United States Government Accountability Office

Report to Congressional Requesters

JULY 2024

RETIREMENT INVESTMENTS

Agencies Can Better Oversee Conflicts of Interest between Fiduciaries and Investors

This Report Is Temporarily Restricted 30 Days Pending Official Public Release.

GAO-24-104632

GAO Highlights

Highlights of GAO-24-104632, a report to congressional requesters

Why GAO Did This Study

The interests of financial professionals and firms often conflict with the interests of retirement investors. This could create risks for millions of investors with over $18 trillion dollars in retirement savings in 401(k) plans and IRAs. Although federal agencies have taken steps to mitigate such conflicts, GAO was asked to assess where issues around conflicts of interest and investment advice stand today.

This report examines (1) industry changes to address the 2016 rule; (2) conflicts that can affect retirement investors, how they are communicated, and their association with investment returns; and (3) federal oversight of conflicts and actions that could improve oversight.

GAO interviewed financial industry associations to identify industry changes, examined disclosures from over 15,000 firms and conducted undercover calls to 75 financial professionals to identify conflicts and determine how they are communicated. GAO also performed a regression analysis to assess the association between conflicts and investment returns; and reviewed relevant federal laws and regulations and interviewed agency officials and others.

What GAO Recommends

GAO is making two recommendations to IRS, including that it develop and implement a proactive process to identify prohibited transactions between IRA fiduciaries and IRAs, and assess any associated excise tax. IRS agreed with our recommendations.

View GAO-24-104632. For more information, contact Tranchau (Kris) Nguyen at (202) 512-7215 or nguyentt@gao.gov.

July 2024

RETIREMENT INVESTMENTS

Agencies Can Better Oversee Conflicts of Interest between Fiduciaries and Investors

What GAO Found

Financial professionals providing retirement investors fiduciary investment advice must generally avoid conflicts of interest. Conflicts of interest can arise from, among other things, proprietary products, payments from third parties, and compensation arrangements, among other things. The Department of Labor (DOL) issued a final rule in 2016 that expanded the definition of fiduciary investment advice. That rule was vacated in 2018.

Firm responses to DOL's rule change varied. To comply, some firms moved toward standardized compensation for financial professionals, and away from compensation that can depend on recommendations, according to several industry association representatives. After the rule was vacated, some firms reversed certain practices established under the rule, and other firms kept their new practices.

Conflicts of interest disclosures are not always clear or understood. GAO found many conflicts associated with recommending one product over another in a review of over two thousand descriptions of conflicts of interest in required disclosures. Firms' disclosures of conflicts are available to investors, although—based on GAO's review of disclosures and prior GAO work—investors may not review or understand these documents. Federal agencies encourage investors to ask professionals about conflicts of interest, but GAO's undercover calls found that doing so may not always produce helpful information.

Mutual funds that compensate financial professionals are associated with lower average returns. GAO's analysis of Morningstar mutual fund data from 2018 to 2021 found that funds that compensate financial professionals based on whether their clients invest in those funds (a proxy for conflicts) is associated with lower average returns before fees. This could reduce retirement savings' growth over time and could make a difference of tens of thousands of dollars for investors in actively managed domestic equity funds at retirement.

IRA fiduciary oversight lacking. By law, the Internal Revenue Service (IRS) has sole enforcement authority over firms and financial professionals acting as fiduciaries under the Internal Revenue Code for Individual Retirement Accounts (IRA fiduciaries). IRS's approach to protect IRA investors from the conflicts of interest of IRA fiduciaries who engage in prohibited transactions relies on the IRA fiduciary self-reporting to IRS and paying the applicable excise tax, according to IRS officials. According to IRS, the excise tax is intended to safeguard income for retired workers by taxing transactions deemed particularly objectionable because of the potential for abuse of fiduciary responsibilities by parties having conflicts of interests. IRS officials said their practice regarding IRA fiduciaries is to enforce prohibited transactions that DOL refers to them. However, DOL does not have authority to audit IRAs for prohibited transactions and, therefore, is generally unable to refer IRA fiduciaries to IRS for excise tax enforcement. Until IRS implements an audit process for IRA fiduciaries, IRA investors may continue to be exposed to adverse impacts of prohibited transactions that can jeopardize their financial security in retirement.

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Abbreviations

AUM	assets under management
Advisers Act	Investment Advisers Act of 1940
BD	broker-dealer
DOL	Department of Labor
employer plan	employee pension benefit plan under ERISA
ERISA	Employee Retirement Income Security Act of 1974, as amended
ETF	exchange traded fund
Fifth Circuit	U.S. Court of Appeals for the Fifth Circuit
FINRA	Financial Industry Regulatory Authority, Inc.
Form ADV	Uniform Application for Investment Adviser Registration and Report by Exempt Reporting Advisers
IRA	individual retirement account
IRC	Internal Revenue Code
IRS	Internal Revenue Service
LB&I	IRS' Large Business and International Division
LIBOR	London Interbank Offered Rate
MOU	Memorandum of Understanding
PIC	Plan Investment Conflicts Project
PTE	prohibited transaction exemption
Relationship Summary	customer or client relationship summary
RIA	registered investment adviser
SB/SE	IRS' Small Business Self-Employed Division
SEC	Securities and Exchange Commission
TE/GE	IRS' Tax Exempt and Government Entities Division
Treasury	Department of the Treasury

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U.S. GOVERNMENT ACCOUNTABILITY OFFICE

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July 29, 2024

The Honorable Patty Murray
Chair
Committee on Appropriations
United States Senate

The Honorable Bernard Sanders
Chair
Committee on Health, Education, Labor and Pensions
United States Senate

The Honorable Robert C. "Bobby" Scott
Ranking Member
Committee on Education and the Workforce
House of Representatives

Conflicts of interest can occur in employer plans, including 401(k) plans, and in Individual Retirement Accounts (IRA), when a financial professional in a position of trust has professional or personal interests that compete with those of retirement investors.[1] These conflicts can have consequences for the tens of millions of workers who invest in 401(k) plans and IRAs. The estimated federal tax expenditure, or annual net revenue forgone, for tax-preferred retirement accounts was over $195 billion in 2022, according to the Department of the Treasury.[2] If the interest of a firm or financial professional in their own compensation erodes the future value of retirement accounts that are provided

[1]In this report we refer to employee pension benefit plans under the Employee Retirement Income Security Act of 1974, as amended (ERISA), as employer plans, and the term Individual Retirement Accounts (IRA) refers to individual retirement accounts and individual retirement annuities under 26 U.S.C. § 408(a) and (b).

[2]Department of the Treasury, Office of Tax Analysis, "Tax Expenditures" (Washington, D.C.: Mar. 6, 2023), https://home.treasury.gov/policy-issues/tax-policy/tax-expenditures. The tax expenditure annual cost is the income tax revenue that the government will not collect because of activities undertaken in calendar year 2022, which cause payment deferrals or other long-term receipt effects. In this case, we report the present value calculation of tax expenditures that follow from 2022 tax deferred and after-tax contributions that workers and employers made to defined contribution accounts and individual retirement accounts. These contributions cause a deferral of income tax payments on wages in 2022 and on subsequent investment earnings in later years, though taxes in the future will be due on amounts distributed that are attributable to the pre-tax contributions (including earnings).

preferential tax treatment, it impedes the policy goal of retirement income security.

Generally, a conflict of interest is an interest that might incline a firm or financial professional, consciously or unconsciously, to make a recommendation that is not disinterested, or not in the best interest of a retirement investor. Conflicts can derive from, among other things, proprietary products, payments from third parties, and compensation arrangements. Federal law generally requires firms and financial professionals providing investment advice for a fee as a fiduciary to employer plans or IRAs to either avoid transactions involving conflicts of interest or comply with an exemption.

In 2016, the Department of Labor (DOL) promulgated a final rule (the 2016 rule) that updated and superseded the 1975 regulatory definition of fiduciary in the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (IRC).[3] The 2016 rule aimed to ensure impartial advice in consumers' best interest, thereby rooting out excessive fees and substandard performance otherwise attributable to the conflicts of interest of financial professionals, producing gains for retirement investors.

In 2018, the U.S. Court of Appeals for the Fifth Circuit (Fifth Circuit) vacated the 2016 rule, reinstating the 1975 rule. Under the 1975 definition, recommendations associated with one-time product sales are not generally fiduciary advice under ERISA and the IRC. Since the Fifth Circuit's decision, questions have persisted about how industry prepared to implement DOL's 2016 rule and how conflicts have been regulated.

This report examines (1) the changes industry reported making to address DOL's 2016 rule; (2) conflicts of interest that can affect retirement investors, how they are communicated to investors, and their association with investment returns; and (3) the extent to which federal regulators oversee conflicts of interests and actions that could potentially improve their oversight.

[3]The rule applied to a plan under ERISA (such as a 401(k) plan) or a plan under the IRC (such as an IRA). DOL's 2016 rule expanded who is considered a fiduciary when providing investment advice for compensation. For more on the 2016 rule, see "Department of Labor's 2016 Fiduciary Rule Background and Issues." Congressional Research Service, R44884, Updated July 3, 2017.

To examine changes the industry reported making to address the 2016 rule, we conducted interviews or received written responses from 15 associations of financial professionals concerning industry changes to compensation and products and services in response to relevant laws and regulations. Specifically, we reached out to three associations from each of five subgroups: registered investment advisers (RIA), broker-dealers (BD), insurance firms, retirement plan sponsors, and fiduciary compliance firms—firms that help clients who are fiduciaries to understand and comply with fiduciary requirements. Five associations chose to respond to our questions in writing and we interviewed an additional 10. To augment the interviews and to provide illustrative examples, we reviewed selected industry surveys and reports provided by the associations. We selected associations with broad national membership that represented professionals across a range of business models associated with retirement investors and investment advice.

To describe the conflicts of interest that can affect retirement investors we reviewed responses to various questions by the universe of over 15,000 Securities and Exchange Commission (SEC)-registered investment advisers on Form ADV Part 1A as of September 2023.[4] For example, we reviewed whether the RIAs accepted payments for client referrals, recommended a related BD, or sold products or provided services other than investment advice to their advisory clients. We also reviewed conflicts disclosed by a non-generalizable sample of 20 RIAs, on the firms' Form ADV Part 2 advisory brochures. We constructed our sample to include a variety of compensation models and generally selected firms serving large numbers of non-wealthy individual investors.[5]

To describe communication about conflicts, we reviewed disclosures and placed undercover phone calls. For example, we analyzed the readability of the disclosure content on conflicts we reviewed from the nongeneralizable sample of 20 firms mentioned above. We placed undercover phone calls to a nongeneralizable sample of 75 financial professionals at a variety of types of firms providing access to retirement investment advice, posing as a retirement investor. We used Form ADV Part 1A data to construct a sample of firms to contact that included a

[4]Investment advisers file the Uniform Application for Investment Adviser Registration and Report by Exempt Reporting Advisers (Form ADV) to register with the SEC or state securities authorities. The SEC maintains the information submitted on this form and makes it publicly available.

[5]See appendix I for methodological information including our definition of "non-wealthy".

variety of compensation structures (commissions, asset-based fees, hourly and fixed fees) and business models (including RIAs that reported their firm was actively engaged in business as an insurance broker or agent and as broker-dealer of securities). Within each firm type, we selected firms working with large numbers of non-wealthy investors.

We selected firms located in states with large quantities of annuity premium revenue. Most of the offices we contacted were in Florida, Ohio, Pennsylvania, and Texas. We generally used "contact-us" forms or other generic forms of communication to be referred to a financial professional. We analyzed transcripts of the calls for information the retirement investor might learn about conflicts of interest, standards of care, and financial incentives, which is information that might help a retirement investor make related decisions.[6] Findings from our nongeneralizable samples cannot be used to make inferences about the population of RIAs, financial professionals, or industry associations.

To describe the association that conflicts may have with investment returns, we conducted a regression analysis with industry mutual fund data on revenue sharing and other fees that mutual funds or fund advisers pay to firms with associated financial professionals who recommend mutual funds. We describe the association between those financial incentives and fund performance.[7]

To describe the extent to which federal regulators oversee conflicts of interests and actions that could potentially improve their oversight, we reviewed relevant federal laws, regulations, and agency documentation. We interviewed agency officials and staff at DOL, the Internal Revenue Service (IRS), and SEC. We also interviewed officials at the Financial Industry Regulatory Authority (FINRA), a self-regulatory organization. We interviewed other relevant stakeholders including ERISA attorneys, behavioral economists, fiduciary compliance professionals, industry stakeholders, consumer advocates, and academics. We assessed the actions federal regulators take to oversee conflicts against their statutory

[6]SEC staff said they would not consider "managing" conflicts to be a role of retirement investors. While retirement investors receive disclosures and other information about conflicts, SEC officials view managing those conflicts to be the obligation of a firm and/or the financial professional.

[7]Retirement investors had $11.2 trillion invested in mutual funds in their retirement accounts (IRAs and defined contribution plans) in mid-2023, according to the Investment Company Institute.

authority, regulatory roles, internal controls, and strategic plans. Appendix I provides more information on our scope and methodology.

We conducted this performance audit from November 2020 through July 2024 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. We conducted our related investigative work in accordance with standards prescribed by the Council of the Inspectors General on Integrity and Efficiency.

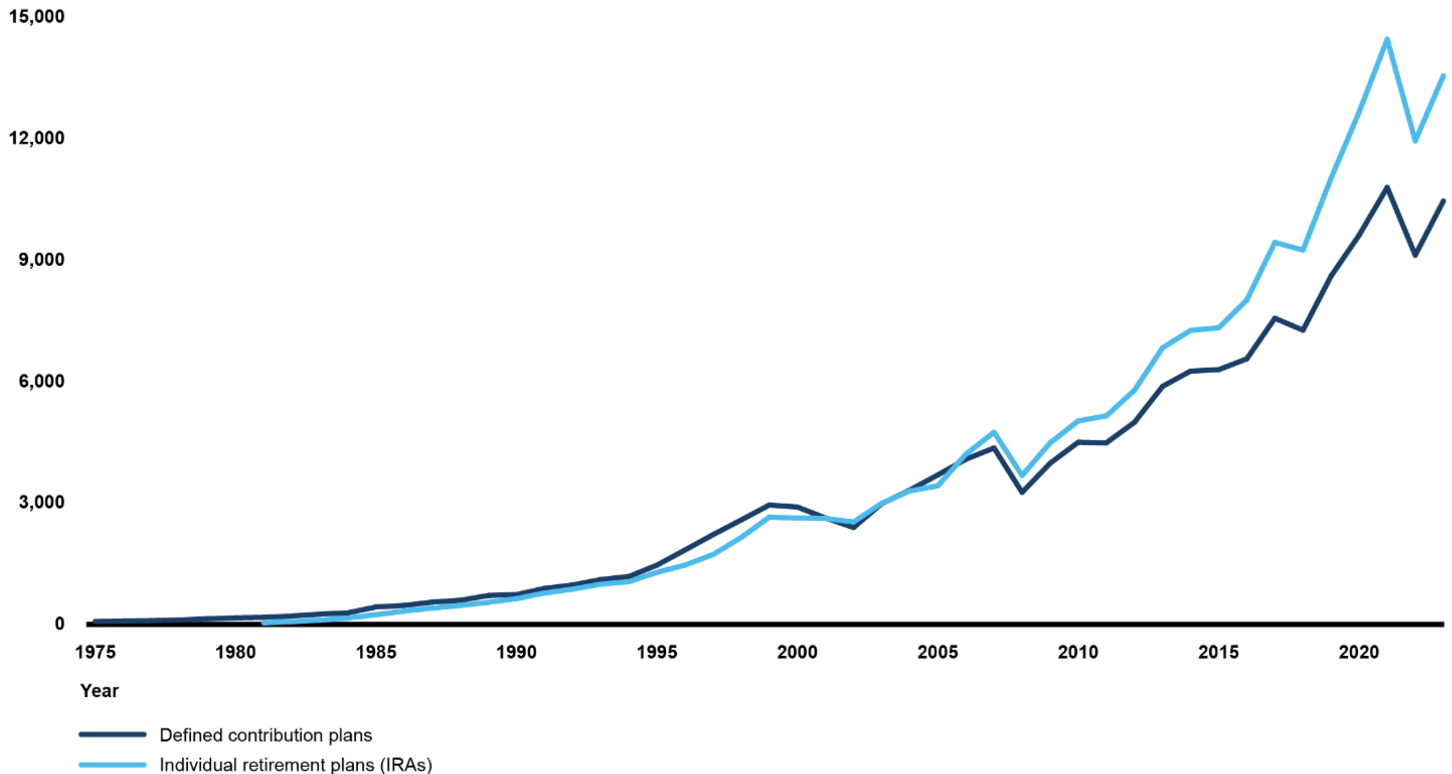
Background

Since ERISA was enacted in 1974, 401(k) plans have become the predominant type of employer plan, and IRAs have become a key retirement savings vehicle for many individuals.[8] Together, 401(k) plans and IRAs hold $18.6 trillion—comprising about 54 percent of all U.S. retirement assets.[9] While both have grown over time, the amount of assets held in IRAs is now greater than the amount of assets in defined contribution plans such as 401(k) plans. (See fig. 1.)

[8]The rise of 401(k) plans, and of IRAs—primarily funded through transfers from 401(k) plans (rollovers)—shifted investment decision-making obligations from employers to individual investors. In 401(k) plans, investors generally choose from a menu of investment options selected by their plans. 401(k) plan investors who do not make a choice will often have savings invested in their plans' default investment. That default is often a target date fund, which adjusts investments over time based on an investor's projected retirement date. However, IRAs generally require investors to choose their investments from a large number of options or obtain advice on investments. The larger number of investment options increases the decision-making obligation on an IRA owner compared to a 401(k) investor.

[9]*The Brightscope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans, 2020* (Sept. 2023). The report cites $12.0 trillion in IRAs and $6.6 trillion in 401(k) plans at year's end in 2022.

Figure 1: Assets Invested in Individual Retirement Accounts and Defined Contribution Retirement Plans Over Time



Source: GAO analysis of Financial Accounts of the United States data. | GAO-24-104632

Note: In a defined contribution plan the employee or the employer or both contribute to the employee's individual account under the plan. The employees will ultimately receive the balance of their account plus or minus investment gains or losses. An individual retirement account is a trust created for the exclusive benefit of an individual or the individual's beneficiaries that provides tax advantages for retirement savings.

Conflicts of Interest

Conflicts of interest are common in investment advice, including advice on transactions involving retirement assets. Financial professionals may favor themselves over retirement investors, some investors over others, or a line of business or product over others, because it financially benefits them to do so. For example, financial professionals may work on behalf of retirement investors who care about how investment or administrative fees affect their investment returns but recommend products that will help the professionals grow their business. Large firms with multiple lines of business and affiliates can often take advantage of economies of scale, but those large firms' business lines and affiliates can also create sources

of conflicts. Firm types that may offer products or advice to retirement investors include the following[10]:

- **Commercial banks** may provide recordkeeping and investment management and advisory services to employer plans, and frequently act as either trustees or custodians to employer plans and IRAs. Banks typically offer “sweep services” to invest excess cash in employer plans for which banks act as custodians or directed trustees, and administer collective investment trusts used as investment vehicles in employer plans.
- **Broker-dealers** help facilitate securities transactions, and may be involved in their solicitation, recommendation, negotiation, and execution.[11] Brokers are persons engaged in the business of effecting transactions in securities for the accounts of others. Dealers are persons engaged in the business of buying and selling securities, for their own accounts, through a broker or otherwise.[12] Compensation to broker-dealers for participating in the transactions may depend on the size of the transaction, among other things.
- **Insurance companies** may offer annuities or other insurance products to retirement investors. Insurance companies may do business as a broker-dealer and/or as an RIA. Insurance agents can also be financial professionals representing broker-dealers and RIAs (registered representatives of broker-dealers and investment adviser representatives). Fixed annuities and fixed indexed annuities are chiefly regulated by individual state agencies.
- **Investment companies** generally issue securities and are primarily in the business of investing in securities. A mutual fund is a type of investment company. The Investment Company Act of 1940 regulates the organization and operation of investment companies, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public.
- **Investment advisers** generally include any person who, for compensation, engages in the business of advising others as to the value of securities or as to the advisability of investing in, purchasing,

[10]Note that these firm types are not mutually exclusive, and a firm can be actively involved in all these lines of business and others, directly or through affiliates, simultaneously.

