Consumer Federation of America

DOL Delivers on its Promise: Conflict of Interest Rule Proposal Provides Needed Protections for Retirement Savers, Flexibility for Financial Firms

In mid-April, the Department of Labor did what many thought to be impossible: it issued a proposed rule that strengthens protections for retirement savers by requiring all financial professionals to put the interests of their customers first, but does so in a way that enables financial professionals who are compensated through sales commissions to comply. By simultaneously closing loopholes in the definition of investment advice under the Employee Retirement Income Security Act (ERISA) and permitting the receipt of sales-based compensation subject to certain conditions, the revised rule proposal effectively addresses the concerns raised by industry regarding the original 2010 proposal while enhancing its investor protection benefits. With the revised rule now out for public comment, this document is designed to answer some of the key questions that have been raised.

How are retirement savers being harmed under the current regulatory approach?

American workers and retirees are more dependent than ever on financial professionals to help them navigate the complex decisions they must make to fund a secure and independent retirement. Unfortunately, because of loopholes in rules specifying who is a "fiduciary" under ERISA, many of the financial professionals that retirement savers rely on for advice are free to put their own financial interests ahead of the interests of their customers. While many of these professionals nonetheless seek to do what is best for their customers, others take advantage of gaps in the regulations to steer their clients into high-cost, substandard investments that pay the adviser well but eat away at retirement savers' nest eggs over time. This is a particular problem for small savers – including many women and people of color – who are disproportionately likely to be served by non-fiduciary advisers and to receive conflicted advice. Stemming the tide of financial losses attributable to conflicted advice, as this rule seeks to do, is a concrete step that we can and should take to address our nation's retirement savings crisis.

What is the extent of the harm to retirement savers?

The cost to retirement savers of conflicted advice is enormous. Working from a wide range of independent studies, DOL estimates that investors will lose somewhere between $210 billion and $430 billion over 10 years, and between $500 billion and $1 trillion over 20 years, as a result of conflicted advice just with regard to mutual fund investments in Individual Retirement Accounts (IRAs). Furthermore, a retirement saver who moves money out of a 401(k) plan and into an IRA based on conflicted advice can expect to lose 12 to 24 percent of the value of his or her savings over 30 years, according to the DOL analysis. Overwhelming evidence from a wide variety of sources supports the conclusion that these losses are the direct result of financial advisers' freedom to place their own financial interests ahead of the interests of their customers when offering retirement investment advice.

DOL details the basis for these estimates, and broader conclusions about the harmful impact of conflicts of interest, in a comprehensive Regulatory Impact Analysis (RIA) issued at the same time

as the revised rule proposal. As DOL explains in the RIA, it chose to focus on mutual fund investments in IRAs to quantify the harm, not because this is an area considered to be particularly prone to abuse, but rather because it is where the best data is available. If data were available to support an estimate of the cost to retirement savers of all aspects of conflicted advice, the total would likely be significantly higher.

How does the rule fix that problem?

The revised rule proposal closes loopholes in the definition of investment advice, so that anyone who provides individualized investment recommendations to retirement savers would be covered by ERISA's fiduciary duty. As fiduciaries, they could no longer legally put their own financial interests ahead of the interests of their customers. The rule proposal covers advice to traditional and defined contribution pension plans, such as 401(k) plans, as well as advice to plan participants and to those who save through Individual Retirement Accounts. In an important improvement over the 2010 proposal, it covers advice about recommendations to roll money out of a pension or 401(k) plan and into an IRA. This is the most important financial decision many people will ever make, with a potential to seriously affect their standard of living in retirement, and it is an area of well documented abuses.

I've heard the rule would make it impossible for broker-dealers, insurance agents and others who charge sales fees to offer retirement investment advice. Is that true?

No. One of the most significant enhancements in the revised rule proposal is the addition of an exemption that spells out the terms under which financial firms and their advisers can receive sales-based compensation and still comply with the ERISA fiduciary standard. Known as the "best interest contract exemption," this provision ensures that broker-dealers, insurance agents, and others who are compensated through commissions and other forms of sales fees will continue to be able to offer retirement investment advice to both small savers and small plans. As such, it preserves the ability of retirement savers to choose how they prefer to pay for retirement advice without requiring them to give up their right to best interest recommendations when they choose to pay through sales fees.

Won't permitting advisers to earn sales fees put retirement savers at risk?

