



## Consumer Federation of America

### If Financial Firms Support a Best Interest Standard Why do they Encourage Harmful Advice?

Broker-dealers and insurers insist that they want their “financial advisors” to act in their customers’ best interests. So why do these firms pay their advisors more to recommend products that cost the customer more? And why do they pay their advisors more to recommend higher risk and less liquid investments? **No firm that truly wanted its advisors to put the customer’s interests first would pay them this way.**

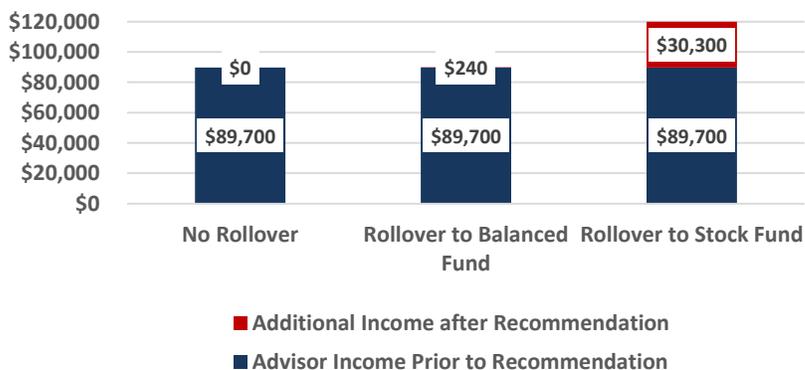
The problem with these compensation systems is not simply that advisors are paid more to sell certain products, but that the financial incentives often favor the sale of products that expose investors to excess costs and unnecessary risks. In recent House [testimony](#), University of Mississippi Professor of Law Mercer Bullard detailed the “mind-boggling” magnitude of the conflicts that can result from common industry compensation practices.

The differences in compensation aren’t just a matter of a few hundred dollars here or there.

- ❖ Advisors can easily earn twice as much recommending one mutual fund over another. Since higher risk funds typically pay more than lower risk funds, this creates incentives to increase the risk in investor portfolios.
- ❖ When advisors recommend a variable or fixed-index annuity or a non-traded REIT the pay premium for the advisor goes up even more, but so do the investor’s costs. And the liquidity of the investor’s portfolio is reduced.
- ❖ Under some of the most egregious payment schemes, known as ratcheted payout grids, an advisor who is approaching the next rung up on the grid can make more money on a single investment recommendation than the entire value of the recommended investment. Advisors who face conflicts of that magnitude will be hard-pressed to set aside their own financial interests and do what is best for the customer. (See illustration next page.)

As Professor Bullard asked, if an advisor can easily earn twice as much, or ten times as much, or 250 times as much without

#### Ratcheted Payout Grids Magnify Conflicts, Encourage Risky Recommendations



spending any additional time or doing any extra work, what do you think the advisor will do?  
**More to the point, what is the advisor *paid* to do?**

The Department of Labor doesn't think retirement savers should have to bet their life savings on financial advisors' willingness to do the right thing even when they are being richly rewarded not to. That's why its rule proposal backs up its best interest standard with a requirement that financial firms eliminate practices that magnify the conflicts inherent in sales-based advice. Advisers could still be paid through commissions and other sales-based fees, but the incentives to favor the sale of one investment over another would have to be reduced, if not eliminated.

That, even more than the best interest standard itself, has generated vehement opposition from financial firms and their lobbyists who claim the requirement is "unworkable." The fact that some firms have taken steps voluntarily to eliminate these conflicts gives the lie to that claim. It suggests that the requirement is not unworkable, but rather unpalatable to firms that are able to earn billions in excess profits under the existing system.

### **How Ratcheted Payout Grids Magnify Conflicts, Encourage Risks**

It's the end of the year, and Sue, a financial advisor, has brought \$299,000 in commission revenue into the firm. Stuck at the 30% rung on the firm's ratcheted payout grid, meaning she gets to keep 30% of the commission revenue she brings into the firm, Sue needs to bring in just \$1,000 more in commissions to move up to the 40% pay level. Since the increase is retroactive, one additional sale could earn her an extra \$30,000 in pay for the year. (See chart, previous page.)

Needless to say, Sue is motivated.

She looks around and finds a prospective client, Bob, who just left a federal government job and has \$20,000 in the Thrift Savings Plan (TSP). Bob's portfolio is in a well-diversified target date fund appropriate for his age. If Sue convinces Bob to roll that money out of the TSP and into an Individual Retirement Account (IRA), Sue can generate the extra \$1,000 in commission revenue she needs to boost her pay, but only if she also moves him out of the target date fund and into a stock fund. The stock fund would pay Sue a higher commission than a balanced fund, but it would also increase Bob's risks.

Viewed objectively, Bob's best option is to stay put. Taking Sue's advice would increase his costs, reduce his diversification, and increase his risks. But that would deny Sue her \$30,000 pay day. With that much money on the line, whose financial interests do you think are likely to be served?

**If we want advisors to provide good advice, we need to stop paying them to provide bad advice.** Remember that the next time a financial industry spokesperson says they support a "best interest" standard, but not changes in how they pay and reward their financial advisors.

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*The Consumer Federation of America is a non-profit association of nearly 300 consumer groups that was established in 1968 to advance the consumer interest through research, advocacy, and education.*