The Department of Labor Fiduciary Rule:

Why it won't Benefit Everyone Involved

By: Erik Dartsch

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Dr. David Carter, First Reader

Stephen Hull, Second Reader

Cindy Lane, Honors College Advisor

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Abstract

Erik Dartsch, Finance
Dr. David Carter, First Reader
Stephen Hull, Second Reader

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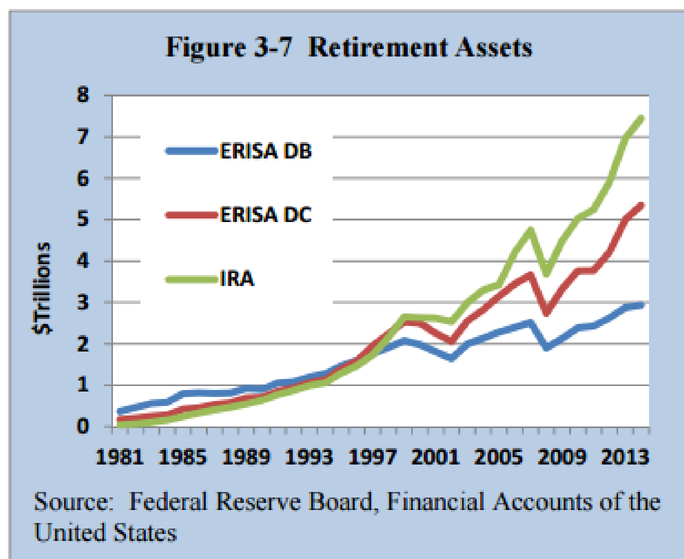
In April of 2016 the Department of Labor implemented a new rule that will affect millions of Americans. The goal of this rule is to protect middle class investors from unnecessary investment fees and to save retirement investors billions of dollars a year. The goal of the rule has very good intentions however it will not benefit everyone. The rule is very complex and will impact the investment management industry indefinitely. The primary change the rule brings is the requirement for financial advisors to have a fiduciary relationship with their clients. Through research and analysis the impact of this rule can be concluded on both a qualitative and quantitative level. As with any reform there are almost always consequences, and the Department of Labor Fiduciary ruling is no different.

Introduction

On April 8th, 2016 the Employee Benefits Security Administration, an agency under the Department of Labor, implemented a new rule that will have a major impact on the financial industry. According to the Department of Labor the rule is intended to “address conflicts of interest in retirement advice, saving middle-class families billions of dollars a year”. My aim is to determine the actual outcome of this major new ruling by weighing the pros and cons and assessing who will be the “winners” and who will be the “losers”. As with any major rule change, people in all different categories who will be affected are concerned and apprehensive about what is to come.

To assess and analyze the implications of the rule it is vital to understand the content of the rule and why it was created and eventually implemented. Over the last 40 years, ERISA (Employee Retirement Income Security Act) has served as the core mechanism to protect Americans retirement savings. Since 1974, when ERISA was enacted, much has changed in the financial services industry. “When the basic rules governing retirement investment advice were created in 1975, 401(k) plans did not exist and IRA’s (Individual Retirement Accounts) had just been authorized” according to the Employee Benefits Security Administration. Today, 401(k)’s and IRA’s make up a large portion of invested assets in the United States.



Source: Federal Reserve Board, Financial Accounts of the United States

Figure 3-7 demonstrates how IRA's have become the largest portion of retirement assets over the last 30 years. The ERISA DB and DC depicted on the graph are referring to defined benefit and defined contribution plans that are/were required to be governed by the ERISA act. In the last twenty years, employers have shifted their retirement benefits from defined benefit and defined contribution plans to 401 (k)'s. This large change in the composition of investment assets created a large need for new governance, as IRA's and 401(k)'s were hardly addressed in the ERISA act. Looking forward, the amount of defined benefit and defined contribution plans are only going to decrease over time as nearly every private company has removed them. Overall this means there is more responsibility on the employee to ensure they are saving enough and investing responsibly in order to retire comfortably.

