Transcript

Better conversations. Better outcomes.

Episode 1.24 - Now what? Fred Reish on the future of DOL's fiduciary rule

Ben Jones - A quick programming note for our international listeners, this episode is U.S.-centric.

Fred Reish - The impact that I've seen on retirement plans is actually pretty slight.. The impact on IRAs and rollovers is quite large. You know, I think it's possible, I don't know if the government will do it, but it is possible that if they went back and just sort of trimmed around the edges of the fiduciary rule, going to make some structural changes to this thing called the best interest contract exemption, that I actually think that many, many more organizations in the financial services sector would support the rule or at least would be willing to go along with it, but it's going to take a rewrite. There's a huge amount of controversy and disagreement over that part of the rule.

Ben Jones - Welcome to Better conversations. Better outcomes. presented by BMO Global Asset Management. I'm Ben Jones.

Matt Smith - And I'm Matt Smith. In each episode, we'll explore topics relevant to today's trusted advisors, interviewing experts and investigating the world of wealth advising from every angle. We'll also provide actionable ideas designed to improve outcomes for advisors and their clients.

Ben Jones - To learn more, visit us at bmogam.com/betterconversations. Thanks for joining us.

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Matt Smith - Today, we're talking about a hot topic in the financial services industry that is evolving by the minute. By the time you listen to this podcast, there may be new information that changes your outlook, but hopefully this episode will give you a base understanding and ways to move forward with your business.

Ben Jones - We're talking about the fiduciary rule, also known as the conflict of interest rule. This rule was put forth by the Department of Labor under the Obama administration, and it deals with retirement plans, advisor choice, and much, much more. The rule brought changes to our industry that would need to be implemented and enforced starting in April of this year, but then this month, things changed.

Matt Smith - On February 3, 2017, President Trump signed a memorandum that directed the Department of Labor to exam the fiduciary duty rule. This brought uncertainty to the rule and left many advisors waiting to see what would happen. We explore this topic on today's show.

Ben Jones - Our guest today is Fred Reish, partner in the law firm of Drinker Biddle & Reath and the chair of their financial services ERISA team. I spoke with Fred over the phone from Los

Angeles about the history of the rule, the intentions behind it, and some of the implications for the future. We recorded our conversation just days after the Trump memorandum and so we discussed the possibilities that now there could be some changes or even a repeal of the rule.

Fred Reish - If you get all the way up at the 50,000 foot level, the reason for the rule is really based on demographics, and what I mean by that is that we have approximately 10,000 people every day retiring in America, just a huge number. And most of those, or at least many of those, are taking distributions or at least are entitled to distributions from retirement plans, generally, and specifically from 401(k) plans. When people retire and they have a 401(k) account, they've been bubble wrapped. They're in investments that the fiduciaries provided that are low cost, high quality investments. They've been given a little bit of education about investing, but they've never really had to learn about it, not at any level of detail, and then when they leave the plan, they leave this bubble wrapped environment, and in affect, they go out and swim with the sharks in the retail world. There are great advisors in the retail world, great advisors for IRAs, and great advisors on rollovers, but we would kid ourselves if we didn't realize that there are some bad ones also, and those participants, those mid-level employees with their $100,000, $200,000, $300,000 account balances really don't have the experience or the education to know how to pick between the good advisors and the bad advisors. They don't have the information to know where to look about expenses and conflicts of interest and all of the materials, like prospectuses that are given to them. So, the government looked at that and said, you know, we need to take that bubble wrapping that is there for 401(k) plans and other ERISA governed plans under the fiduciary rule, and we need to extend that bubble wrapping to the distribution and rollover process and to investment advice for IRAs so that we can afford the same kind of protections to people in the decumulation stage that we have afforded for them in the accumulation stage. So, it's really demographically driven, although very people actually talk about that, and the ultimate demographic concern is that those 65 years olds that are retiring today, 20 years from now are going to be 85; in 30 years; 95. If the conflicts of interest are too great, if the investments are mediocre, if the expenses are excessive, then most people will run out of money, and they will be living on just hundreds or $1,000 a month of Social Security, and all of their lifetime savings will be gone. That's the picture that the Department of Labor wanted to avoid. They wanted to put a system in place that minimized the risk of that happening.

