Hello from the other side: recent echo of U.S. fiduciary standard

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For obvious reasons, the DOL fiduciary rule has captured the U.S. advisory industry's attention since the final rule was rolled out in April 2016. But, the rule is not the first of its kind. A series of nearly identical rules have unfolded in advisory markets around the world: the Canadian Client Relationship Model, the Australian Future of Financial Advice, the U.K. Retail Distribution Review (RDR), for instance. This paper focuses on lessons the U.S. advisory industry can learn from their British brethren about "life after the rule." And yes, there is life there.

Economic motivations for the RDR and DOL fiduciary rules

In both the U.S. and the U.K., the fiduciary rule was intended to cause more consumer-directed assets to move into retirement accounts and to improve the likelihood that those assets would grow sufficiently to keep the middle class from slipping into the lower class in retirement.

In many ways, the rules revealed that the "penny had finally dropped" for the government regarding the implications of the potentially catastrophic retirement savings shortfalls of individual citizens: the proportion of consumers' future spending covered by public and corporate pensions is inadequate; simultaneously, lifespans are longer now and often characterized by heavy doses of inflationary health care costs, especially in the last stage of life. (The latter being especially problematic in the U.S.) The large numbers of indigent elderly might be inhumane, but, worse, it is economically counterproductive for government. Correcting this was the common structural economic objective.

Both governments recognized that if they did not intervene, ultimately, they would be forced to step in as safety net of last resort, or face the obvious political consequences. The urgency in the U.S. was in some ways felt more acutely, given that the U.S. retirement market is historically heavily dependent on investor-driven effort than the (more "socialist") U.K. retirement savings model.

That said, Americans, broadly speaking, have a general distrust of government and, no matter how much reality tells them to believe otherwise, they suppose they will be financially successful and, hence, don't need paternalism to interfere with their financial optionality. The reality, however, is that U.S. investors – and the U.S. government – need retirement savings to work harder for investors than is the case in the U.K., where structural differences may mitigate some of that individual funding need. Regardless, the U.K. reform has survived several prime ministers and it is likely that the DOL rule will also prevail across leadership changes in Washington.

Accomplishing this core objective relies on two strategies:

1. more saving; and

2. more productivity of those saved dollars.

Equating the solution with low cost (passive) products has been presented as a means to this second end. It is a happy coincidence for passive providers that during this period, the most visible part of active management—U.S. large cap equity—profoundly underperformed.[1] Moreover, the flagship innovation in passive products, ETFs, had fewer of the transparency problems (12b-1 fees in the U.S., baroque retrocession structures in the U.K.).

Political motivations for the RDR and DOL fiduciary rule

The political motivation for the rules centers on consumer protection from predatory practices. The political face of the rules became untrustworthiness: The brokerage, asset management, and Defined Contribution platform providers have been cast in the roles of clever parasites interacting to dupe naive investors.

In the U.K., this stemmed from a series of insurance scandals (the British middle class relies on pension wrappers—basically like variable annuities), which were routinely sold with substantial loads. Client accounts were regularly churned. Very little advice accompanied the sales of these products, many failed and lawsuits were common. If that wasn't bad enough, proprietary products were standard, as were compensation structures that benefited them. The tied sales forces were known to score lower than second hand car salesmen on trust surveys.

Whether the practices were predatory or not can, and was, debated; the fact that mistrust of the industry weakens enthusiasm to contribute to retirement plans, cannot! The analog to this in the U.S. was not so much predatory selling, churning, or proprietary product as it was a perception that the current retirement system was rigged against the individual investor:

- Wealth distribution from retirement savers to advisors in the form of fees, especially at the moment of an individual retirement account (IRA) roll-over;
- Conflicted incentives that resulted in sub-optimal choices/recommendations by advisors;
- High costs for active management relative to (most) passive product alternatives.

Ultimately, the opaque fees and fee-sharing arrangements—which the DOL correctly (in our opinion) characterizes as a hidden tax on consumers' retirement investments—engendered distrust, reducing contributions and participation rates. Hence, the DOL's focus now on "share class reform."