The change in the retirement asset landscape has led to a situation where millions of Americans with 401(k)'s and IRA's have sought advice from financial advisors. Because the management of IRA's and 401(k)'s has been relatively unregulated, the Department of Labor decided to put measures in place to ensure that the retirement assets of individual investors were being protected. The main component of the new rule that will have the greatest impact on the industry and investors is the portion requiring all financial advisors to have a fiduciary agreement with their clients, in relation to their retirement assets. The fiduciary agreement is intended to remove any conflict of interest, to ensure advisors are only acting in their clients' best interest.

Because of the rapid increase in IRA's and 401(k)'s, the DOL has looked at how other countries have implemented similar regulatory changes. Figure 2-3 shows developed nations that have made significant regulatory changes in relation to retirement assets in recent years.

Figure 2-3 Reform Abroad	
Country	**Description**
Australia	Banned payments from product providers and conflicted remuneration payments for retail investments and created a statutory duty for advisors to act in the best interest of their clients.
Canada	New regulations, implementation of which began in 2014, require much greater transparency about the direct and indirect costs to the client for each account and details on advisor compensation by clients and product providers.
India	Banned all front loads for mutual fund products beginning in 2009. Implemented heightened requirements to disclose the value and justification for any commission payments to advisors.
Italy	Banned commissions for discretionary portfolio management services beginning in 2007.
Germany	Increased disclosures about the cost of advice and whether the advisors are compensated solely through client fees or by payments from service providers.
The Netherlands	Banned all payments by a product issuer to an advisor relating to advice beginning in 2013. The ban applies to investment, insurance, and mortgage protection (annuity) products.
United Kingdom	Banned conflicted payments, increased education and credential standards, and required advisors to disclose whether they make recommendations from a restricted menu of products or across all products beginning in 2013.

Many supporters of the new rule believe that in many ways the U.S. has actually been behind in terms of regulating the management of individual retirement assets. However, having several countries implement new rules before the U.S. has allowed the Department of Labor to assess alternatives and the impact those rules have had on other countries.

The DOL specifically spent a considerable amount of time analyzing the effects of the United Kingdom's regulatory changes under the RDR (Retail Distribution Review) which was enacted by the FCA (Financial Conduct Authority). The United Kingdom's regulatory reform was much more extensive compared to the DOL's rule, in that it banned commissions for all investment accounts, not just retirement accounts. According to the Department of Labor, "Early evidence from the UK indicates that regulatory changes that ban commissions entirely have not resulted in consumers being abandoned by their financial advisers … despite a small reduction in adviser numbers, firms have adapted successfully to the post-RDR world."

The U.K. is a good country to compare to because of its similar demographic and economic state. It is reassuring that the U.K. saw an overall positive outcome after the implementation of new regulations. The fact that the U.K. placed more invasive regulations and it still worked is encouraging that the U.S. will experience the same success after the fiduciary ruling is fully implemented.

The conflict of interest issue has been an area of concern for some time because of the commission based compensation structure for financial advisors. Traditionally financial advisors have been compensated for making transactions (buying and selling investment products) as well as providing advice. The new fiduciary rule will not allow advisors to earn compensation by making transactions in retirement accounts. The idea is that in the past advisors could have been making investment decisions for their clients to generate profits for themselves without consideration of the client's best interest. Instead, under the new rule, advisors will have to be compensated for their advice, generally in the form of an annual fee. This means that whether an advisor makes 100 trades or none, their compensation will be same. In turn, compelling advisors to make investment decisions that are only in their clients' best interest to ensure they are able to retain current clients and attract new ones.

More important than that, is the simple fact, that if advisor's only incentive is to accumulate personal wealth, they will have to do so for their clients in order to earn more money. The fiduciary relationship aligns the clients' and the advisors' goals because of the compensation structure. The new fee structure for advisors will be based on the total value of their clients' accounts. For example, if the advisor charges a 1% fee they would earn $1,000 per year if the account is worth $100,000 or $10,000 per year if the account is worth $1,000,000. The

compensation structure incentivizes advisors to do everything they can to help their clients' accounts grow because it will directly affect their compensation.