[11]See 15 U.S.C. § 78c(a)(10) for the definition of a security.

[12]While the definition of broker-dealer is limited to securities, broker-dealers can also distribute other investment products, according to DOL officials.

or selling securities. Investment advisers generally charge ongoing fees based on a percentage of either each investor's assets they manage or the assets in advisory accounts.[13] The Investment Advisers Act of 1940 (Advisers Act) and any applicable state laws generally require that firms or sole practitioners compensated for advising others about securities register with SEC or their state and conform to regulations designed to protect investors.[14]

Employee Retirement Income Security Act of 1974

ERISA is the primary federal law governing the U.S. private sector retirement plans.[15] It includes both labor and tax provisions that govern the conduct of fiduciaries to employer plans and IRAs. Since ERISA was enacted, both the Internal Revenue Code (IRC) and ERISA have been amended, partly in response to the significant shift in the types of retirement plans offered by private sector employers and the transfer of considerable risk and responsibility from employers to individuals.

- Title I of ERISA includes the law's labor provisions governing the conduct of employer plan fiduciaries, among other things. Specifically, fiduciaries must act solely in the interest of the participants and beneficiaries and with care, skill, prudence, and diligence.[16] Title I also includes provisions that bar fiduciaries from engaging in transactions that are likely to adversely affect a pension plan (prohibited transactions).

- Title II of ERISA includes the law's tax provisions and amended the IRC. Title II governs fiduciary conduct regarding IRAs, among other things. Title II also includes prohibited transactions, which generally mirror Title I, and provides for excise taxes on prohibited transactions, including taxes that can be imposed on fiduciaries involved in such transactions.

- Title III requires the DOL and the IRS to coordinate to administer the provisions in Title I and Title II, including on prohibited

[13]Investment advisers generally manage assets on a discretionary basis and have an obligation to provide advice and monitoring over the course of the relationship. Under federal law, an investment adviser is a fiduciary. The fiduciary duty an investment adviser owes to its client under the Advisers Act comprises a duty of care and a duty of loyalty. This is distinct from and in addition to any fiduciary duty owed under ERISA or the IRC.

[14]The RIAs discussed in this report are SEC-registered investment advisers.

[15]See Pub. L. No. 93-406, 88 Stat. 829 (codified as amended in scattered sections of 26 U.S.C. and 29 U.S.C.).

[16]29 U.S.C. § 1104(a).

transactions. ERISA assigned prohibited transaction oversight roles to both DOL and IRS. To avoid confusion over dual jurisdiction, Reorganization Plan No. 4 of 1978 clarified each agency's roles and responsibilities regarding prohibited transactions. The IRS, within Treasury, is responsible for enforcing the prohibited transactions provisions in the IRC but is bound by the regulations, rulings, opinions, and exemptions issued by DOL.

Fiduciaries Under ERISA and the IRC

Under ERISA and the IRC, the definition of fiduciary is a functional test based on functions such as discretion over plan administration or management, authority or control over plan assets, or the provision of investment advice.[17] In 1975, DOL issued a rule (a five-part test) that defined the circumstances under which a person would be considered an investment advice fiduciary under ERISA.[18] In 2016, DOL issued an updated definition under ERISA and the IRC that expanded when a person would be considered a fiduciary when providing investment advice for compensation, but the rule was vacated in 2018.[19]

[17]See 26 U.S.C. § 4975(e)(3) and 29 U.S.C. § 1002(21).

[18]See 29 C.F.R. § 2510.3–21(c)(1). Under the 1975 5-part test, a person is a fiduciary only if they: (1) render advice as to the value of securities or other property, or make recommendations as to the advisability of investing in, purchasing, or selling securities or other property (2) on a regular basis (3) pursuant to a mutual agreement, arrangement, or understanding with the plan or a plan fiduciary that (4) the advice will serve as a primary basis for investment decisions with respect to plan assets, and that (5) the advice will be individualized based on the particular needs of the plan. At the time, Treasury issued a similar regulation under the IRC applicable to IRAs. Prior to the Reorganization Plan No. 4 of 1978, Treasury issued a parallel rule in 1975.

[19]Under the 2016 rule, persons would render investment advice if they provided, for a fee or other compensation, certain types of advice within certain types of relationships. The types of advice included recommendations as to the advisability of buying, selling, holding or exchanging investments; how investments should be invested after being rolled over, transferred, or distributed from an employer plan or IRA; the management of investments; and rollovers, transfers, or distributions from an employer plan or IRA, including whether, in what form, in what amount, and to what destination rollovers, transfers, or distributions should be made. The types of relationships included: recommendations by person(s) who represent or acknowledge that they are acting as a fiduciary within the meaning of ERISA or the IRC; advice rendered pursuant to a written or verbal agreement, arrangement, or understanding that the advice is based on the particular investment needs of the advice recipient; and recommendations directed to a specific advice recipient or recipients regarding the advisability of a particular investment or management decision with respect to securities or other investment property of the plan or IRA.

On April 25, 2024, DOL issued a final rule amending the definition of fiduciary under ERISA and the IRC.[20] Under the final rule, a person is an investment advice fiduciary if they make an investment recommendation to a retirement investor, for a fee or other compensation, and (1) they hold themselves out as a trusted adviser by specifically stating that they are acting as a fiduciary under Title I or II of ERISA or (2) they make the recommendation under circumstances that would indicate to a reasonable investor that they are acting as a trusted adviser making individualized recommendations based on the investor's best interest. The final rule was set to become effective on September 23, 2024. However, on July 25, 2024, the federal court for the Eastern District of Texas issued an order temporarily staying the final rule.

Prohibited Transactions and Exemptions

Federal law prohibits plan fiduciaries from engaging in prohibited transactions. The aim of the prohibited transaction rules generally is to provide protection from the conflicts of interest of parties who may be able to exercise improper influence over plan assets, and they apply to employer plans and IRAs.[21]

Prohibited transactions generally fall into two categories, transactions involving interested parties and transactions involving fiduciary self-dealing. Transactions involving interested parties, such as a fiduciary, certain family members of a fiduciary, or a service provider to an employer plan or IRA, are generally prohibited unless the interested party complies with an exemption. In addition, the fiduciary self-dealing prohibition generally prevents an employer plan fiduciary or an IRA fiduciary who does not have an exemption from engaging in a transaction with the employer plan or IRA through which the fiduciary personally benefits.[22]

A fiduciary that complies with an exemption avoids the consequences of engaging in a prohibited transaction. Statutory exemptions are written into

[20]89 Fed. Reg. 32,122 (Apr. 25, 2024).

[21]The prohibited transaction rules are nearly identical in ERISA and the IRC. To describe interested parties, Title I of ERISA used the term "parties in interest" and Title II of ERISA (which amended the IRC) used the term "disqualified person." A fiduciary is an interested party. Also, the prohibited transactions rules, both in Title I and Title II, apply to a "plan" but define "plan" differently. IRAs are not plans under ERISA but are plans under the IRC.

[22]The self-dealing prohibitions in ERISA and the IRC prohibit a fiduciary from dealing with the assets in a plan for their own interest or for their own account and prohibit receipt of any consideration for a fiduciary's own personal account from any party dealing with the plan in connection with a transaction involving the assets of the plan.

the law, and a statutory exemption for investment advice is available to those who meet the conditions. DOL grants administrative exemptions to the prohibited transaction rules. However, DOL is not permitted to grant any exemptions that are not administratively feasible, in the interests of the plan and of its participants and beneficiaries, and protective of the rights of participants and beneficiaries of the plan.

Federal Regulators' Jurisdiction Over Retirement Investments and Conflicts of Interest

Federal regulators with jurisdiction and oversight related to conflicts of interest in retirement plans have specific authority provided by law:

- DOL interprets and enforces the labor provisions in Title I of ERISA, including fiduciary responsibilities, applicable to employer plans. DOL has civil enforcement authority to investigate potential violations and issue fines for violations of the employer plan fiduciary responsibilities. DOL also has primary responsibility for regulations, rulings, opinions, and exemptions related to prohibited transactions applicable to employer plans and IRAs.
- FINRA—the Financial Industry Regulatory Authority—is a self-regulatory organization for broker-dealers and is overseen by SEC. Among other things, FINRA adopts rules that supplement those of SEC, conducts examinations, enforces member firm compliance for those rules and the federal securities laws appliable to broker-dealers, and provides investor education.
- IRS is responsible for administering the tax provisions that employer plans and IRAs must comply with to maintain their favorable tax treatment. IRS is also responsible for imposing excise taxes on fiduciaries to employer plans and IRAs who participate in prohibited transactions.
- The Office of the Comptroller of the Currency (OCC) regulates the federal banking system.[23] OCC examines how banks manage risks associated with providing retirement plan products and services, including collective investment trusts (bank-administered

[23]The OCC publishes information on bank-provided retirement plan products and services. See https://www.occ.treas.gov/publications-and-resources/publications/comptrollers-handbook/files/retirement-plan-products-services/index-retirement-plan-products-services.html

pooled funds used in employer plans).[24] Compliance risk is a substantial factor for banks, including compliance with the prohibited transaction rules which aim to limit conflicts of interest.

- SEC regulates the exchange of securities, broker-dealers and investment advisers providing investment advice on securities, and investment companies (including mutual funds). SEC has authority to interpret and enforce the legal obligations of broker-dealers, investment advisers, and investment companies, and to oversee FINRA and other self-regulatory organizations.

Interviews with Selected Associations Found That Commission-Based Business Models May Have Been More Affected than Others by DOL's 2016 Rule

According to interviews and written responses with 15 national associations of financial professionals, certain firms using fee-based business models, such as Registered Investment Advisers, reported limited changes to comply with the DOL's 2016 fiduciary rule (see text box). Other firm types using commission-based business models reported making more changes to comply with the rule.

DOL's 2016 Rule Redefining Investment Advice Under ERISA and the IRC

In 2016, the Department of Labor issued a final rule determining who was a fiduciary when providing investment advice for compensation to plans under ERISA or the IRC (which includes 401(k) plans and IRAs). Under the rule, more financial advisers became fiduciaries under ERISA or the IRC.

The 1975 rule required, in part, that investment advice be provided on a regular basis in order to qualify as a fiduciary. The 2016 rule expanded the definition of fiduciary investment advice to include some advice that was not provided on a regular basis. For example, advice to roll over a 401(k) account to an IRA would be included under the 2016 definition even if no other investment advice was provided.

Source: GAO analysis of 40 Fed. Reg. 50,842 (Oct. 31, 1975) and 81 Fed. Reg. 20,946 (Apr. 8, 2016). | GAO 24 104632

[24]We previously reported that in 2022, collective investment trusts held 47 percent of the assets in Target Date Funds, which are the most common investment option in 401(k) plans. See *401(k) Retirement Plans: Department of Labor Should Update Guidance on Target Date Funds,* GAO-24-105364 (Washington, D.C.: Mar. 28, 2024).

Selected Associations' Representatives Reported That Fee-based Professionals Made Limited Changes to Comply with DOL's 2016 Rule

When DOL finalized the 2016 rule, RIAs made few changes, according to representatives of the three selected RIA industry associations.[25] Specifically, when asked about changes to compensation in response to the 2016 rule, two of the three RIA association representatives said that RIAs needed to make few changes to their fee-based compensation. One said compensation changes allowed members to comply with the streamlined version of an exemption. Fee-based compensation, such as an asset-based percentage fee, does not necessarily vary depending on the products sold or frequency of transactions, which may reduce the opportunities for conflicts of interest related to variable compensation to influence advice.[26]

What is a Registered Investment Adviser's fiduciary standard of care?

Under the Advisers Act, an investment adviser is subject to a fiduciary standard that includes a duty of care and a duty of loyalty to the client. According to the Securities and Exchange Commission, the duty of care requires an investment adviser to provide investment advice in the best interest of its client, based on the client's objectives. The duty of loyalty requires an investment adviser to eliminate or make full and fair disclosure of all conflicts of interest that might incline an investment adviser to render advice that is not disinterested, such that a client can provide informed consent to the conflict.

Source: "Commission Interpretation Regarding Standards of Conduct for Investment Advisers", 84 Fed. Reg. 33,669 (July 12, 2019). | GAO-24-104632

In addition, RIAs operate under fiduciary standards of care in securities law that are similar in some respects to the standards of care provided in Title I of ERISA, according to DOL officials. Certain investment advisers were also ERISA fiduciaries before the 2016 rule, because they worked with retirement plan assets, according to a representative of one of the three RIA associations we selected, addressing our question about changes to fiduciary status because of the 2016 rule. (See text box.) Another association representative noted that advisers with discretionary authority over clients' assets were also already ERISA fiduciaries, prior to the expanded definition of advice established in the 2016 rule. Thus, fewer changes were needed from RIAs to address this aspect of the 2016 rule.

Representatives of one industry association said…

"…investment advisers have been fiduciaries always. They've always adhered to fiduciary principles. Investment advisers are fiduciaries separate and apart from what DOL has done. For advisers, fiduciary is a status. It's what you are, who you are, and it extends to the whole relationship."

Source: GAO interview with a national investment adviser association representative. | GAO 24 104632

[25]We asked the associations to what extent members serving retirement investors assumed a new fiduciary role with regard to investment advice in response to DOL's 2016 rule.

[26]A minority of advisers charge a flat hourly rate for advice, rather than asset-based fees or commissions, based on our quantitative analysis of Form ADV Part 1A data. Compensation based on hourly fees removes conflicts of interest that could arise from an incentive to maintain and increase the amount of assets under management or transactional fees.

Some RIAs did, however, make certain changes to their documentation, in-plan education and advice, and rollover advice as a result of the 2016 rule, according to several industry association representatives.

Changes to documentation

RIAs did change some documentation practices under the rule, according to an industry association representative. According to DOL, investment advisers compensated on what DOL characterized as a level-fee basis, like RIAs who typically earn a fixed percentage of assets under management, could comply with a streamlined version of exemption requirements for fiduciaries. The streamlined conditions included providing clients a written statement of fiduciary status, compliance with impartial conduct standards, and, as applicable, documentation of the specific reasons for their recommendation, including a rollover recommendation. Documentation for rollover advice needed to include how the adviser considered the investor's alternatives to a rollover, such as the investments and services offered in the current employer plan, among other things. One industry association representative explained that many professionals—including RIAs—retained the due-diligence practices around products and services developed as a result of the rule. An exemption DOL issued after the 2016 rule was vacated required rollover recommendation rationales to be documented.[27] Additionally, while the SEC does not require documentation for rollover recommendations, documenting certain account recommendations may support firms' compliance efforts, according to SEC staff, and DOL officials said this might also explain why RIAs would continue to document rollover recommendation rationales.[28]

Changes to education and advice in employer plans

According to representatives of the three selected plan sponsor industry associations, the 2016 rule had mixed effects on retirement education and advice that some employer plans offered to participants.

- Risk-averse plan sponsors that had historically offered investment education and call center services to their retirement plan

[27]DOL, *Prohibited Transaction Exemption 2020–02, Improving Investment Advice for Workers & Retirees*, 85 Fed. Reg. 82,798, 82,800 (Dec. 18, 2020). Under DOL's Prohibited Transaction Exemption (PTE) 2020-02, investment advice fiduciaries to plans may receive compensation, including as a result of advice to roll over assets from an employer plan to an IRA, that would otherwise violate the prohibited transaction provisions of Title I of ERISA and the IRC.

[28]According to SEC staff, it may be difficult for a firm to assess periodically the adequacy and effectiveness of its policies and procedures or to demonstrate compliance with its obligations to retail investors without documenting the basis for certain recommendations. See https://www.sec.gov/tm/iabd-staff-bulletin.

participants cut back on those services. This reduction in services was due to concerns about added legal liability for providing what was now "advice" under the 2016 rule, a representative of one of the three selected plan sponsor associations said.[29] We reported in 2013 that some plan sponsors feel uncertain about when education may border on advice.[30] Another plan sponsor association representative said that members avoided providing investment advice in employer plans as much as possible under the 2016 rule to avoid becoming subject to the ERISA fiduciary standards for advice. According to a plan sponsor association representative, plans reported feeling concerned about helping some participants with fundamental questions about their plans and savings for retirement. For example, a DOL official told the association that telling a participant who wanted to invest in a target date fund that the participant should select just one fund would be fiduciary investment advice under the 2016 rule, according to the representative.[31]

- Plan sponsors that were more willing to assume ERISA fiduciary responsibility and also prioritized maintaining participant benefits made fewer changes to comply with the 2016 rule, a plan sponsor association representative said. The association representative said these plans maintained a consistent participant experience by continuing to provide education and call center access.

Despite some employer plans' reservations about providing advice, employer plan survey data show an increase in 401(k) participants'

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[29]In its discussion of the final 2016 rule, DOL noted that, "in the case of an employer or plan sponsor, neither the employer, plan sponsor, nor their employees ordinarily receive fees or other compensation in connection with the educational services and materials that they provide to plan participants and beneficiaries. Thus, even if they crossed the line from education to actual investment advice, the absence of a fee or other compensation would generally preclude a finding that the communication constituted fiduciary investment advice."

[30]See GAO, *401(k) Plans: Labor and IRS Could Improve the Rollover Process for Participants*. GAO-13-30. Washington, D.C.: Mar. 7, 2013.

[31]DOL's Interpretive Bulletin 96-1 "Participant Investment Education" identifies specific categories of investment related information that, when furnished to plan participants or beneficiaries, would not constitute the provision of investment advice under ERISA. The categories of information include the following: plan information; general financial and investment information, asset allocation models; and interactive investment materials. According to Vanguard, target date funds' portfolio allocations are based on an expected retirement date and allocations grow more conservative as the investor approaches the fund's target year. Vanguard Research Note: Professionally managed allocation adoption in 2021, (May 2022).

access to advice from 2016, when the DOL's rule was finalized, and after 2018, when it was vacated. Of 401(k) plans responding, 36 percent reported offering investment advice to participants in 2016, and 46 percent reported offering it in 2021.[32] More plans are also offering access to fiduciary advice through a managed account option. According to Vanguard, 30 percent of its defined contribution plan clients offered managed account advice to plan participants in 2017, which increased to 41 percent in 2021.[33]

Changes to rollover education and advice

Both before and after the 2016 rule, DOL distinguished between investment education, including about rollover options, which did not trigger fiduciary responsibility, and fiduciary investment advice. Thirteen associations' representatives addressed whether members serving retirement investors assumed a new fiduciary role with regard to investment advice because of the rule. Representatives at two associations said that because the 2016 rule redefined advice, their members reduced some interactions, such as providing education on distributions. Plan survey data show that more plans responding in 2020 reported providing education on distributions—like rollovers, than plans responding in 2016. (See table 1.) Survey results are not generalizable to all 401(k) plans.