Matt Smith - Fred makes the point that the rule's intentions were about demographics. The rule was created to help and protect the 10s of thousands of people going into retirement every day in America. If you're a financial advisor in the U.S., you know that regardless of the rule's intentions, the reality of the rule was controversial when it was released. Fred discussed what the rule meant for different types of people.

Ben Jones - Now, can you walk me through what this means for kind of two different categories of advisors, first, registered investment advisors, and the second being the traditional broker/dealer rep.

Fred Reish - Sure. To do that kind of a walkthrough, you really have to break the impact of the rule into four categories, and those are: What's the impact on plans, advice for plans? What's the impact on advice to participants? What's the impact on advice to IRAs? What's the impact on advice about rollovers? Looking first at plans for registered investment advisor, assuming they're following the rules that are in effect today, the new requirements will impose no changes. In other words, the new rules are really built around the RIA model. So, if an advisor, if a registered investment advisor is following all the rules today, come April 10 or whenever the applicability date is, there will be no change then as compared to now. But in terms of investment advice to participants, the same thing is true. For an RIA, come April 10 or the

applicability date, no change. What about advice to IRAs? The same thing is true. For advice to IRAs for an RIA who is following the rules that are in effect right now, there will be no change. What about rollovers? Well, that where there's going to be a big change. And RIAs, whenever these new rules are applicable, are going to have to make a decision. Are they going to provide distribution and rollover education to participants and then let the participants make the decision? That's a non-fiduciary act. You just have to provide good education. Or are they going to make recommendations to participants to take distributions and roll over IRAs. That is a fiduciary act, and they have to engage in a prudent process to make that, which involves, among other things, looking at how the potential terms to invest in in the plan, what are the expense ratios? What's the quality of the investments? What are the services? What are the costs? And they're comparing that to the IRA that they're going to propose to the participant, and then making a recommendation that is in the best interest of the participant. That is a big change. The information gathering in particular and the evaluation process of making that kind of a comparative analysis are both big changes. What about for broker/dealers? For commissioned sales people, commissioned advisors? What about advice to plans? Well, I think there you're going to see one of two things: Either the broker/dealers -- probably the broker/dealers will let their most experienced retirement plan advisors become advisor representatives investment advisors. That is, they'll work under a corporate RIA, and they will be fiduciaries. Then for their financial advisors who are less experienced with retirement plans, they'll probably require that they work with a 401(k) provider who has a fiduciary on the platform, on the provider's platform, a third party independent fiduciary and require that that third party fiduciary select the investments so that the inexperienced advisor does not become a fiduciary. I think -- by the way, that's here to stay. I really think most broker/dealers are going to go down that path regardless of what happens with the rules. In terms of participants, I don't think most broker/dealers will allow their advisors to give fiduciary investment advice to participants, and therefore, they'll be providing investment education only, probably using asset allocation models that useable funds designated investment alternatives. Again, I think that's baked in the cake. What about advice to IRAs? For a commissioned salesperson, that is just a huge change, and there they're going to have to almost by definition comply with one of the exemptions, the best interest contract exemption is such a big deal, yet it was written to be so burdensome and so expensive and so difficult, that it created a lot of the controversy, and it's really about advice to IRAs. So, I think there will be big changes there. At this point, all I can really say is that it will require compliance with one of the exemptions, and hopefully they're rewritten to be more usable, and then finally what about advice on rollovers. It's very similar to what I said about registered investment advisors. The broker/dealers are going to tell their advisors that either that they provide only distribution and rollover education, or if they're going to provide recommendation about distributions and rollovers, which most will, they're going to have to develop a service where they can gather that information about the investments, expenses, and services in the plan, and then compare those to the proposed IRA and then make a recommendation that is in the best of the investor. That is obviously a much more formalized process than what is generally used now. So, big changes to IRAs, big changes to rollovers.