Impact

This new ruling will have a major impact on several different groups of people in different ways. Some groups will be positively affected while others will be less fortunate. Analyzing the effect this rule will have on each group will help determine the net impact that this rule will have. The groups that will be most affected are as follows; Large firms, Traditional Investors, Passive Investors, Accredited Investors, Small firms, and Financial Advisors. Each of these groups will be affected in unique ways that contribute to the overall impact of the rule.

The new regulations from the ruling will go into effect in April of 2017, leaving roughly 12 months for firms and investors to prepare for the change. Most firms have issued press releases on the matter in an attempt to demonstrate they are preparing and also to start educating clients about the rule change. Most Americans are largely unfamiliar with the specifics of the rule, so educating investors is a vital step that needs to be taken in preparation for the new changes to come.

First I will examine the effect this new rule will have on those it was intended to benefit the most, traditional investors. I would consider a traditional investor to be anyone who is employed or self-employed that regularly contributes to a retirement investment account. Traditional investors often contribute to regular taxable investment accounts as well; however this rule will have little impact on those accounts.

For the traditional investor, the new DOL ruling will have a positive effect for a few reasons. The main reason being the fiduciary relationship which directly affects the costs

associated with investing retirement assets. The fiduciary relationship should, in theory, ensure that investors are receiving advice that is in their best interest at all times. This higher standard of the legal relationship between the client and advisor should have a positive impact on the investors' returns and overall satisfaction with their investment experience. The fiduciary standard will improve the traditional investors experience as the advisor will be required to have a much better understanding of the client's risk tolerance, goals, and time horizon. By having a better understanding of these three components, advisors will be better prepared to make investment decisions that are in the best interest of the client.

The next added benefit to traditional investors would be the cost component, which overall affects total return. The fee-based compensation structure will allow advisors to make transactions on behalf of their clients without incurring additional costs for the client. The DOL has conducted extensive research on this matter and has come up with actual dollar figures to show the impact this will have. Figure D-1 shows the data that the DOL has provided in regards to the partial gains investors would have once the rule is in place.

Figure D-1 Partial Gains to Investors and Compliance Costs Accounting Table

Category	Primary Estimate	Low Estimate	High Estimate	Year Dollar	Discount Rate	Period Covered
	Partial Gains to Investors (Includes Benefits and Transfers)					
Annualized	$3,420	$3,105		2016	7%	April 2017-April 2027
Monetized ($millions/year)	$4,203	$3,814		2016	3%	April 2017-April 2027

It is clear that annualized additional gains between $3.1 billion and $3.4 billion for investors would have a substantial positive impact. The DOL calculated these numbers by assessing several different areas in which investors would benefit under the new rule.

There is also one more aspect that benefits the traditional investor, which is legal recourse. With the fiduciary standard in place, investors will have much more power legally, to hold their advisors accountable when they don’t believe they were acting in their best interest. Obviously, the goal is not to have millions of investors suing their advisors, rather it provides more incentive for advisors to ensure they are doing everything they can to act in the best interest of their clients.

Overall the fiduciary rule will have a positive impact on the traditional investor when all aspects are considered. The fiduciary relationship, higher returns, and legal recourse will allow the majority of retirement investors to be more protected, earn more on their investments, and be treated more fairly.

The next group that would be most affected by the new rule would be large firms. For simplicity, the term firm will refer to any broker-dealer, bank, or asset manager that provides advisory services. The new DOL ruling will require major changes in the financial industry and with large changes come large costs. Most financial services firms have already spent millions of dollars preparing for the new change by implementing new procedures, product offerings, and compensation structures. The Securities Industry and Financial Markets Association (SIFMA) and the Financial Services Institute (FSI) spent time with financial services firms all over the country to see how much this rule change would cost for firms to implement and manage over time.

Large firms would incur the most costs but they are also the most equipped to handle major cost increases. SIFMA and FSI determined that the largest costs related to the new rule requirements would be in the following categories: data collection, modeling future returns and

costs, disclosure requirements, record keeping, implementing BICE contracts, training and licensing, supervisory, compliance, and legal oversight, and litigation. Figure 5-2 and 5-3 represent the start-up and ongoing costs for firms per SIFMA and FSI's research.

