Consumer Federation of America

6 Ways the DOL Fiduciary Rule Improves Protections for Retirement Savers

Earlier this month, the Department of Labor issued landmark new regulations to strengthen protections for workers and retirees who turn to financial professionals for advice about their retirement investments. The biggest beneficiaries of the new rule are middle income retirement savers, both because they need to make every dollar count to afford a secure and independent retirement and because they are most likely today to be getting advice that is not in their best interests.

The rule aims at eliminating harmful practices that have become deeply embedded in the business models of sales-based financial firms. It does this by closing loopholes in the current regulations that have allowed brokers and insurance agents to masquerade as objective advisors while acting as self-interested salespeople, by requiring all financial professionals to make a legally binding commitment to set aside their own interests and seek to do what is best for the customer, and by requiring firms to eliminate practices, including compensation and personnel practices, that conflict with that goal.

The following describes the key benefits retirement savers will receive from this ground-breaking rule.

1) Retirement savers will know that whomever they turn to for advice has to act in their best interests.

What's the problem?

Broker-dealers and insurance agents market themselves as advisors but are allowed to act like salespeople, steering their customers into investments that are profitable for the advisor but that aren't in the best interest of the customer.

How does the DOL rule fix it?

The DOL rule requires all financial professionals who offer retirement investment advice to abide by a fiduciary standard. That means they have to offer recommendations that are in the best interests of the customer and they must charge only reasonable fees.

How do retirement savers benefit?

Jim is a 27-year-old engineer who has managed to set aside some money towards his retirement. A good engineer but a financial neophyte, Jim decides he needs advice from someone he can trust on how to better invest his retirement savings. Reassured by ads that promise to put the customer's interests first, he turns to a "financial advisor" at a major broker-dealer firm for recommendations.

> Before the Rule: Noting that Jim is a long-term investor who doesn't expect to actively trade in the account, the broker recommends a commission account. While that makes sense in terms of Jim's trading practices, it comes at a heavy price. By putting him in a commission account, the

broker avoids any fiduciary responsibility to act in Jim's best interests. A salesperson rather than a true advisor, he is free to recommend investments that pay him more even when there are comparable investments available with lower costs and a better performance record.

Forty years later, when Jim gets ready to retire after years of careful saving, those higher fees and reduced returns will have cost him more than $100,000 in retirement savings without his ever knowing what hit him.

After the Rule: Customers who pay for advice through commissions won't have to give up their right to best interest recommendations. Brokers who now steer customers into the funds that are most profitable for them and their firm will have to recommend the options that are best for the customer. Instead of seeing his retirement savings eroded through high costs and substandard performance, Jim will see his lifetime of careful saving rewarded with a higher standard of living in retirement.

2) Workers who change jobs won't be lured into rolling their money out of their pension or 401(k) plan and into a higher cost IRA.

What's the problem?

Two simple facts combine to create significant challenges for retirement savers. Most workers save for retirement primarily through workplace retirement plans. And the typical worker today changes jobs every four to five years. With each job change, those who've accumulated some savings in the 401(k) plan face a choice: do they leave their money in the current plan, move it into their new company's plan, or roll it out of the plan and into an Individual Retirement Account? How they handle those complicated decisions can have a real impact on their saving success.

But under the old rules, recommendations regarding rollovers and benefit withdrawals are not considered fiduciary retirement investment advice. That means financial firms can encourage workers to roll over their money, even when they'd be better off staying put, and recommend investments that are worse for the investors than the investments they own through the 401(k).

How does the DOL rule fix it?

The DOL rule includes advice about rollovers in the definition of fiduciary investment advice. That means that both the recommendation of whether to rollover and the recommendation of what to invest in must be in the best interest of the customer.

How do retirement savers benefit?

Lisa just left her job on the Hill to go to work for a consulting firm. She has saved about $40,000 through the Thrift Savings Plan in an age-appropriate target date fund, which gives her broad diversification at the lowest costs around. A teller at Lisa's bank, who knows she's changed jobs, asks if she'd like to talk to an advisor about moving her money to the firm. She refers Lisa to a colleague who works for the affiliated broker-dealer.