Ben Jones - So, the question now is, are the big changes still coming, or will the rule be changed or repealed completely? The directive from President Trump simply adds a period of waiting and uncertainty to the industry for all of us. We had a question submitted from one of our listeners that I asked Fred. The question from one of our listeners was around the issue of taking individuals that are currently in commission-based IRAs and moving them into fee-based accounts. While this helps comply with the spirit of the law, in some cases, the fees that the client would be paying for the new services that they would be receiving would be higher and how will that work with the DOL and the SEC and this kind of gray area of is it more expensive for the client but are they getting more fees and who will police that?

Fred Reish - When the DOL issued its proposed set of fiduciary rules, one of the comments I got back was, wait a second, you're encouraging level fees for everything. One result of that can be what's called reverse churning. What reverse churning is, is an account that doesn't get very much in the way of services, they just have an occasional transaction, but you're not providing a lot of services to the account, but then if you put them in a fee-based account, you're charging them every year as if you were providing services. So, the DOL thought about that, and the way they dealt with it is when they issued the final rules, it is a fiduciary act to recommend that someone switch from a commission-based account to a fee-based account, and what that means is that you can't -- an advisor would get in trouble if the advisor recommended that somebody switch to a fee-based account if the advisor couldn't show that the fee-based account, that is the extra fees that would be paid, would be justified by extra services. So, that concern is shared. Now, the SEC already has its reverse churning rules in effect. So, the SEC could supervise it. The -- FINRA, the self-regulatory organization for broker/dealers could supervise it or check it, examine it, and in terms of what the DOL can do, they don't have any jurisdictions for enforcement purposes over IRAs. However, there are -- under the best interest contract exemption, the advisor has to acknowledge in writing that the advisor is a fiduciary for that purpose, and I think there's a good chance that could be actionable in arbitration under the FINRA rules.

Ben Jones - Fred, what are some of the unintended consequences that you've seen to date for the rule, and I know you've written extensively in a series of articles on this topic, but what are some of the unintended consequences you think our advisor audience should be aware of?

Fred Reish - The rollover rules are hard enough to comply with that I think it could discourage advisors from making recommendations, particular from smaller rollovers. Similarly for IRAs, I think that there's a real risk that these rules would cause broker/dealers to be less likely to take on small IRAs, just a matter of complying with all the rules versus what kind of money you're going to make on them. I do think that there is a risk that the smaller accounts and 401(k) plans, the smaller accounts on the rollover side and the smaller accounts on IRAs could be less likely to get advice. Now, then the question becomes will there be services that step in to fill that void. I know of people out there who think that some of the robo advisory services for example might come in at a lower cost and be able to provide advice on smaller IRAs. I think that's probably true over time, but there could be a period of disruption, and some of the older people retiring today may not be that comfortable with technology and internet-based solutions. So, there would almost be some disruption at the lower end of the scale.

Matt Smith - Now, we turned to the recent news of President Trump's memorandum and how that changes the rule.

Ben Jones - We're recording this on Tuesday, February 7, and last Friday, the Trump administration released a directive that instructs the Department of Labor to examine the fiduciary rules to assess whether -- and I'm going to read this so I don't get it wrong -- whether it adversely affects Americans from gaining access to retirement information and advice. And furthermore, I think Sean Spicer went on to say at the press conference that the rule is a solution in search of a problem. So, for our audience, could you just explain what exactly this directive does?

Fred Reish - Well, you know, it's interesting. The directive was technically a memorandum. It was called a presidential memorandum, and in a way, it was a made-for-TV moment in the sense that an official looking piece of paper could be signed by the president while the TV

cameras were rolling, but it does nothing more than if the President, in the quiet of his office, had just picked up the phone, called the Department of Labor and said, would you guys take a closer look at this rule? And if you need to do -- if you need some time to do that, to make sure that it doesn't create some bad outcomes. If you need some time to do that then throw away the applicability date of the rule and that phone call would have had the exact same legal affect as the memorandum, the TV cameras, and the president's signature. So, I can't overstate how much it was the memorandum itself was more show than go, but regardless of whether it would have been a phone call or a memorandum, what it did was it told the Department of Labor to take a closer look at the fiduciary rule and the exemptions, and to determine whether or not either it increased the cost of advice to participants, IRA owners, or whether it limited the access of participants and IRA owners to investment advice. That though, simply punted the ball to the Department of Labor. So, any actual activity is actually going to be at the Department of Labor.

