Consumer Federation of America

U.K. Experience Suggests Retirement Savers Will Benefit from DOL Rule to Rein in Conflicts of Interest, Promote Best Interest Advice

DOL Rule Opponents Mischaracterize Findings of Study on U.K. Financial Markets, Draw Faulty Analogy between U.K.'s Commission Ban and DOL Rule Proposal

Last week, the government of the United Kingdom released a report[1] analyzing the state of the U.K.'s financial advice market, including the effects that banning commissions and other regulatory changes have had on that market. The report presents a largely positive picture, indicating that the Retail Distribution Review (RDR) reforms have significantly improved the quality of financial advice. But it also suggests that more can and should be done to make the provision of advice and guidance to the mass market "more cost-effective."

Predictably, opponents of the Department of Labor's proposed conflict of interest rule have seized on the report – or at least carefully cherry-picked quotes from the report – to reiterate their oft-repeated claim that the DOL rule is likely to cause middle income retirement savers to lose access to affordable advice. This argument is laid out in an analysis circulated last week by Davis & Harman, which represents a number of financial firms fighting to stop the DOL rule.

The premise behind the Davis & Harman analysis is that the effects of the DOL rule will be "identical" to the effects of the U.K.'s RDR and that the result will be a loss of advice for small savers. But to reach this conclusion, the authors have conveniently glossed over fundamental differences between the two regulatory approaches, have painted a misleadingly negative picture of the effect of the RDR on the U.K.'s financial advice market, and have blamed the commission ban for effects that cannot reasonably be attributed to it.

The Davis & Harman Analysis is Based on an False Premise

Davis & Harman's analysis hinges on the assumption that the effects of the DOL rule and the U.K.'s RDR would be "identical" despite fundamental differences in their regulatory approaches. The RDR not only banned commissions as a compensation mechanism for advisers, it also imposed new education and credentialing requirements on advisers and imposed a new financial levy on advisory firms to support a Financial Services Compensation Scheme.[2] DOL's proposed rule does none of those things. On the contrary, the DOL rule affirmatively permits advisers to receive commissions subject to compliance with the best interest contract (BIC) exemption.

Davis & Harman dismisses these fundamental differences in approach as irrelevant because the BIC exemption is so "unworkable," in their view, that "no financial institution can or

[1] HM Treasury and Financial Conduct Authority, "Financial Advice Market Review: Final Report," March 2016, available here.

[2] The Financial Services Compensation Scheme was created to compensate victims of bad advice from firms that have since become insolvent or are otherwise unable to pay valid claims.

will use" it. This is the sort of rhetorical flourish we've come to expect from rule opponents who, because they plan to challenge the rule in court, cannot afford to have any statements in the public record acknowledging that the rule is either needed or workable. But it is a statement that has no basis in fact.

On the contrary, a number of financial professionals filed comments in support of the proposed DOL rule in which they attested to its workability for fee- and commission-based advisers alike. Financial planner Ray Ferrara, whose firm offers retirement advice on both a fee- and commission-basis, testified to that fact at the DOL public hearing. "Many in the industry say the re-proposed rule is unworkable, too costly and will force advisers to abandon middle-class clients," he said. "Based on our firm's actual experience, we don't share these views; we believe that, with some refinements and clarifications, the rule is workable."

Further evidence exists that firms are already beginning to plan for life under the DOL rule. Morningstar analyst Michael Wong has indicated that, in discussions he has had with firms across the industry, he has encountered some firms that have already begun preparing to comply with the BIC and others that are waiting to see the final rule before deciding how to proceed. A new report from Cerulli Associates predicts that firms will adjust to the rule, taking advantage of technological advances to serve small accounts, and that prices for annuities are likely to drop.

