Spring 2018

The Department of Labor Fiduciary Rule: How Will it Affect Financial Advisors and Their Clients?

Claire Hawkes
University of New Hampshire, Durham, cnh2001@wildcats.unh.edu

The Department of Labor Fiduciary Rule: How Will it Affect Financial Advisors and Their Clients?

Keywords
Finance, Department of Labor, Financial Advisor, Wealth Management

Subject Categories
Finance and Financial Management

The Department of Labor Fiduciary Rule: How Will it Affect Financial Advisors and Their Clients?

Claire Hawkes
Caitlin DeSoye, Faculty Advisor

May, 2018

Within the past year numerous articles about the Department of Labor (DOL) Fiduciary Rule have been published on popular business news websites. Headlines such as Searcy Financial's "The DOL's Fiduciary Rule: Bad for Small Guy?", NASDAQ's "The DOL Rule Isn't Dead Yet", and Forbes's "Are Cosmic Fiduciary Powers Needed For Your Best Interest?" have bombarded investors ever since the DOL Fiduciary Rule (Fiduciary Rule) was announced. These articles have many people questioning whether their advisors are acting in their best interest and, ultimately, who they can actually trust. Since many investors do not know who they can and cannot trust, the DOL has taken on the responsibility of ensuring that investors can feel more confident by requiring that all financial advisors act as fiduciaries.

The Certified Financial Planner Board of Standards defines a fiduciary as "one who acts with utmost good faith, in a manner he or she believes to be in the best interest of the client" (Pasztor, 2017). There are over 200,000 financial advisors in the United States alone ("Occupational Employment Statistics" 2018), but how many of them uphold the fiduciary standard? Well, surveying every financial advisor or trying to obtain statistics on the number of advisors who act as fiduciaries would be extremely difficult. What is certain is that at least 80,960 people are certified by the Certified Financial Planner (CFP) Board and hold the CFP designation ("CFP Professional Demographics" 2018). Holding the CFP designation requires an individual to act as a fiduciary when giving financial advice. This means that at least 80,960 people are required to always act in the best interest of their clients, but who is enforcing this standard?

In the past there have been many attempts to regulate the financial services industry in order to protect the client. Unfortunately, many advisors found ways around these regulations. Advisors who failed to act in the best interest of their clients caused many investors to question whether their trust in the financial services industry was misplaced. In the interest of investors, the DOL has introduced and partially implemented a rule requiring all financial advisors to act as fiduciaries when working with retirement accounts. In an article from Forbes, author Jamie Hopkins stated that this rule will be "disruptive to the financial services industry, for better or worse" (Hopkins 2017). But which will it be?

The Fiduciary Rule "demands that retirement advisors act in the best interests of their clients and put their clients' best interests above their own" (Investopedia 2018). Research shows that the Department of Labor Fiduciary Rule will change the financial services industry in a positive manner because it will provide the client protection that prior acts and rules have not, it will reinstall trust in the financial services industry, and it will benefit the clients without significantly hurting the financial advisors.

Nonetheless, from the time the Fiduciary Rule was proposed by the Obama Administration in 2010 it has faced significant pushback from both financial advisors and certain elements in the federal government. In April of 2016 the Fiduciary Rule was published in the Federal Register, stating that it would go into effect June 7, 2016 with a delay applicability date of April 10, 2017. Throughout the following year, pushback surrounding the rule increased under the Trump Administration. In February of 2017, President Trump ordered the DOL to review their Fiduciary Rule again and prepare an updated legal and economic analysis of the rule and the effects it could have on all parties. On March 3rd 2017, the DOL issued a proposed rule which called for a 60 day delay to the April 10th applicability date. Seven days later, the DOL announced that it would not enforce the Fiduciary Rule “in the near term”. On April 7th, 2017 the DOL officially delayed the implementation of the rule from April 10th, 2017 to June 9th, 2017. Finally, on June 9th, 2017 the DOL Fiduciary Rule went into partial effect. The requirement that all advisors uphold the fiduciary standard when working with retirement accounts was delayed until January 2018. Starting in January of 2018, the Securities Exchange Commission (SEC) has partnered with the DOL in order to speed up the implementation of the remainder of the rule. The expected implementation date is now June 2019, however it would not be unexpected to see it get pushed into 2020 (Investopedia 2018).

