBM Blue. You are unlikely to know the name of any checkers masters, and you are not interested in having me tell you about one. In tic-tac-toe, there is no such thing as an expert; anyone can learn how to play perfectly in a few minutes. Consequently, a chess champion can make a good living; checkers experts will win some bar bets; tic-tac-toe champions, nada. RIA fees will go down as the game simplifies.

FOUR PERSPECTIVES

To make sure that I am not just engaging in the old man’s pastime of grumbling about the current collapse from idealized past glories, I did four phone interviews with other veterans of the mutual fund industry: a compliance officer, a fund group manager, a retired manager for a mutual fund company, and a portfolio manager.

THE COMPLIANCE OFFICER. I asked a mutual fund compliance officer whether the new DOL rule would categorically bar actively managed mutual funds (AMMFs) as inherently “conflicted” in the new regulatory scheme. Being a good compliance officer, he didn’t give a clear answer, but he agreed that there is no upside but significant downside for AMMFs. There is a clear trend in the intermediary market. AMMFs are developing new share classes to deliver portfolios to the intermediaries—portfolios that will then be marketed under the intermediary brand and pay a fee to the mutual fund manufacturer. If this occurs, I think that the management fee will be substantially lower than current levels. Experience has taught me that the company that controls fund distribution will get a decent

fee but that there will not be much left over for suppliers of portfolios.

External pressure will come from various class-action lawsuits, which will be filed against advisers incautious enough to use AMMFs. Compliance officers will recommend what they perceive to be safe-harbor conduct, and ETFs will be the logical choice. Advisers will be in the jaws of a vise—legal threats on the left, compliance conservatism on the other. This vise will crush any adviser rash enough to resist the minimum fee trend.

A CHESS CHAMPION CAN MAKE A GOOD LIVING; CHECKERS EXPERTS WILL WIN SOME BAR BETS; TIC-TAC-TOE CHAMPIONS, NADA. RIA FEES WILL GO DOWN AS THE GAME SIMPLIFIES.

THE FUND GROUP MANAGER. This source told me the new regulations are a threat. There will be a new share class “stripped of everything” with a separate pricing structure for each intermediary. There will be a management fee fixed on the share class but no front-end loads and no marketing expenses, such as 12b-1 fees. If a third-party RIA wants to use such a fund, he or she may add an additional fee, but that fee will be external to the share class—nothing that looks like a sales commission. Management fees for the portfolio constructor will be negotiated down. In US large-cap funds, the largest sector of the equity funds market, most of the money will be indexed. There will be a specialty market for select funds with a higher fee, which may resemble smart-beta funds or hedge funds.

The changes that will be forced on retirement plan funds will inevitably cross over into the individual market as well. Lower fees for the mutual fund industry will require firing many people.

THE RETIRED SALES MANAGER. The retired sales manager for a mutual fund company gave me a long answer:

“I do have an opinion. I think this is part cyclical and part secular. The regulations are coming at a difficult time for active management. With recent performance challenges versus passive as well as fee compression, these new regulations will continue to erode market

share and confidence, extending this difficult period that active is experiencing.

“Having said that, I think the active versus passive performance disparity is more cyclical than secular. As soon as active managers start outperforming their indexes again (and this will happen), the move to passive will slow. Fees, however, will continue to come down, and mediocre active managers will have difficulty growing assets and retaining AUM with their underperformance (versus their universe and benchmark).

“I do think active will bounce back and the best managers will continue to prosper but with lower margins and increased competition in the future.”

THE PORTFOLIO MANAGER. I called an old friend who was a very well-known and successful fund manager. He fully agreed that the role of actively managed mutual funds in retirement funds is collapsing: “Active managers as a group have not proved their ability to beat indexed-based passive funds net after fees.” The DOL is accelerating a trend that is already advanced and inexorable.

If active funds are out of the retirement market, then passive funds will take over the individual market as well. As the category winds down, all of the best people will quit, and what might remain of active funds will be a dull, unattractive, and shrinking business run by less capable people. The two of us concluded, with regret, that if our grandchildren asked us for career advice, we would tell them not to work for a mutual fund company.

CONSEQUENCES

What is the DOL missing? First its rules on ERISA destroyed the defined-benefit pension plans after 1975, and now its actions will destroy AMMFs. The new policy will save some money for retirement funds but will result in major costs.

In 1975, the public hated equities. The terrible bear market of 1973–1974

scared everyone, creating a violent revulsion toward stocks. And in 1975, every family had an Uncle Jack who still remembered the bear market of 1930–1942. In this hot environment, the mutual funds spent a generation selling the idea of equity to the public. Sales don’t happen by magic. Salesmen don’t sell out of moral responsibility; they want—and earn—commissions. I ran a no-load fund for 30 years and was highly successful in no-load land, building US\$9 billion in assets, but once the fund was acquired and entered the load market, we sold US\$20 billion in 5 years. To keep money going into equities, paid salesmen are essential.

Under the new DOL rule, we will no longer have salesmen building interest in equities, and retirement plans will rotate away from equities to fixed income.

As a result of the new rule, three things will happen:

(1) This change will cost retirement plans a lot of return in the future—undoubtedly more than the fraction of 1% that the new rule will save.

(2) Capital formation will be handicapped. Venture capitalists need institutions to buy their IPOs, and no AMMFs will mean lower return on venture capital, inhibiting innovation and entrepreneurship.

(3) The S&P 500 Index fund was developed around 1970, and there is no reason to think that this index is the final answer in optimal portfolios. The algorithm that runs an index fund requires zero intelligence. Although few human managers have been able to beat the index, I think (or at least hope) some managers will do better. Funds are just getting started using artificial intelligence programs to analyze big data. And computer power allied with the pattern-recognition skills of CFA charterholders may produce “beat the market” returns.

In the long run, capital markets do not depend only on covariance matrices. The animal spirits of human investors feed on exciting stories to motivate them in a way that an index fund cannot.

Ralph Wanger, CFA, is a trustee of Columbia Acorn Trust.