While the catalysts and culprits were slightly different in the U.S. and in the U.K., the political argument in both cases was identical: Consumers need to be shielded, the industry needed reform. Self-regulatory bodies had failed to stand up to revenue pressure. In our view, the DOL's early drafts of the rule got a lot wrong—much of which was improved later but they were not wrong in the fundamental definition of the predicament.

Fall-out from the U.K. RDR: potential parallels for the U.S. advisory industry?

The RDR reshaped the business in the U.K. and its new profile has, in Russell Investments' opinion, three important attributes that may be echoed to some degree in the U.S.

1. The population of advisors is smaller.
The data is imperfect but the estimated high watermark of the U.K. IFA population prior to RDR was as high as 40,000 advisors at the end of 2011.[2] By the time the rule came into effect on January 1, 2013, the headcount had reportedly already dropped to approximately 31,000.[3] Headcount estimates two years post-RDR ranged around 20,000.[4] However, some of the pre-RDR estimates overstate the actual population due to a cultural trait: many of

[1] Only 17% of the actively-managed mutual funds included in the Morningstar U.S. Large Blend Category outperformed the Russell 1000® Index for the five years ending December 2016.

[2] Source: Cass Business School, City University London, "The Impact of the RDR on the UK's Market for Financial Advice: Challenge and opportunity," June 2013.

[3] Source: Cass Business School, City University London, "The Impact of the RDR on the UK's Market for Financial Advice: Challenge and opportunity," June 2013.

[4] Financial Advice Network, "RDR two years on- How has it affected advisers?" 14 January 2015.

these advisors worked “part time.” Additionally, some advisors have also succumbed to technological and competitive forces that occurred simultaneously—though not because of—the RDR. A more believable estimate in the total population reduction due to RDR is roughly 25-30%. The decline was felt most strongly among advisors working at banks.[5]

Attrition in the U.S. could be within a similar range. Fidelity reported in a September 2016 survey of U.S. advisors[6] that 10% of respondents said they are planning to leave or retire from the field earlier than they expected because of the rule. Another 18% of respondents said they are “reconsidering their career as advisors.” In sum, that means a staggering 28% of advisors are considering exiting the industry. By some accounts that estimate may in fact be conservative, though, because it doesn’t include those advisors who may simply fail to adapt appropriately and will be forced out of the industry. It’s reasonable to assume that bank and broker-dealer advisors will be harder hit by attrition than the RIA space, given that they face a larger change in the post-DOL world.

2. Younger, more planning-oriented advisors.
Like the DOL rule, the RDR is a principle-based rule and has raised the level of disclosure requirements for advisors. Unlike the DOL rule, the RDR raised the minimum professional qualification level of advisors. Older and part-time advisors bailed out to avoid retraining. This has skewed the remaining population to be younger, more competent. In fact, within two years of the rule taking effect, about one quarter of U.K. advisors reportedly had attained qualifications levels that surpassed the minimum requirements.[7]

Planners are typically attracted to process efficiency, are more systematic, more investment literate and more skeptical of asset managers. On balance, they are more receptive to outsourcing portfolio construction and are more technology-oriented. Those drawn to efficiency are often attracted to low priced products. In the U.K., flows into high-cost investments shrank after RDR was implemented, with lower fee products experiencing more inflows.[8]

3. More team-oriented and networked.
Like the RIA market in the U.S., many of the most successful advisors in the post-RDR world in the U.K. now work in teams, whether actual or virtual.[9] That's the good news. The not so good news is that both the U.S. and U.K. markets have shortages of incoming advisors—and younger advisors demand more. This is classic wage inflation and will have the effect of reducing the profitability of advisory practices. That said, it does not appear that the unbundling of fees and retrocessions in the U.K. caused advisor compensation to suffer in the post-RDR world.

4. The “advice gap” is a myth.
As is now the case in the U.S., industry observers feared that the introduction of the RDR in the U.K. would create an “advice gap,” especially for investors on the lower end of the wealth spectrum as a result of advisor attrition, advisors “firing” smaller/unprofitable clients, or clients “firing” their advisor because of the new fee arrangements.