The Fiduciary Rule is not the first of its kind. Throughout the twentieth century a number of acts and rules were put in place in attempts to protect clients in the financial services industry. For example, “misrepresentation, fraud, and market manipulation in the 1920s led to the Securities Exchange Acts of 1933 and 1934” (Pasztor, 2017). This act was one of the first to regulate the stock market and the trading of secondary securities in the United States (Pasztor, 2017). Later, in 1940 the Investment Advisers Act “required advisors to act as a fiduciary when giving advice to their clients” (Pasztor, 2017). However, this was difficult to enforce because it still allowed advisors to collect both fees and commissions. ERISA was enacted in 1974 in order to “protect employees from underfunded and mismanaged pensions” (Pasztor, 2017). In 2010, the same year that the Obama Administration proposed the Fiduciary Rule, the Financial Industry Regulatory Authority (FINRA) promulgated Rule 2111 that requires an advisor or a firm to “have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the firm…” (“FINRA…” 2018). This brought about the suitability rule that advisors must follow when they are not working under the fiduciary standard.

There are three suitability obligations; reasonable-basis suitability, customer-specific suitability, and quantitative suitability. Reasonable-basis suitability “requires a broker to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors” (Kilbride 2018).The prior diligence must give the advisor a generally good understanding of the potential risk/reward of the recommended security or investment strategy. The Customer-specific suitability “requires that a broker, based on a particular customer’s investment profile, has a reasonable basis to believe that the recommendation is suitable for that customer” (Kilbride 2018). In this obligation of suitability the broker must analyze many customer specific factors to be able to support the claim that the investment is suitable for their client. Lastly, quantitative suitability “requires a broker with actual or de facto control over a customer’s account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, is not excessive or unsuitable for the customer when taken together” (Kilbride 2018).

Overall, the suitability rule attempts to have financial advisors invest their clients’ assets in securities that will benefit the clients. However, there are many securities that could be deemed “suitable” for a client based on their risk tolerance, but a security may not be the best choice for the client if it has higher fees. However, under the suitability rule, advisors may put their clients' money in a suitable security with higher fees to earn a higher commission. In some situations, clients may want their money to be invested in the security with a higher fee, but most of the time when advisors choose to put a client's money in a security with higher fees it is not in the client's best interest (Kilbride 2018).

Many financial advisors work under the suitability rule rather than the fiduciary standard. The difference between these two can be confusing for many clients. In fact, in a 2017 study of 1,025 people over the age of 18, conducted by ORC International, results showed that 53% of people thought that their financial advisor was already required to act in the client's best interest as a fiduciary. Today, financial advisors are not legally required to act as a fiduciary at any time. Certain companies require their employees to uphold a fiduciary standard, but it varies depending on the company and what types of accounts they work with. Acting as a fiduciary is both a legal and ethical duty in which the advisor must put the client's interest ahead of their own (Kilbride 2018). If advisors work under the fiduciary standard, they are legally required to invest their client's money in the securities that are suitable for their accounts and also have the lowest additional fees. In other words, the advisors are legally prohibited from making trades that could potentially result in a higher commission for themselves or their firm (Investopedia 2018).

