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LOOMING DODD FRANK RULE TO ROIL MONEY MANAGEMENT

Dodd-Frank became law in 2010, but its major impact on certain publicly-traded insurance companies, mutual fund issuers, and broker-dealers may not be felt until 2017. Before the 45th President takes office in January 2017, the Obama Administration plans to implement a regulation that its Council of Economic Advisers expects will save consumers $17 billion a year, with the brunt of the savings coming from the pockets of financial institutions or financial services companies. Put plainly, the Administration believes some investment advisers extract excessive compensation by preying on the financial ignorance of the unprepared, who turn to them for advice when they cash out their 401(K) plans and roll the proceeds into IRAs as they retire. The Administration believes the problem will intensify: "Rollovers to IRAs exceeded $300 billion in 2012 and are expected to increase steadily in the coming years." Others agree. According to Cerulli Associates, 401(k) rollovers will reach $500 billion per year by 2019.

These overcharges take place when advisers convince their retiree clients to convert IRA holdings into financial instruments that generate large commissions to the advisers, but which many investors do not understand they will pay for with lower cost-adjusted returns. The Administration has singled out two products as especially abusive:

- variable annuities with high mortality and expense charges and high surrender penalties, and
- mutual funds that charge high front-end or back end loads.

Employees of broker-dealers can sell both legally, despite high costs to clients, and enjoy generous commission flows because they operate under a “suitability standard,” not a “fiduciary standard.” According to the Council, “conflicted advice” clouds adviser recommendations made on $1trillion in mutual funds and $700 billion in variable annuities.

Broker-dealers make strong arguments when they say they are cost effective, even if what the Administration claims is true. Left alone, retail customers often are terrible market timers, getting out when the market stumbles and getting back in later when it is higher. Studies confirm that long-term investing is similar to riding a roller coaster: you will be fine unless you get up in the middle of the ride. Broker-dealers may provide the discipline and assurance that leads to riders staying seated. They also enhance returns and lower risk by rebalancing retail portfolios which few investors know how to do. One widely cited study finds the value of holding on during a market downturn to be $80 billion a year.

The Administration appears unconvinced, however, and wants the Labor Department to issue a rule to rein in advisers who do not “put their retiree clients interest first.” The Department issued its proposed rule on April 20, 2015. It is accepting

comments, and these can be found on their docket. Nearly three thousand companies and individuals filed comments on how to improve the proposed rule. The Department plans to issue a "final rule" no later than May 2016, with an eight months phase-in requirement. It intentionally will take effect before the next President is sworn into office.

Much of the lobbying against the proposed rule has aimed at changing the "Best Interest Contract" exemption. This Contract exemption would have to be signed by the broker-dealer, the adviser, and the retail sales prospect before presentations begin. The BIC exemption would acknowledge the fiduciary status of the investment firm and investment adviser, their commitment to act as fiduciaries, and describe any conflicts of interests. The BIC exemption permits advisers to sell otherwise forbidden financial products that spawn mutual fund or insurer commissions to them. Sales disclosures in the Contract exemption would include cost projections for investments over 1-, 5- and 10-year holding periods, sales charges, commissions, fees, and any other costs that would reduce the investment's rate of return. Industry attorneys fear that the BIC exemption will be used rarely, in part because slip-ups could lead to costly class action lawsuits.

If BIC exemption critics are right, then broker-dealers will have to rely more heavily on fees paid by clients for their revenue as commission revenue shrinks sharply. If the BIC exemption works better than they expect, firms may still find it desirable to bring many independent advisers in house to ensure compliance with the Rule. Most analysts view the revenue impact as much more serious, but compliance costs also could be high.

Will the GOP Congress Rescue the Industry?

For these reasons, industry is hoping Congressional Republicans will aid them in staving off the Rule entirely. So far, so good. By using the power of the purse successfully, Congress can stop the issuance of a new regulation in its tracks. The mechanism is a "limitation amendment" to an appropriations bill that lands on the President's desk as a rider. Such an amendment forbids the Administration from spending a penny on the proposed rule Congress finds offensive. When it works, the President signs the appropriation bill despite inclusion of a limitation amendment because the bill has enough other good features to make it worth becoming law. The alternative is a veto.

A new federal fiscal year begins in three weeks but, as has become the custom, Congress and the Executive branch are not close now to settling their differences on what will become a $1 trillion bill to fund ongoing government operations. These differences will be settled in a hothouse fashion, with potential for brinkmanship high. Previously, the GOP-led House passed HR 3020 ,which in section 113 on page 17 forbids the Labor Department from issuing "the fiduciary rule." To make its case even stronger, the House GOP held a hearing on their approach yesterday. Meanwhile, the GOP-dominated Senate Appropriations Committee adopted similar language in section 110 of S 1695, but a threatened Democratic filibuster prevented its floor consideration.

