CFA Consumer Federation of America

DOL Retirement Security Proposal
Would Protect Retirement Savers From Bad Investment Advice

The Department of Labor (DOL) recently released a rule proposal that would strengthen protections for retirement savers who seek professional investment advice. The current rules need to be modernized to close loopholes that allow investment professionals and firms to put their own financial interests ahead of retirement investors' best interests. They may steer retirement savers into products, services, or account types that maximize their own revenues but come with excessively high costs, poor performance, unnecessary risks, or illiquidity, jeopardizing retirement savers' financial security. Conflicts of interest among many investment professionals and firms take a huge toll on the ability of millions of workers and retirees to have a financially secure and dignified retirement.

The DOL's proposed rule would close the current regulatory loopholes to ensure that all investment professionals provide advice that is in retirement savers' best interest and that any conflicts of interest do not taint their advice. This "best interest" standard would apply across the board: to any investment professional advising on retirement accounts for any recommended investment product.

The Current DOL Rule Requires Modernization to Adequately Protect Retirement Savers From Conflicted Investment Advice.

Because of loopholes in the regulatory definition of who is considered a fiduciary under the Employee Retirement Income Security Act (ERISA) of 1974, some financial professionals are allowed to provide investment advice without being held to the high professional standards appropriate to their consequential role. A major loophole in the current rule is that one-time advice—no matter how financially consequential—is not covered. This means that when an individual leaves a job, the recommendation to roll over their entire 401(k) to an Individual Retirement Account (IRA) is currently not covered—even if doing so would leave the retirement saver worse off. Firms and investment professionals often have strong incentives to recommend rollovers because it can mean a big pay day for them. There have been cases of investment professionals winning all-expense paid exotic vacations for persuading retirement savers to roll over their life savings to their firm. Similarly, a one-time recommendation to a 401(k) plan sponsor as to the menu of investment options provided to employees may include investments marked by high costs and low performance, which can erode employees' hard earned savings and returns. Studies indicate that the annual costs to retirement savers attributable to conflicted advice is huge, representing billions of dollars in lost savings every year. At an individual level, retirement savers may lose tens if not hundreds of thousands of dollars over time.

Other Regulators Have Not Fully Addressed the Problem of Conflicted Retirement Advice.

<u>The SEC has not fully solved the problem.</u> While the Securities and Exchange Commission (SEC) finalized Regulation Best Interest (Reg. BI) in 2019 to enhance the standard of conduct for broker-

dealers, this standard does not apply to all investment professionals, all products, or all accounts. Specifically, Reg BI is limited to recommendations to retail customers about *securities*. Thus, to the extent an investment professional provides recommendations about non-securities, such as some insurance products, real estate, futures or options, precious metals, or cryptocurrency offerings, Reg. BI simply doesn't apply. Similarly, to the extent an investment professional provides recommendations to retirement plans, which do not meet Reg. BI's definition of retail customer, Reg. BI doesn't apply. As a result, there is a lack of uniform protections for retirement savers, which leave them vulnerable to harmful conflicts of interest.

<u>The NAIC provides weak protections.</u> Attempts to shore up the standards applicable to annuity recommendations have proven even less effective. The National Association of Insurance Commissioners (NAIC) adopted updates to its Annuity Transactions Model Regulation (#275) in 2020, but it is a meaningless standard. Unlike Reg. BI, which imposes an explicit best interest obligation on broker-dealers, the NAIC Model Rule states that an insurance producer "has met" their best interest obligation if they "have a reasonable basis to believe the recommended option effectively addresses the consumer's financial situation, insurance needs, and financial objectives." This "effectively addresses" standard is a lower standard than the one Reg. BI places on broker-dealers.

In addition, unlike Reg. BI, which defines "material conflict of interest" broadly to include all forms of compensation and requires firms to mitigate conflicts of interest that create incentives for investment professionals to place their or their firm's interest ahead of the retail customer's interest, the NAIC Model Rule remarkably excludes both cash and non-cash compensation from its definition of "material conflict of interest." As a result, the NAIC Model Rule does not require investment professionals recommending annuities to mitigate their compensation-related conflicts. This fractured regulatory environment has created uneven protections for investors and loopholes in the regulation of annuities, where annuities that are regulated as securities are subject to Reg. BI while annuities that are not regulated as securities are subject to the weaker NAIC Model Rule.