Ben Jones - Interesting. And so, I think there were a lot of people that speculated there was going to be this delay that was announced, and it was clear that in the directive there was no specific delay. So, in your opinion, delay, no delay, what do you think?

Fred Reish - Well, there was a draft of the memorandum that circulated the day before, and a lot of people wanted to jump the gun and get the news out there before other folks did. So, they wrote articles saying there's a six-month delay, and so half the world started thinking there was six-month delay, but of course when the final memo was signed, it didn't have anything about that in there, and so all those people who jumped the gun ended up with some egg on their face. Having said that though, shortly after the memo was signed in a coordinated event, the acting Secretary of the Department of Labor issued a statement that the Department of Labor would explore ways to delay the application of the rules so they could study it further. The rumor was that that was going to happen yesterday, and then the new rumor was that it was going to happen to today, and I'm sure by tonight there will be a rumor that it's going to happen tomorrow, but regardless of the rumors, I do think there will be some effort to delay the rule, and it could be one piece of guidance or it could be several pieces of guidance, but I think we're looking at a delay of at least 6 to 12 months or an effort to make a delay of at least 6 or 12 months. It'll take a while to study it. I mean, I'm not trying to take away from that. To do a really proper analysis, it will take six months to a year just to get that part done, and then once they decide what to do, assuming there are either some modifications or that they would get rid of the rule entirely, then that would take additional time after that, so we're in an extended wait and see period here.

Ben Jones - By the time you're listening to this, it's very possible that there will be new information that will have already come out maybe clarifying how long the delay will be and what the potential next steps are. The future of the rule also depends on the Department of Labor secretary. Trump's nominee of Andrew Puzder at the time of this recording had not yet even had a hearing yet, but it was confirmed on February 15th that Andrew has withdrawn his nomination for the Secretary of Labor. Fred and I discussed some possible scenarios for the future of the rule. So, let's just maybe play out two scenarios here. I mean, a lot of people have put a lot of work into complying with the rules and moving forward towards an April 10th date. What does the world look like if the rule is actually repealed and not enforced?

Fred Reish - It looks a lot like last year and the year before, but with some changes. What I mean by changes is that some of the broker/dealers in particular that have been working on compliance for the last year or more have realized that they actually like some of the changes that they've made, that in certain cases they prefer advised accounts over sold accounts. They prefer an account where they actively help the investor every year and they charge a 1% or a

1.25% fee per year rather than an account where they just sell the mutual fund that's got say a 5% first year load and a 25 basis point 12b-1 fee trail. And so some of them are going to stick to that model. I mean, there are business decisions being made right now that say that people are going to go forward with the model in certain cases. Not every case, but in certain cases as if the fiduciary rule were in effect. In another area, a lot of the work that's been done on rollovers, how you recommend rollovers or educate for rollovers, much of that's going to be retained. People forget that in 2013 FINRA issued regulatory notice 13-45 that effectively created a fiduciary-like process for making recommendations -- for broker/dealers making recommendations for participants to roll over to IRAs. And some of the broker/dealers are now looking at what they've done for compliance with a fiduciary rule and saying you know, we could take and modify this a little bit and it would be a great tool for complying with 13-45. So, I see much better practices, not universally, but in many cases, particularly for the more sophisticated organizations. I see better processes coming out for making recommendations that participants take rollovers.

Ben Jones - And so, in our second scenario, what does the future look like when or if the rule gets modified and maybe what parts might survive or perish as part of that?