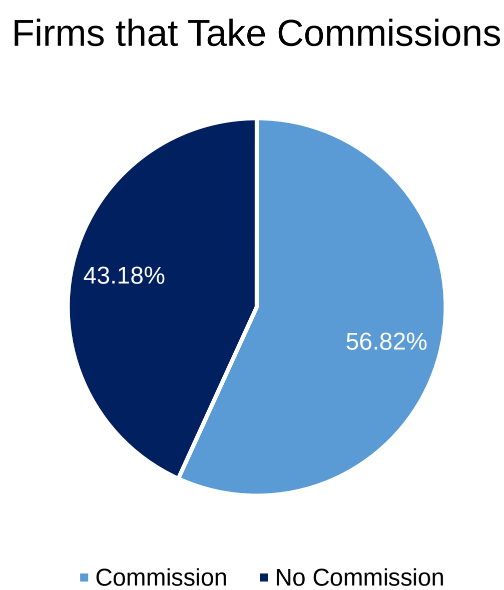
The DOL is a major player in the attempt to further regulate the financial services industry by expanding the definition of "investment advice fiduciary" under the Employee Retirement Income Security Act, otherwise referred to as ERISA (DiCarlo, Hootkins 2017). Under ERISA and the Internal Revenue Code (the Code) not all advisors in the financial services industry qualify as fiduciaries, leaving many clients without proper investment and financial advice. Those who qualified as fiduciaries were advisors who were advising clients on a “regular basis”, which was defined as once a week. With that definition of “regular” there were many client contracts that were not receiving advice “regularly” and therefore the advisors working with those clients were not held to a fiduciary standard (DiCarlo, Hootkins 2017). The Fiduciary Rule works to fix this problem and cover many loopholes in previous acts. With the Fiduciary Rule in effect, it will be harder for brokers to take advantage of their clients. The suitability rule allows brokers and advisors to recommend options that could end up costing clients more, resulting in higher profits for the broker or advisor, even if there were cheaper options available. With all advisors being held to a fiduciary standard, they would be obliged to invest their clients’ money in a cheaper equivalent, saving their clients money (“Suitability” 2013).

The financial services industry will benefit from this additional regulation because unethical advisors will not be able to use exceptions to the rules to increase their personal profits. With the Fiduciary Rule, there is only one exemption; the Best Interest Contract Exemption (BICE). Under the Fiduciary Rule, the only way that an advisor would be allowed to not act in a client’s best interest is if the client signs a disclosure agreement stating that the client was aware that the advisor was not going to act in the client’s best interest (Investopedia 2018). This is new for the industry and will prove to be beneficial once the Fiduciary Rule goes into full effect.

The Fiduciary Rule will also benefit the financial services industry by reinstalling a fair amount of trust in it. Those in favor of implementing the Fiduciary Rule argue that “a client is dependent on the skill and integrity of a professional advisor” (Aikin, 2016). Being assured that an advisor will always act in the client’s best interest would reverse a trend of mistrust, and encourage investment. This is necessary, given that the level of trust in the financial industry is currently relatively low. One of the main concerns in the financial services industry is that financial advisors are not acting in the best interest of their client in order to increase their commissions. For this reason, many clients do not always trust their financial advisors. This lack of trust is economically inefficient and has the potential to weaken the strength of a community. Many individuals believe that the Fiduciary Rule is necessary in order to establish a difference between manufacturers and distributors of financial products and financial advisors. At the moment there is a lot of gray area in terms of who is selling a product and who is giving a client financial advice (Aikin, 2016). There are also many clients who receive subpar advice from firms that later are fined for unethical behavior (Pasztor, 2017).

In a study conducted by Harris Poll on behalf of McAdam in 2015 of over 2,000 U.S. adults, 71% of people said that some aspect of talking to a financial advisor scared them. Of that 71%, 49% said that they were scared to talk to an advisor because it would end up costing them a lot of money (Wanczyk 2015). Many Americans have a fear of being taken advantage of by someone in the financial services industry and according to this same survey, many of them are Millennials. While only 63% of Americans age 45 or older were scared to talk to an advisor for fear of being taken advantage of, a whopping 82% of Millennials were scared for the same reason (Wanczyk 2015). This fear of talking to financial advisors has to come from somewhere. One possibility is that the 2008 financial crisis installed a deep sense of fear of the financial industry in Americans. Over the past 10 years some faith has been restored in the U.S. financial industry, but the '08 crisis could be a subconscious reason why Millennials are reluctant to talk to financial advisors (Wanczyk 2015). Another possibility is that scandals surrounding the financial services industry have installed fear in American investors. It is no secret that there are financial advisors who take advantage of their clients, but there are plenty of financial advisors who do not and suffer from this stereotype. **Exhibit 1** shows the percentage of firms, out of 44 of the largest firms measured by assets under management (AUM), that allow their employees to receive commissions and the percentage of firms that do not.