Table 1: Rollover Education Offered by 401(k) Plans Responding to Plan Surveys, 2016 and 2020

401(k) plans' education offerings	2016[a] (percentage of plans responding)	2020[b] (percentage of plans responding)
Plans offering education on retirement distribution (e.g., on rollovers)	42	46
Large plans (5,000+ participants) offering education on retirement distribution (e.g., on rollovers)	39	54

Source: Plan Sponsor Council of America, 60th and 64th Annual Survey(s) of Profit Sharing and 401(k) Plans. | GAO-24-104632

Note: The Plan Sponsor Council of America is a non-profit trade association supporting employer-sponsored retirement plans. The companies responding to the survey are not statistically representative of a larger known population of companies and their plans. Survey results are not

[32]Plan Sponsor Council of America, 60th and 65th Annual Survey(s) of Profit Sharing and 401(k) Plans. Of plans surveyed, 235 401(k) plans responded to the 2016 plan year survey and 294 401(k) plans responded to the 2021 plan year survey. The companies responding to the survey are not statistically representative of a larger known population of companies and their plans. Survey results are not generalizable to all 401(k) plans.

[33]Vanguard Research Note: Professionally managed allocation adoption in 2021, (May 2022). Managed account advice assists investors with planning and investing. A managed account manager generally has discretionary control of plan assets, and exercising discretion over plan assets is a fiduciary function under ERISA and the IRC.

generalizable to all 401(k) plans. The survey asked about distribution education offered before and at retirement. Retirement distribution options include but are not limited to rollovers. The 2020 survey did not report 401(k)-only data for this question; however, we report data on all plan types surveyed for both years as 401(k) plan data because 401(k) plans and 401(k)/Profit-Sharing combination plans were 99 percent of surveyed plans in each year.

[a]Of plans surveyed, 590 plans responded to the 2016 survey. The 2016 plan year survey asked plans if they provided education to participants taking a retirement distribution, beyond the required government forms.

[b]Of plans surveyed, 518 responded to the 2020 plan year survey. The 2020 plan year survey asked plans if they provided education to participants taking a retirement distribution but did not limit education to that "beyond the required government forms," as in the 2016 survey.

A plan sponsor association representative said that plan sponsors and service providers reported taking a variety of steps to ensure their advice complied with the 2016 rule. For example:

- Plan sponsors that wanted to continue giving plan participants access to advice revised their agreements with service providers to reflect the increased fiduciary duty.
- Professionals serving employer plans who wanted to give advice sought to qualify for an exemption under the Best Interest Contract Exemption.[34] To protect retirement investors, these service providers generally needed to sign a contractual agreement with retirement investors, which investors could enforce under state law.
- Large plan sponsors added non-solicitation clauses to their contracts with service providers in an effort to protect plan participants from conflicts of interest with the plans' selected service providers.[35]

[34]DOL published the Best Interest Contract Exemption simultaneously with the 2016 rule. The exemption was available for firms and financial professionals that made investment recommendations to retail retirement investors, including plan participants and IRA owners. To qualify for the exemption, fiduciaries had to acknowledge their fiduciary status in writing, among other things. The exemption included streamlined conditions to apply to fiduciaries under ERISA or the IRC who charged level fees, defined to include compensation based on a fixed percentage of assets under management, in connection with advisory or investment management services. Best Interest Contract Exemption, 81 Fed. Reg. 21,002 (Apr. 8, 2016), (corrected July 11, 2016). DOL, Question 5, *Conflict of Interest FAQs (Part I-Exemptions)* (Oct. 27, 2016).

[35]A plan sponsor association representative said that IRA providers—which can be 401(k) plan service providers—actively solicited plan participants for their IRA rollover business.

Selected Associations Reported that Broker-Dealers and Annuity Providers Were More Affected by the 2016 Rule than Registered Investment Advisers and Plan Sponsors

Several industry association representatives said that the 2016 rule ushered in changes to the commission-based business model that broker-dealers and annuity providers had been using. The changes described by these representatives pertained to compensation and products and advice.

Changes to Compensation

What are commission-based and fee-based compensation models?

In commission-based compensation, financial professionals receive compensation from selling certain products to retail investors. Brokers who sell securities like mutual funds and insurance agents who sell annuities typically receive commission-based compensation. In fee-based models, a professional might charge a percentage of the assets under management or a flat fee, which would generally not vary between products sold.

Source: GAO analysis of Congressional Research Service and Department of Labor reports. | GAO-24-104632

According to representatives of three selected industry associations, broker-dealers and annuity providers who were giving advice while facilitating sales and other transactions to retirement investors had to change how they were compensated to qualify for the exemption issued with the rule.[36] According to one insurance-industry association representative, before the rule was vacated many members expected to or had already experienced a decrease in commission compensation as a result of the 2016 rule. This association's representative described several types of compensation changes that occurred among broker-dealers and insurance agents who kept serving clients with retirement plan assets.

- **Reducing commission-based incentives.** Commission-based compensation incentivizes broker-dealers and insurance agents to sell certain products that yield higher commissions than other products.[37] After DOL issued the 2016 rule, more investment recommendations to retirement investors became fiduciary investment advice. This meant that for professionals providing this advice, commission-based compensation would not comply with the prohibited transactions rules applicable to fiduciaries without an

[36]These were three of the 10 industry associations that addressed what changes their members made to compensation because of the 2016 rule.

[37]Professionals' investment recommendations could affect the commission-based compensation they earn. For example, recommending a larger transaction over a smaller one may result in additional compensation. Likewise, commission-based compensation could disincentivize a professional from recommending products that are not available on a commissioned basis or from recommending the investor pay down high-interest debt, which might result in no compensation.

appropriate exemption. Representatives of all three insurance associations said that to help comply with the 2016 rule, insurance agents selling annuities to retirement investors generally reduced commission-based sales.[38]

What is variable compensation?

Compensation in the securities and insurance industries can vary—that is, firms and financial professionals can earn more or less—depending on which products they sell. For example, a professional who earns a higher commission by selling a specific annuity product over another has a personal, financial incentive to do so. Variable compensation is permitted under securities law.

Source: GAO interviews and analysis of agency documents. | GAO-24-104632

- **Moving from variable to standardized compensation across products.** Variable compensation offers incentives to financial professionals that could harm investors and is prohibited under ERISA and the IRC without an exemption. To ensure compliance with the 2016 rule and related prohibited transaction exemptions (PTE), several industry association representatives said that some firms moved away from variable compensation and toward standardized compensation across products, including between mutual funds and annuities.[39]

Changes to Products and Advice

Products. To comply with the 2016 rule, representatives of five of the six selected insurance-industry and broker-dealer associations generally indicated that members restricted the investment products they recommended.[40] This reduced the range of products that retirement investors could access.[41] Association representatives said members implemented the restrictions to avoid being subject to the rule or to comply with the accompanying exemption requirements to establish

[38]Under the rule, professionals' commission-based compensation qualified for the DOL's Best Interest Contract Exemption.

[39]More standardized compensation across products, such as from eliminating higher pay for selling proprietary investment funds, could help mitigate conflicts of interest resulting from commission-based compensation, which fiduciaries could not receive without an exemption under the 2016 rule.

[40]We interviewed or received written responses from 15 selected industry associations, including 3 insurance industry focused associations and 3 broker-dealer focused associations.

[41]DOL officials told us that a regulation focused on reducing imprudent advice might reduce recommendations of certain products to some retirement investors, but that those retirement investors may be better off without those products.

safeguards that prevent conflicts of interest from harming investors, among other things.

We reviewed several industry reports related to changes industry members reported they had made or anticipated making to comply with the 2016 rule. Three industry-sponsored surveys conducted in 2017 documented the reduction of securities and bank products sold to retirement investors:

- A survey of financial professionals sponsored by the Financial Services Roundtable reported that 63 percent of respondents indicated that they had limited, or they probably or definitely would limit, investment options and products available to clients in response to the 2016 rule.[42] It is unknown if the professionals indicating future changes to products actually made those changes, given that the rule was vacated.
- Financial institutions participating in another industry-sponsored 2017 survey reported broker-dealers reducing the investment products offered to retirement investors.[43] The survey report observed that the reduction in the mutual fund products offered occurred, in part, during enhanced product due diligence efforts firms undertook during their 2016 rule compliance implementation.
- In an industry-sponsored survey of banks, 30 percent of responding banks reported eliminating or reducing the number of retirement products or services available to customers to

[42]Harper Polling, *National Survey of Financial Professionals*, July 7-12, 2017. Harper Polling conducted interviews with 600 financial advisers across the country. We are unable to determine whether this result is generalizable to any larger, known population.

[43]Deloitte, "The DOL Fiduciary Rule: A study on how financial institutions have responded and the resulting impacts on retirement investors," Aug. 9, 2017. The survey was commissioned by the Securities Industry and Financial Markets Association (SIFMA), which—at the time of the survey it sponsored—was a co-plaintiff in a lawsuit against the DOL concerning the 2016 rule. The survey population included 21 SIFMA member firms whose businesses include providing individual investors with financial advice and related services. Deloitte states that it was not asked to and did not independently verify, validate, or audit the information provided. The firms participating in the survey are not statistically representative of a larger known population of firms. The survey results are not generalizable to all financial institutions. Deloitte does not elaborate on how the 21 member firms were selected (or excluded) to participate beyond potential or assumed considerations of representativeness in firm size, business model, client segment, and business offering, nor does the report provide further detail on how non-selected and non-participating member firms may compare.

avoid fiduciary status, because of the 2016 rule.[44] Banks eliminating or reducing retirement products or services indicated that customers with accounts of $25,000 or less were most impacted. For retirement accounts with assets below that level, financial institutions may have determined the added compliance cost was too high.

Representatives at all three selected insurance associations said fewer products were available to retirement investors because of the 2016 rule:

- One insurance association representative said that the rule limited retirement investors' access to annuities. Because annuities are often sold under commission-based business models, brokers and insurance agents were restricted in recommending them as retirement assets, two association representatives said. Therefore, to buy annuities, many retirement investors likely needed to roll over their employer-based retirement savings to IRAs,[45] according to an insurance association representative—and a recommendation to do so remained fiduciary advice under ERISA. An insurance industry association representative told us that variable annuity product sales, in particular, declined in response to the 2016 rule.[46]

[44]*American Bankers Association Survey: Department of Labor Fiduciary Rule*, July 20, 2017. The American Bankers Association surveyed approximately 250 member banks participating in retirement investment account working groups to determine banks' understanding of the 2016 rule and its impact on banks and their retirement customers. Of the 250 banks surveyed, 57 banks responded. Of those, 73 percent were community banks (under $10 billion in assets), 14 percent were midsize banks ($10-$50 billion in assets), 5 percent were regional banks ($50-$100 billion in assets), and 7 percent were large banks (over $100 billion in assets). Representativeness and reliability of survey results cannot be assessed. Results are not generalizable to either the non-responding American Bankers Association workgroup members or to any larger population of banks.

[45]In 2021, 8 percent of 401(k) type plans responding to Plan Sponsor Council of America's annual survey offered an annuity option for retirees. The companies provided with and responding to the survey are not statistically representative of a larger known population of companies and their plans. Survey results are not generalizable to all 401(k) plans. *PSCA's 65th Annual Survey of Profit Sharing and 401(k) Plans*.

[46]Recommendations of variable annuities to retail customers by registered broker dealers and their registered representatives are subject to Regulation Best Interest, according to SEC staff. In addition to Regulation Best Interest, SEC staff added that broker-dealers recommending a purchase or exchange of a deferred variable annuity to a retail customer must also comply with FINRA Rule 2330, and recommendations of variable annuities by investment advisers and their investment adviser representatives are subject to the investment adviser's fiduciary duty.

What is a variable annuity?

A variable annuity is a security and also a contract between an investor and an insurance company. It may provide periodic payments, which can begin immediately or in the future and may be paid for up front or through a series of payments. The contract value can vary depending on underlying investments.

Source: Securities and Exchange Commission. | GAO-24-104632

- One insurance industry association representative said that independent insurance agents faced challenges as the exemption issued with the rule required ongoing oversight of an agent by a firm, which independent agents may not have.[47] A compliance professionals' association member we interviewed said that after the 2016 rule was vacated many insurance providers resumed selling annuities to retirement investors using a restored exemption, under which their recommendation did not have to be in the retirement investor's best interest.[48] Independent insurance agents without supervision and shared responsibility by a firm currently cannot use PTE 2020-02 to sell annuities to retirement investors, one association representative said.

Several associations' representatives said firms' compliance reviews—steps firms take to ensure legal requirements are met and risks minimized, which are not specific to the 2016 rule—are ongoing. Nevertheless, representatives of four of the 13 associations addressing what changes members made to compliance because of the 2016 rule said members' added compliance efforts were extensive. For example, one industry association representative described members reviewing:

- Product categories, product lines, and providers for appropriateness and possible reduction, and
- Reasonableness of fees and commissions across and within product categories and providers—for example, offering only products that charge equal 12b-1 fees.[49]

Some firms sought to simplify compliance with the 2016 rule by modifying sales-based incentives for broker-dealers, according to two association representatives. For example, when a broker-dealer receives a bonus for generating a certain level of sales, the 2016 rule required firms to monitor and manage that conflict of interest to ensure the brokers' sales remain

[47]DOL, Question 22, *Conflict of Interest FAQs (Part I-Exemptions)* (Oct. 27, 2016).

[48]PTE 84-24 generally allows insurance agents to sell retirement investors annuities and to receive commissions for those sales. On April 25, 2024, DOL issued an amendment to PTE 84-24. 89 Fed. Reg. 32,302 (Apr. 25, 2024). Under DOL's amendment, investment advice professionals seeking to comply with the exemption would need to comply with impartial conduct standards, which include care and loyalty obligations. On July 25, 2024, the federal court for the Eastern District of Texas issued an order temporarily staying the amendment to PTE 84-24.

[49]12b-1 fees pay for sales-based commissions, marketing for the mutual fund, distribution of the mutual fund, or shareholder services.

appropriate for clients. Because the rule applied across the entire retirement industry, firms could also eliminate such sales incentives, giving compliance officers less to monitor and reducing compliance costs, according to one association representative.

Advice. Certain firms also restricted clients' access to advice under the 2016 rule.[50] For example, some professionals reduced services, like investment advice, for smaller accounts, according to representatives of five of the 12 selected associations that addressed changes to products and services made because of the 2016 rule.[51] One association representative said that the 2016 rule made it prohibitively expensive for professionals to work with smaller accounts, even for rollovers, because of the potential liability cost.[52]

Some firms determined they would no longer offer commission-based retirement accounts after the 2016 rule, one association representative told us. The representative added that the firms took steps to convert

[50]We did not assess the extent to which retirement investors' access to investment advice was affected by industry changes. Automated investment advice—"robo-advice"—services, for example, may have expanded the range of advice accessible by lower-balance consumers and supplanted the advice withheld by certain professionals under the rule. We also did not assess the quality of the advice that industry associations reported was no longer provided. According to DOL officials, less access to certain advice may make retirement investors better off if remaining advice is more prudent, as intended by the rule.

[51]Investors with smaller balances may also find it difficult to work with an RIA firm. In a small, non-generalizable sample of financial professionals affiliated with independent advisory firms, about half of respondents answering the question self-reported that their firm required clients to have a minimum asset level in 2020. The median minimum asset level reported was $500,000. While most respondents indicated they would work with clients with assets under management (AUM) of $100,000, this represented a small percentage of the overall client base (a median of 3 percent of clients, among respondents). The study was sponsored by BNY Mellon-Pershing and data were collected and reported by InResearch in InvestmentNews' 2021 report "Benchmarking the Financial Performance of Advisory Firms: Pricing and Profitability Update". About 70,500 financial professionals were invited to take part in the study. Financial professionals representing 244 unique firms responded. Respondents predominantly self-identified firms as Registered Investment Advisers (75 percent), while 12 percent self-identified firms as broker-dealer, and 13 percent as both. Findings are not representative of all financial advisory firms.

[52]One study found a relationship between compliance with a higher standard of care and higher risk -adjusted returns, which may be driven by the increased cost of doing business and higher quality investment advice. See Vivek Bhattacharya, Gaston Illanes, and Manisha Padi, "*Fiduciary Duty and the Market for Financial Advice"* (May 2019, Revised November 2023). NBER Working Paper No. w25861. NBER Working Papers have not been peer-reviewed or reviewed by the NBER Board of Directors.

appropriate brokerage accounts to advisory relationships or, when appropriate, informed clients—often with smaller balances—of the need to close their account with the firm. (See textbox.) The association representative said that, to prepare for the 2016 rule, member firms' compliance processes included reviewing such transfers.

Rollover recommendations

Before the Department of Labor issued its 2016 rule, financial firms providing recordkeeping services to employer plans might have offered incidental rollover recommendations to participants, an industry researcher said. In 2013, we reported that employer plan participants are often subject to biased information and aggressive marketing of Individual Retirement Accounts when seeking assistance and information regarding what to do with their 401(k) plan savings when they separate or have separated from employment with a plan sponsor. Two associations' representatives said that members stopped making rollover recommendations because doing so would make them fiduciaries under the 2016 rule. IRAs can be associated with higher fees compared to institutional fees offered in employer plans, and they also have fewer ERISA protections, which apply to employer plans.

Source: GAO interviews and GAO-13-30. | GAO-24-104632

After the 2016 rule. After the Fifth Circuit vacated the 2016 rule, certain firms reversed additional compliance policies they felt were burdensome, such as requirements to document compliance with an impartial conduct standard, according to a fiduciary compliance professional. On the other hand, one industry association representative described a member firm that did not need to reverse new policies because it had not complied in the first place, believing that the rule was unenforceable. The firm's view was that some investors had no alternative other than to complete a rollover—such as from their employer plan to an IRA—which they believed made it unnecessary to justify a rollover recommendation, as required by an exemption issued with the rule. One fiduciary compliance association representative said that a large member firm resumed the sales of firm-underwritten securities, which they suspended under the rule.[53]

While some firms reversed some practices they established under the rule, other firms kept their new practices. For example, representatives of two of the 10 associations that addressed what changes to products or services members made when the 2016 rule was vacated said that

[53]Under 15 U.S.C. § 77b(a)(11), an underwriter is "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking…."

member firms did not reverse investment product decisions. Association representatives reported that several factors contributed to firms keeping some new practices after the rule was vacated:

- Broker dealers' belief that DOL may revisit the definition of investment advice, and thus the definition of fiduciary under ERISA and the IRC, led them to keep some changes made to comply with the vacated rule, one association representative told us.[54]
- SEC's regulatory actions also factored into professionals' decisions to keep the changes they made. Representatives from two associations said that they kept policies and compliance procedures in place because the changes helped their broker-dealer members to comply with a SEC regulation adopted in June 2019.[55]

Firms and Financial Professionals Disclose a Variety of Conflicts of Interest, and Conflicts May Be Associated with Lower Investment Returns

Based on our review of conflicts disclosed by a non-generalizable sample of 20 RIAs, there are a variety of conflicts arising from particular products generating additional compensation for the firms, including products involving revenue sharing, compensation from proprietary products, and the products of affiliates.[56] We also found from this review that there are limitations of disclosure as a communication mechanism, including the complexity of the writing and the conflicts and the inability for disclosure to convey the applicability and magnitude of conflicts to a particular retirement investor. Based on our disclosure review and our undercover phone calls, conflicts can be numerous, complex, and dynamic, which can make it challenging to completely convey them all, and their implications, through a real time conversation with a retirement investor. Retirement investors have a stake in understanding conflicts of interest in

[54]On April 25, 2024, DOL issued a new final rule amending the definition of fiduciary under ERISA and the IRC. 89 Fed. Reg. 32,122 (Apr. 25, 2024). The final rule was set to become effective on September 23, 2024. However, on July 25, 2024, the federal court for the Eastern District of Texas issued an order temporarily staying the final rule.

[55]SEC issued Regulation Best Interest in June 2019, having proposed it in May 2018, shortly after the Fifth Circuit vacated the DOL's 2016 rule.

