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.