Exhibit 1:



In this chart it is shown that 56.82% of firms allow their employees to receive commissions while 43.18% do not. Over half of these firms allow their employees to earn commissions, which could directly influence which products and securities they sell to their clients. If an advisor is not held to the fiduciary standard and has the option to sell a client a financial product at a higher price and in turn take home more money, then they may do so. This is one of the reasons why clients have lost trust in the financial services industry and why the Fiduciary Rule is necessary.

One way to reinstall trust in the financial services industry would be to require all financial advisors to act as fiduciaries, especially when working with retirement accounts. When surveyed, 99% of wealthy investors ranked “honesty and trustworthiness” as most important out of all the criteria when selecting a financial advisor (Elliott 2013). While 99% of respondents to this particular survey believe that honesty and trust are the most important factors, there are individuals who do not know how to pick out a dishonest or untrustworthy financial advisor from the rest.

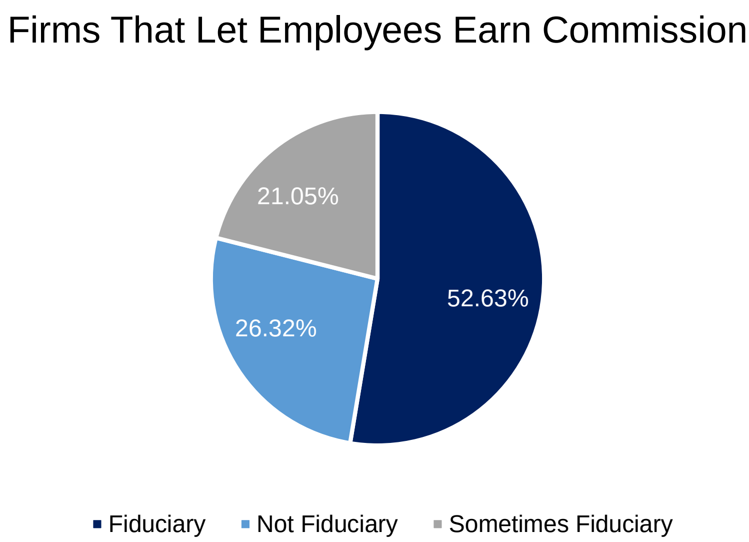
When choosing a financial advisor, clients who do not understand certain financial terms are at risk of having their advisor take advantage of them. Results from a 2017 survey of 1,025 adults conducted by ORC International showed that 61% of adults do not know what it means for a financial advisor to be a fiduciary and 38% of adults who work with a financial advisor do not know if their advisor is a fiduciary (”In Whose Best Interest?” 2018). Individuals who are not well informed are at a higher risk of being taken advantage of by their financial advisor (Elliott 2013). To avoid this, financial advisors should be required to make decisions that are in the best interest of their clients. In addition, if financial advisors acted as fiduciaries, the industry would gain more clients. In a Personal Capital survey, 54% of people said they did not use a financial advisor and of that 54%, 45% said it was because they did not trust them (Fischer 2016). If the DOL Fiduciary Rule went into full effect and all financial advisors were required to act as fiduciaries then there would be an increase in the amount of

Americans who use financial advisors because they would then have a reason to trust their advisor.

The Fiduciary Rule has been a controversial topic since it was first announced. There are many individuals who are opposed to this rule being fully implemented because they believe that it will decrease advisors' salaries, causing advisors to leave their jobs because the amount that they will be paid will not be worth the amount of work they have to do to keep up their clientele. If advisors leave the industry, this will leave clients without financial advice. The clients that will most likely be hurt by this are the low income families and those who have less than $250,000 to invest. Due to the fact that advisors will become scarce and advice will cost more, fewer advisors would want to take on clients who will not generate as much income. Other clients could also be priced out of working with a financial advisor. As the cost of giving advice increases, the cost of receiving advice also increases. The amount that some advisors will charge in flat-fees will increase to make up for the commissions that they are no longer allowed to receive. While this is on a case by case basis, many firms operate on a commission based model may have to restructure.