[56]The sample included a group of RIAs that were firms reporting on Form ADV Part 1A that they were actively engaged in business as broker-dealers and as insurance brokers or agents, and a group of RIAs reporting receiving commissions for their advisory services, among other groups. We generally use the more generic term "firm" to describe the RIAs in our disclosure review due to the influence other lines of business may have on the conflicts.

their relationships with their firm and financial professional because conflicts of interest may be associated with lower investment returns.

Compensation and Recommended Products Create Conflicts of Interests

We reviewed conflicts disclosed in advisory brochures and Relationship Summaries of selected RIAs.[57] The firms that reported earning commission for advisory services in our review disclosed more conflicts overall than the group of RIAs receiving asset-based or hourly and fixed fees.[58] However, as large, complex entities, firms accepting commissions for advisory services in our review also had particularly long disclosure brochures. On a per-page basis, we found that the two RIAs that disclosed the most conflicts in our sample were firms that reported doing business as a broker-dealer and as an insurance broker or agent. In contrast, the advisory brochures we reviewed from RIAs that accepted hourly and fixed fees, but not commissions or asset-based fees, disclosed few conflicts of interest, compared to any of the other, larger firms.[59] Notably, none of the firms in our review charging hourly fees conducted business as a broker-dealer or as an insurance company and none

[57]Registered investment advisers (RIA) are required to disclose conflicts when they file their ADV Form Part 2 (advisory brochure) with the Securities and Exchange Commission (SEC). They also disclose limited information on conflicts on Form ADV Part 3, (Relationship Summary). To understand the types of conflicts disclosed we reviewed all the advisory brochures and Relationship Summaries of a non-generalizable sample of 20 RIA firms. We refer to this non-generalizable sample as our “disclosure review.” We reviewed 2,330 total references to conflicts of interest in this review. We also analyzed quantitative data on all RIAs provided through Form ADV Part 1A as of September 2023. See appendix 1 for firm type selection details and methodological information.

[58]RIAs report the ways they are compensated for investment advisory services, including by the receipt of commissions for those services, on Form ADV Part 1A question 5E. Such RIAs served about 23 percent of all non-wealthy clients in September of 2023. DOL officials told us that hourly-fee based compensation is uncommon in the advice world, although they said this business model would be relatively conflict-free, because the financial professional has no financial interest in what they recommend. Our Form ADV Part 1A analysis also found that few RIAs charge fixed or hourly fees but not asset-based fees or commissions, in part because, as two behavioral economists we interviewed said, people do not want to pay up front for advice. In contrast, with asset-based and commission-based compensation, the costs are deducted from assets and often depend on the total amount invested and the performance of the investments. Our analysis also found that RIAs earning hourly and fixed fees serve relatively few non-wealthy individual investors (less than 1 percent in September 2023).

[59]Conflicts were reported as such on the Form ADV and we did not make an independent assessment as to whether an arrangement constituted a conflict of interest.

disclosed any revenue sharing or affiliate conflicts.[60] In addition to the general model through which clients pay for services, for example, commission, asset-based, or hourly and fixed fees, firms and professionals disclosed other financial interests that can create conflicts with investors.

Product Sales

Our analysis of Form ADV Part 1A data showed 47 percent of non-wealthy individual clients were with firms that disclosed selling products and providing services other than advice to their advisory clients. Sixteen of the 20 firms in our review of advisory brochures noted that they may benefit when their financial professionals recommend their proprietary products instead of other products. Such firms may have an incentive to encourage their financial professionals to recommend proprietary (and affiliate) products because in addition to receiving an advisory fee, the firm also receives revenue from the sale of its product.[61]

RIAs may have a financial incentive to sell mutual fund share classes that return the highest fees for themselves. Mutual funds can come in various share classes, each of which represents an interest in the same portfolio of securities. In our review of advisory brochures, a firm disclosed that investors should not expect their investment adviser to choose the least expensive publicly available share class of a mutual fund. SEC staff told us that there are cases in which a low-cost share class available in an employer plan is not available to a client with a retail IRA, and so publicly available low-cost share classes may not be available to a retail IRA investor. However, SEC staff told us that of the share classes available to the particular retirement investor, the RIA still has a duty to invest in the share class that is best for the client, and that cost is one of the factors a firm should consider in making the determination that a given investment is in an investor's best interest.

According to SEC, it has found numerous cases in which an investment adviser failed to disclose the conflicts of interest associated with selecting

[60]Affiliate conflicts occur when firms financially benefit from recommending products or services because they relate to those companies financially, for example, as minority shareholders. Revenue sharing occurs when the sponsor of investments shares revenue it earns on those investments with the firm recommending the investment. This arrangement creates an incentive to recommend certain investments rather than others because they are more lucrative to the advice provider.

[61]In the case of a mutual fund, the expense ratio associated with the proprietary product includes the management fee and the firm's profit on the product. The expense ratio is the fund's total annual operating expenses expressed as a percentage of average net assets.

a share class that paid the adviser or a related entity a 12b-1 fee for advisory clients when a lower cost share class was available. Every dollar an investor pays in fees and expenses is a dollar not invested for the investor's benefit. SEC launched a Share Class Selection Disclosure Initiative in 2018 to reduce this practice and estimated in November of 2022 that the initiative returned approximately $112 million to advisory clients.[62]

Changing Account Types

FINRA officials told us that account-type conflicts were among those they encountered in their examination and enforcement efforts. For example, they said FINRA is currently investigating potential Regulation Best Interest violations involving dually registered member firms (RIA and broker-dealer firms) recommending that clients open accounts on one side versus the other, as well as move securities between accounts, in circumstances where it may not be in the client's best interest.[63] Four of the 20 firms in our review disclosed they had a financial incentive to recommend that retirement investors transfer their 401(k) account to an IRA. One RIA also disclosed the incentive to recommend advisory accounts over brokerage accounts to generate an ongoing revenue stream. SEC officials told us that despite such incentives (and related disclosures), firms have obligations to only make such recommendations when they are in the best interest of retirement investors.

Principal Trading

What are Principal Trading Conflicts?

Principal trading conflicts can occur when financial professionals buy or sell investments, for or from their own accounts. This presents a conflict because, according to SEC staff, the financial professional is likely also setting the price at which the investor transacts. As a result, the financial professional has an incentive to increase the sale price when the firm is selling to the investor, and

[62]Under the Share Class Selection Disclosure Initiative, the SEC Division of Enforcement agrees not to recommend financial penalties against investment advisers who self-report violations of the federal securities laws relating to certain mutual fund share class selection issues and promptly return money to harmed clients. See https://www.sec.gov/enforce/announcement/scsd-initiative.

[63]FINRA staff said that, to the extent that the issues fall outside of FINRA's jurisdiction, they refer potential violations of the Advisers Act to the SEC, and potential violations of state investment adviser laws to state securities agencies.

firms may also have an incentive to "dump" underperforming securities on customers and clients.

Source: GAO analysis of SEC guidance and comments. | GAO-24-104632

We observed references to "sales" or "selling" more frequently in disclosure language describing principal trading than the other conflicts we reviewed, and 14 of the 20 firms in our review disclosed this conflict.[64] (See sidebar.) For example, one firm disclosed that when it buys securities from the client or sells securities to the client from its inventory, the firm typically earns compensation by marking down the price of the securities it buys from the client or by marking up the price of the securities it sells to the client.[65]

Client Referrals or Changing Firms

Thirteen of the 20 firms in our review disclosed referral conflicts in their ADV.[66] One RIA in our review disclosed that when it refers one of its existing clients to another adviser, it has a financial incentive to do so. For example, the firm will be entitled to compensation from the other adviser if the referred client becomes a client of the other adviser. The RIA also disclosed that it does not conduct a suitability assessment of the other advisers' services for referred clients, and it may not be in the referred client's best interest to become a client of the other adviser.

According to FINRA officials, conflicts can also arise in recruitment practices when financial professionals move from one firm to another. To provide former customers with a more complete picture (including conflicts of interest) of the potential implications of a decision to transfer assets, FINRA requires broker-dealers to provide an educational communication to a representative's former customers. (See fig. 2.) FINRA officials said the intent of this type of investor education and related communications is to prompt a conversation between broker-dealer representatives and their customers, including questions about incentives and compensation.

[64]See appendix I for methodological information on the disclosure review.

[65]This firm may act in a capacity other than as an RIA when making such trades because generally, according to FINRA officials, investment advisers never trade with clients as principal due to onerous trade-by-trade consent requirements. SEC staff told us dual registrants generally do principal trades in their brokerage capacity and not their advisory capacity.

[66]According to Form ADV Part 1A data, RIAs serving 91 percent of non-wealthy individual clients accept payment for client referrals or receive payments for client referrals.

Figure 2: Financial Industry Regulatory Authority (FINRA) Notice to Brokerage Customers

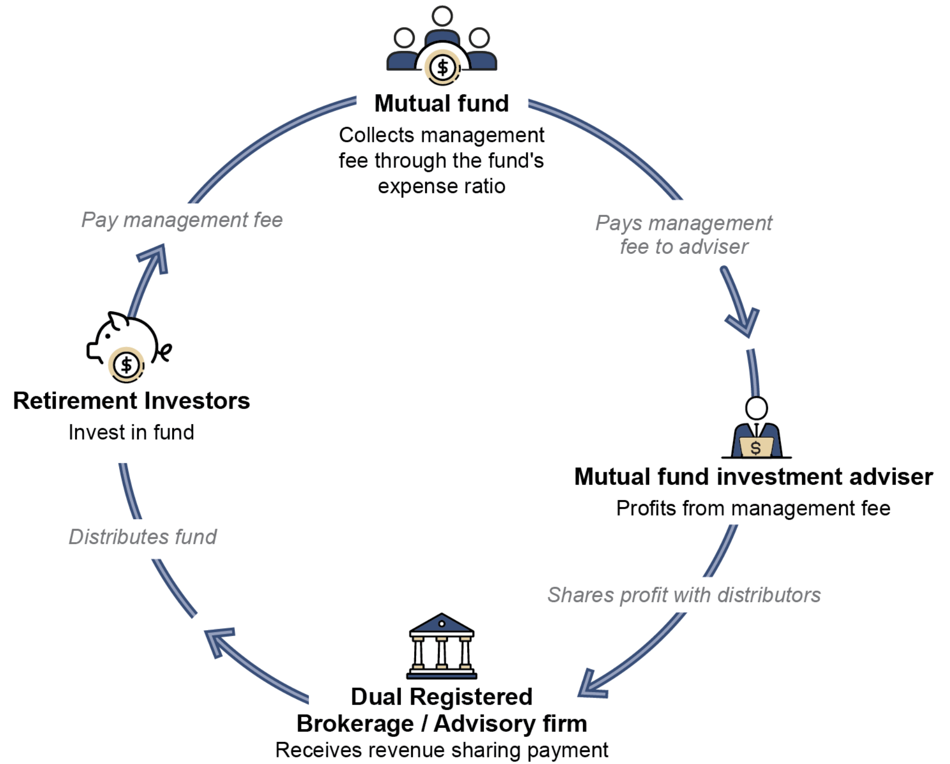
In general, you should discuss the reasons your broker decided to change firms. Some firms pay brokers financial incentives when they join, which could include bonuses based on customer assets the broker brings in, incentives for selling in-house products or a higher share of commissions.

Source: FINRA model recruitment notice associated with FINRA rule 2273. | GAO-24-104632

Compensation from Revenue Sharing

SEC staff we interviewed said it is common for a mutual fund adviser to use its profits for distribution payments to third parties who recommend the mutual fund to investors. Fourteen of the 20 firms in our disclosure review disclosed conflicts related to revenue sharing agreements. These 14 firms received compensation for participating in revenue sharing agreements in which a sponsor of an investment—such as a mutual fund—shared the revenue it earned with firms that recommended the investment to their clients (see fig. 3). SEC staff told us that if the RIA is receiving revenue sharing payments, it is typically receiving those payments indirectly through an affiliated broker-dealer.

Figure 3: Illustration of Mutual Fund Adviser Revenue Sharing for Fund Distribution



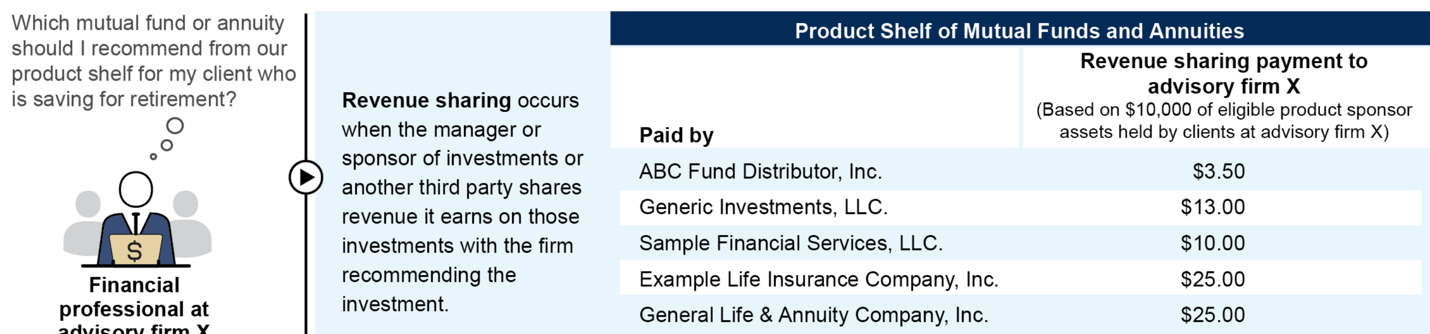
Source: GAO analysis of SEC documents and SEC interviews, academic and industry literature. GAO (icons). | GAO-24-104632

Note: An expense ratio is the total of a mutual fund's annual operating expenses, expressed as a percentage of the fund's average net assets.

SEC staff noted that investment advisers and broker dealers who recommend mutual funds to their clients or customers have incentives to keep such clients' or customers' savings invested in mutual funds that

make revenue sharing payments to the professionals.[67] (See fig. 4). A state securities commissioner said most retail investor clients, including retirement investors, are not aware of payment streams between firms and product sponsors, would never know to ask about them, and therefore are unaware of the consequences that may occur in their accounts as a result of these compensation practices.

Figure 4: Financial Professionals Can Select from Among Products Offering Different Revenue Sharing Payments



Paid by	Revenue sharing payment to advisory firm X (Based on $10,000 of eligible product sponsor assets held by clients at advisory firm X)
ABC Fund Distributor, Inc.	$3.50
Generic Investments, LLC.	$13.00
Sample Financial Services, LLC.	$10.00
Example Life Insurance Company, Inc.	$25.00
General Life & Annuity Company, Inc.	$25.00

Source: GAO analysis of financial companies' disclosures and academic literature. | GAO-24-104632

Note: Whether or not the firm, an affiliate or the financial professional receives revenue sharing payments, broker-dealers and investment advisers must act in the best interest of their customers or clients and cannot place their interests ahead of the client's or customer's interest when providing recommendations or investment advice, according to staff of the SEC, which regulates securities.

Compensation from Affiliates

A firm or financial professional may also direct clients' assets to the products and services of an affiliated business, one in which the firm has a corporate relationship with the business or has a financial stake in the business. Fourteen of the 20 firms in our disclosure review disclosed affiliate conflicts. For example, one firm in our review disclosed that its affiliates earn fees and other benefits from sales of the affiliated products. As a result, the firm has an incentive to recommend the affiliated products rather than making such a determination based on a client's needs. Another firm disclosed that it could invest the cash portion of an investor's advisory account with an affiliated bank to generate revenue for that bank affiliate. The firm disclosed that the investor's advisory account could earn

[67] Revenue sharing can also occur in employer plans. Research suggests record keepers in defined contribution retirement plans may exercise control over the investment options offered on behalf of their own affiliated funds, finding that the affiliated funds studied were less likely than non-affiliated funds to be removed from an investment menu for underperformance. See: Veronika K. Pool, Clemens Sialm, & Irina Stefanescu, "It Pays to Set the Menu: Mutual Fund Investment Options in 401(k) Plans," Journal of Finance vol. 71, no. 4, August 2016. DOL officials told us that in employer plans' plan fiduciaries may use revenue sharing to defray other plan expenses in an economical way that offsets costs to the plan and participants, pursuant to the plan document.

less interest in the affiliate bank account than it would in a money market account.[68]

RIAs may also recommend affiliate broker-dealers to execute client transactions. According to our quantitative analysis of Form ADV Part 1A data from September 2023, RIAs that select or recommend a related broker-dealer for advisory client transactions served 70 percent of non-wealthy investors.[69]

Disclosed Mitigation

SEC staff said the obligation that broker-dealers mitigate certain conflicts is a key enhancement created by Regulation Best Interest, and that significant staff time is spent focusing on broker-dealers' compliance with, among other things, the regulation's Conflict of Interest Obligation, including the mitigation provision.[70] Nineteen of the 20 RIA firms in our disclosure review described how they mitigate conflicts.[71] For example, regarding the recommendation of proprietary products, one firm disclosed that its financial professionals do not sell products. Some firms also disclosed they supervised account recommendations and removed variable compensation for financial professionals. Nine of the 20 RIAs in our review described taking additional conflict mitigation steps for retirement accounts versus nonretirement accounts, at times explicitly citing ERISA compliance standards or prohibited transaction exemptions as reasons for these steps. These additional measures included rebating fees to retirement accounts and granting reduced fees for proprietary products in retirement accounts but no other accounts.

[68]A cash sweep (or bank sweep) program typically involves the automatic transfer of cash into a bank. SEC staff said they have taken a number of enforcement actions against firms who put clients in cash sweep programs (1) without analyzing whether the particular cash sweep vehicle was in the clients' best interests and/or (2) that resulted in firm affiliates receiving revenue sharing when the firms did not provide full and fair disclosure of, and obtain informed consent to, the practice and the associated conflicts of interest.

[69]In some instances, such as this one, the Form ADV Part 1A asks if a firm engages in a particular activity and it is not possible to infer from the data whether the firm engages in the activity often or rarely.

[70]While Form ADV is for RIAs, we had dual-registrants in our sample (RIAs actively engaged in business as broker-dealers).

[71]The one firm in our review that did not describe mitigation practices was a small firm that did not accept commissions or asset-based fees and disclosed relatively few conflicts.

Financial Professionals Are Required to Disclose Conflicts to Investors, but Investors May Not Understand the Risks

SEC requires broker-dealers and investment advisers to disclose all conflicts of interest that might incline them to make a recommendation or offer advice to investors that is not disinterested, so that an investor can provide informed consent or make an informed decision regarding the conflict.[72] For a disclosure to be full and fair, it should be sufficiently specific so that an advisory client is able to understand the conflict and make an informed decision on whether to provide consent.[73]

According to SEC's 2019 interpretation of Advisers Act fiduciary standards, it may be difficult to provide retail clients with disclosures regarding complex or extensive conflicts that is sufficiently specific, but also understandable. According to that interpretation, an investment adviser who is aware that a client does not understand the nature or importance of a conflict after it is disclosed should not infer that the client consents to the conflict. SEC staff said that an adviser in such a situation may be able to correct the misunderstanding by explaining the conflict or they may choose to avoid the conflict. However, informed consent does not require an affirmative determination that a client understood the disclosure. Informed consent can be obtained explicitly, meaning the retirement investor communicates the investor's consent to a conflict to a financial professional, or implicitly, according to SEC staff, through the investor's conduct following disclosure. SEC staff said they did not maintain data on which form of consent was more common. See text box for the views on this subject of the three behavioral economists we interviewed.

Comments of Behavioral Economists

Three behavioral economists we interviewed said retirement investors generally either do not read or understand the financial disclosures that provide information about conflicts. Two commented that retirement investors poorly understand conflicts of interest. According to one behavioral economist, default investments, which are common in defined contribution plans, are effective at limiting conflicts because they represent implicit advice and could reduce an investor's need for explicit advice in some circumstances.