Some have suggested that the only acceptable approach is to continue to ban all sales-related compensation. This view ignores the reality that all forms of compensation involve conflicts and that investors sometimes have sound reasons for preferring to pay for advice through sales fees. It also ignores the strong protections for investors included in the "best interest contract exemption." First, the exemption for sales-based compensation only applies to advice regarding a range of investments that are appropriate for retirement accounts. Both the firm and the adviser providing the retirement advice would be required to enter into a contract with the advice recipient stipulating that they will provide advice under a fiduciary standard and make recommendations that an impartial expert would view as serving the best interests of the retirement saver. The fees charged for that advice would have to be reasonable. Advisers would also be required to provide retirement savers with point-of-sale and on-going disclosures regarding the costs and conflicts associated with the advice.

In perhaps its most significant provision, firms that rely on the exemption would be required to take meaningful steps to eliminate practices that could encourage their advisers to make recommendations that do not serve the best interests of the customer. For example, while firms would remain free to recommend in-house products, they could no longer set quotas for the sale of such products and base advisers' bonuses on their success in meeting those quotas. Similarly, while

firms would be free to pay their advisers more to sell certain investments, those differential payments would have to be based on objective factors, such as the amount of time necessary to research and implement the investment strategy, and not just on a desire to promote sales of particular investments. This has the potential to dramatically reduce harmful business practices associated with sales-based compensation.

Together, these rule provisions should limit the potentially harmful impact of compensation-related conflicts of interest while providing the benefits of investor choice.

I've heard that small savers could lose access to valued services if rule is adopted. Is this true?

The argument that small savers would lose access to advice was based primarily on the assumption that the rule would prevent advisers from earning sales commissions. That concern, always exaggerated, has been fully addressed through the proposal of the best interest contract exemption for sales-based advisers. Some have made a similar argument with regard to compliance costs and litigation risks posed by fiduciary status. But investment advisers who currently serve small savers have shown that it is possible to serve this market profitably under a fiduciary standard.

The only remaining question is whether certain firms will decide that it is simply not financially beneficial for them to serve small savers if they are no longer allowed to profit unfairly at their expense. We believe most firms will choose to continue to serve this market. However, should some abandon the field, other market participants are ready, willing, and able to step in and offer high-quality, low cost advice to these individuals. As the RIA explains, this is an evolving market. In addition to the traditional advisers who already serve this market under a fiduciary standard, so-called "robo-advisers" – service providers that utilize technology to meet the core portfolio management needs of mass retail investors – and products such as target date funds "minimize the need for complex advice [and] are already rapidly gaining market share. Going forward, they promise to make advice far more affordable for small investors, especially young investors who generally are more accustomed to technology-based tools. More traditional advisory firms are scrambling to develop, partner with, or acquire such innovative tools, and to combine these with more traditional services to deliver tailored services to more market segments at far lower cost than that historically associated with traditional approaches alone." This latter development has the potential to deliver the cost savings associated with the robo-adviser model to an even broader swath of the public.

How will the rule benefit small savers?

Far from being harmed, those with modest incomes and low dollar balances in their retirement accounts stand to benefit most from the proposed rule. Because they are disproportionately served by broker-dealers and insurance agents who are not currently required to serve their customers' best interests, small savers are at greatest risk of receiving conflicted advice that drains their retirement savings. This is money that these individuals desperately need if they are to afford an independent and secure retirement. The revised rule offers these small account holders the flexibility of paying for retirement advice through commissions and other sales fees without forcing them to give up their right to best interest recommendations. As such, it would provide them with the same protections that the typically wealthier investors who invest through fee-based advisers already receive under the securities laws.

All savers should receive an additional indirect benefit from the rule's potential to encourage competition among investment products based on the best interests of the customer rather than

compensation to the adviser. Promoting market competition on terms that benefit, rather than harm, advice recipients can be expected to drive down costs to all retirement savers.

I've heard the rule would put small firms out of business. Is that true?

While firms of all sizes will have to adjust their business practices to comply with the rule, there is no valid basis for the claim that small firms would be put out of business. For small firms, the key to compliance will be the initial selection of the product menu they offer to retirement savers to ensure that it comports with a best interest standard. Firms that already offer a mix of reasonably priced, high quality investment options that allows for creation of a diversified portfolio should see relatively little impact from the rule. They would have to enter into a contract with clients, make best interest recommendations, and provide disclosures with regard to costs and conflicts, but their business could otherwise continue largely unchanged. Those whose business is built around the sale of a few high-cost, low-quality products will face a more significant change to come into compliance, but that is appropriate. Either the sponsors of the investment products they recommend will have to adjust their products to make them more competitive under a best interest standard, or the firm will have to consider changing its product mix or, in the case of high-cost products, rebating fees that don't meet the reasonableness standard. While firms are likely to see some increase in compliance cost, including the cost associated with new disclosures, investment advisers who serve the small saver market under a fiduciary standard have shown that it is possible to serve this market affordably.