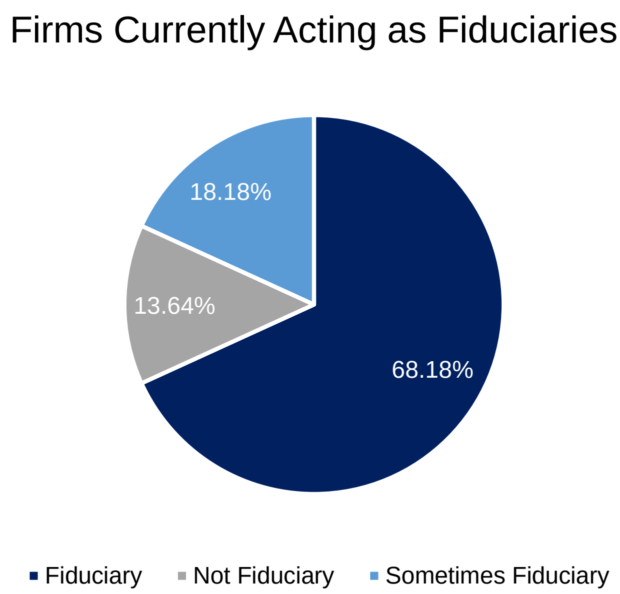
While this is one reason why some oppose the Fiduciary Rule, it should not be a concern. **Exhibit 2** shows the percentage of firms that require their employees to act as fiduciaries when working with retirement accounts.

Exhibit 2:



This chart explains that 68.18% of firms already require their employees to act as fiduciaries, 18.18% of firms sometimes require their employees to act as fiduciaries, and 13.64% of firms do not require their employees to act as fiduciaries. In addition, **Exhibit 3** shows that the top 5 largest firms (Bank of America, Morgan Stanley, J.P. Morgan, Wells Fargo, and UBS Wealth Management) make up 62.82% of the sample's AUM while the other 35 firms make up only 37.18% of the total AUM.

Exhibit 3:



Three out of these four largest wealth management firms (excluding Bank of America) do not allow their employees to earn commissions and on top of that, only one of these four firms does not require their advisors to uphold the fiduciary standard. Looking at the Bank of America Merrill Lynch branches, three out of the five branches allow employees to receive commissions while four out of the five branches require their advisors to uphold the fiduciary standard.

These data show that many firms have already made changes to their fee and compensation structure in anticipation of the Fiduciary Rule. If many firms have already made these changes then, in theory, the implementation of the Fiduciary Rule will have no effect on them. This rule will benefit the clients greatly and will not hurt advisors who already act ethically and charge their clients upfront fees. Those who claim to see a negative effect from the implementation of the Fiduciary Rule are generally those who would prefer to push their company's products or who would prefer to operate without ethical boundaries. In either case, those are advisors that informed clients would not want to work with.

A similar fiduciary standard was implemented in Australia, India, the United Kingdom, and the Netherlands. After those countries banned commissions on open-end mutual funds, they each saw a decline of between 10 and 30 percent in the number of financial advisors in their respective countries (Pasztor 2017). Some fear that if the United States follows in these countries' footsteps, it will also experience a decrease in the number of financial advisors available. However, the exits from the financial services industries abroad were mainly attributed to individuals who collected commissions and were primarily sales-focused as opposed to advice-focused leaving the industry (Pasztor, 2017). Financial advisors who are advice-focused rather than sales-focused may have to change their method of compensation or the way in which they charge their clients; but it may not affect them to the point that they leave the industry as a whole. If the industry slowly makes a shift towards the fiduciary standard, then the implementation of the Fiduciary Rule will not have an adverse effect on the majority of companies.