Source: GAO analysis of interviews with behavioral economists. | GAO-24-104632

[72]In a U.S. Supreme Court case establishing a fiduciary duty for investment advisers under the Advisers Act, the Court stated that the purpose of the federal securities laws "was to substitute a philosophy of full disclosure for the philosophy of caveat emptor [buyer beware] and thus to achieve a high standard of business ethics in the securities industry." See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963).

[73]Under Regulation Best Interest, full and fair disclosure enables retail customers to make informed decisions about recommendations.

According to SEC's 2019 interpretation of Advisers Act fiduciary standards, full and fair disclosure for an institutional client versus a retail client can differ (including the specificity, level of detail, and explanation of terminology). This is because institutional clients generally have greater capacity and more resources to analyze and understand complex conflicts and their ramifications. Regulation Best Interest, which exclusively applies to broker-dealers that make recommendations to retail customers, encourages broker-dealers to consider the usefulness and ease of understanding for retail customers of any existing disclosure document when deciding whether to rely on that document to disclose conflicts of interest, among other things.[74] Similarly, to satisfy PTE 2020-02, DOL has stated that disclosures to retirement investors should "allow a reasonable person to assess the scope and severity of the financial institution's and financial professional's conflicts of interest."[75]

GAO Work on the Challenges of Communicating with Retirement Investors

We reported in 2013 that requiring fiduciaries to disclose financial information about an employer plan might serve accountability purposes; however, the volume of disclosures can create communication challenges. Service providers and associations said participants may miss important information because they must read through such a large quantity of other content to find it, and most participants rarely read the disclosures they receive. In 2021, a generalizable survey we conducted of 401(k) plan participants showed almost 40 percent did not fully understand and had difficulty using the fee information they receive about their retirement plans. We reported that 45 percent of participants are not able to use the information given in disclosures to determine the cost of their investment fee. Additionally, we reported that 41 percent of participants incorrectly believed that they did not pay any 401(k) plan fees.

Source: GAO 14 92 and GAO 21 357. | GAO-24-104632

Based on our review of a non-generalizable sample of 20 firms' disclosed conflicts, advisory brochures often use complex language to describe the

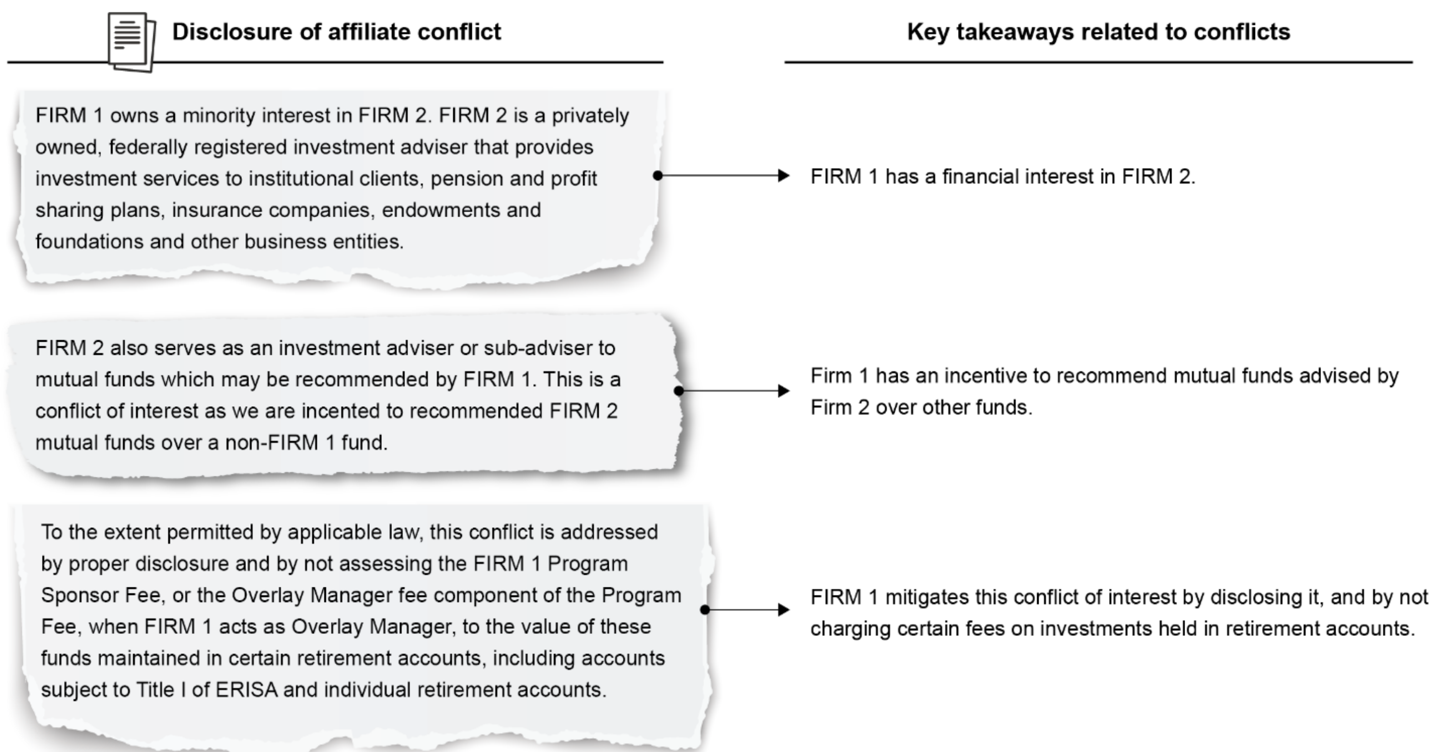
[74]We previously reported that a plan participant rolling funds into an IRA may have to attest to having read more than 50 pages of information. We also reported that reading prospectuses of one or more mutual funds would add additional reading, and that, based on the length one of the most popular target date funds at the time, each prospectus might be 25 pages long. See GAO-13-30.

[75]DOL uses Form ADV and other SEC disclosures for audits but does not assume they are correct. DOL guidance noted that DOL field examiners could not rely on ADVs—which investment advisers must submit to SEC—to determine investment advisers' compliance with prohibited transaction exemptions. Instead, DOL recommended that its examiners investigating advisers should test whether the procedures and policies described in the ADVs are effective, rather than rely on potentially inaccurate ADV descriptions of them. The guidance cited the SEC staff's findings that RIAs failed to follow their own policies and procedures and had inaccurate information on their Form ADVs.

circumstances in which conflicts occur.[76] While SEC requires advisory brochures to be written in plain English, advisory brochures in our review included complex financial concepts and terms such as "underwriting syndicate," "LIBOR-linked products," and "cash alternative vehicle." For example, disclosures referred to proprietary, affiliate, or third-party products, services, or programs with which the RIA has sometimes complex financial relationships that clients may be unfamiliar with.

Complex concepts and circumstances can be difficult for the average retail investor to understand. Figure 5 shows an example of the language and complexity of circumstances through which firms make disclosures to investors.

Figure 5: Example of Advisory Brochure Language Describing Affiliate Conflict of Interest



Source: GAO analysis of Form ADV Part 2A disclosure. | GAO-24-104632

[76]To understand what conflicts retirement investors face and how difficult it would be for retirement investors to understand how conflicts can affect their retirement savings, we reviewed Form ADV disclosures, including Relationship Summaries, from a non-generalizable sample of 20 firms. For methodological information, see appendix I.

Note: The column on the left is anonymized content from an advisory brochure and the column on the right is our effort to explain key takeaways related to conflicts of interest. The Securities and Exchange Commission (SEC) requires that SEC-registered investment advisers disclose conflicts of interest to clients, which is often accomplished through an advisory brochure that is part of the Form ADV.

We used an automated readability tool, the Flesch-Kincaid Grade-Level test to determine the reading level at which the selected firms disclosed their conflicts. The excerpts had an average readability score of 16.3, which was above a college graduate reading level.[77] According to the U.S. Census Bureau, an estimated 38 percent of Americans age 25 and older had a bachelor's degree or higher in 2022.

The SEC has recognized that there are instances where disclosure is insufficient to reasonably address a conflict. DOL officials said that given the asymmetry of expertise in a relationship between a financial professional and a retirement investor, retirement investors might not be able to protect themselves from suboptimal advice resulting from conflicts of interest of a financial professional even after being fully informed about them. Retirement investors who read and interpret disclosure content correctly may not discount advice from biased advisors even when conflicts of interest are disclosed, according to findings from one study.[78]

The customer or client relationship summary (Relationship Summary) provides information to retail investors about a broker-dealer or RIA, according to SEC staff. The Relationship Summary is intended to promote transparency, comparability, and better-informed decision-

[77]Information relevant to conflicts includes descriptions of conflicts and descriptions of conflict mitigation approaches. For methodological information, see appendix I. We focused our evaluation on the disclosure content we coded as relevant to conflicts of interest. The U.S. Navy developed the Flesch-Kincaid Grade Level test to calculate readability and the tool has been used extensively to evaluate reading materials for adults.

[78]A 2005 study investigated the impact of disclosure of conflicts of interest by randomly assigning participants to the role of either an advisor or estimator in a series of experimental conditions. Estimators were asked to estimate quantities of coins in jars. Advisors were provided information about the quantities and instructed to provide advice to estimators. In two conditions, advisors were paid more when estimates were high instead of accurate while estimators were paid for accurate estimates. This conflict was disclosed in one of the treatments but not the other. The study found that disclosing conflicts led to greater distortion of advice and benefited those providing advice rather than those receiving advice. Specifically, advisors provided more biased advice when conflicts were disclosed than when they were not disclosed. Additionally, estimators earned less money with disclosure than without and advisors earned more money with disclosure than without. Study results can only be generalized to the study population, which included 147 undergraduate students recruited for pay. See: Daylian M. Cain, George Loewenstein and Don A. Moore. "The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest." *The Journal of Legal Studies*, vol. 34, no. 1 (2005).

making, through clear, concise disclosures, and by summarizing in one place selected information about a particular firm, including firm and financial professional-level conflicts of interest, according to SEC staff.[79]

For example, on one Relationship Summary we reviewed, the firm provided concise summaries on conflicts related to proprietary products, third party payments, revenue sharing, and principal trading. The firm disclosed that most mutual funds and annuities available through their brokerage service also pay the firm for distribution, marketing, networking, shareholder accounting, and other services. It further noted that these payments create an incentive for the firm to recommend these investments over others, such as stocks and bonds. The Relationship Summaries we reviewed often provided broadly generalized information on conflicts of interest. (See fig. 6).[80] According to SEC, in most instances the Relationship Summary will not be sufficient to satisfy the Disclosure Obligation of Regulation Best Interest.

[79]The Relationship Summary is a disclosure form that both registered investment advisers and broker-dealers must deliver to retail investors who are their clients or customers. (For purposes of federal securities laws, investment advisers have clients and broker-dealers have customers, according to SEC staff.) With respect to RIAs, the Relationship Summary is an additional component of the Form ADV disclosure –Form ADV Part 3, also referred to as Form CRS. The Relationship Summary consists of a brief two- to four-page overview of a firm's conflicts of interest, business relationships, service offerings, and required standard of conduct, among other information. The Relationship Summary is intended to help potential retail investors have conversations with financial professionals about whether their services are a good fit for the retail investor's investment goals.

[80]The concise, general nature of the information does not necessarily mean retirement investors are engaging with it. One broker-dealer representative told us the firm sent out 15,000 Relationship Summaries to its customers and only one called the firm to ask questions about it.

Figure 6: Relationship Summary Excerpt

Client Relationship Summary — Page **2** of 2

CONVERSATION STARTER — Ask your financial professional	Help me understand how these fees and costs might affect my investments. If I give you $10,000 to invest, how much will go to fees and costs, and how much will be invested for me?

What are your legal obligations to me when acting as my investment adviser? How else does your firm make money and what conflicts of interest do you have?

When SAMPLE FIRM acts as your investment adviser, we have to act in your best interest and not put our interest ahead of yours. At the same time, the way we make money creates some conflicts with your interests. You should review the SAMPLE FIRM Form ADV Part 2A Appendix 1 and ask your financial professional about these conflicts because they can affect the investment advice we provide you. Here are some examples to help you understand what this means.

Proprietary Strategies and Products: The SAMPLE FIRM Platform includes proprietary strategies and funds, meaning that they are managed by SAMPLE FIRM. These proprietary strategies and funds create a conflict for us because we receive compensation if your assets are directed to these proprietary strategies or funds; they can be more profitable to us than strategies or products available from third-party firms.

Custodial Relationships: SAMPLE FIRM supports custodial accounts at several custodians, including its affiliated custodian, SAMPLE FIRM Trust Co. ("ATC"). SAMPLE FIRM negotiates fees and services with these custodians, and this creates a conflict of interest in situations where SAMPLE FIRM may pay custodians lower fees or spend less on the services it provides custodians. In particular, SAMPLE FIRM and, therefore, its parent company earn greater revenues, although SAMPLE FIRM provides additional services, on accounts custodied at ATC. For example, ATC receives revenue from the Insured Cash Deposit ("ICD") bank sweep program for cash held in client accounts, and ATC has the ability to affect the interest rate paid to clients in the ICD program. SAMPLE FIRM addresses these conflicts by charging an identical Platform Fee to clients no matter what custodian the clients and their advisors choose, and because SAMPLE FIRM has no discretion in choosing custodians and does not recommend custodians to clients.

Mutual Fund Revenues: Some mutual funds pay Rule 12b-1 fees and shareholder servicing fees, and some service providers to mutual funds make payments in return for shareholder, administrative and sub-transfer agent services provided to those mutual funds. These mutual fund revenues are paid to custodians, including to ATC, and can reduce the fees SAMPLE FIRM otherwise would pay for custodial services. SAMPLE FIRM, therefore, has a conflict of interest when selecting mutual funds that pay different levels of compensation to custodians, and between mutual fund share classes that provide different levels of payments to custodians. SAMPLE FIRM addresses this conflict by taking the receipt of these fees into account when determining the Platform Fee and seeking to use institutional share classes with no 12b-1 fees, where available.

Additional Information: For more information on conflicts of interest, visit our website at *https://www.SAMPLE FIRM.com/info/disclosure*, Form ADV Part 2A Appendix 1, Item 4.

Recommended questions for clients to ask when selecting services or retaining a financial professional

Bolded examples of common conflicts of interest and explanation of how conflicts create incentives for the professional.

Link to more detailed ADV disclosure for clients who may want more information on a specific conflict

Source: Selected and redacted customer relationship summary disclosure. | GAO-24-104632

Note: The page in the figure is from a firm's disclosure with the firm's name anonymized. Our explanations of the content appear on the right.

We found through our non-generalizable disclosure review, which included advisory brochures in addition to Relationship Summaries, that some descriptions of financial conflicts of interest were complex and some of the disclosed material left unanswered questions about a conflict's magnitude or applicability to retirement investors. For example:

- One firm disclosed a revenue sharing conflict in which a product sponsor offered additional compensation to the firm

and financial professional for recommending its product. However, the disclosed conflict did not name the product sponsor or the product or state how much compensation the firm receives for recommending the product. A retirement investor may not be able to understand whether the revenue sharing conflict applies to the investor's investment selection without requesting additional information.

- Another firm disclosed that it earns fees and other benefits by offering affiliated products, and that the firm has an incentive to select its affiliated products based on the compensation and benefits its affiliates receive rather than on a client's needs. In addition, because mutual funds benefit from scale, the firm and its affiliated companies have an interest in the mutual funds gaining greater assets. However, this disclosed conflict did not name which products the firm offers through these affiliate arrangements.

- An additional firm disclosed that it compensates its financial professionals for the products it offers in different ways and that this creates different financial incentives for the financial professionals. The firm noted that these incentives may cause its financial professionals to recommend certain products and account types over others. The incentives may also encourage clients to purchase multiple products and services and to choose a payment structure for products and services that generates greater compensation. However, the firm did not disclose which of these scenarios would lead to the greatest incentive for the financial professional or be most applicable to a retirement investor.

Discussions Between Financial Professionals and Retirement Investors about Conflicts, Standards of Care, and Compensation can be Challenging for a Variety of Reasons

The fictitious persona for our undercover phone calls to financial professionals:

- 60 years old
- Considering retirement
- $600,000 in retirement assets
- 401(k) and IRA accounts

Source: GAO undercover investigation. | GAO-24-104632

Discussing conflicts of interests with clients can be challenging for both the financial professionals and the retirement investor. Based on our analysis of undercover phone call transcripts, such conversations may not be a reliable vehicle for meaningful communication about conflicts of interest. The conflicts of interest and the applicable standards of care limiting them depend on facts and circumstances that may be unknown at the time of the conversation and susceptible to change. Conversations may focus on known, relevant conflicts that a financial professional thinks a retirement investor should be concerned about, of which there may be none.

Federal regulators recommend that retirement investors ask the financial professionals they work with about conflicts of interest. DOL, FINRA, and SEC all make publicly available a list of questions that they recommend asking financial professionals. For example:

- SEC suggests asking "How might your conflicts of interest affect me, and how will you address them?"
- DOL suggests asking "Are you a fiduciary under the federal laws specifically applicable to retirement accounts (Title I of ERISA and the Internal Revenue Code) when you give me investment advice for my retirement accounts?"
- FINRA suggests asking "How do you get paid? Do you receive commissions on products I buy or sell? A percentage of the amount of my assets you manage? A flat or an hourly fee? Any other method?"

Call excerpt: compensation-based conflicts

One financial professional said "so in the financial advice industry, there's a lot of conflict of interest. There's, first, you want to be wary of any commission-driven brokerage kind of advisors. There are some advisors out there like that they might put you in the mutual funds that have a kickback fee to them, so they're getting paid through the mutual fund, so they might not be putting you in the lowest cost, best possible thing for you…. There's a conflict of interest, some people say AUM [assets under management] advisors have a conflict of interest because let's say you tell me you want to buy a house, or buy a beach house, and I'm managing your assets, and if you spent $500,000 on a house and take $500,000 out of the account that I'm managing, then my fee just went down 1 percent of $500,000. So AUM advisors, I think, have a conflict of interest in that they're inclined to want you to be invested more in order to earn more fees."

Source: GAO undercover investigation. | GAO-24-104632

To understand what prospective clients might learn from discussions with financial professionals, we conducted undercover phone calls and spoke to financial professionals at 75 firms.[81] Topics discussed with financial professionals included conflicts of interest, fiduciary protections, and compensation.[82]

Unidentified Conflicts. According to SEC, all broker-dealers, investment advisers, and their financial professionals have conflicts of interest between themselves and their retail customers and clients. However, a retirement investor may assume there are no conflicts if they ask about them and none are identified.

Twelve of the 55 financial professionals that we asked about conflicts of interest said they did not have them. Among the 12 who reported not having conflicts, two said the way they are compensated for providing services removed conflicts; two said there were only specific instances (not applicable to them) in which they could have conflicts, such as selling proprietary products or recommending investing in a company for which the financial professional served on the board. One financial professional said, "I barely met you, so I have no conflicts of interest." Another said they were not aware of any conflicts to be concerned about, but if they were to recommend an annuity, they would "disclose to you our conflict of how much we might make for that annuity."[83]

[81]Statements of financial professionals cited in this section are attributable to these undercover calls. Because we did not ask an identical set of questions of each financial professional, when we report on what we heard from a certain number of financial professionals on a particular topic, we also report a denominator indicating the number of conversations in which we discussed the topic. See appendix I for methodological information.

[82]Financial professionals described conflicts of interests, standards of care, and compensation, among other things. We did not make independent determinations as to whether a conflict of interest existed or whether a financial professional was subject to a fiduciary duty or other standard of care.