Before the rule: The broker assures Lisa that she'd be better off moving her money out of the TSP and into an IRA, and he recommends that she invest in a mix of the firm's proprietary mutual funds. After all, the TSP may have rock bottom prices, "but you get what you pay for," he tells her. With a 5.75 percent sales load, the new funds cost Lisa $2,300 is sales charges right off the bat, with on-going expenses that are more than 25 times as high as what Lisa was paying in the TSP target date fund. The advisor tells Lisa not to worry about the higher costs, because while the plan he's suggesting costs "a little more" in the short-run, she'll do way better in the long-run. Since costs are one of the best predictors of fund performance, this statement is highly questionable. In fact, if the two funds perform identically, Lisa will have about $30,000 less in retirement savings at the end of 20 years than she could have if she follows this broker's "advice."

After the rule: Financial advisors will only be able to recommend rollovers when they are in the worker's best interests. So, unless the broker can offer Lisa a better option, he'll have to tell her that she's better off leaving her money where it is. And misleading statements like those suggesting she'd be better off paying higher prices will be strictly prohibited.

3) Employees of small businesses should see better investment options in their company retirement plans.

What's the problem?

Small business owners who want to offer retirement benefits to their employees can find the decisions involved in setting up a retirement plan daunting. Lacking financial expertise themselves, they rely heavily on the advice they get from the plan consultant (hired by the plan's record-keeper), little knowing that what they are getting isn't really advice, but is actually just a sales pitch dressed up as advice. The result is all too often a retirement plan that is loaded up with substandard investment options that saddle employees with poorly performing, high cost retirement investments.

How does the rule fix it?

The rule provides the same protections to small plan sponsors that it does to individual investors, requiring those who provide investment advice to these plans to either operate without conflicts or comply with the requirements of the best interest contract exemption. This means that small business owners will have the assurance that all those who provide them with advice will be required to act solely in the interests of the plan and plan participants. Relying on plan consultants who are prepared to act as fiduciaries and give unbiased advice should result in better plan design, with investment options that produce better outcomes for employees.

How do retirement savers benefit?

A small bakery has been operating for three years and just became profitable. The CEO, Erica, who is also the pastry chef, wants to offer better benefits for her employees, so she decides to create a 401(k) plan. Being more of an expert in pastries than investments, she looks for a financial firm to set up and run the plan.

Before the rule: Lisa turns to a financial advisor at a well-known insurance company to set up the plan. The insurance company advisor is incredibly helpful. Recognizing that she is short on time and expertise, he offers to walk her through the entire process. The advisor recommends a menu of 30 of the company's funds that he says will be great for her and her employees' retirement. Not knowing anything about the options and being very impressed with the advisor, she defers to his expertise. Because of their above-average costs, the funds suffer from chronic underperformance, eating into her employees' retirement savings.

After the rule: The plan consultant is required to act in the best interest of the plan and plan participants when providing advice on the design of the plan. As a result, the advisor helps her select a menu of low-cost, high quality investment options instead of the high-cost options most profitable for him and his firm. Erica's employees enjoy better returns on their retirement savings as less of their money is siphoned off to pay high investment costs.

4) Retirement savers will be able to trust their advisors, who will have far fewer incentives to offer advice that is not in their customers' best interests.

What's the problem?

Financial firms routinely pay and reward their advisors in ways that encourage advice that is not in the customer's best interests.

How does the rule fix it?

The rule requires financial firms to eliminate a wide range of practices that encourage advisors to offer recommendations that are not in the customer's best interest. The firm must take special care to reduce the incentives to recommend risky, complex, opaque and illiquid investments, and it is responsible for supervising their advisors to ensure compliance.

How do retirement savers benefit?

Scenario One

Rob is a 60-year-old electrician whose company has just terminated its pension plan in order to lower costs. The company offers employees the option of taking their accumulated benefits as a lump sum withdrawal, $350,000 for Rob, or as an annuity, which would pay Rob a guaranteed $1,500 a month for life. He asks for advice from his financial advisor, whose business card describes him as a "retirement expert."

