NOV 8, 2016

THE FIDUCIARY STANDARD: ACT II The code of conduct for which investors should shop

by

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Jack Bogle—founder of Vanguard and a man whose opinion I have respected for years—says the fiduciary rule recently passed by the Department of Labor for advice on retirement assets will expand to non-retirement assets soon. Mr. Bogle states, “As a practical matter, I can’t imagine brokers serving their nonretirement-plan clients with a lower standard of duty and care than their retirement-plan clients. How could they possibly defend such action?”

Views expressed in this column echo Bogle’s sentiments. Announced in April of this year and scheduled to go into effect in April 2017, the DOL’s rule focuses on an adviser’s fiduciary duty to put the client’s best interest ahead of the adviser’s own. Industry observers expect the rule to reduce fees on mutual funds and to encourage advisers to employ more bargain-basement Exchange Traded Funds (ETFs)—a win-win for investors.

ETFs are not only more cost efficient than traditional mutual funds, but they also represent a passive investment strategy as opposed to an active strategy employed by traditional mutual funds. Academic studies consistently show passive investing outperforms active investing over the long-term on a risk-adjusted basis. Data clearly show a shift away from mutual funds toward ETFs in the marketplace. The implication is traditional mutual funds benefit the adviser at the expense of the investor.

The Wall Street Journal opines the DOL rule will kill the commission model for middle-income investors. A few big brokerage firms, including Charles Schwab and Edward Jones, already have stated their intention to stop selling commission-base mutual funds. Stockbrokers employ the commission model, whereas registered investment advisers employ a fee-based model.

The macroeconomic view is clear. A fair game in the securities market encourages the transfer of funds from investors to private-sector enterprises that need growth capital. An unfair game—or one that benefits Wall Street at the expense of Main Street—deprives businesses of adequate growth capital. Such deprivation hinders employment and productivity.

It’s perplexing as to why it has taken so long for the US capitalistic system to respond to this unfair game. Ultimately, the invisible hand of capitalism will define boundaries of the game as informed investors vote with their feet. The hurdle is education.
The DOL is fighting lawsuits in several courts to halt the rule. These suits come from

those who benefit from excessive fees. Recently, opponents to the rule were handed a severe setback with the Wells Fargo consumer fraud case. The gigantic bank was hit with penalties of $190 million and damages of $5 million to customers who regulators say were placed in fee-generating accounts they did not request. The bank, ultimately, fired 5,300 employees connected with the matter.

Wells Fargo's misbehavior is an example of a large financial institution creating an environment of incentives contrary to the best interests of its clients. But Wells Fargo is not alone. The list of big-bank misdeeds and penalties paid is shocking. Since the financial crisis of 2008, the six largest US banks collectively have incurred more than $100 billion in legal costs—and those costs are continually increasing.

I would not be surprised if this topic's confusing. Briefly, the issue is: Who is a fiduciary when giving financial advice and what is that person's responsibility in giving such advice? The easiest and most direct way to deal with this issue is to ask an adviser if he/she subscribes to the fiduciary standard of conduct. I have mentioned this before, but it bears repeating. Hopefully, the adviser will say he/she is a fiduciary whether giving advice regarding retirement or non-retirement accounts.

If the response is convoluted and investors are still unclear, pursue the issue with a heavy dose of common sense. As Mr. Bogle says, the prime responsibility of any adviser should be for the best interests of the client, not that of the adviser. The fiduciary standard is the only model in which financial markets should operate. Otherwise, investors may have a view that the deck is stacked against them and not invest. There, we all lose.

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