



Insight

In Whose Best Interest?

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Executive Summary

- The Department of Labor (DOL) has proposed a new rule to regulate the business of investment advice under the perception that existing standards are outdated and fail to appropriately safeguard consumers; the Biden Administration is positioning its efforts as part of its continued assault on “junk fees”.
- Specifically, the DOL’s proposed rule seeks to extend existing standards to cover IRA rollover recommendations by amending a small section of a test that determines whether a fiduciary responsibility exists.
- The proposed change to the law is so broad, however, that it would potentially cover all financial advice, creating higher costs for investment advisors, necessarily raising the cost of financial advice and thus reducing the financial advice available to consumers

Introduction

The Department of Labor (DOL) has proposed [a new rule](#) to regulate the business of investment advice, with the Biden Administration [positioning its efforts](#) as part of its continued assault on “[junk fees](#).” This marks the third attempt by three successive administrations – including a failed attempt under the Obama Administration and a successful initiative under the Trump Administration – to update the fiduciary standard that exists between brokers and the clients they serve as policymakers struggle to reconcile the perceived need for consumer protection against free and open markets. This latest iteration, despite the unnecessary and unhelpful framing as part of the Biden administration’s war on junk fees, seeks to expand the definition of “investment advice fiduciary” to allow existing protections to apply to rollover individual retirement accounts (IRAs). The proposed change to the existing test is so broad as to potentially capture all financial advice, creating higher

costs for investment advisors, necessarily raising the cost of financial advice and thus reducing the financial advice available to consumers.

Background

Investors have a wide range of financial advisors they can turn to for guidance, most prominently stockbrokers and financial advisors. The activities that a broker and an independent financial advisor perform may look very similar; some financial advisors are both. The key differentiator is who regulates the professional and, relatedly, the duty each owes his or her customers.

Investment advisors (if registered) are regulated by the Securities and Exchange Commission (SEC) and have, since the [Investment Advisers Act of 1940](#), a “fiduciary” obligation to their clients. Fiduciary, which comes from the Latin “fides,” meaning “faith,” (or alternately, “fiducia,” meaning “trust”) requires investment professionals to put the best interest of their clients (the beneficiaries) first.

By comparison, brokers are usually, but not always, self-regulated by the Financial Industry Regulatory Authority (FINRA). They must meet a lower standard of duty to their clients, known as the five-part “suitability” rules. The suitability standard is neither too low nor insufficient a protection for the investor, but it is clearly a lower bar; brokers are required to recommend to their clients a “suitable” product, rather than a product in their “best interest” (although it could be argued that this standard is more reasonable than some amorphous and unattainable “perfect” investing solution).

Brokers increasingly have moved from their original function, which was to facilitate investment transactions, into advisory-like activities. Likewise, the business of investment advice has itself changed, with the Investment Advisers Act predating the invention of the 401(k). Although this trend has been apparent over the past 50 years, it was [greatly accelerated](#) by DOL’s recent fiduciary rule (more on this below). Although only partially enacted, the rule made it overly costly to sustain the brokerage model. Some smaller investors are not able to meet typical account minimums of advisory accounts, and therefore their only option is a brokerage account. Any regulation under which the brokerage model is not viable is not doing investors any favors.

As brokers performed increasingly advisor-like activity, some brokers assumed the title of “advisor,” despite not being regulated by the SEC, and used the implied credential to sell investments that netted the largest broker commission. Few would argue that Investment Advisers Act cannot or should not be updated; yet agreement on the details of that reform has proven difficult for successive administrations and Congresses to obtain.

Previous Reform Efforts

The perceived lack of investor protection motivated two previous notable recent regulatory responses: the first by the Obama Administration in the form of the DOL fiduciary rule, and the second by the Trump Administration in the SEC Best Interest proposed regulation.

The DOL fiduciary rule, first proposed in April 2016 and originally slated to be phased in from April 10, 2017, was executed in the worst possible manner. The fiduciary rule sought to apply the fiduciary standard to all investment professionals who provided retirement investment advice, regardless of what they called themselves. Financial advisors would be required to disclose all conflicts of interest and compensation, and a lengthy and painful Best Interest Contract Exception (BICE) would be required in certain cases. BICE would allow financial advisors to recommend transactions that would otherwise be prohibited, provided that they had contractually committed to a fiduciary standard; BICE itself, however, came with a significant number of caveats.

The fiduciary rule represented a significant expansion of the relevant regulation, the Employee Retirement Income Security, or ERISA, Act of 1974. Curiously, despite financial advisors largely falling under the SEC or FINRA, the law fell under the purview of the DOL, which, as a result, had only retirement accounts within its scope. The SEC, slow to act on reform, was beaten to the punch by the DOL in what amounted to a significant regulatory land grab. The fiduciary rule has since received substantial opprobrium on a number of fronts: It was voluminous (over 1,000 pages); disclosure requirements for financial advisors were punitive, with the most attractive products in the industry (variable and indexed annuities) necessitating BICE coverage; and, most odd, the executive power and expansion in scope the DOL arrogated to itself.

