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.

Consumer Federation of America

Industry Claims That DOL Fiduciary Will Unleash Flood of Litigation Don't Hold Water

Industry groups seeking to stave off a new Department of Labor rule proposal to strengthen protections for retirement savers have argued that it would unleash a flood of litigation. While it is true that retirement savers with meritorious claims should find it easier to recover their losses if the rule is adopted, there is simply no basis for the claim that the rule would significantly increase the amount of litigation. To suggest that it would ignores not only the high cost of pursuing claims, and the particular difficulty of pursuing class action lawsuits, but the plain language of the rule itself.

Advisers Won't Face Lawsuits Based Solely on the Outcome of their Recommendations

Perhaps the most extreme of the claims with regard to litigation risk is that financial professionals will be vulnerable to lawsuits anytime their customers lose money on an investment they recommended or make less money than they could have made had they invested differently. This is patently absurd. There is no evidence that investment advisers who are subject to a best interest standard under securities laws face such claims. Moreover, the DOL rule proposal makes clear that recommendations will be assessed for compliance with the best interest standard based, not on the outcome of those recommendations, but on the circumstances prevailing at the time the recommendation was made.

Indeed, the DOL rule proposal poses even less of a threat of such litigation than the securities law best interest standard, since it does not automatically impose an ongoing duty of care on ERISA fiduciaries. Only where the adviser agrees by contract to provide ongoing account oversight would he or she would have to monitor the recommendation to ensure that it continues to serve the best interests of the customer under the DOL rule proposal. Absent such an agreement, there would be no ongoing duty and thus no basis for a claim. Moreover, even where the adviser has an ongoing duty, compliance with the standard would be determined based, not on hindsight, but on whether an impartial expert would view the recommendation as in the best interest of the customer in light of prevailing circumstances.

Finally, customers who wish to bring a case based solely on the outcome of the investment would be unlikely to find an attorney willing to represent them. Because of the unlikelihood of success, attorneys whose pay typically depends on the outcome of the claim would have no incentive to take such a case.

Class Action Lawsuits Will Remain Rare

Some opponents of the rule have seized on the provision prohibiting advisers from forcing customers to sign away their right to participate in class action lawsuits as representing a broad new expansion of liability. In reality, however, this provision merely reaffirms existing FINRA policy, which already prohibits any such limitations on customer rights. There are two main reasons to believe class actions will remain the rare exception, rather than the rule. The first is that very few cases will lend themselves to class treatment. The second is that even cases that lend themselves to class treatment face significant barriers.

Claims based on violation of fiduciary duty turn on whether the recommendation was in the best interest of the customer. That is a very fact-specific determination that will differ for each customer based on his or her personal situation and needs. However, an attorney seeking to certify a class must prove commonality of the harm suffered throughout the class. As a result, the vast majority of claims based on violation of fiduciary duty simply will not lend themselves to class treatment and will continue to be brought as individual claims in arbitration.

Moreover, class actions face daunting procedural barriers that often prevent such actions from moving forward. First, a judge must approve of the formation of a class and allow the named plaintiff to bring the action on behalf of the class. For this to occur, a representative plaintiff must prove commonality of harm among class members, that the class is so numerous that it is impracticable to bring suit otherwise, that the claims or defenses of the named plaintiff are typical of the claims or defenses of the class, and that the named plaintiff will fairly and adequately represent and protect the interests of the class. Most classes seeking money damages also require a judge to find that issues common to the class members predominate over issues affecting individual members and that a class action is superior to other available methods of adjudicating the controversy. If a class manages to clear these hurdles and is certified by a judge, a defendant can appeal the court's decision, which can tie up the case and increase costs for a named plaintiff and his or her attorneys. The appeals process can delay, and often cripple the progress of a class action, turning it into a battle of attrition where the party with the most resources (usually the defendant) wins.

As a practical matter, smaller firms simply do not have a big enough client base to makes class treatment worthwhile. Instead, the most likely class action target under the DOL rule would be a large firm that, in clear violation of the rule, adopts policies and practices that encourage their advisers to provide conflict-ridden retirement investment advice. For example, a large firm that continued to use quotas and bonuses to encourage the sale of in-house products across its IRA platform could be vulnerable to class action litigation. Similarly, a large firm could face class action litigation if it relied on the best interest contract exemption to engage in widespread sale of products that are clearly not permitted under that exemption, such as non-traded REITS. These are precisely the sorts of situations where class actions provide an appropriate and effective mechanism to hold firms accountable for compliance with the rule.

Most Claims Will Continue to Go to Arbitration

For the reasons noted above, most claims brought under the DOL rule proposal are likely to be individual claims. Because the DOL's proposal specifically allows firms to include pre-dispute binding arbitration clauses in their contracts, the vast majority of these claims will likely be heard in the industry-run FINRA arbitration forum rather than in court. Although arbitration is promoted as providing an inexpensive alternative to court, the costs are sufficient to deter even small meritorious claims, let alone the frivolous claims industry argues are a threat under the DOL rule proposal.

For example, a combination of filing fees, discovery costs, expert witness fees, hearing session fees, and costs for a court reporter can easily add up to $30,000 before attorney's fees, according to attorneys who are familiar with the system. Most attorneys work on a contingency fee, which means they agree to front a significant portion of the litigation costs in return for receiving reimbursement and a percentage of any recovery. Cases have to be worth their time, effort, energy and resources, otherwise they aren't going to invest in them. As a result, they have little if any incentive to take cases unless they expect to win and to win an award sufficient to cover the considerable costs of bringing the claim. Alternatively, an attorney can charge by the hour. That can add up very quickly to tens of thousands of dollars in legal bills that all but the wealthiest claimants will be unable to afford. If, despite these deterrents, an investor brings a frivolous claim, that investor may be responsible for paying the other side's attorneys fees, possibly amounting to tens of thousands of dollars.