Fred Reish - Two things are happening and you have to consider them together. One is major trend lines. The expectations for transparency, the importance of retirement benefits, the retirement of older people whose accounts were largely accumulated in a 401k plan. All of that's happening independent of all these rules and it's creating certain pressures. But I think if we do end up with a fiduciary rule and to a degree even if we don't, we're going to see greater expectations places on advisors both advisors and broker/dealers and on RIAs. Expectations that they're going to manage IRAs as if it was retirement money and not just a personal wealth account. Expectations that advisors are going to help people withdraw money from their IRAs in a way that the money will last for the lifetime of the investor. Expectations of transparency. I believe you'll see fee compression on mutual funds. I believe you'll see fee compression on annuities. I think you'll see fee compression on advisor's compensation. All of that suggests that, particularly the latter, that advisors need to be building business models that are consistent with retirement income and with working with a lot of retirees. That might include for example assistants, having compensated salaried assistants that can help people with their IRAs, help them answer questions such that the advisor's time can be spent the most profitably, training those assistants on minimum required distribution rules and on and on and on. I can see advisors specializing in retirement, not just in retirement plans. And that's going to be a big deal in the future. I mean America is growing very, very quickly and people are living longer and longer. So, if you have a 65 year old customer who is retiring today, that could be a client for 30 years. How are you going to help them navigate 30 years of investing, of withdrawals, maybe of Alzheimer's, or other diminished capacities? There's a whole challenge our there for advisors who want to embrace that opportunity.

Ben Jones - Fred, I get an opportunity to travel around the country and talk to a lot of advisors much like you and one of the things that I consistently hear is that they're all a bit still confused. And in fact, a lot of them are still waiting on final guidance from their BDs. Given the news last Friday and a potential delay, does this just create more confusion for those advisors and BDs, and maybe how do you recommend they talk to their clients or provide clarity to clients who are seeing some of this play out in the news.

Fred Reish - Actually, I think clients are probably the least engaged of anybody. Most clients trust their advisors and are happy and comfortable working with them. To the extent that their clients have any questions, I think I would -- it was okay with the broker/dealer or the RIA for

them to say this about an advisor, I would just say something like rules are changing and they'll keep the clients informed as they develop. Because the truth of the matter is nobody knows right now. We just know that we're in limbo. That's all we know. And I suspect that three to six months from now, that will probably still be all that we know. So, I wouldn't try overthink the issue. I would just say the rules are changing some. I'm with a great firm, my firm and I are in a position to comply with whatever the rule changes are. We'll keep you informed as things develop. But I would not make a big deal out of it.

Matt Smith - Whether it's delayed or repealed down the road, there's a period of uncertainty in the market. Ben asked Fred if this period of uncertainty provides a marketing opportunity for RIAs to get the word out about how they're conflict free.

Fred Reish - If I were an RIA, a pure level fee advisor, I would go to the client and say here's a list of five principals. I will only accept the fee that you pay me, I will not recommend any investments that are affiliated with me, I will not recommend any investments that pay me or my supervisory entity additional amounts of money. And then I would say this is my statement of principals. Whoever you talk to in addition to me, get them to sign this same statement of principals. And the last one, by the way, would be I will always put your interests first. And I get whoever is competing against me to sign that so that we're on a level playing field and so that you know there aren't conflicts of interest where they're going to have hidden fees and charges. I mean, I'm overstating the case a little bit, but that would be -- to me, that's the great competitive advantage of a level fee fiduciary or a level fee advisor is that you, by definition, have said I'm not going to play in the conflict of interest sandbox. I want to get out of that and promise clients that we'll never get back in. That to me is compelling. Now certain people that will matter a lot to, other people it won't, but at least for the folks that care you've positioned yourself properly.

Ben Jones - Wonderful. And you know whether it's delayed or repealed, is it really going to make a difference? Because the genie is kind of out of the bottle. Will future litigation drive most advisors to kind of a similar outcome anyways?