Figure 5-2 Start-up Costs Using Updated Number of Firms

Firm Size Category	# of Firms	SIFMA		FSI	
		Per Firm Average Costs	Total Costs	Per Firm Average Costs	Total Costs
	(a)	(b)	(c)	(d)	(e)
Large BD	42	$38,100,000	$1,600,200,000	$16,266,000	$683,172,000
Medium BD	147	$23,100,000	$3,395,700,000	$3,350,000	$492,450,000
Small BD	2,320	NA	NA	$1,118,000	$2,593,760,000
Total	2,509		$4,995,900,000		$3,769,382,000

Figure 5-3 Ongoing Costs Using Updated Number of Firms

Firm Size Category	# of Firms	SIFMA		FSI (DOL Estimated)	
	(a)	(b)	(c)	(d)	(e)
		Per Firm Average Costs	Total Costs	Per Firm Average Costs	Total Costs
Large BD	42	$9,500,000	$399,000,000	$4,055,827	$170,344,724
Medium BD	147	$5,000,000	$735,000,000	$725,108	$106,590,909
Small BD	2,320	NA	NA	$241,991	$561,419,913
Total	2,509		$1,134,000,000		$838,355,547

Their research indicates that the new rule would cost the industry between $3.7 billion and $4.9 billion for start-up costs and between $.8 billion and $1.1 billion for ongoing costs. Besides increased costs, there are also two other factors large firms will have to consider under the rules new requirements. As stated earlier, the rule will increase the legal responsibility of firms, thereby increasing their liability. Lawsuits can have a negative impact on firms in two main ways; costs and public image. Lawsuits by their nature are costly, regardless of the result. The suit being brought, can greatly damage the reputation of the firm. As the current environment of financial services industry is heavily under scrutiny, increase in regulations will further expose the industry to mistakes and wrongdoing.

The last impact I will address in regards to large firms is the opportunity for growth. As these rules get implemented many smaller firms will be forced to close or seek acquisition.

Because large firms have the capacity to manage the large costs associated with new requirements it is likely there will be many opportunities to acquire smaller firms and expand their business.

It is somewhat difficult to determine the net impact this rule will have on large firms but overall my research indicates that it will be positive in the long run. In the short term there will many issues and problems to address. Once the new procedures are in place, the large firms will be well suited to handle the new regulations. The controversial aspect related to large firms is the potential expansion they will see as the investment management industry becomes more consolidated due to higher barriers of entry and higher operating costs. Many Americans don't like the idea of their being only a few very large firms that control the majority of retirement assets, however the new regulations will force the industry to consolidate.

Accredited investors are one group that may not benefit from the new rule change. According to the Securities Exchange Commission an accredited investor is someone who earns $200,000 a year (or $300,000 in joint income) or has a net worth in excess of $1 million and has high level of financial sophistication and the ability to sustain the risk loss of an investment. This group of investors is quite small in relation to the total amount of American investors however they obtain a large portion retirement assets.

There are many investment products that are only available to accredited investors, largely because of the risk associated with them. These investment vehicles generally have individual costs associated with them because of the nature of the investment. Under the new rule, there cannot be costs to the investor associated with individual investments in regards to

retirement assets. This would limit accredited investors from using their tax-deferred retirement assets in these types of investments.

Overall the new DOL rule will have a negative impact on accredited investors as they will be forced to move their retirement assets into taxable accounts if they want access to more sophisticated investment vehicles. There are very few investors in the U.S. that are considered accredited so although it will not benefit them directly, it will only affect a small portion of the population. It is also important to keep in mind that the goal of this rule was to help those in the middle class saving for retirement.

Passive retirement investors are another category that needs to be addressed. There are millions of investors who have their IRA's in a transaction-based account because it is already in their best interest. It is in their best interest because these investors make very few transactions in their account. For example, I have personally encountered several investors nearing retirement that have IRA's with holdings that they rarely change; it might be a group of mutual funds or blue chip dividend paying stocks. Either way, they are not buying or selling in their account. For the investor, this means they have very low costs because of the low trading volume. If they were forced to move to a fee based structure, it is likely many investors would actually pay more.