Before the rule: The advisor says taking the lump sum is a "no-brainer." Rob can invest the money in a variable annuity inside an IRA and get a stream of lifetime income that is much higher than $1,500. And, unlike with the company's annuity, he can expect to leave some money to his family when he dies.

Rob understands that the advisor will make money on the sale, whereas he wouldn't if Rob chose the company's guaranteed annuity, but he doesn't realize the advisor's payoff on this one transaction amounts to a hefty $20,000. And, although he tries to read the literature his advisor gave him, he really doesn't understand exactly how the annuity works. He follows the advice. After all, that's why he consulted an expert.

Several years later, after he's retired, Rob gets a rude awakening when the payments from the variable annuity he purchased drop below $1,500 because of the combined impact of the high fees and the poor performance of the annuity's subaccounts.

After the rule: The advisor will only be able to recommend that Rob take the lump sum payment if the advisor has an alternative to recommend to Rob that is superior to the guaranteed $1,500 annuity the company is offering. This will help to spur competition among investment products based on meeting a best interest standard, driving costs down and quality up. (See below.)

Scenario Two

As Diane approaches retirement, she consults a financial advisor with a well-known broker-dealer firm for advice on how to manage the $500,000 she has accumulated in her 401(k) plan once she retires. The broker suggests she invest her money in a well-diversified portfolio of mutual funds held in one of the firm's fee accounts charging a 1% asset under management fee in addition to the operating expenses of the funds she invests in. Impressed by the firm's reputation and the fiduciary duty that comes with a fee account, she signs up.

Before the rule: The advisor, who has a quota she must meet for the sale of the firm's proprietary mutual funds, puts a significant portion of Diane's portfolio in these funds, even though alternatives with lower costs and a better performance record are available. Lost in the fine print of disclosure documents Diane receives at the time of the sale is a disclosure that the firm engages in this practice of pushing its own funds. (That disclosure is enough to satisfy the fiduciary duty according to the Securities and Exchange Commission.) Over the course of her retirement, Diane loses out on tens of thousands of dollars in income as a result.

After the rule: The DOL rule focuses on minimizing conflicts, not just disclosing them. With quotas for sale of proprietary products banned under the rule, the advisor has no incentive to push these higher cost options when better alternatives are available. As a result, Diane invests in a portfolio of lower cost, higher quality funds and reaps the reward in improved performance and increased retirement income.

Scenario Three

Steve is a 45-year-old junior executive who just left his job at a Fortune 500 company after working there for five years. He has about $20,000 in his 401(k) and is invested in an appropriately diversified mix of extremely low-cost funds with strong records of performance.

Before the rule: A college buddy who is working at a well-known brokerage firm tells Steve he is invested way too conservatively and instead should have all his money in a 100% stock fund. He offers Steve two choices of funds that he says will beat the market and be way better for him for years to come.

What Steve's buddy doesn't tell him is that his firm has a "ratcheted" compensation grid and that he is currently stuck at the 30% rung on the payout grid. That means he gets to keep 30% of the commission revenue he brings into the firm. The $1,000 in commissions from Steve's fund purchase would be enough to move him up to the 40% pay level. And, since the increase is retroactive, that one sale could earn him an extra $30,000 in pay for the year. But, since stock funds pay higher commissions than bond funds, only a purchase of the 100% stock fund would produce commission income high enough to get the advisor to the next payout level.

Steve follows his buddy's advice and moves his money to one of the 100% stock funds he recommended. But the decision increases his costs, reduces his diversification, and exposes him to significantly more risk.

After rule: Ratcheted payout grids are prohibited under the rule, because they encourage advisors to make recommendations based on their own financial interests rather than the interests of the customer. Steve's buddy looks over his portfolio and concludes Steve is best off leaving his money in the company's 401(k) plan, where the costs are lower and the investments are every bit as good as anything he has to offer.

