New Rules for Nest Egg Advisers

BY CHARLES GERENA

The shift from traditional pensions to defined contribution plans and IRAs has put more people in charge of their nest eggs. In response, IRA holders have turned to broker-dealers, insurance companies, pension consultants, and other firms for help.

Often, these advisers charge hefty fees over the life of the investment, and their staffs may receive commissions and other forms of compensation for recommending investment vehicles that may not give clients the biggest bang for their buck. As a result, savers may be earning 1 percentage point less annually than they would have otherwise, according to a 2015 estimate from the President's Council of Economic Advisers.

To address this potential misalignment of incentives, new rules from the U.S. Department of Labor (DOL), which go into full effect in January 2018, impose stricter standards of conduct on a broader array of retirement investment advisers. "We are putting in place a fundamental protection into the American retirement landscape," said Labor Secretary Thomas Perez when the rules were announced in April 2016. "A consumer's best interest must now come before an adviser's financial interest."

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Conflicts of interest are common in a market economy. For example, a real estate agent hired by a young couple looking for a cheap fixer-upper may instead steer them toward a newer, more expensive house he is trying to sell for another client. Or, a physician may send a patient for follow-up bloodwork at a diagnostic lab that she has a financial interest in.

"Societies rely on various devices to manage these conflicts," wrote Joel Demski, an emeritus professor at the University of Florida and accounting researcher, in a 2003 article in the *Journal of Economic Perspectives*. "Some activities are prohibited, such as an auditor engaged with an explicit pay-for-performance contract, while at other times, we rely on disclosure of relationships."

The DOL's new rules take both of these approaches. First, if a bank, broker-dealer, or insurer is paid for recommending an investment, the firm is considered a "fiduciary investment adviser." Such firms can continue to benefit from commissions, revenue sharing arrangements, and other forms of compensation as long as the pay is deemed "reasonable."

In addition, they must adhere to standards of conduct defined under the Employee Retirement Income Security Act of 1974 for pension and health plan administrators. These tougher standards are aimed at ensuring that investment advice is impartial and in the best interest of customers. For example, currently brokers are only required to recommend products that are "suitable" for an investor's needs or risk tolerance, even when there are conflicts of interest at play.

Second, fiduciaries will be obligated to acknowledge their status and the status of their employees. They will also have to disclose material conflicts of interest and document their adherence to the standards of conduct.

There has been a lot of discussion about how the DOL's rules will affect the retirement investment industry. What about the broker who volunteers to provide general information on saving for retirement at a Rotary Club meeting? Such communications may be considered "educational" and not a recommendation.

As for their impact on individuals planning for their golden years, the rules may prompt some retirement investment advisers to move their clients from commission-based accounts to accounts that charge an ongoing flat fee based on the size of assets invested. This has already been happening. In 2014, 35 percent of the average adviser's assets under management were in accounts that charged a flat fee, according to PriceMetrix, up from 26 percent in 2011. The problem is such fee-based accounts may turn out to be more expensive for savers who are in it for the long haul and rarely make changes to their portfolios.

Worse, savers with only small accounts may be dropped as clients by investment advisers. A recent report by Morningstar predicted that many of these people will turn to lower-cost ways to manage their retirement savings, such as index-based funds and online investment services (known as "robo-advisers") that use algorithms to create an investment portfolio automatically.

The net effects of the DOL's rules, for the companies that provide advice and for the clients they serve, are unknown. But they will certainly ripple through the financial services industry.

It's no wonder that a multitude of industry participants and groups — including the Securities Industry and Financial Markets Association and the National Association of Insurance and Financial Advisors — have filed lawsuits to block implementation of the DOL's new rules. In addition, a bill introduced by Rep. Jeb Hensarling, R-Texas, in September 2016, the Financial CHOICE Act, would reverse the rules. **EF**