Won't the rule increase advisers' liability costs?

Some have suggested that the rule would leave advisers vulnerable to lawsuits anytime their customers lose money on an investment or make less than they could have if they had invested differently. This is patently absurd. The rule makes clear that recommendations are assessed for compliance with the best interest standard based on the circumstances prevailing at the time of the recommendation and not on the outcome of that recommendation. As a result, an individual who sought to bring a case on the flimsy grounds cited above would be unlikely to find an attorney willing to represent them. Another significant limitation on firms' liability exposure is the inclusion of language in the rule reaffirming existing FINRA policy with regard to arbitration of claims. Under the rule, firms would still be permitted to include pre-dispute binding arbitration clauses in their contracts but not to force customers to sign away their right to participate in class action lawsuits, just as they are today. As a result, the vast majority of claims would be heard in the industry-run arbitration forum rather than in court.

Other features of the rule are likely to reduce firms' liability risks. As FINRA CEO Rick Ketchum recently stated in a letter to members, firms actually reduce their regulatory risk when they put their customers' interest first and alleviate conflicts. By requiring firms to take concrete steps to eliminate practices that encourage bad conduct, the DOL rule proposal achieves what FINRA only suggests. As a result, firms that take seriously their obligation to mitigate conflicts and put the interests of customers first should see their liability risks reduced as a result of the better outcomes they achieve for clients. The threat of litigation should therefore serve to encourage compliance without raising the specter of excessive liability exposure.

Will the rule prohibit sales of in-house products?

No. The rule permits the sale of in-house products subject to the conditions of the "best interest contract exemption." If an impartial expert would deem the in-house product to be in the best interest of the investor and if the fees are reasonable, advisers would be free to recommend them to retirement savers. In-house products that already meet these standards would therefore be unaffected

by the rule. Those that don't currently meet these standards would have to adjust or risk losing market share.

Where a firm's product menu consists entirely of a limited menu of in-house products, additional requirements would apply. In such circumstances, the firm would have to make a written finding that the limitations do not prevent the adviser from providing advice that is in the best interest of the retirement investors. Payments received for the services could not exceed the fair market value of the services provided, a more specific determination than is required under the best interest contract exemption's reasonable fees requirement. Before making recommendations, the firm would have to provide clear notice of any limitations placed by the firm on the investments offered by the adviser. And the adviser would have to notify the customer if their product menu did not include options that meet that individual's needs. These are reasonable precautions to address the particular risks associated with this business model.

Will the rule prohibit sales of annuities?

No. Annuities are on the list of products advisers would be free to recommend under the terms of the best interest contract exemption. Where an annuity is in the best interest of the retirement saver and the costs are reasonable, the adviser who otherwise complies with the terms of the best interest contract exemption would be free to recommend that annuity. Sales outside of retirement accounts, which is where one would expect the bulk of variable annuity sales to occur, would also be unaffected.

Will mutual fund companies and financial firms still be able to offer investor education materials without being regulated as fiduciaries?

Yes. The rule draws a clear distinction between advice, which is subject to a fiduciary duty, and investor education, which is not. The key distinction is whether the information includes a specific investment recommendation that the retirement saver can reasonably be expected to act upon, in which case it is regulated as advice and subject to a fiduciary duty. As long as an adviser is providing general information and not a specific investment recommendation, the provision of information will not be treated as fiduciary advice under the rule. That is true regardless of who provides the information or the form in which the information and materials are provided.

Will the rule put call centers out of business?

Firms that use call centers to provide routine account services and investor education would be unaffected by the rule. There are clear carve-outs for both types of activities in the definition of investment advice. The rule would only affect call center operations in the narrower circumstances that call center personnel actually offer investment advice. In those cases, the call centers would have to adjust their practices to comply with the best interest contract exemption, but even so there is no basis for the concern that they would be put out of business.

There is good reason, moreover, to ensure that investment advice offered through call centers is covered by the rule. A 2013 report by the Government Accountability Office (GAO) provides alarming evidence of the tactics that call centers engage in to encourage workers to roll over their 401(k) plan savings into IRAs. GAO investigators found that call center staff often make recommendations with only minimal knowledge of a caller's financial situation. Investors may also receive "cold calls" pressuring them to roll over their savings and offering them various incentives to do so. In many if not most of these situations, this conflicted advice profits the call center staff and the firms that they work for, to the customer's detriment. A firm that operates according to such a

harmful business model will have to substantially change its practices. That should be viewed as a feature, not a flaw, in the rule. As President Obama said recently, "If your business model rests on bilking hard-working Americans out of their retirement money, then you shouldn't be in business."