No one can predict if the Obama Administration or the Congressional GOP will give way in this limitation amendment struggle, but it should play out no earlier than next month and no later than February, the anticipated time frame for resolving the entire $1 trillion funding bill. We do know that if the GOP loses, then so will certain publicly-traded companies. We discuss those next.

Insurance Companies that Rely Most on Variable Annuity Sales Might Be Hurt

In a standard variable annuity, a retail customer invests cash inside a tax-deferred account operated by an insurance company and then purchases mutual funds, stocks, or bonds inside the vehicle. The insurer guarantees a minimum payment, but the total value of the payment depends on the performance of the underlying investments. Over time, most likely, these will go up in value. Any gains above the amount invested are taxed at ordinary rates, however, when they later are withdrawn.

In the first quarter of 2015, sales of variable annuities totaled $31.8 billion. There are now $1.92 trillion variable annuity assets outstanding, representing approximately 10 percent of all assets in tax-qualified retirement accounts

Consumer critics of variable annuities have been around since at least 1998 when Forbes published "The Great Annuity Ripoff." They claim that high fees often make variable annuities a less desirable investment option for many retirement accounts. This is most likely to be true for anyone who expects to be in at least a 20 percent income tax bracket or higher when he takes funds out of the variable annuity during retirement. Here is why. All annuity payments in excess of premiums paid are taxed as ordinary income at the taxpayer's marginal tax rate. But had the funds gone instead into taxable investments, using a standard brokerage account, then appreciating securities would be treated as capital gains and taxed at only 20 percent.

Critics also complain about sales commissions and surrender fees that they claim are abusive. Broker-dealers that sell variable annuities as intermediaries between insurance companies and retail investors typically receive 7 to 8 percent of the amount invested from these insurance companies as sales commissions. Insurance companies commonly recoup this marketing fee by charging retail policyholders a “mortality and expense fee” of 1 percent or more per annum. Policyholders also face surrender charges of declining severity over time, typically starting at 7 percent, if they wish to cancel the policy in the first year, and zero if they want out after seven years or more. Together, the “M and E fee” and surrender charges guarantee that the retail customer, not the insurance company, ultimately pays the broker’s 7 or 8 percent sales commission.

Supporters argue that retail investors benefit by having their retirement funds put to work for many years, “locked in” by the surrender charges, and that many people retire in the 15 percent tax bracket, pocketing substantial tax savings.

We will not take sides over who has the better arguments. Instead, we present our findings of which publicly-traded insurance companies appear most vulnerable if broker-

dealers can no longer sell traditional, highly-commissioned variable annuities because they become fiduciaries under the Department of Labor's proposed rule. If they do, then they most likely will have to find cheaper ways to place clients in variable annuities.

Companies such as Lincoln National (**LNC**), Prudential Financial (**PRU**), and American International Group (**AIG**), which often charge 2 to 3 times more for variable annuities than Vanguard and Fidelity-- to name two low-cost providers-- risk significant erosion in their revenues and profits if consumer cost issues come into focus. These companies derive a significant portion of their revenues from variable annuity sales, as can be seen in the table below:

Company	Ticker	Variable Annuities ($M)	Revenues ($M)	Variable % of Revenues
Lincoln Financial Group	LNC	$13,092	$13,554	81%
AIG Companies	AIG	$12,728	$64,406	20%
Prudential	PRU	$9,950	$54,105	18%

Mutual Funds Charging High Front-End Loads Also May Be Vulnerable

Reformers in the Obama Administration also believe that some financial advisers give conflicted advice when they recommend that clients buy mutual funds with front-end loads. Approximately 75 percent of U.S. mutual funds do not charge loads while the remaining 25 percent charge up to 5 percent. According to the Department of Labor, the typical adviser who recommends a load fund in 2017 will earn 134 basis points out of an average of 164 basis points charged to retail customers, under revenue sharing agreements they have with load mutual funds. The Administration argues that this compensation arrangement rarely is disclosed to clients and the loads seldom are justified by superior portfolio management; this benefits mutual fund companies and advisers, but leaves retail clients worse off. This is not to say that all loads will be deemed unreasonable under the Rule. One possible exception would involve a fund specializing in investing in illiquid assets. Under a "fiduciary standard," though, it may be very difficult for advisers to recommend high front-end load funds, and claim that buying them would be in the best interests of retail clients.

We present below several publicly-traded mutual fund families along with some visibility into their possible vulnerability to the proposed Labor rule.

