Consumer Federation of America

Modernizing Fiduciary Duties: Why Rules Relating to the Provision of Professional Investment Advice Must be Updated

- Many retail investors assume that when they seek financial advice from a financial professional, the financial professional is acting in their interests. But that is not always the case. Unless a financial professional has a fiduciary duty to his or her client and is therefore legally required to act in the client's interests, the financial professional can take advantage of the client to maximize the professional's profits.
- Both the Department of Labor (DOL) and the Securities and Exchange Commission (SEC) have jurisdiction over financial professionals, but regulate in different contexts. The DOL has authority to directly regulate employer-sponsored plans (like 401(k)s and 403(b)s) and its regulations indirectly affect non-employer-sponsored retirement accounts (like IRAs). The SEC has authority to regulate retail accounts, which can include retirement accounts.
  - With regard to the SEC's jurisdiction under the Investment Advisers Act: while registered investment advisers owe a fiduciary duty to their clients to act in their clients' best interests, broker-dealers do not. Broker-dealers are merely required to provide advice that is "generally suitable," a much lower standard, and one that allows broker-dealers to profit at investors' expense.
  - With regard to the DOL's jurisdiction under ERISA: ERISA became law in 1974 and the rules promulgated pursuant to ERISA were enacted in 1975. Those rules severely restricted the applicability of a fiduciary duty to act in a client's sole interests. Also, the DOL's fiduciary rules took effect around the time that Individual Retirement Accounts (IRAs) were created and several years before 401(k)s came into existence, and were not adapted to work effectively with those types of accounts.
- Both the SEC's and DOL's rules are outdated. They don't adequately protect investors or reflect the current realities of the marketplace, given the shift in the last few decades from traditional pension plans to IRAs, 401(k)s, and other investment options for which investors are personally responsible.
- Consider these trends:
  - According to DOL, the number of active participants in private-sector defined contribution plans increased from 11.2 million in 1975 to 73.4 million in 2010, while the number of active participants in private-sector defined benefit (traditional pension) plans declined from 27.2 million to 17.1 million during the same time period.[1]
  - According to the Investment Company Institute (ICI), 68 percent of U.S. households reported that they had employer-sponsored retirement plans, IRAs, or both, in May 2012. Of the $19.5 trillion in total retirement market assets, $5.1 trillion is invested in employer-sponsored defined contribution plans and another $5.4 trillion is invested in IRAs.[2]
  - Workplace retirement plans, IRAs, and other tax-deferred accounts constitute the vast majority of Americans' mutual fund ownership. According to ICI, 92 percent of households that owned mutual funds held shares inside workplace retirement plans, individual retirement accounts (IRAs), and other tax-deferred accounts.[3]
  - For those Americans that owned mutual funds outside workplace retirement plans, 82 percent made their purchases with the help of an investment professional, including registered investment advisers, full-service brokers, independent financial planners, bank and savings institution representatives, insurance agents, and accountants.[4]

---

[1] U.S. Department of Labor. Employee Benefits Security Administration, Private Pension Plan Bulletin Historical Tables and Graphs (June 2013) http://1.usa.gov/Rp8Bwu

[2] Investment Company Institute, 2013 Investment Company Fact Book, A Review of Trends and Activities in the U.S. Investment Company Industry, http://bit.ly/1jKM4U0