To the extent that such a gap emerged following the RDR, it has been very small. We expect the same outcome to hold true in the U.S. because firms will likely find a way to sell smaller clients their advisory product for a fee that is reasonable to the services rendered. These advisors are likely to either:

- Rely on technology—like robo to automate fact finding, allocation, trading and monitoring;
- Rely on advice-embedded products—like target date funds or models; or
- Provide advice on a one-time basis for a fee (basically, acknowledging they are selling a product, albeit with the recognition that the product is in their best interest, that the fees are reasonable, etc.).

[5] Source: Financial Advice Network, “RDR two years on- How has it affected advisers?” 14 January 2015.

[6] Source: Fidelity Investments. “Number of Financial Advisors Who See Opportunity in the DOL Investment Advice Rule More Than Doubles, According to Fidelity—Conversely, the Rule is Prompting 10 Percent of Advisors to Consider Exiting the Business.” September 26, 2016

[7] Source: Europe Economics: Retail Distribution Review: Post-Implementation Review,” 16 December 2014.

[8] Source: Financial Services Board, “Retail Distribution Review: Discovery Financial Planning Summit,” 19 May 2015.

[9] Source: Cass Business School, City University London, “The Impact of the RDR on the UK’s Market for Financial Advice: Challenge and opportunity,” June 2013

How might the U.S. experience diverge from the U.K. RDR aftermath?

Although there are several similarities between the U.K. and U.S. rule, the societal environment and competitive landscapes they are being applied to will cause some divergent outcomes.

1. More litigation and private right of action

Although the RDR and DOL rules both mandate increased disclosures by advisors, the U.S. requirements are based on not omitting anything that could be "material" to an investor's understanding. Under the DOL rule this extends to documenting reasons for choosing one product or account type over another, all of which can be requested by the client or a regulator.

In addition, because the U.S. is such a litigious society and because the DOL rule relies heavily on private right of action to regulate behavior (increase the right in the full BIC), that risk of litigation could drive excessive disclosure until the DOL prescribes best practices in future guidance. Anecdotal evidence suggests that some plaintiff's firms are building out new teams to handle lawsuits in this area.

2. Greater pressure to reduce fees

Even before the DOL rule was introduced, the advisory industry was facing mounting pressure to reduce fees. Robo-advisors (e.g., standalone firms like Betterment, and robos within firms like Schwab, Vanguard, TD) and low-cost passive providers (which have far greater penetration in the U.S. than they do in the U.K.) had already begun forcing some amount of transparency regarding fees. The DOL rule is adding fuel to that fire by calling out 12b-1 fees and revenue sharing agreements as conflicted payments. In addition, the SEC has been scrutinizing "distribution in guise" payments. All of this could potentially play into attrition among U.S. advisors.

In contrast, the RDR rule didn't eliminate existing fees—they "simply" changed the nature of the fees and required advisors to disclose them to clients. Also, robo-advisors and passive providers are not nearly as entrenched in the U.K. market as they are in the U.S.—especially when the RDR first came out.

3. Product consolidation

It's unclear how much product consolidation has been observed following the introduction of the RDR in the U.K. However, movement in that direction is already afoot in the U.S. at a firm/home office level, with many broker-dealer firms talking about reducing shelf-space and placing restrictions on advisors' ability to make investments in off-platform products.[10]

The bottom line

Will all this be a headwind or a tailwind? We believe the DOL rule will have more positive than negative consequences – but the difference between riding the wave or getting capsized depends on how successful advisors are in positioning compound products as efficient client outcome solutions. Advisors urgently need help operationalizing new working models that ascend to the standard of fiduciary best practice.

[10] Source: Ignites, "Merrill to Start Second Round of Product Cuts," June 27, 2017. "Endangered Species: Trillions in Subpar Funds Face Extinction," March 24, 2017. "Shrinking Shelf Space Amplifies Pressure on Product Teams," June 26, 2017.

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