5) Retirement savers will be put into the type of account that is best for them, and not just the account that is more profitable for the financial firm.

What's the problem?

Some financial firms have suggested that, rather than comply with the requirement to manage conflicts associated with sales-based compensation, they will simply move all their customers to fee accounts. Unless changes are made to reduce the costs of fee-based accounts, however, investors could end up paying more than they otherwise would have, and paying for services they don't actually need.

How does the DOL rule fix it?

The DOL rule makes clear that firms must recommend the type of account that is best for the investor. If a firm moved a customer to a higher cost account, the firm would have to be able to show why that account is better for the investor, what additional services they are providing to justify the increased costs, and why those services are appropriate for the investor. If the firm charges an ongoing fee, it would at a bare minimum need to provide ongoing account management to justify those fees. Firms that cavalierly move customers to higher cost accounts without first determining that is a good move for the investor would risk losing their ability to rely on the exemption.

How do retirement savers benefit?

Anne is a 27-year-old private school teacher with $25,000 in a commission-based IRA at a broker-dealer firm.

> Before the rule: A commission account makes sense for Anne, because she rarely trades, is holding her investments for the long-term, and has no need for ongoing advice or account management services.
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> After the rule: In an effort to simplify compliance with the new rule, the firm develops a new fee account with lower account minimums and significantly reduced costs for customers who have only minimal needs for advice and ongoing account maintenance. In designing the account features, the firm stays focused on the fact that the account must be in the best interest of customers. The result is an account that keeps Anne's costs to a minimum and comes with the assurance that, when she does need advice, the advice she receives will be in her best interests.

6) Market forces will work to benefit, rather than harm, investors.

What's the problem?

Companies that develop investment products for the retail investor operate in a highly competitive market, but that competition occurs on terms that are at least as likely to harm as to help investors. Specifically, in developing investment products to be sold through brokers and insurance agents, companies' profits depending on getting them widely sold, and the easiest way to do that is through generous pay to the financial advisor salesforce. That not only tends to drive up costs, but it also encourages development of products that are needlessly complex and opaque. After all, the easiest way to hide the higher costs is in a product that is too complex and opaque for the typical investor to understand.

How does the DOL rule fix it?

By requiring all financial professionals to act in the best interests of their customers, and by requiring financial firms to eliminate incentives that conflict with that goal, the DOL rule changes the terms on which investment product sponsors will have to compete for sales. Companies that want to succeed in the multi-trillion-dollar retirement market will need to develop investment products that can compete under the rule's best interest standard. And those that already compete by providing a high quality product at a reasonable price should gain a larger share of the market. Retirement savers will benefit directly from lower costs, reduced complexity, and improved performance across all types of investments.

How do retirement savers benefit?

ABC Insurance Company is looking at developing a new annuity product that will be sold primarily to retirement investors.

> Before the rule: Seeking to maximize profits, the company develops a product that pays a high commission to the salesperson. To recover those costs of promoting the product, the company

charges higher fees to the investor. To mask those costs, the company adds a variety of complex features and riders that make it extremely difficult to determine whether, and under what conditions, the product would be the best option for the investor. Insurance agents and brokers operating under a suitability standard aggressively sell the annuity in order to earn the generous compensation.

After the rule: Seeking to maximize profits, the company develops a product that has modest costs and includes excellent investment options within its subaccounts. The company makes the product as simple and straightforward as possible, so that advisors will easily be able to determine whether, and under what circumstances, it is the best option for the investor. Insurance agents and brokers operating under the DOL fiduciary standard sell the investment with confidence, knowing that it allows them to meet the rule's best interest and reasonable compensation standards. Retirement savers get the benefits of guaranteed income in retirement, without the excessively high costs that have too often marred annuity products.

Workers and retirees who struggle to afford a secure and independent retirement deserve advice they can trust. The new DOL conflict of interest rule helps to deliver that reform by holding financial advisors accountable for acting like the advisors they claim to be. Once the rules are implemented, retirement savers will reap enormous rewards in the form of reduced costs and improved performance on their retirement investments.

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