Won't the compliance costs on industry outweigh any benefits to retirement investors?

Using information from industry surveys, the DOL estimates that the compliance cost associated with the proposal will total between $2.4 billion and $5.7 billion over 10 years. Those estimated costs pale in comparison to the significant benefits that this proposal will provide. By limiting or mitigating advisers' conflicts, the new proposal will encourage competition based on the best interests of the investor rather than compensation to the adviser. Investment products that can't currently compete based on quality will have to adjust or risk losing market share. Market competition based on cost and quality should dramatically reduce both the excessive fees and the inferior investment performance associated with conflicted advice. Investors and sponsors of high-quality, low-cost products should both benefit from this approach.

Because of limitations of the literature and available evidence, only some of the potential gains can be quantified with confidence. Focusing only on how load shares paid to brokers affect the amount that IRA investors holding load mutual funds pay and the returns they achieve, the proposal has the potential to deliver gains of between $40 billion and $44 billion over 10 years just to these IRA investors. The potential gains to the entire retirement market are likely to be much greater. However, if only 75 percent of anticipated gains to IRA investors were realized, that would amount to between $30 billion and $33 billion over 10 years. If only 50 percent were realized, that would total between $20 billion and $22 billion over 10 years. Even under the most conservative estimates, therefore, the benefits to investors of best interest advice are many times greater than the costs to industry of complying with this rule.

Broker-dealers are already extensively regulated by the SEC and FINRA. Aren't existing regulations adequate to protect all investors, including those saving for retirement?

The SEC and FINRA play an important role in protecting investors, including those investing for retirement, but there are significant gaps and weaknesses in that regulatory regime. The tens of billions of dollars that retirement savers lose each year as a result of conflicted advice stems from conduct that is permissible under the rules and laws overseen by the SEC and FINRA. Specifically, while broker-dealers market themselves as trusted advisers, it is still permissible for them to favor their own interests over the interests of their customers when recommending securities, as long as the investment is generally suitable. This falls well short of the protection retirement savers reasonably expect when they turn to someone for advice. While the SEC has the authority to reduce that harm by strengthening the standards that govern broker-dealers when they provide investment advice about securities, it has failed to act on that authority. In other areas, including the recommendation of insurance products and recommendations to retirement plans, the SEC and FINRA have no authority. Investors need both the SEC and DOL to act to ensure that they are adequately protected when they rely on financial professionals for advice. It is unfortunate that the SEC has lagged so far behind in providing those protections.

Shouldn't the SEC, rather than DOL, take the lead in setting standards for retirement advisers?

While the SEC is responsible for regulating securities professionals, the DOL has primary responsibility for protecting retirement assets, including by setting standards for those who provide investment advice with regard to retirement assets. When Congress adopted ERISA, it gave DOL

sole rulemaking authority under the statute. DOL also has sole responsibility for interpreting the Internal Revenue Code (IRC) prohibited transaction provisions, which specifically apply to IRA investment advice. In the more than forty years since ERISA became law, the DOL's "role in interpreting those provisions has become well established under law and in practice." The SEC, on the other hand, has no authority to interpret the Internal Revenue Code provisions. It also has no authority with regard to non-securities retirement investments. It is therefore incumbent on the DOL to use its authority under ERISA and the Internal Revenue Code to protect retirement savers from harmful adviser conflicts. Based on the proliferation of IRA assets and the compelling evidence of adviser conflicts in the current IRA market, "the special protections in the IRC Prohibited Transactions are even more critical today than when Congress first enacted ERISA more than 40 years ago."

Shouldn't the DOL wait for the SEC to act so that the standards can be harmonized across all types of accounts?

When Congress enacted ERISA, it intentionally set a higher standard for protecting retirement assets than applies to other investments. There are good reasons to do so. Retirement assets are special, as evidenced by the fact that they are heavily subsidized by the government through the tax code. IRAs were subsidized by $16 billion in 2014. However, as the RIA explains, "this figure drastically understates the degree to which current IRA savings have been subsidized by taxpayers. Because most of the savings flowing into IRAs comes from rollovers primarily from job-based retirement plans, much of the savings currently in these plans may eventually be rolled over into IRAs." The tax preference for defined contribution plans amounted to $45 billion in 2014. These tax subsidies should flow to individuals, not financial firms, and should not be depleted by conflicts of interest.