<u>The Proposed Rule Includes Key Protections for Retirement Savers.</u>

The DOL proposal would close the current regulatory loopholes:

- It would **cover rollover recommendations** to ensure that retirement savers receive strong protections when they are most vulnerable to receiving conflicted advice that harms their financial security.
- The proposal would **cover advice to employers who sponsor 401(k) plans** to ensure that the advice they receive about the menu of 401(k) plan investment options they should offer to their employees is not tainted by conflicts of interest.
- The proposal would **apply to all retirement investments**, including not only securities but also non-securities such as many insurance products and a wide range of other investments not currently covered.

Under the proposal, a person who makes an investment recommendation in one of the following contexts would be a fiduciary:

(1) The person has **discretionary authority or control** over the retirement saver's investments;

(2) The person makes investment recommendations on a **regular basis as part of their business** and the recommendation is provided under circumstances indicating that the recommendation is **based on the particular needs or individual circumstances** of the retirement investor and **may be relied upon by the retirement investor** as a basis for investment decisions that are **in the retirement investor's best interest**; or

(3) The person **represents or acknowledges** that they are a **fiduciary**.

The proposal is designed to ensure that ERISA's fiduciary standards uniformly apply to all situations where retirement investors reasonably expect that their relationship with an advice provider is one in which the investor can—and should—place trust and confidence in the recommendation.

<u>This Proposal is Substantially Different From the 2016 Rule and is Responsive to the 5th Circuit Court of Appeals' Concerns.</u>

<u>This proposal defines fiduciary retirement investment advice much more narrowly than the 2016 rule.</u> According to the 5th Circuit Court of Appeals, the 2016 fiduciary rule was overbroad in defining who was an investment advice fiduciary because it captured certain interactions where an investor might not have placed their trust and confidence in the investment professional. In response to these concerns, the proposal provides that fiduciary status would attach only if compensated recommendations are made in certain specified contexts where a retirement investor can and should reasonably place their trust and confidence in the advice provider.

<u>This proposal does not require firms to execute contracts warranting compliance</u>. The 2016 fiduciary rule required firms to execute best interest contracts with warranties guaranteeing that they and their investment professionals would comply with certain protective conditions. The contract created an enforcement mechanism for harmed IRA investors, allowing them to sue for a firm's breach of the warranties. Because the 5th Circuit held that the DOL was prohibited from creating this private right of action, the new proposal neither includes a contract requirement nor requires firms to warrant that they will comply with certain protective conditions. The only enforcement mechanism for violating the rule with regard to IRA investment recommendations, consistent with already-existing law, is an IRS imposition of an excise tax.

<u>Opponents' Purported Concerns for Small Savers Are Groundless.</u>

Many in the financial services industry have long opposed DOL efforts to fix the problem of conflicted retirement investment advice. Their interest is in preserving the very profitable status quo. And their arguments against the rule are unpersuasive.

Industry opponents claim that savers with low account balances or of modest means would be worse off because they would lose access to investment advice under this rule. This is little more than a scare tactic based on their 2016 rule assumptions, which are not applicable to the current proposal.

The reality is that strong protections won't deprive retirement savers of access to advice. In the first instance, many financial professionals already support and successfully operate under a strong fiduciary standard while serving clients all along the income spectrum. In addition, the proposal broadly aligns with the SEC's Reg. BI, and there is no evidence that this regulation has reduced small savers' access to investment recommendations. To the contrary, Reg. BI has demonstrated that investment professionals and firms can operate under an explicit best interest standard that requires the mitigation of conflicts of interest while still allowing investment professionals to be paid by commission. We expect the DOL rule to operate similarly, providing comparable protections to retirement plans and participants and to individual retirement savers.

Far from harming small savers, the proposal would provide them with important protections. Small savers are particularly vulnerable to the detrimental effects of conflicted advice. With fewer economic resources, they can least afford to lose any of their retirement savings to bad advice. Contrary to the rule opponents' assertions, small savers, in fact, have the most to gain from the DOL proposed rule.