[83]Commissions and other sales charges are not material conflicts of interest under the 2020 National Association of Insurance Commissioners Suitability in Annuity Transactions Model Regulation.

Call excerpt: "best interest" in context

One financial professional said: "So we are required by law to act in your best interest and not me, personally. I am not an advisor… I have my license to sell anything I can. So, if I wanted to go knocking on doors and selling like whole-life insurance policies, I could. I am not required to – me personally, am not required to act in your best interests."

Another financial professional said "...and that's why we really start… with the financial planning, because we don't really know what's in your best interest until we, you know, we line it all out, and we see, you know what it is, where you are."

Source: GAO undercover investigation. | GAO-24-104632

Difficulty distinguishing fiduciary from best interest protections. Our undercover investigation found that financial professionals often used the term "best interest" when describing "fiduciary" duties. Of the 70 financial professionals who we talked to about the term "fiduciary," 41 said it meant acting in the client's "best interest." One financial professional was reportedly a fiduciary under FINRA.[84] Another said a financial professional has a fiduciary responsibility to make sure he is selling the right products.

Whether a fiduciary standard applies can vary based on context. As a result, it may not always be apparent whether a financial professional has a fiduciary obligation to the retirement investor or not. Financial professionals can have multiple roles, such as registered representative of a broker-dealer of securities and insurance agent, and retirement investors may not fully understand the conflicts associated with each role.[85] Most financial professionals we spoke to (49 of 75) were both registered representatives of broker-dealers and investment adviser representatives, which meant they could act in either capacity.[86]

[84]According to the financial professional, "So I have what's called a Series 65. It's by FINRA, which is a regulating agency for like financial advice. And if you have your Series 65, you are legally registered with like FINRA, so a federal agency, to be a fiduciary, and essentially guarantee that you're always putting your client's best interest first." FINRA officials told us that under Regulation Best Interest, which FINRA examines for and enforces against its members, financial professionals associated with broker-dealers must act in their retail customers' best interests when recommending securities transactions or investment strategies involving securities. Separately, FINRA administers the Series 65 North American Securities Administrators Association Investment Advisers Law Examination, which FINRA officials said most states require for persons providing investment advice on behalf of an investment adviser. However, while FINRA administers the Series 65 examination, FINRA officials said an investment adviser representative who is not also associated with a broker-dealer is not required to be registered with FINRA.

[85]Representatives of an investor advocacy association cautioned that dual registration encourages putting high-commission generating activities on the broker-dealer side, and more passive activities on the RIA side, which can lead to high-risk products that should be monitored in accounts that do not require oversight and management.

[86]Of the 75 financial professionals we spoke to in our investigation, we were able to collect information on the investment-related licensing information, years of experience, and qualification exams of 69 financial professionals from brokercheck.finra.org or adviserinfo.sec.gov. Five of those six remaining individuals not found represented annuity firms and may not have security licenses. One financial professional was a para-planner. (A paraplanner is someone who works with a financial planner to help provide information and financial planning services to clients. Similar to a paralegal who works with a lawyer, a paraplanner works with a financial planner.)

Fifteen financial professionals told us that recommending insurance products, such as annuities, would constitute fiduciary advice, and three financial professionals told us that recommending insurance products would not constitute fiduciary advice.[87] One financial professional explained that with the purchase of an annuity, our 60-year-old retirement investor would not be exiting the fiduciary relationship but would potentially be exiting a fee-based relationship. Another financial professional said he could not act as a fiduciary when recommending an annuity because he could earn commission from that product.

Call excerpt: 401(k) to IRA rollovers

One financial professional said, "The real thing you want to consider with that is first, if your 401(k) may be in a different share class of the fund, it could potentially be in a better share class…."

Another said, "rule of thumb is… if you can get your money away from your employer, you're generally going to be better off…."

Source: GAO undercover investigation. | GAO-24-104632

As of September 2023, 83 percent of non-wealthy RIA clients were with firms that were registered as or affiliated with a type of broker-dealer and 63 percent were clients of investment advisers who were also doing business as an insurance broker or agent or affiliated with an insurance company or agency. Financial professionals may provide one recommendation as an RIA and another as a broker-dealer or insurance agent, which may not be apparent or meaningful to a retirement investor.[88]

Challenges understanding changes in fiduciary protections for IRAs. Twelve of the 29 financial professionals we asked about changes to fiduciary protections associated with 401(k)-to-IRA rollovers said that the rollover generally involves no loss of fiduciary protections.[89] Those financial professionals may not have considered the fiduciary protections that apply to retirement accounts beyond securities law. However, IRAs are not employer plans covered by ERISA's labor provisions so retirement investors who complete a 401(k)-to-IRA rollover lose certain ERISA rights and protections, including the right to sue an employer plan

[87]Of the 70 financial professionals with whom we discussed the meaning or obligations of a fiduciary, we found statements from 18 that insurance recommendations either would or would not be associated with a fiduciary standard.

[88]Research suggests dual-registered investment adviser/broker-dealers have conflicts of interest that independent RIAs do not and that those conflicts can have consequences. See Boyson, Nicole M., The Worst of Both Worlds? Dual-Registered Investment Advisers (December 1, 2019). Northeastern U. D'Amore-McKim School of Business Research Paper No. 3360537. SEC officials said that retirement investors need to understand when financial professionals are switching standards.

[89]We spoke with 70 of the 75 financial professionals about fiduciary protections, and of the 70 we spoke with, we discussed fiduciary protections associated with rollovers with 29 of them.

Call excerpt: paying for advice

One financial professional said, "Now, if I go back to that example of you might find a financial advisor that's willing to work with you and not charge you for a financial plan, but then how are they making money? So they're going to make money by trying to convince you to buy some expensive insurance product. That's how they make money. But you are paying fees for my advice, so if you only pay me for my advice — and maybe I advise you, just say, 'Hey, you need to have an annuity, and this is a type of annuity that I recommend.' And you decide to go out and buy it from somebody else, I don't care. You're not paying me for the annuity, you're paying me for my advice. That's the agreement or the contract that we entered into. So I would say those would be your conflicts of interest that you want to make sure that you understand."

Source: GAO undercover investigation. | GAO-24-104632

fiduciary for breach of fiduciary duty in federal court.[90] After a rollover, anyone meeting the definition of a fiduciary in the IRC for the functions they perform for that IRA is a fiduciary to the IRA under the IRC. One financial professional explained this by telling us the financial professional still had a fiduciary role under ERISA rules, even when the 401(k) savings roll over to an IRA, subject to IRS guidelines, which has different rules than 401(k) plans.[91] However, we also heard other things. One financial professional said "401(k)s and IRAs both fall under ERISA rules… fiduciary rules apply to us just as they do your 401(k) administrator." One said, "in the IRA it would be the SEC standard."

Under federal law, employers generally cannot require 401(k) retirement investors under age 62 who meet minimum-balance requirements to take a distribution after a job change.[92] Our fictitious persona was 60 years old, had six figure retirement account balances, and had at least a couple years before needing to take a distribution. However, one financial professional said the retirement investor should check if the 401(k)-plan provider allows plan participants to stay in the plan after leaving their job. Another professional said depending on the employer, sometimes, "whenever you leave, they have a certain timeframe where you have to have it out of there by…."

When discussing reasons to implement a 401(k) to IRA rollover, a few financial professionals described IRAs' greater number of investment options as a beneficial feature or described employer plans' limited

[90]We previously reported ways 401(k) service providers may avoid meeting the five-part test for ERISA fiduciary investment advice. They may state in their contract with the 401(k) plan that their recommendations are not intended to be a primary basis for investment decision or offer recommendations only when setting up the plan and not on an ongoing basis. See GAO. *401(k) Plans: Improved Regulation Could Better Protect Participants from Conflicts of Interest*, GAO-11-119 (Washington, D.C.: Jan. 28th, 2011).

[91]While the prohibited transaction rules applicable to IRAs, which this financial professional may have been referring to as "ERISA rules", are in the tax title of the U.S. Code (Title 26) rather than the labor title of the U.S. Code (Title 29), they in fact have their legislative origins in ERISA.

[92]26 U.S.C. § 411(a)(11) generally provides that active 401(k) plans may not distribute accounts with vested account balances of over $7,000 without the consent of the participant.

number of investment options as a downside.[93] One financial professional said that an IRA allows retirement investors to invest in whatever they want to, naming public companies as examples.

Compensation models can drive conflicts. In 18 of our undercover conversations, financial professionals described ways that other financial professionals are compensated, such as through sales and fees that can lead to conflicts of interest.[94] Twelve financial professionals recommended ways retirement investors can protect themselves from conflicts of interest or made statements about general products or firm types to avoid. Four of those discussed product types to pay attention to with regards to conflicts of interest. For example, financial professionals discussed avoiding certain investment products because of the compensation a financial professional would receive for selling them, including annuities, load mutual funds, and proprietary products.[95] Six of the 12 financial professionals discussed compensation models a retirement investor should pay attention to for conflicts of interest. While some compensation models create more conflicts than others, no one model benefits all investors in all circumstances, according to a state securities commissioner we interviewed.

[93]Research suggests that the level of additional investment diversification achievable with the large number of investment options offered in an IRA may be of limited value to an investor. See Shen, Sally and Turner, John A. “Conflicted Advice About Portfolio Diversification” (Nov. 22, 2017).

[94]Of the 75 financial professionals we spoke with, we brought up the subject of conflicts of interest with 55 of them. The 18 cited here is of the 55 that we explicitly discussed conflicts with, as are the other counts (12, four, and six) in this paragraph.

[95]A load mutual fund is a mutual fund with a sales load or sales charge, which is like a commission and is paid to the selling brokers. There are two general types of sales loads—a front-end sales load investors pay when they purchase fund shares and a back-end or deferred sales load investors pay when they redeem their shares. According to FINRA officials, while mutual fund class B shares impose back-end or deferred sales loads, that share class has almost completely disappeared in the last 10 years. FINRA officials told us the two most common types of share classes with sales loads are those with front-end sales loads (class A shares) and shares with no front-end sales loads but that impose an ongoing Rule 12b-1 fee of 1.00 percent (class C shares).

We heard industry, government, and non-profit stakeholder perspectives about the compensation models included in our undercover investigation.[96]

- **Asset-based** is an ongoing fee based on the value of the portfolio. Such fees might vary widely, for example, between 0.25 percent and 2 percent of a retirement investor's assets every year. Registered investment adviser association representatives said conflicts are common with investment advisers. They said their financial professionals typically receive asset-based compensation and generally do not have a financial incentive to recommend specific products, but if the client bought a house with the invested assets it would reduce the financial professional's fee. Representatives also told us asset-based fees are for providing account services rather than for selling investment products. As assets grow, the fees received by the financial professional grow as well, which in one way aligns the interests of financial professionals and clients. However, a representative of a fiduciary compliance firm said the relationship between fees and asset growth creates a bias for financial professionals to take unnecessary investment risks to increase their compensation after a retirement investor's retirement needs are satisfied.

- **Commission** includes, generally, a one-time fee, (which could range widely from, for example, under 1 percent to over 10 percent of the investment), depending on the product, and a recurring fee (which could also range widely from 0.04 to 1.25 percent of the investment). Commissions compensate financial professionals for product sales. According to a fiduciary compliance expert, the most problematic conflict is the dual role of financial professionals selling financial products for a commission while having the sanctioned authority to advise retirement investors on which products to use. However, a state securities commissioner said a commissioned product for an investor intending to keep the product for an extended period may be the best thing for that individual.

[96]To construct the sample of firms we selected for the investigation, we used the same four categories of RIAs (Commission, Asset-based, Hourly, and Conglomerate) that we used for the disclosure review, and added a fifth group, annuity providers. See appendix 1 for methodological documentation.

- **Fixed and hourly** includes fixed fees (other than publication subscription fees). According to financial professionals we spoke to in our undercover investigation, fixed fees might be between $3,000 and $10,000 per year and hourly fees might be between $250 and $400 per hour. Representatives of an investor advocacy association said they viewed the hourly rate model as the least conflicted but said only a small number of financial professionals charge by the hour, which they said provides less opportunity to bring in revenue. Registered investment adviser association representatives said hourly fees make sense if there is a one-time engagement to create a financial plan and it is not clear how long it will take.

  One researcher discussing fixed or hourly compensation said that when an investor pays a financial professional only to render advice, then there is not necessarily a conflict. The researcher explained that someone providing rollover advice about employer plan assets for a fixed fee does not need a prohibited transaction exemption (for fiduciaries who engage in activities that may create a conflict of interest) because there is no conflict. Similarly, the financial professional paid only on a fixed fee could recommend an annuity without a conflict of interest because it would not affect their compensation, according to this researcher.

Call excerpt: variable mutual fund compensation

One financial professional said: "There's a conflict of interest in the commission side because you're getting paid to pick a specific mutual fund…Mutual fund A, now mutual fund B from a different company is going to pay the broker the exact same amount…but there's some funds, mutual funds that don't pay anything…they don't have a commission side to their business. So there's a conflict there because the broker is not likely to go to the…fund in a commissioned account because they can't get paid on it."

Source: GAO undercover investigation. | GAO-24-104632

Variable compensation. Variable compensation, which is compensation to financial professionals that can depend on what they recommend, was a theme in 52 of our 75 undercover conversations with financial professionals.[97] Twenty-four of the 52 financial professionals we discussed compensation with said that their compensation did not vary by the products, services, or companies that they might recommend to a retirement investor. Nine of these financial professionals mentioned receiving asset-based fees or a salary. Eighteen financial professionals discussed variable compensation they do or could receive. Nine of those cited the variable compensation created by annuities or insurance products. A few indicated that the variable compensation would not affect their advice.

Through 12b-1 fees, the assets of a mutual fund owned by a retirement investor can be used to pay for sales activities and create an ongoing trail

[97]A behavioral economist said that the most egregious conflicts for financial professionals arise when they have a stake in the decisions that an advisee makes.

of commissions for sales personnel. Some mutual funds pay larger 12b-1 fees than others and some funds do not pay 12b-1 fees.[98] In addition to sales activities, such fees can also be used for administrative services and incidental advice on an ongoing basis.[99]

What are 12b-1 fees?

12b-1 fees are paid by the mutual fund out of fund assets to cover distribution expenses and sometimes shareholder service expenses.12b-1 fees get their name from the Securities and Exchange Commission (SEC) rule that authorizes a fund to pay them. The rule permits a fund to pay distribution fees out of fund assets only if the fund has adopted a plan (12b-1 plan) authorizing their payment. They can also include fees paid for marketing and selling fund shares, such as compensating professionals and others who sell fund shares, and paying for advertising, the printing and mailing of prospectuses to new investors, and the printing and mailing of sales literature.

Source: GAO analysis of SEC information. | GAO-24-104632

Of the 34 financial professionals we discussed 12b-1 fees with in undercover calls, nine said the fees go to financial professionals. One financial professional described the 12b-1 fee as "…about 25 basis points, or 0.25 percent that gets charged per year for the remainder of the time you hold the fund." According to SEC staff, the receipt of 12b-1 fees may be transaction-based compensation that may require broker-dealer registration.[100] SEC staff said financial professionals charging investors' accounts an advisory fee for the advice generally should not be receiving 12b-1 fees, although there may be circumstances in which using 12b-1 fee paying share classes, even if they also include a sales load, are in an advisory client's best interest.[101]

[98] 12b-1 fees can vary from one share class to another, and among mutual funds in the same share class.

[99] We previously reported that plan participants may pay for administrative fees for their plan though their investments' operating expenses. Our survey, generalizable to the population of all 401(k) participants in the U.S., found that about a third of participants understand they could be paying administrative expenses that are disclosed as investment fees. GAO, *401(k) Retirement Plans: Many Participants Do Not Understand Fee Information, but DOL Could Take Additional Steps to Help Them*, GAO-21-357 (Washington, D.C.: Jul. 27, 2021).

[100] One financial professional described a practice for advisory accounts in which trailing compensation is billed against the advisory fees so that the client only pays their advisory fees. 12b-1 fees are an example of trailing compensation. In addition to asset-based sales charges, 12b-1 fees can include services fees, also known as trailing commissions, for continuing services to clients.

[101] We previously reported that retirement investors may not understand fees associated with certain products or a financial professionals' compensation. See GAO-21-357.

Variable compensation may accompany proprietary and affiliate products.[102] Firms that develop their own products can generate ongoing compensation from a proprietary product transaction. An independent broker-dealer firm's representative we interviewed cited difficulties mitigating conflicts of interest that arise from selling proprietary products, which is why that firm does not develop them. During our undercover conversations, five financial professionals explained that selling proprietary or affiliate products was a potential conflict of interest for the industry.[103] Three told us that selling proprietary products was or could be a conflict of interest for them.

Mutual Funds that Compensate Financial Professionals are Associated with Lower Investment Returns

Mutual fund companies that compensate financial professionals based on whether their clients invest in those funds can create conflicts of interest between the professionals and their investors. Our analysis of Morningstar's mutual fund performance data used fees that pay BDs or RIAs, which Morningstar says is a proxy for potential conflicts of interest.[104] We found that mutual funds with these fees are associated with lower before-fee investment returns for investors.[105] Our findings are consistent with related academic research, which has shown that funds that pay BDs are associated with lower performance. Our review of academic literature and industry reports also indicates that there can be

[102]An example in which a proprietary product recommended by a fiduciary would not generate additional compensation for the fiduciary relative to a third-party product could be if other fees the fiduciary was receiving were offset by the amount of the compensation associated with the proprietary product. See Department of Labor Advisory Opinion 97-15A Washington D.C.: May 22, 1997. PTE-77-4, which provides a class exemption for certain transactions between investment companies and employee benefit plans, is available for certain proprietary product compensation, and according to Department of Labor Advisory Opinion 93-26A, DOL considers PTE 77-4 applicable to transactions involving IRAs.

[103]We identified these five and the three cited in in the following sentence, from the 55 financial professionals with whom we explicitly discussed conflicts of interest broadly, rather than the 52 conversations in which we discussed variable compensation.

[104]RIAs receiving the variety of payments described in this section are likely to be dual-registered as broker-dealers. Independent RIAs may be unlikely to receive certain payments such as revenue sharing from a fund adviser.

[105]We analyzed a Morningstar data set from 2018-2021, comprised of 28,358 mutual funds covering around $17 trillion dollars of assets as of December 2021, to investigate the relationship between payments to BDs or RIAs and mutual fund performance. While retirement accounts can hold a wide variety of product types, we focus on mutual funds because they make up 48 percent, or $11.2 trillion, of retirement account assets (IRAs and defined contribution plans) in mid-2023 according to the Investment Company Institute. Further, available account-level data are not likely to be representative of the full retirement market. The unit of observation is a fund-share class month-year. See appendix II for more detail about the data.

greater financial benefits to BDs from selling some products compared to others—creating potential conflicts of interest with retirement investors.[106]

What are bundled, semi-bundled, and unbundled mutual funds?

Bundled Funds: May include sales-based commissions (also called loads) and 12b-1 fees. Broker-sold funds have comparable compensation structures to bundled funds. Bundled funds also may make payments associated with the semi-bundled fund fee group below.

Semi-bundled funds: Do not pay sales commissions or 12b-1 fees. The fund adviser may still share revenue with the broker-dealers and registered investment advisers who sell the fund. Semi-bundled funds can also charge fees that cover services, such as to maintain a website for transactions (platform fee).

Unbundled funds: Do not include any bundled or semi-bundled fees from the fund or the fund adviser.

Source: GAO analysis of Morningstar documentation. | GAO-24-104632

Beginning in 2018, Morningstar developed a labeling system that groups mutual funds into one of three mutual fund fee types: bundled, semi-bundled, or unbundled.[107] These groups are based on whether the fund bundles distribution and advice fees into its expense ratio (see sidebar).[108] Table 2 describes in more detail the payments that BDs or RIAs can receive for selling bundled, semi-bundled, and unbundled mutual funds. Some Morningstar mutual fund fee groups reflect compensation practices that can create potential conflicts of interest for BDs or RIAs, who advise retirement investors, as summarized below and shown in figure 7.