Furthermore, there is no assurance that the SEC will act to strengthen protections for investors who receive investment advice from broker-dealers. The SEC has been considering action for nearly a decade with no evidence of concrete progress. While recent statements of support from SEC Chairman Mary Jo White are encouraging, there is still no clear roadmap or timeline for finalizing a rule. The process could take years. Meanwhile, the current inconsistent standards would be perpetuated. The typically wealthier investors who invest through fee-based investment advisers would continue to receive fiduciary protections, while the small savers who are more typically served by commission-based broker-dealers and insurance agents would not.

Will the DOL rule conflict with securities laws?

Despite the different regulatory frameworks under which the two agencies operate, the DOL took great pains to draft its fiduciary rule to work in harmony with securities laws. The definition of investment advice proposed by DOL is virtually identical to the securities law definition. The best interest contract exemption deals directly with several issues that SEC would need to address if it adopted rules under Section 913 of the Dodd-Frank Act, including how fiduciary protections would apply to one-time advice, sale of proprietary products, and sale from a limited menu of products. The approach proposed by DOL is consistent with the provisions of Dodd-Frank. The DOL rule also deals very effectively with the question of how to mitigate conflicts of interest under the broker-dealer business model, a topic SEC has yet to take up despite a clear mandate in the Dodd-Frank Act to do so. This doubtless reflects the extensive consultation that has taken place between DOL and the SEC to ensure that the revised proposal would not conflict with the securities laws. The DOL explains that a key goal of the consultation was to ensure that compliance with the new proposal would not cause a regulated entity to be out of compliance with the securities laws. And, in the DOL's view,

"the current proposed regulation neither undermines nor contradicts the provisions or purposes of the securities laws."

If retirement savers are confused, why not just improve disclosures? Wouldn't that achieve the same result at a lower cost?

As the DOL discusses at length in its Regulatory Impact Analysis, available academic and empirical evidence strongly suggests that disclosure alone is ineffective at mitigating conflicts in financial advice. First, extensive evidence demonstrates that a majority of retail investors are incapable of adequately understanding the implications of disclosed conflicts and factoring that understanding into their choice of adviser and investments. Furthermore, most retail investors are unlikely to have the financial sophistication necessary to check the quality of advice and detect adviser misbehavior. Many if not most investors also are likely to ignore disclosures. For example, the RIA cites the 2008 Rand Study that interviewed representatives of brokerage firms who reported extensive efforts to clearly disclose conflicts. Several acknowledged that "investors rarely read these disclosures…[F]or many investors, the fact that they were given disclosures was seen as meaningless."

There is even evidence that conflict disclosures can have a harmful impact on investors. Behavioral economists have found that, where investors are able to pay attention to and understand disclosures regarding adviser conflicts, they still may react to disclosures in ways that exacerbate the harms that can result from these conflicts. For example, they might interpret conflict disclosures as a sign of honesty or high professional standing, or feel socially constrained from questioning their adviser's integrity or threatening their livelihood. And, their adviser may feel "morally licensed" to pursue their own interests over their customers' interests after having warned them of their conflicts. One legal academic who has surveyed the literature of broker obligations, conflicts, and disclosure concludes that, "disclosure alone is a frail tool with which to attack the many ills that arise from blatant conflicts of interest in the financial industry."

Based on the extensive academic and empirical evidence, the DOL has rightly concluded that a rule that relies on disclosure alone to mitigate adviser conflicts would be ineffective, would yield little or no investor gains, and would therefore fail to justify the compliance cost associated with requiring increased disclosure.

Conclusion

Financial firms and their advisers are understandably nervous about a rule that could force them to make significant changes in the way they conduct their business. But change is necessary to ensure that retirement savers who turn to financial professionals for advice receive recommendations that promote their ability to enjoy a secure and independent retirement. The DOL has exceeded expectations in proposing a rule that carefully balances the need to strengthen protections for retirement savers with the need to allow compliance under a variety of business models. They have done everything that industry asked of them when they withdrew their 2010 proposal: they produced a comprehensive economic analysis showing the harm to investors that justifies rulemaking; they revised the rule to reflect the legitimate concerns raised by industry; and they issued the draft exemptions which are crucial to understanding how the rule will be applied in practice. They did all that while enhancing the rule's protections for retirement savers. While the rule will doubtless undergo some fine-tuning as a result of the comment process, this is a strong proposal that deserves all of our support.