In June 2018, following the Trump Administration's unwillingness to defend the fiduciary rule, the Fifth Circuit Court of Appeals vacated the rule, noting that the DOL's implementation represented "[an arbitrary and capricious exercise of administrative power.](#)" Brokers (and insurers more broadly) spent millions of dollars preparing for a rule that only ever partially came into effect.

Into this environment, the SEC then provided its own interpretation. The SEC was always the appropriate body for this rulemaking, and the proposed Best Interest Regulation applied to all investment accounts, significantly decreasing the fragmentation and confusion of the fiduciary rule. Perhaps recognizing the fraught history of the term fiduciary, the SEC suggested a "best interest" standard that all but knocks on the door of fiduciary. As SEC Commissioner Hester Peirce noted at the time, fiduciary is a term that is "[wonderful for marketing purposes, but potentially misleading for investors.](#)"

The primary criticism leveled against the Best Interest Regulation was that “best interest” itself was not defined, trading one amorphous legal concept for another. The best interest standard as developed had its positives, however – a standard that is clearly greater than suitability but less than fiduciary allows for development and debate. The best interest standard may even provide greater legal protection than fiduciary standards, as brokers must mitigate and eliminate conflicts of interests, whereas under the fiduciary duty, all that was required was disclosure. Further, the SEC provides for a spectrum of advisor-investor obligation, allowing investors to choose their desired level of protection based on their risk appetite and finances. The criticism of allowing this fluidity – that investors may not understand the duty of care provided by their advisor – was mitigated by the SEC requirement that brokers at stand-alone broker-dealerships not be able to use the word “advisor” in their title.

The SEC’s Regulation Best Interest [still applies and is in effect today](#).

A New Proposed Rule

Under the five-part “[1975 Test](#)” that determines whether there is a fiduciary relationship under ERISA, an advisor’s advice must be provided on a “regular” basis. This excludes much one-time advice, including the recommendation to make a rollover. In its new proposed rule, the DOL is attempting to update this language. Yet rather than trying to better capture the relationship between an advisor and their client over time, the DOL is attempting to once again significantly broaden the scope of ERISA standards, with “regular” instead being used to describe the financial advisor’s typical activities. A fiduciary duty could arise between an advisor and a client simply because an advisor often acts in a fiduciary capacity, with no reference whatsoever to the actual business conducted with that particular consumer.

The Obama’s Administration’s attempt to update the fiduciary rule is viewed to have failed for several reasons. The proposed rule was far too broad in scope, covering all investment advisors and all investment products despite the key differences in both. In addition, the rule as proposed was close to unworkable, with extraordinarily burdensome disclosure requirements that notably included a significant number of caveats undermining the point in the rule. Notably, despite efforts by the DOL to craft a “more narrowly tailored” rule, this expansion and fundamental restructuring of the 1975 Test risks the same end in the courts as the Obama-led fiduciary rule, where the U.S. Court of Appeals for the Fifth Circuit [ruled](#): “The Fiduciary Rule conflicts with the plain text of the ‘investment advice fiduciary’ provision as interpreted in light of contemporary understandings, and it is inconsistent with the entirety of ERISA’s ‘fiduciary’ definition. DoL therefore lacked statutory authority to promulgate the Rule with its overreaching definition of ‘investment advice fiduciary.’”

In its new proposal, the Biden Administration proposes to make these same errors again and goes one step further by appearing to ignore the SEC's own Best Interest reform. Even putting these concerns aside, the rule as proposed will create higher costs for investment advisors, necessarily raising the cost of financial advice and reducing the financial advice available to consumers – the cost of which the DOL has not considered. Under the proposed rule, it will fundamentally become significantly more difficult to sell annuities via 401(k) rollovers, causing millions of Americans to lose both access to financial advice and the products that may best suit their needs.

Conclusions

The Biden Administration [fact sheet](#) (interpreting that concept rather broadly) that accompanies the announcement of the rule includes the following astounding assertion: “When the saver pays for advice that is not in their best interest, and it comes at a hidden cost to their lifetime savings, that’s a junk fee.” This wild mischaracterization of investment advice, the current regulatory environment, and the continually abused concept of the “junk fee” makes it difficult to see the proposed rule as anything other than what it may just be: a Trojan horse for populist politics masquerading as policy. At its core, however, the proposed rule seeks to make one very minor adjustment to the existing fiduciary standard but in doing so seeks to extend the existing framework far past the point of breaking.