[106]See, for example, Bergstresser, Daniel, John MR Chalmers, and Peter Tufano. *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry* (2009), Florentsen, Bjarne, et al. *How important is the distribution channel for mutual fund flows,* (2020), and Christoffersen, Susan EK, Richard Evans, and David K. Musto. *What do consumers' fund flows maximize? Evidence from their brokers' incentives,* (2013).

[107]With asset-weighting, 26 percent of actively managed funds are bundled, 56 percent are semi-bundled, and 18 percent are unbundled in the analysis sample.

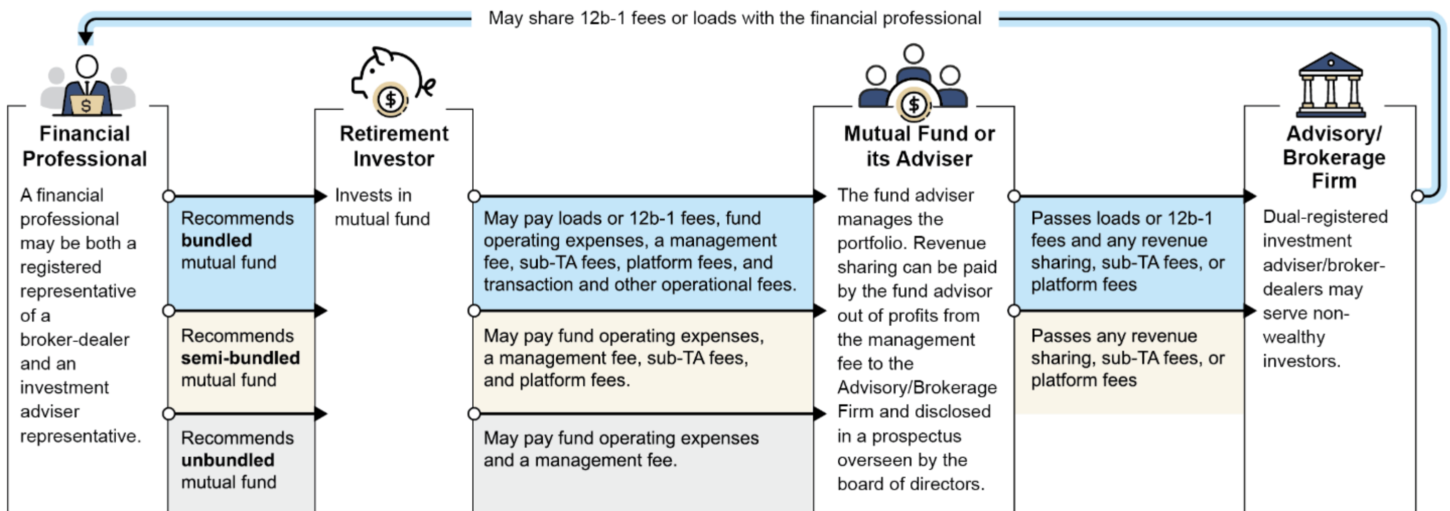
[108]According to Morningstar, no one service fee arrangement is inherently better than another.

Table 2: Types of Mutual Fund Payments According to Morningstar

Fee name (source of payments)	Definition	Mutual fund fee group		
		Bundled	Semi-bundled	Unbundled
12b-1	Pays for sales-based commissions, marketing for the mutual fund, distribution of the mutual fund, or shareholder services.	✓		
Front-end and back-end loads	Pays for sales-based commissions at the purchase (front-end) or sale (back-end) of a mutual fund.	✓		
Platform and access	Pays for platform support. An investment platform creates the mechanism, such as a website, that allows financial professionals to select investments for retirement investors.	✓	✓	
Sub-transfer agency	Pays for account maintenance, including shareholder services such as maintaining account records and distributing a fund's prospectus.	✓	✓	
Revenue sharing	Pays for marketing of the mutual fund from legitimate fund adviser profits obtained through the management fee.	✓	✓	
Management	Pays to manage and administer the investment portfolio.	✓	✓	✓

Source: GAO analysis of Morningstar documentation. | GAO-24-104632

Figure 7: Flow of Fees for Bundled, Semi-bundled, and Unbundled Funds



Source: GAO analysis of Morningstar fund classification documentation and other agency, academic, and industry documents. | GAO-24-104632

Note: Morningstar identifies 12b-1 fees (for distribution and sometimes shareholder services), sub-transfer agency (sub-TA) fees (for account maintenance), platform fees (for platform support), and revenue sharing (third party payments for marketing) by reviewing Securities and Exchange Commission filings. Retirement investors pay 12b-1 fees, sub-TA fees, management fees, and platform fees on an ongoing basis through the expense ratio of their mutual fund share class. While this depiction shows sales loads moving through the mutual fund, a common type of sales load (front-end loads) is not invested into the mutual fund before going to a broker-dealer. Retirement investors can also pay back-end loads from their proceeds when they sell their shares of the fund. The revenue sharing depicted here does not generate a separate fee to the retirement investor because it is included in the management fee, but the revenue that can be shared leads to variable compensation to the Advisory/Brokerage Firm.

Mutual funds that create potential conflicts of interest by paying sales-based commissions or 12b-1 fees are associated with lower returns for investors compared to funds that do not have these conflicts, according to our analysis of Morningstar mutual fund data from 2018 through 2021. Specifically, among actively managed mutual funds,[109] we found annual before-fee[110] returns of bundled funds were on average 0.28 percentage points lower than unbundled mutual funds.[111] For active domestic equity funds, before-fee returns of bundled funds were on average 0.89 percentage points lower than unbundled mutual funds. Both estimates are statistically significant.[112] (See appendix II for more details on our analysis.)

These findings are based on models that allow us to control for certain key fund characteristics, such as 145 Morningstar mutual fund categories (e.g., U.S. Large Blend Fund), so our results compare similar funds to each other. We also found the underperformance of bundled funds persisted through several important sensitivity analyses. The underperformance found in before-fee returns suggests that BD and RIA incentives, rather than expected performance, may have been driving investments these funds during this period.[113]

[109]Actively managed mutual funds aim to outperform an index through buying and selling portfolio assets. By contrast, passively managed funds aim to match the performance of an index. Actively managed mutual funds represent about 80 percent of funds weighted by assets in our sample. Domestic equity funds comprise a large portion of the funds available in the Individual Retirement Account market (see Department of Labor, Regulating Advice Markets (2016)).

[110]We use the before-fee return, also called gross return, to ensure the payments themselves are not generating the underperformance in our results.

[111]For sensitivity analyses, we use monthly net returns and net returns plus the 12b-1 fee, in place of gross returns. We see the same pattern of results, but payments are associated with a more negative effect on returns. We use standard deviation and semi-standard deviation as an outcome variable to investigate the volatility of bundled and semi-bundled funds relative to unbundled funds. See appendix II for more information on sensitivity analyses.

[112]The 95 percent confidence interval for -0.28 percentage points (all active funds) is -0.55 percentage points to -0.004 percentage points. The 95 percent confidence interval for -0.89 percentage points (active domestic equity funds) is -1.45 percentage points to -0.33 percentage points. These estimates are negative because we are stating the underperformance of bundled funds relative to unbundled funds.

[113]Because 12b-1 fees can pay for advertising and promotion in addition to distribution, financial professionals may be more aware of bundled funds than other funds, which could also be a factor influencing recommendations, according to SEC staff.

Additionally, the differences in fund performance that we identified cannot be a result of differences in actively versus passively managed funds because our analysis only compares active funds and excludes passive funds.[114] The association between such payments and lower investment returns is consistent with academic literature, which shows funds that pay broker-dealers are associated with lower performance.[115] For example, an academic study compared broker-sold funds to direct-sold funds for actively managed funds and active domestic equity funds from 2003 to 2012 and found that net returns for both broker-sold active funds and active domestic equity funds were lower than the net returns of direct-sold funds on an asset-weighted basis.[116]

The differences in bundled and unbundled fund performance could have implications for investors' retirement savings over time. Figure 8 illustrates one potential outcome based on a hypothetical retirement investor who invested a portion of her retirement savings in bundled active domestic equity funds for her working life (about 45 years). Lower average returns on bundled funds in our analysis suggest she would have accumulated about $55,000 less in savings by the time she retired than what she would have accumulated had she invested that same portion in semi-bundled and unbundled active domestic equity funds.[117]

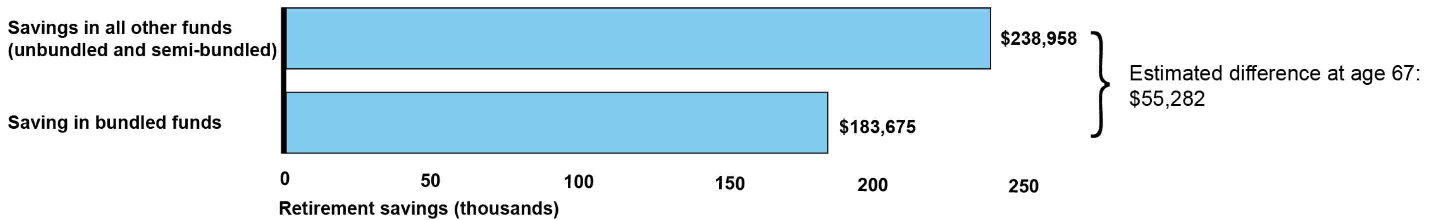
[114]For details on sensitivity analyses for including passively managed funds, see appendix II.

[115]Broker-sold funds in the literature correspond to our bundled funds and direct-sold funds correspond to our semi-bundled and unbundled funds. There is a history of literature on the underperformance of broker-sold funds. See, for example, Del Guercio, Diane, and Reuter, J. (2014), *Mutual Fund Performance and the Incentive to Generate Alpha.* The Journal of Finance, 69: 1673-1704.

[116]See Reuter, Jonathan, *Revisiting the Performance of Broker-Sold Mutual Funds*, (2015).[117]This value only applies to the domestic equity portion of the retirement portfolio. The calculation assumes a constant 5 percent inflation-adjusted annual rate of return for the average performing unbundled fund and a constant 4.11 percent inflation-adjusted annual rate of return for the underperforming bundled fund. The return of 4.11 percent is derived from subtracting the 0.89 percentage point difference in performance found in the active domestic equity asset-weighted regression analysis from the 5 percent return of unbundled funds. For more details about the illustrative example assumptions see appendix II.

[117]This value only applies to the domestic equity portion of the retirement portfolio. The calculation assumes a constant 5 percent inflation-adjusted annual rate of return for the average performing unbundled fund and a constant 4.11 percent inflation-adjusted annual rate of return for the underperforming bundled fund. The return of 4.11 percent is derived from subtracting the 0.89 percentage point difference in performance found in the active domestic equity asset-weighted regression analysis from the 5 percent return of unbundled funds. For more details about the illustrative example assumptions see appendix II.

Figure 8: Hypothetical Difference in Retirement Savings After a Lifetime Investment in Active Bundled Funds Compared with All Other Funds For the Domestic Equity Portion of a Retirement Portfolio



Source: GAO analysis. | GAO-24-104632

Note: The illustrative example assumes an investment portfolio that follows a glide path style asset allocation that is invested in semi-bundled and unbundled funds or bundled funds over a working lifetime of 46 years. A glide path refers to an investment portfolio where the asset allocation mix changes as the investor approaches a target withdrawal date. These values only apply to the domestic equity portion of the retirement portfolio. Numbers are rounded to the nearest whole number. For more details on the assumptions of illustrative example see appendix II.

Federal Agencies Share Oversight of Conflicts of Interest, but IRS Does Not Have a Process for Enforcement or Collaboration with DOL about IRA Fiduciaries

Under the Investment Advisers Act (for investment advisers) and SEC and FINRA Rules (for broker-dealers), investment advisers and broker dealers are required to identify and eliminate or mitigate and disclose conflicts of interest to which they are subject. SEC examines investment advisers and broker-dealers and FINRA examines broker-dealers, to ensure they are complying with these obligations. For retirement assets in employer plans and IRAs, DOL and IRS oversee prohibited transaction rules in ERISA and the IRC to limit conflicts. These rules generally prohibit transactions between interested parties and retirement assets, allowing for only certain exceptions. IRS has not developed a process to identify prohibited transactions between IRAs and firms or financial professionals who are fiduciaries to the IRAs. IRS can assess excise tax on entities committing prohibited transactions, particularly if IRS is supported by formal coordination with DOL. Finally, DOL could improve the information financial professionals have on employer plan investment options that could help them better advise clients about IRA rollovers. According to industry representatives, financial professionals cannot always easily access their clients' employer plan information from available sources.

Federal Agencies Have Varied Efforts to Oversee Conflicts of Interest

SEC, FINRA, and DOL regulate conflicts of interest between financial firms and professionals and retirement investors.[118]

SEC

SEC promulgated Regulation Best Interest in 2019. Regulation Best Interest requires broker-dealers that make recommendations of any securities transaction or investment strategy involving securities (including account recommendations) to retail customers to act in the best interest of the retail customer at the time the recommendation is made, without placing the firm's or its associated persons' financial or other interest ahead of the retail customer's interests.[119] This general obligation is satisfied only if broker-dealers comply with four specified component obligations.[120] With respect to the Conflict of Interest Obligation, SEC explained that, firm-level conflicts of interest at a minimum must be addressed through disclosure or elimination, while conflicts at the

[118]One association of financial professionals said a firm could test for patterns to see if incentives are influencing outcomes. Regulation Best Interest, which applies to dealers and their associated financial professionals, does not explicitly require such testing, although firms do have an obligation to assess their policies and procedures for addressing conflicts as they may have been reasonably designed under the Conflict of Interest Obligation.

[119]Under Regulation Best Interest, retail customer means a natural person, or the legal representative of such natural person, who receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer, or a natural person who is an associated person of a broker or dealer and uses the recommendation primarily for personal, family, or household purposes. Regulation Best Interest does not cover recommendations to employer plans themselves or to their legal representatives when they are receiving advice on the plan's behalf, and it generally does apply to recommendations of investments in employer plans and IRAs that are not securities.

[120]For more on the Disclosure Obligation, Care Obligation, and Compliance Obligation, see 17 C.F.R. § 240.15l-1.

financial professional level must be disclosed and either mitigated or eliminated.[121]

SEC staff reported eight public SEC Regulation Best Interest enforcement matters as of July 1, 2024. According to our review of publicly available documentation on those cases, two describe the failure to comply with the regulation's Conflict of Interest Obligation, both resulting from a failure to establish reasonably designed policies and procedures. One of those cases included conflicts associated with the receipt of finders' fees from an affiliated wealth management firm for customer referrals. The enforcement matters also included a broker-dealer failing to comply with three of the regulation's four component obligations in connection with its providing IRA investors a pre-selected core menu of affiliated investments in higher-cost share classes when lower-cost share classes of the same investments were also available through the IRA (off the core menu).[122]

As part of its oversight of RIAs, between October 1, 2020, and September 30, 2023, SEC conducted 6,927 investment adviser examinations. SEC's 2024 examination priorities include reviewing investment advisers' adherence to their fiduciary standard, including their processes for identifying and addressing conflicts of interest, and advice to retirement investors.[123] SEC staff told us that SEC examination priorities consistently include issues related to conflicts of interest.

FINRA

Subject to oversight by SEC, FINRA examines and enforces Regulation Best Interest, including the Conflict of Interest Obligation. FINRA officials told us to the extent possible, they coordinate the timing and scope of

[121]Specifically, Regulation Best Interest's Conflict of Interest Obligation requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to 1) identify and at a minimum disclose, pursuant to the Disclosure Obligation, or eliminate all conflicts of interest associated with such recommendations; 2) identify and mitigate any conflicts of interest associated with such recommendations that create an incentive for the broker-dealer's associated persons to place their interest or the interest of the broker-dealer ahead of the retail customer's interest; 3) identify and disclose any material limitations, such as a limited product menu or offering only proprietary products, placed on the securities or investment strategies involving securities that may be recommended to a retail customer and any conflicts of interest associated with such limitations, and prevent such limitations and associated conflicts of interest from causing the broker-dealer or the associated person to place the interest of the broker-dealer or the associated person ahead of the retail customer's interest; and 4) identify and eliminate sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific securities or specific types of securities within a limited period of time.

[122]Specifically, the Disclosure Obligation, Care Obligation, and Compliance Obligation.

[123]See https://www.sec.gov/files/2024-exam-priorities.pdf.

their examinations with SEC staff to avoid duplicating efforts. FINRA officials told us that examinations with a Regulation Best Interest component are risk-based and can include a review of a broker-dealer's procedures, including but not limited to identifying and addressing conflicts and its conflict mitigation strategies. Officials also told us that a key part of their supervisory work around the Conflict of Interest Obligation is ensuring that firms are keeping an accurate inventory of, and taking steps to mitigate, conflicts of interest.

FINRA officials described conflict mitigation methods that they have encountered, including firms limiting incentives for certain products and eliminating product specific sales contests. If FINRA finds that investors have been harmed due to the violation, FINRA may pursue an enforcement action that includes restitution of customer losses. As is common among regulatory organizations, exceptions identified in exam findings are not conveyed to customers. Nonetheless, FINRA officials told us that a history of disciplinary actions, including relevant criminal, regulatory and arbitration history, among other things, are publicly disseminated through FINRA's BrokerCheck.[124]

As of January 2023, FINRA officials said FINRA had conducted 821 broker-dealer examinations for compliance with Regulation Best Interest. For example, FINRA's examination program identified firms that failed to identify and address all potential conflicts of interest relevant to a firm's business model. FINRA also found instances in which a firm failed to conduct a reasonable investigation of offerings prior to recommending them to retail customers, as well as firms recommending a series of transactions that were excessive, considering retail customers' investment profiles. As a result of its examination program, FINRA also identified effective practices firms had implemented to comply with the regulation, such as applying heightened supervision to recommendations of products that are high-risk, high-cost, complex or present a high conflict of interest.

DOL

As part of its oversight of conflicts of interest, DOL issued a final rule on April 25, 2024, that broadens the definition of investment advice fiduciary under ERISA and the IRC.[125] According to DOL officials, a key ERISA

[124]See https://brokercheck.finra.org/.

[125]The final rule was set to become effective on September 23, 2024. However, on July 25, 2024, the federal court for the Eastern District of Texas issued an order temporarily staying the final rule.

innovation was in determining who is considered a fiduciary. DOL officials noted that without fiduciary status, advice providers would be free to engage in self-dealing transactions.

DOL also investigates employer plans for civil and criminal issues including improper use of plan assets, failure to monitor service providers, fraud, and embezzlement. For example, in Fiscal Year 2016 DOL established the national Plan Investment Conflicts (PIC) Project to investigate fiduciary service providers' compensation and conflicts of interest in relation to assets held by an employer plan (for example, mutual funds or other securities). The PIC Project also examines whether employer plan fiduciaries are conducting due diligence of employer plan investment decisions and employer plan service provider selection. As of Fiscal Year 2021, the PIC Project had 103 open priority investigations.