Even if some firms choose to serve smaller accounts through fee-based accounts rather than commission accounts, it doesn't mean that middle income advisers will lose access to advice or see their costs rise. Two of the largest firms that serve middle income clients, LPL Financial and Edward Jones, recently announced that they would be lowering costs and account minimums for their fee-based accounts, making them available and affordable for individuals with as little as $5,000 or $10,000 to invest. Both firms cited coming compliance with the DOL rule as the impetus for the changes. ***In other words, contrary to Davis & Harman's dire predictions, the evidence suggests that the DOL rule is already delivering cost savings to small savers even before it is finalized.***

Davis & Harman Blames the U.K.'s Commission Ban for Unrelated Market Conditions

Ignoring the findings of the report it purports to summarize, Davis & Harman paints a highly negative picture of the U.K. financial advice market and then blames every negative feature of that market on one aspect of the RDR, the ban on commissions. In particular, Davis & Harman takes a few carefully selected quotes from the U.K. report and presents them out of context in order to create the impression that the U.K. ban on commissions has caused a "massive exodus of advisors from the small account market." The U.K. report itself, which is based on input from a wide range of stakeholders, reaches no such conclusion. On the contrary, it notes that the majority of those who submitted comments agreed that the ban on commissions had "produced good outcomes for consumers, and there was not a case for a return to the pre-RDR rules on charging structures."

The "advice gap" that Davis & Harman seeks to blame on the U.K.'s commission ban, the report itself attributes to other factors. These include: the significant fixed costs associated with providing face-to-face advice, which may make it uneconomical for firms to serve smaller accounts regardless of the compensation model; lack of clarity under the new rules about the ability of firms to offer guidance or streamlined advice that does not cover an individual's complete financial situation; and failure of firms to recognize and take advantage of the

flexibility under the regulations to charge for advice through installment-based payments rather than exclusively through up-front fees, an approach that is particularly daunting for small account holders. ***None of these key factors is the result of the ban on commissions, and none raises concerns regarding the DOL's proposed regulatory approach.***

Moreover, while Davis & Harman uses the term "advice gap" to imply that consumers are unable to access desired services, the U.K. report uses the term more broadly to include factors that reduce consumer demand for advice. These demand-related factors include concerns about the cost of advice, "limited confidence in engaging with financial issues," and "lack of trust following past instances of mis-selling." While the RDR has made "significant progress" in improving the professionalism of advice, "trust remains relatively low," according to the report, and more time will be needed "for awareness of the changes introduced by the RDR to lead to higher levels of confidence in the industry."

Davis & Harman is correct when it states that the report also documents a decline in the number of advisers immediately before and after enactment of the RDR. And the report does find that this decrease has occurred primarily at the "banks and building societies" that have traditionally been more likely to serve smaller accounts. The report cites a number of reasons for this decline that have nothing to do with the commission ban. These include the "declining profitability of branch-based distribution models, a lesser role for branch-based activity … and the consequences of episodes of mass mis-selling (in terms of redress and reputational damage)." On a positive note, the report finds that some larger firms "have recently signaled a return to the advice market." This has been facilitated in some cases "by effective and creative use of new technologies." And it finds that a number of firms currently in the advice market are planning to increase the number of customers they serve as well as the number of advisers they employ.

While the report also attributes the recent decline in the number of advisers in part to "anticipation of the RDR," it focuses primarily on aspects of the RDR other than the commission ban to explain this occurrence. Among the most significant are the RDR's increased education and credentialing requirement for advisers, which forced some in the industry to return to school before they could resume offering advisory services, and its newly imposed levies to pay for a Financial Services Compensation Scheme, which firms have complained imposes significant and unpredictable costs even where they themselves are not culpable for creating those costs. In its rush to blame the commission ban, Davis & Harman ignore these aspects of the RDR entirely. Neither is included in the DOL rule.

Conclusion

An even more fundamental point that Davis & Harman either fails to grasp or chooses to ignore is that lack of access to affordable advice for small savers is a feature of the ***current*** U.S. advice market. That's because what many firms characterize as advice today is really just a sales pitch dressed up as advice from a financial professional who is free under current rules to place his or her own financial interests ahead of those of the client. That's not what most people have in mind when they seek out professional advice. The DOL rule would help to ensure that individuals, including many middle income workers and retirees, who prefer to pay for investment advice through commissions aren't relegated to these second class services and instead get the best interest advice they expect and deserve. A complete and unbiased reading of the U.K. experience suggests this is an achievable goal. Don't America's working families and retirees deserve at least that much?