[3] *Id.*

[4] *Id.*

- With so many people depending on professional advice to make their investment decisions, it's critical that they are protected from unscrupulous tactics. However, our current patchwork regulatory regime allows non-fiduciary financial professionals to recommend to their clients investments that offer lucrative remuneration for the financial professionals but with excessive costs, substandard features, high risks, or poor performance that makes them inferior to other alternatives for the investors.
- Excess fees can have a significant impact on the long-term savings of investors. As the SEC warned in a recent bulletin for investors, "[o]ver time, even ongoing fees that are small can have a big impact on your investment portfolio," reducing returns, shrinking a nest egg, and preventing investors from achieving financial goals.[5]
- The DOL illustrated the harm associated with fees that accompany non-fiduciary advice: "Assume that you are an employee with 35 years until retirement and a current 401(k) account balance of $25,000. If returns on investments in your account over the next 35 years average 7 percent and fees and expenses reduce your average returns by 0.5 percent, your account balance will grow to $227,000 at retirement, even if there are no further contributions to your account. If fees and expenses are 1.5 percent, however, your account balance will grow to only $163,000. The 1 percent difference in fees and expenses would reduce your account balance at retirement by 28 percent."[6]
- IRA rollovers provide another illustration of where investors can be harmed from advice given by a financial adviser who is not operating under a fiduciary standard. Rollovers do not currently fall within ERISA's overly restrictive definition of "investment advice" and, as a result, not all advice relating to rollovers is held to a fiduciary standard. A 2013 report by the Government Accountability Office (GAO) provides alarming evidence of the tactics that financial advisers engaged in through the IRA rollover process to secure workers' assets. For example, financial advisers aggressively encouraged rolling 401(k) plan savings into an IRA, and with only minimal knowledge of a caller's financial situation. They often claimed that 401(k) plans had extra fees and that IRA's "were free or had no fees," or argued that IRAs were always less expensive, notwithstanding that the opposite is generally true. They also made it more convenient to rollover into an IRA, offering to fill out IRA paperwork on behalf of customers, and provide cash bonuses for opening an IRA. The report found that investment firms sometimes offer financial or other incentives to financial advisers who persuade workers to perform a rollover. These practices and the abuses that naturally flow from them are precisely why the ERISA fiduciary standard should apply to rollover transactions.
    - As of May 2012, of the 39 million households that own traditional IRAs, 51 percent (or 20 million U.S. households) report that their IRA accounts include rollover assets from another retirement plan.[7] Among traditional IRA-owning households with rollovers, 27 percent had undertaken a rollover since 2010.[8] And thirteen times as many assets were rolled over into IRAs as were directly contributed in 2011.[9] Cerulli Associates, a research firm based in Boston, estimates that workers rolled over nearly $358 billion from 401(k)s into IRAs in 2013—and that between 2014 and 2018, another $2.1 trillion will follow.[10]
- Financial advisers are also more likely to target less sophisticated and less affluent investors with products that are higher-cost, or include substandard features, high risks, or poor performance that makes them inferior to other alternatives. The academic literature strongly suggests that it is the less wealthy, often less sophisticated investors who are most at risk from recommendations that are not in their best interests.[11]
- **Bottom line:** Investors are not currently protected from unscrupulous financial professionals who don't have their interests in mind when they provide them personalized investment advice. As a consequence, investors are vulnerable to being taken advantage of. Without prompt and appropriate action by DOL and SEC, investors will continue to be exposed to those in the financial services industry who seek to profit at their expense.

---

[5] U.S. Securities and Exchange Commission Investor Bulletin: "How Fees and Expenses Affect Your Investment Portfolio," February 19, 2014, http://1.usa.gov/1nbMSF6
[6] U.S. Department of Labor, "A Look at 401(k) Plan Fees," August 2013, http://1.usa.gov/1paeI6G
[7] Investment Company Institute, 2013 Investment Company Fact Book, http://bit.ly/1jKM4U0
[8] *Id.*
[9] Mark Shoeff Jr., *Navigating 401(k) rollovers*, INVESTMENT NEWS, Mar 2, 2014, http://bit.ly/1j0F3LI
[10] Jason Zweig, *Who's Training Your Retirement Navigator?,* THE WALL STREET JOURNAL, February 14, 2014, http://on.wsj.com/1hLJxKJ
[11] Dr. Michael Finke, "Fiduciary Standard: Findings from Academic Literature," attached to the letter from IMCA, July 5, 2013 to the SEC in response to the request for comments on the "Duties of Brokers, Dealers and Investment Advisers," http://1.usa.gov/1kyBBw9