Company	Ticker	Total Assets ($M)	Loads ($M)	No Loads ($M)	Loads (%)	No Loads (%)
Blackrock	BLK	$1,404,727	$658,691	$746,036	47%	53%
Eaton Vance	EV	$365,481	$166,605	$198,876	46%	54%
Federated Investors	FII	$300,357	$135,020	$165,337	45%	55%
Invesco	IVZ	$1,082,898	$419,969	$662,929	39%	61%
Alliance Bernstein	AB	$408,287	$158,112	$250,175	39%	61%
Gabelli Equity Trust Inc	GAB	$73,553	$28,364	$45,189	39%	61%
Franklin Resources	BEN	$2,456,096	$888,389	$1,567,707	36%	64%

Westwood Holdings	WHB	$10,147	$3,096	$7,051	31%	69%
Company cont.	**Ticker**	**Total Assets ($M)**	**Loads ($M)**	**No Loads ($M)**	**Loads (%)**	**No Loads (%)**
Janus	JNS	$834,929	$188,112	$646,817	23%	77%
State Street	STT	$10,749	$2,083	$8,666	19%	81%
Voya	VOYA	$415,109	$54,114	$360,995	13%	87%
Affiliated Managers	AMG	$53,061	$86	$52,975	0%	100%
T Rowe Price	TROW	$1,429,166	$0	$1,429,166	0%	100%
U.S. Global Investors	GROW	$697	$0	$697	0%	100%
Charles Schwab	SCHW	$64,547	$0	$64,547	0%	100%

Source: Morningstar, August 26, 2015

Some Broker Dealers Also Will Be Unhappy

Having decided that high cost variable annuities and mutual funds with sales loads often are abusive retirement products sold to the financially illiterate, the Department of Labor has made broker-dealers the focus of its enforcement efforts to curtail their sale. If the GOP limitation amendment drops out of the upcoming FY 2016 omnibus appropriations bill, then broker–dealers will have to operate under a fiduciary standard. Under this standard, they will have a hard time proving their customers will not be better off in low cost annuities and no-load mutual funds. If the GOP effort falls short, then shareholders of broker-dealers could be hurt, depending on the importance of these products to their bottom lines.

These are our observations after reviewing the financial statements of companies that appear to have some exposure:

CAN believes that among publicly-traded broker-dealers, Primerica (**PRI**), Raymond James (**RJF**), and LPL Financial (**LPLA**) are negatively affected, at least initially, if they must adapt to the proposed DOL rule. Primerica and Raymond James have business models that rely to a significant degree on commission revenues, generated by a high proportion of independent advisers and brokers that may have to be brought in house for legal reasons. A reduction in commission revenue, not fully offset by a shift towards greater fee generation, and the avoidance of legal liability due to new fiduciary standards could pressure revenues and increase costs.

Primerica (**PRI**), which generates almost 40 percent of revenues from sales of investment products primarily for retirement accounts, depends heavily on independent contractors. According to the company, if Primerica were successful in shifting variable annuity sales to mutual funds, 10 percent of profits would be affected by the DOL rule. If not, CAN believes that as much as 24 percent of profits would be impacted. If commissions were reduced by half, profits could be down by 5 to 12 percent.

Raymond James Financial's (**RJF**) Private Client Group (PCG) accounted for 67 percent of revenues and 40 percent of pre-tax income in 2014. Though stable fee-based accounts generate almost half of this group's revenues, the company still depends on a

large number of independent advisors and brokers. CAN believes that up to 10 percent of Raymond James' profits could be threatened by the DOL rule.

Companies that provide platforms from which to service advisers, such as LPL Financial (**LPLA**), are also likely to experience negative impacts on revenues. LPL derives 48 percent of its revenue from commissions, from "revenue sharing arrangements" for mutual funds, some of them with loads, as well as sales of variable annuities. To the extent that LPL has to pare higher cost mutual funds and annuities from its menu, profits will be hurt. However, to date, the company has stated only that the Rule would hurt sales of specialty products, principally non-traded REITs, which carry sales commissions of 7 percent, most of which are paid to their advisor clients.

Investing While Waiting on Washington For a Decision

Pericles famously said, "Just because you do not take an interest in politics doesn't mean politics won't take an interest in you." If you invest in the money management industry, you have decisions to make. The first is to get out of these investments-- or await the outcome of the Congressional appropriations struggle with the Obama Administration. This fight could be settled in early October or drag on into next year. If the GOP loses, then it will be time to consider if the markets are fully pricing in the Department of Labor's costly fiduciary rule, because at that point it will be highly likely to become law next May, and drive industry wide changes in early 2017.

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