In conclusion, the implementation of the Fiduciary Rule would benefit the industry as a whole because it will provide clients with the protection they need, it will make clients trust industry professionals, and it will benefit the client without harming the advisors. This rule has been necessary from an ethical standpoint since advisors began to abuse the suitability rule. In addition to protecting clients, the Fiduciary Rule has the potential to reinstate trust in the financial services industry and increase the numbers of clients who want to work with advisors. This will happen once investors understand that every advisor has the obligation under the fiduciary standard to work in their best interest. Lastly, the Fiduciary Rule will not have a negative impact on financial advisors as a whole because many of them already uphold the fiduciary standard. Over half of the firms that were part of this study already require their financial advisors to act as fiduciaries, so this rule will not change how their clients are charged or how the advisors are compensated. While slightly over half of the firms studied allow their employees to earn commissions, a majority are allowed to take commissions from their product sales only if it truly is in the best interest of the client. Overall, implementation of the Fiduciary Rule would be in investors' best interests; and those advisors who suffer from implementation are likely not the most trustworthy advisors.

Since the Fiduciary Rule has not been fully implemented, it's full impact is unknown as of yet. Will investors become more confident? Will they place greater trust in advisors? Will there be a decrease in the number of financial advisors in the United States? Will firms change their methods of compensation, increase the fees that their clients pay, or decrease the number of clients that they work with? Will the Rule have an adverse effect on financial advisors and their firms (i.e. increasing a firm's costs or seeing a mass exit of financial advisors due to decreased salaries)? Although this research leads one to believe that the industry will not see drastic changes, we will have the answers to these questions only if the Rule is entirely implemented and when it goes into full effect.

References

Aikin, B. F. (2016). Why the Fiduciary Standard Exists. *Journal Of Financial Planning, 29*(8),17-19.

CFP Professional Demographics. (2018, April 30). Retrieved from https://www.cfp.net/news-events/research-facts-figures/cfp-professional-demographics

DiCarlo, P., & Hootkins, E. (2017). How Are the Fiduciary Duties under the DOL's New Fiduciary Advice Rule Different from the Securities Laws?. *Benefits Law Journal, 30*(3), 5-15.

Elliott, R.C. (2013). Regaining Client Trust Requires Further Commitment by Wealth Managers. *Journal Of Wealth Management, 16*(1), 81-84

FINRA Rule 2111 (Suitability) FAQ. (2018, January 01). Retrieved May 05, 2018, from http://www.finra.org/industry/faq-finra-rule-2111-suitability-faq

Fischer, M. S. (2016, June 21). Most Americans Get No Financial Advice: Survey. Retrieved April 18, 2018, from https://www.thinkadvisor.com/2016/06/21/most-americans-get-no-financial-advice-survey/?slreturn=20180406213152

In Whose Best Intereset? (Part 2) [PDF]. (2017, April 01). Sunnyvale, CA: Financial Engines.

Investopedia. (2018, March 19). The DOL Fiduciary Rule Explained. Retrieved May 05, 2018, from https://www.investopedia.com/updates/dol-fiduciary-rule/

Kilbride, Richard. *Reinvesting 08, planning* [PowerPoint Slides]. Retrieved from https://mycourses.unh.edu/courses/39483/files/2051901?module_item_id=764118

Occupational Employment Statistics. (2018, March 30). Retrieved May 6, 2018, from https://www.bls.gov/oes/current/oes132052.htm#(1)

Pasztor, J. (2017). Fiduciary Standard Moving Ahead Despite Labor Department Delay. *Journal Of Financial Service Professionals, 71*(6), 25-27.

Suitability. (2013, September 25). Retrieved April 18, 2018, from http://www.finra.org/industry/suitability

Wanczyk, S. (2015, October 27). Financial Advisor-Phobia: 71 Percent of Americans Say They Are Scared of Talking to a Financial Advisor. Retrieved April 18, 2018, from http://www.marketwired.com/press-release/financial-advisor-phobia-71-percent-americans-say-they-are-scared-talking-financial-2067524.htm