The Rule Proposal Could Decrease the Amount of Litigation

One over-looked aspect of the rule proposal is its potential to reduce litigation by reducing predatory practices. In a recent letter to members, FINRA CEO Rick Ketchum noted that firms could significantly reduce their compliance problems and regulatory risks if they would put the interests of their customers first. By requiring firms to take concrete steps to eliminate practices that encourage bad conduct, the DOL rule proposal achieves what FINRA only suggests. Moreover, it would not only require firms and advisers to put customer interests first, it would also require firms to eliminate the practices that encourage advisers to act in ways that are not in the customer's best interest. By reducing the incentives to steer clients into inferior investment options, the rule should reduce abusive conduct. 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.

Meritorious Claims Should Fare Better under the DOL Rule

While the DOL rule would not increase the amount of litigation, it should improve the ability of those with meritorious claims to recover losses sustained as a result of abusive retirement investment advice. As a recent study by the Public Investors Arbitration Bar Association documented, the same financial professionals who routinely market themselves as objective advisers putting their customers first immediately drop that pose in arbitration and deny any such obligation. Because the rule proposal would force financial professionals who receive conflicted compensation to sign a contract in which they acknowledge their duty to give fiduciary advice, plaintiffs would no longer have to prove that a fiduciary relationship existed. Instead, it would be enough to show a violation of the standard, rather than that the standard applies.

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Financial professionals who take advantage of retirement savers' trust should be held accountable for their abusive conduct. The DOL rule proposal provides that accountability without posing any credible threat of excessive litigation or frivolous claims. It deserves our strong support.

Consumer Federation of America

May 18, 2015

Dear Representative:

Small broker-dealers and insurance agents have been hearing ominous predictions from their trade associations for years about the consequences of a Department of Labor (DOL) rule proposal that would require them to meet the fiduciary standard of serving their clients' best interests when providing retirement investment advice. So it is not surprising that they are worried. The truth is, however, that the rule the DOL has proposed is very different from what they have been led to expect and will allow them to continue to serve their clients while earning sales-based compensation and selling from a limited menu of investment products. This approach will benefit retirement savers, the many advisors who already seek to serve their customers' best interests, and product sponsors that compete on the quality and cost of their investment options.

The DOL rule proposal would close loopholes in the definition of investment advice that have allowed broker-dealers and insurance agents to escape the fiduciary duty under the Employee Retirement Income Security Act (ERISA) when offering advice to retirement savers. At the same time, however, DOL has proposed exemptions that will allow these advisors to continue to maintain their sales-based business model subject to appropriate restrictions.

- They will have to enter into a contract with customers in which they promise to obey the law and provide advice that is in the best interest of the customer.
- They will have to charge reasonable fees for their services.
- They will have to take concrete steps to minimize conflicts of interest associated with their business model.
- They will have to provide point-of-sale and on-going disclosure regarding the cost of their services and the investments they recommend.

The same trade associations that previously sold these small advisors on the message that they wouldn't be able to charge commissions at all are now telling them that they won't be able to meet these reasonable compliance obligations. Their new predictions have no more factual basis than their earlier misinformation about restrictions on commission compensation. Indeed, small advisors that choose to offer a menu of high-quality, reasonably priced investment options will see relatively little impact from the rule. For example, contrary to the fear mongering they've heard from their trade associations:

- Advisors will remain free to recommend variable annuities, so long as the recommendation is in the best interest of the investor and the fees are reasonable.

Annuities are on the list of financial assets advisors can recommend when relying on the best interest contract exemption.

- Advisors will be free to sell from a limited menu of products, including a menu of products made up exclusively of proprietary products. When they do, they will simply have to notify their customers of this limitation on their services, ensure that the investment menu is sufficiently broad to allow them to meet their best interest obligation to recommend a diversified portfolio, and ensure that any fees charged do not exceed the fair value of services provided.
- Advisors who sell products with high fees will still be able to comply with the rule by rebating excess fees to the customer.
- Advisors will not be at risk of being sued just because an investment they recommend performs poorly. The rule proposal clearly states that the best interest determination is based on the conditions prevailing at the time the recommendation is made, not its ultimate outcome. Where disputes do arise, existing FINRA policy with regard to pre-dispute binding arbitration clauses will continue to apply.

In short, those broker-dealers and insurance agents who charge reasonable fees for recommendations that serve their customers' best interests will see relatively little impact from the rule, and could in fact benefit from a leveling of the playing field. Those whose business is built around the recommendation of high-cost, low-quality investment options will be forced to make a more dramatic adjustment, and appropriately so. Perhaps the biggest impact will be on product sponsors who, instead of competing on the quality and cost of their investment options, currently compete by compensating advisors more generously. They will have to either adjust or risk losing market share, and that too is an appropriate outcome of the rule.

Retirement savers deserve investment advice that will help them achieve a secure and independent retirement. The DOL rule proposal helps to achieve that goal while providing sufficient flexibility for advisors operating under a variety of business models to comply. It deserves all our strong support.

Respectfully submitted,

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