There are some exclusions in place that would benefit this group, however these exclusions are very limited in nature. Some firms have allowed their clients to "grandfather" their accounts, with the understanding that no changes in the account can be made outside of regular re-occurring activity such as consistently monthly deposits. If a transaction is made in a grandfathered account after April 2017, the account would have to transition to a fee based advisory account.

The opposing argument to this issue is that if an advisor is acting in their clients' best interest that they should not keep a retirement account stagnant. Like accredited investors, this will only impact a relatively small group of people and in some ways in could benefit them in the long run. It is likely that these passive retirement investors will yield higher returns if their advisors are actively managing their accounts by rebalancing portfolios and ensuring their holdings are sufficiently diversified.

Small firms are probably the group that will get hit the hardest due to the rule change. Although SIFMA and the FSI found it difficult to accurately estimate the cost burden of meeting the new requirements it is quite clear that the impact would be dramatic. Small firms vary in size drastically, the ones on the smaller size of the spectrum would likely be forced to close their doors or seek acquisition from a large firm, as mentioned earlier. It's unfortunate but it is a reality.

Small firms would not be able to afford the compliance costs nor hold the increased liability. It has also been projected that the new rule will significantly reduce the number of financial advisors in the U.S., largely those who are owners of, or advisors for, small firms. On the issue of the new DOL rule, CEO of Ameriprise said "The regulatory environment will likely lead to consolidation within the industry, which we already see. Independent advisers or independent broker-dealers may lack the resources or the scale to navigate the changes required."

Overall there will be a substantial negative impact on small firms. It is likely that small local broker-dealers will have to close their doors. Fortunately, although there are a lot of small firms, they do not control a large portion of the investment assets in the United States.

The last major group that will be affected directly are financial advisors. It is quite difficult to determine whether this rule change will have a positive or negative on advisors because there are advantages and disadvantages associated with the new rule. There are two factors that have advisors most concerned; compensation structure and increased liability. There are definitely advantages and disadvantages to the new compensation structure.

There is no real benefit for the advisors in terms of the increased liability as it will just make them more vulnerable to law suits over time. However, with the increased liability should come increased trust with clients, because they will be legally obligated to act in their best interest. In that respect, it could help financial advisors businesses, making it easier to attract and retain clients.

Another point to consider in regards to this group is how this will affect existing advisors versus new advisors that will enter the field in the years to come. Existing advisors will likely see this new rule as more of a disadvantage for a few reasons. First, existing advisors are having to make major changes to their practices in order to meet the new regulations, while new advisors will already be prepared and equipped to handle the new regulations. Second, existing advisors who are compensated mostly from commissions might find it difficult to earn the same amount of money when switching to a predominantly fee based compensation structure. Lastly, existing advisors who had not already had a fiduciary relationship with their clients might be ridiculed for not doing so in the first place.

I would conclude that this new rule change will be detrimental for existing advisors but beneficial for new advisors. It would be detrimental for existing advisors for the reasons I have mentioned above. New advisors on the other hand will likely have more credibility starting out

with the fiduciary standard in place and they will also be accustomed to a fee-based structure if they start out with it.

Conclusion

To summarize the impact on the groups listed above, the winners are traditional investors, new advisors, and large firms, while the losers are accredited investors, small firms, existing advisors, and passive investors. From a proportional aspect, the number of people in the category of traditional investors, large firms, and new advisors far outweighs those in the losing category.

Through thorough research and analysis it would appear that the new DOL fiduciary ruling will have an overall positive impact on those it was intended to benefit. From a quantitative view it is estimated that investors will gain between $3.1 billion and $3.4 billion per year from the rule and the industry will incur costs of anywhere between $.8 billion and $1.1 billion per year. Overall this results in a net positive cash flow of somewhere between $2 billion and $2.6 billion per year, which is substantial. The initial startup costs to meet the new regulations will have a negative impact on the financial services industry, but over time those costs will decrease. On a qualitative level, the new ruling will help rebuild trust with the financial services industry and better protect retirement investors from over paying for investment services and advice. The department of labor had a very difficult task regarding a very complex industry. I believe that they have managed to create a rule that will accomplish what they set out to do.

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