Fred Reish - Yeah, slowly but surely. I mean, the benefit of rules like this is that they will accelerate it. They're like throwing gasoline on the fire. They make it burn faster and brighter. But even without that, it seems if you look at what's going on today, that the trend is towards getting rid of conflicts of interest. The trend is towards full transparency. The trend is for being paid for the services you offer rather than the products you sell. So, I think while that's happening it will happen first with the largest, most sophisticated clients, and it will gradually work its way down to mid-size clients. I assume someday it will get to the smallest clients, but my crystal ball isn't that good.

Ben Jones - Fast forwarding into the future 10 years, are you and I still going to be talking about the conflict of interest rule?

Fred Reish - I'm afraid so. What I know we're going to be talking about is we're going to be talking about what's happening to older people, the people in their 70s, 80s, and 90s who have been taken advantage of by their financial advisors. I will guarantee you money that there will be articles in the business sections of every newspaper in the country about that. There will be stories on the Internet and on TV because it's such a dramatic event to show an older person who's had most of their money taken away from them. So, it will be highly publicized and underlying that will probably be a conflict of interest or where somebody recommended something that made them a lot more money even though it put the investor or the older person

in a bad position. So, I hate to say this, but I'm afraid that's the case, yes. We will be talking about it.

Ben Jones - Any predictions about kind of what's the next shoe to drop outside of the fiduciary rule?

Fred Reish - Yes, the only world I know a lot about now is the retirement world, and so I'm going to limit my comments to that. The SEC and its examination priorities for 2017 has already said it's going to focus on older retirees. Sales to retirees and advice to retirees. FINRA and the SEC in their examination priorities for 2017 have both said they're going to focus on elder abuse. Well, as 401k participants grow older and they get distributions out of their plans and that money sits in their IRAs, they become elder. I mean I think that IRAs, retirees, and elder abuse is all connected at the hip. And so I can see, not just for Department of Labor -- as a matter of fact, even more FINRA and the SEC focusing on elder abuse, retirees, and money and IRAs and how it’s being invested. We're really, I'd say, just at the beginning of this story even though we've been dealing with this fiduciary rule for five years. We're really just at the beginning of the story. There's going to be a drumbeat of this over the next 10 or 20 years.

Matt Smith - It will be interesting to see how the next chapter of this story unfolds as we find out more about the presidential memorandum and whether or not there will be changes to the rule. Fred left us with a thought about how fast these changes could take place.

Fred Reish - Well one of my favorite sayings is from Yogi Berra for those of you who are Yankee fans who are a little older. You'll know who I mean. I recently quoted Yogi Berra in a speech to young people and they had no idea who I was talking about or they thought it was the cartoon character. Yogi Berra said it's hard to make predictions, particularly about the future. And it is. The future is unknown and unknowable. But, I think what I said today is directionally correct. If anything, the mistake I make more often than not is I think things are going to happen faster than they actually do. So, I think by and large, these statements about the future will roll out in due course, but it could take a lot more time than I may have suggested in some of my answers.

Ben Jones - To hear more from Fred Reish you can subscribe to his blog or follow him on Twitter. You'll find both of those links in the show notes at bmogam.com/betterconversations. We want to thank Fred for his time on the show today. We really appreciated it.

Matt Smith - And thanks to our listeners for supporting this show. We'd love to hear what you thought on this topic or what topics you'd like covered in the future. You can e-mail us at betterconversations@bmo.com.

Ben Jones - Thanks to our team at BMO, which includes Pat Bordak, Gayle Gibson, and Matt Perry. And thanks to the team at Freedom Podcasting which includes Jonah Geil-Neufeld and Annie Fassler.

Ben Jones - Thanks for listening to Better conversations. Better outcomes. This podcast is presented by BMO Global Asset Management. To learn more about what BMO can do for you, go to bmogam.com/betterconversations.

Matt Smith - We hope you found something of value in today's episode, and if you did, we encourage you to subscribe to the show and leave us a rating and review on iTunes. And of

course the greatest compliment of all is if you tell your friends and coworkers to tune in. Until next time, I'm Matt Smith.

Ben Jones - And I'm Ben Jones. From all of us at BMO Global Asset Management, hoping you have a productive and wonderful week.

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