IRS

Although DOL has the authority to interpret the prohibited transaction rules and grant exemptions to those rules, IRS is responsible for enforcing the excise tax provisions in the IRC regarding prohibited transactions. The IRS Employee Resource Guide applicable to employer plans outlines the basic process for auditing a prohibited transaction after it is identified. It instructs IRS examiners to determine whether the person receiving the prohibited compensation met the conditions for a prohibited transaction exemption granted by DOL. Examiners who find no applicable exemption then ascertain whether a statutory exemption is available. If no statutory exemption is available, it instructs the examiners to pursue the issue to solicit a Form 5330, Return of Excise Taxes Related to Employee Benefit Plans, if it has not already been filed.[126] IRS has litigated the

[126]Form 5330 instructions indicate interested parties ("disqualified persons"), other than fiduciaries acting only as such, are liable for tax under section 4975 for participating in a prohibited transaction. The instructions list the six prohibited transactions in the section including self-dealing transactions between fiduciaries and plans and specify that an IRA is a plan that the form applies to. Form 5330 asks if all the prohibited transactions have been corrected and if not, the instructions are to attach a statement indicating when they will be corrected.

prohibited transaction rules against employers[127] and self-directed IRA owners.[128]

IRS Does Not Have a Process to Identify Prohibited Transactions of IRA Fiduciaries to Assess Applicable Excise Taxes

Compared to the IRS processes that exist for employer plans and IRA owners, IRS does not have a process to identify prohibited transactions of firms and financial professionals who are fiduciaries to IRAs under the IRC (IRA fiduciaries) to assess applicable excise taxes.[129] According to DOL, the aim of the prohibited transaction provisions is to protect plans, their participants, and beneficiaries from conflicts of interest that threaten the safety and security of plan benefits. Researchers have detailed the realities of conflicts of interest in the open market for common securities and insurance products—such as mutual funds and variable annuities.[130] Brokers have incentives to sell certain products, such as mutual funds with lower before-fee returns or variable annuities with higher expenses, because those products financially benefit the financial professional—as demonstrated by our regression analysis and by academic researchers.

IRS's approach to protect IRA investors from the conflicts of interest of IRA fiduciaries who engage in prohibited transactions relies on the IRA fiduciary self-reporting to IRS and paying the applicable excise tax,

[127]See, e.g., Zacky v. Comm'r, No. 3539-02, LEXIS 127 (May 27, 2004) (holding that a company owner engaged in self-dealing by, in part, using plan loans for payroll); Morrissey v. Comm'r, No. 13074-97, LEXIS 444 (Dec. 16, 1998) (holding a prohibited transaction occurred when a company owner transferred the owner's real estate to the plan to repay a loan).

[128]See, e.g., Ellis v. Comm'r, No. 12960-11, LEXIS 254 (Oct. 29, 2013) (holding that self-dealing occurs when an IRA owner directs an LLC funded by the IRA to pay the owner compensation); Harris v. Comm'r, No. 6094-92, LEXIS 31 (Jan. 19, 1994) (holding that an IRA owner living in property they purchased with their IRA resulted in a prohibited transaction).

[129]In 1969 and 1974, Congress sought to establish a new kind of excise tax aimed at deterring certain transactions rather than raising revenue from the sale of products whose users receive the benefit of government services (e.g., the highway gasoline excise tax). The new excise taxes were imposed on specific transactions deemed particularly objectionable because of the potential for abuse by fiduciaries with conflicting interests. The excise taxes safeguarded trusts that receive significant tax benefits from the federal government in exchange for serving the important national goals of providing private philanthropy for public causes and income for retired workers. By making each prohibited act more costly, Congress intended to reduce the incidence of such abuses by fiduciaries, and to safeguard the public purposes being served. Congress also sought to minimize the need to apply subjective standards, which had been difficult to enforce, by prohibiting transactions per se, with limited exemptions.

[130]For example, see Mark Egan & Shan Ge & Johnny Tang. "*Conflicting Interests and the Effect of Fiduciary Duty: Evidence from Variable Annuities*," The Review of Financial Studies, vol 35, No, 12 (Dec. 2022): 5334-5386.

according to IRS officials. Specifically, IRA fiduciaries submit IRS Form 5330 Return of Excise Taxes Related to Employee Benefit Plans and excise taxes calculated on Schedule C Tax on Prohibited Transactions.[131] However, IRS officials said they do not know whether the excise tax on the prohibited transactions between IRA fiduciaries and IRAs is paid because it is not clear to IRS that the fiduciaries are using the Form 5330 to submit excise taxes. They said it is possible that IRA fiduciaries do submit the excise taxes to IRS, but they were not aware of it happening.

IRS enforces the IRC's prohibited transaction rules in part by auditing IRA owners of self-directed IRAs.[132] Under those audits, IRS provides job aides for examiners to help them identify prohibited transactions IRA beneficiaries might engage in when, for example, the IRA purchases a business, the IRA beneficiary personally manages that business, and the IRA owner receives wages from the business. Additionally, IRS examinations can include requests for documents and questions about recommendations they received, including who made them, the amount of their compensation, and whether the IRA or the taxpayer paid them.

If an IRA owner engages in a prohibited transaction, the IRA loses its tax-favored status, and the account is treated as distributing all its assets to the owner at the fair market value on the first day of the year in which the prohibited transaction occurred. When a fiduciary to an IRA other than the IRA owner engages in a prohibited transaction with the IRA, the fiduciary

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[131]Form 5330 covers employer plans and IRAs and multiple types of excise taxes on plan transactions The form requests the name of the plan sponsor, which the instructions describe as an employer, an employee organization, or an association, and asks for the name of the plan and the plan sponsor's employer identification number, noting that these should correspond to the name and Employer Identification Number on Form 5500, a form that does not apply to IRAs not established by an employer. The Form 5330 instructions do not indicate how firms or financial professionals liable for excise tax for prohibited transactions with IRAs should complete the plan identification fields. Generally, an IRA does not have an employer identification number, and IRS receives Form 5498 with IRA information filed under the IRA owner's Social Security Number and the Trustee or Issuer's Tax Identification Number.

[132]Self-directed IRAs allow investments in unconventional assets, such as real estate, certain precious metals, private equity, and virtual currency. IRA owners who invest in unconventional assets take on a heightened risk of engaging in a prohibited transaction and losing tax-favored status for their retirement savings. For more on self-directed IRAs, see GAO, *Individual Retirement Accounts: IRS Could Better Inform Taxpayers about and Detect Noncompliance Related to Unconventional Assets,* GAO-20-210 (Washington D.C., Jan. 27, 2020), and *Retirement Security: Improved Guidance Could Help Account Owners Understand the Risks of Investing in Unconventional Assets*, GAO-17-102 (Washington, D.C.: Dec. 8, 2016).

becomes liable for excise tax.[133] If a firm claims an exemption, IRS officials told us the burden of proof is on the firm to prove to IRS that it meets the requirement of the exemption. The following text box provides an example of how the cost of the tax and the correction increases if it is not paid promptly after receiving an IRS notice of deficiency.

Assessing Excise Tax and Correcting Prohibited Transactions Under the Internal Revenue Code

The initial excise tax on prohibited transactions required to be reported on Form 5330 is equal to 15 percent of the amount involved in the transaction for each year of the taxable period. The period begins with the transaction and ends with the mailing of the notice of deficiency, with the date the tax is assessed, or with the completion of the correction of the prohibited transaction, whichever comes first. The amount involved for the initial tax is valued as of the date of the transaction. A correction means undoing the transaction to the extent possible, but in any case, placing the plan in a financial position not worse than that in which it would have been had the fiduciary or other interested party ("disqualified person") acted according to the highest fiduciary standards.

The additional tax on prohibited transactions is imposed when the prohibited transaction is not corrected within the taxable period. When not corrected, the taxable period ends when IRS mails a notice of deficiency for or assesses the initial excise tax. The additional tax is 100 percent of the amount involved, and the amount involved is the highest fair market value of the transacted assets during the taxable period rather than the value at the time of the transaction.

According to one legal analysis of the tax a few years after the Employee Retirement Income Security Act of 1974 was enacted the higher valuation used to compute the 100 percent tax is also the amount that needs to be restored to the IRA to correct the prohibited transaction. For example, suppose a fiduciary is involved in a prohibited transaction involving IRA assets with a fair market value of $50,000. If during the taxable period the assets involved in the transaction reached a value of $100,000, but on the date of the correction the value was $10,000, the 100 percent tax is levied against the $100,000 value. As a result, the fiduciary is required to pay an excise tax of $100,000 to the IRS and to deposit $100,000 in the IRA to correct the prohibited transaction.

Source: GAO review of 26 U.S.C. § 4975, IRS documents and H. Stennis Little, Jr.* and Larry T. Thrailkill, Fiduciaries Under ERISA: A Narrow Path to Tread; 30 VAND. L. REV. 1 1977. | GAO-24-104632

[133]The self-dealing prohibitions of sections 4975(c)(1) (E) and (F) impose a duty of undivided loyalty to the plans for which they act. These prohibitions are imposed upon fiduciaries to deter them from exercising the authority, control, or responsibility that makes such persons fiduciaries when they have interests that may conflict with the interests of the plans for which they act. In such cases, the fiduciaries have interests in the transactions which may affect the exercise of their best judgment as fiduciaries. See 26 C.F.R. § 54.4975-6(a)(5)(i).

DOL does not have authority to audit IRAs for prohibited transactions, although it has a formal process for auditing employer plans under ERISA. Consequently, the only way DOL would refer an IRA to IRS is if DOL incidentally found something while examining an employer plan.[134] For example, a DOL official described an occasion in which they referred a misused IRA to IRS which DOL encountered during an audit of an Employee Stock Ownership Plan.

IRS divisions overseeing IRA fiduciaries include:

- The Large Business and International (LB&I) division collects income taxes from the largest corporations that likely serve most retirement investors and includes the largest firms with fiduciary obligations to IRAs under the IRC.[135]
- The Small Business and Self-Employed (SB/SE) division oversees small businesses and self-employed taxpayers, including financial professionals serving retirement investors, and retirement investors themselves.
- The Tax Exempt and Government Entities (TE/GE) division includes the Employee Plans Office, which oversees employer plans.[136]

Although multiple IRS divisions have a role in overseeing IRA fiduciaries, none of these follow a process for identifying prohibited transactions of IRA fiduciaries they oversee, according to IRS officials. According to the Internal Revenue Manual, the audit process for the largest corporations (including large financial firms) includes open and candid discussions about new issues between the corporate taxpayers and IRS, a study of taxpayers' tax return preparation methodology, and industry practices. Identifying the highest potential compliance risks among LB&I taxpayers to assign resources accordingly is a key focus of LB&I's mission. IRS receives Form 5498 from IRA trustees or issuers that shows IRS

[134]We do not refer to any employer-sponsored plan as an IRA in this report. DOL does oversee employer-sponsored IRA plans such as Savings Incentive Match Plan for Employees, and Simplified Employee Pension IRAs.

[135]Most individual non-wealthy clients of RIAs—including IRA investors—are clients of just a few dozen large firms, according to SEC Form ADV Part 1A data, and based on their size, the firms are within the scope of LB&I. LB&I serves corporations, S corporations, and partnerships with assets equal to or greater than $10 million.

[136]TE/GE also includes Exempt Organizations. Exempt Organizations oversees the compliance of private foundations with their prohibited transaction rules, which are similar to the retirement prohibited transaction rules.

information on an IRA participant, and the amount of rollover contributions incoming during a year.[137] However, an IRS official told us identifying IRA fiduciary prohibited transactions would require the type of investigation DOL does, which IRS lacks the expertise to do. IRS officials said the focus of the LB&I division would only be on whether a financial firm properly reported its fees as income, and not their excise tax obligations for prohibited transactions. An IRS official also said advice on IRAs is not generally within the jurisdiction of the Employee Plans office because it would refer such a prohibited transaction to SB/SE or LB&I as appropriate.[138]

IRAs receive significant tax benefits to serve important national policy goals. According to IRS, the excise tax is intended to safeguard income for retired workers by taxing transactions deemed particularly objectionable because of the potential for abuse of fiduciary responsibilities by parties having conflicts of interests.[139] IRS can help ensure that the tax expenditures applicable to IRAs are implemented with the safeguards designed for them with retirement security policy objectives in mind.

ERISA assigned prohibited transaction oversight roles to both DOL and IRS. To avoid confusion over dual jurisdiction, Reorganization Plan No. 4 of 1978 (reorganization plan) clarified each agency's roles and responsibilities regarding prohibited transactions. The reorganization plan transferred authority to interpret the prohibited transaction rules in the IRC to DOL. However, according to DOL officials, it did not include any express transfer to DOL of the authority to investigate prohibited

[137]An attorney told us IRS could identify IRA-to-IRA rollovers by comparing the source of the form—the firm's Employer Identification Number—for a given client from one year to the next.

[138]An IRS official told us that the excise tax would then be charged against the broker or company the broker worked for, not the individual account or individual receiving advice.

[139]See Internal Revenue Service G.C.M. 38846, Washington D.C.: May 4, 1982.[140]The details of the required collaboration between DOL and IRS to facilitate IRS's enforcement authority over IRA fiduciaries are established in Reorganization Plan No. 4 of 1978, which was subsequently ratified by Pub. L. No. 98-532, 98 Stat. 2705 (1984), 26 U.S.C. § 4975(h), and 29 U.S.C. § 1203. The reorganization plan transfers interpretive authority over 26 U.S.C. § 4975 to DOL while expressly stating that it shall not affect the ability of the IRS to enforce the excise tax. 26 U.S.C. § 4975(h) requires IRS to notify DOL before sending notices of deficiency and provide DOL a reasonable opportunity to obtain a correction or comment on the imposition of the excise tax. 29 U.S.C. § 1203 clarifies that the notification and comment requirements apply unless they jeopardize the ability of IRS to collect the tax.

transactions under the IRC. The reorganization plan left IRS's authority to enforce the prohibited transactions provisions in the IRC unaffected.[140]

According to the IRS Inflation Reduction Act Strategic Operating Plan, maintaining appropriate compliance coverage and enforcement across all taxpayer segments helps to ensure that all taxpayers comply with tax laws, and IRS intends to use risk-based methods to select compliance cases and develop new enforcement approaches for excise taxes.[141] IRS is responsible for enforcing the excise tax. Further, internal control standards for federal agencies require that federal agencies establish an organizational structure, assign responsibility, and delegate authority to achieve the agency's objectives.[142]

IRS currently has no process to identify prohibited transactions of IRA fiduciaries, according to IRS officials. IRS officials said their practice regarding IRA fiduciaries is to enforce prohibited transactions that DOL refers to them. However, DOL lacks IRS's audit authority to identify prohibited transactions between fiduciaries and IRAs, and therefore is generally unable to identify and refer such prohibited transactions.

Although they have not yet done so, IRS officials told us that they could examine a small number of IRAs for IRA fiduciary prohibited transactions. The excise tax on prohibited transactions can work as a strong deterrent of conflicts of interest and can protect the interests of retirement investors in practice. By developing and following a process, including assigning responsibility, to enforce the prohibited transaction rules not just on

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[140]The details of the required collaboration between DOL and IRS to facilitate IRS's enforcement authority over IRA fiduciaries are established in Reorganization Plan No. 4 of 1978, which was subsequently ratified by Pub. L. No. 98-532, 98 Stat. 2705 (1984), 26 U.S.C. § 4975(h), and 29 U.S.C. § 1203. The reorganization plan transfers interpretive authority over 26 U.S.C. § 4975 to DOL while expressly stating that it shall not affect the ability of the IRS to enforce the excise tax. 26 U.S.C. § 4975(h) requires IRS to notify DOL before sending notices of deficiency and provide DOL a reasonable opportunity to obtain a correction or comment on the imposition of the excise tax. 29 U.S.C. § 1203 clarifies that the notification and comment requirements apply unless they jeopardize the ability of IRS to collect the tax.

[141]See initiative 3.5 in *Internal Revenue Service Inflation Reduction Act Strategic Operating Plan*, Publication 3744 (Rev. 4-2023) (Washington, D.C.: Apr. 2023). IRS lists excise taxes along with employment, estate, and gift taxes as key areas where audit coverage has declined. The plan also states that robust compliance enforcement sends a strong message that the IRS will detect and address noncompliance, which will encourage voluntary compliance.

[142]See GAO, Standards for Internal Control in the Federal Government, GAO-14-704G (Washington, DC: Sept. 2014).

employer plan sponsors and self-directed IRA owners but on IRA fiduciaries, IRS could reduce the risk to retirement investors of adverse impacts of conflicts of interest. However, without a process to proactively to identify IRA fiduciaries, IRS is not able to ensure that it properly enforces the prohibited transaction rules for IRAs, which receive significant tax benefits to serve important national policy goals.

IRS Does Not Have Formal Coordination with DOL on Prohibited Transactions Between IRAs and IRA Fiduciaries

IRS also does not have any formal, written process for collaboration with DOL on IRS's enforcement authority over the conduct of IRA fiduciaries. For employer plans, including for prohibited transactions, IRS and DOL have entered into a Memorandum of Understanding (MOU), which establishes referral procedures, at least semi-annual meetings, and information sharing, among other things. The coordination effort demonstrates leading practices and considerations for implementing collaborative mechanisms that our 2023 report on interagency coordination identified.[143] According to our review of 2 years of past meeting agendas, the agencies discuss a variety of topics, including areas of expertise, coordinating IRS promoter investigations and DOL service provider investigations, and disturbing industry practices and known bad actors.[144] However, the scope of the MOU is governed by the Employee Plans Office within IRS' Tax Exempt and Government Entities division, and the scope of the office generally excludes IRAs, according to IRS officials.[145]

What is the current Memorandum of Understanding (MOU)?

The Memorandum of Understanding between the Internal Revenue Service (IRS) and the Department of Labor (DOL) regarding prohibited transactions coordinates examinations/investigations and litigation activities, including on the prohibited transaction rules, between the Employee Benefits Security Administration of DOL and Employee Plans Office of the IRS, on joint investigations, among other things.

Source: 2023 Internal Revenue Service and Department of Labor MOU. | GAO-24-104632

IRS divisions are organized by taxpayer segment. The prohibited transaction rules applicable to IRAs affect a variety of types of taxpayers extending across the scope of multiple IRS divisions. The IRA self-dealing prohibition in the IRC applies to anyone who meets the definition of a fiduciary in the IRC, which could be a large or small business or a self-employed financial professional. However, the MOU does not include the

[143]GAO, Government Performance Management: Leading Practices to Enhance Interagency Collaboration and Address Crosscutting Challenges, GAO-23-105520 (Washington, D.C.: May 24, 2023).

[144]They also discussed enforcement of PTE 2020-02, which includes a prudence requirement incorporating language from ERISA associated with IRA-to-IRA rollover transactions that only IRS can enforce.

[145]The guidance IRS has issued on the excise tax on prohibited transactions has similarly focused on employer plans. See IRS Revenue Rulings 2002-43 and 2006-38. There is some limited guidance on prohibited transaction excise taxes in IRS publications 590-A and 590-B for IRA owners.

IRS divisions that look at the large and small businesses and at the self-employed financial professionals.

Institutional knowledge of the prohibited transaction rules spans IRS divisions. SB/SE has enforcement experience in cases in which IRA investors violate the prohibited transaction rules.[146] The TE/GE division applies prohibited transaction rules to employer plans and private foundations.[147] IRS also has attorneys with experience representing the IRS in tax court on questions about the applicability of the prohibited transaction rules to employer plans and self-directed IRA owners. We reported in 2020 that a cross-divisional IRS team identified prohibited transactions as a crosscutting compliance challenge.[148]

IRS officials said that through coordination with DOL they could moderate conflicts of interest by enforcing the excise tax on prohibited transactions outlined in the IRC. However, IRS officials have not coordinated with DOL through a formal means, such as a memorandum of understanding, on prohibited transactions involving firms and financial professionals who are IRA fiduciaries and owe excise tax.

The prohibited transaction rules require collaboration between DOL and multiple IRS divisions to be implemented effectively because without IRS, the obligations of fiduciaries under the IRC cannot be enforced. However, IRS has not effectively coordinated with DOL to enforce the rules for IRA fiduciaries because IRS itself has not attempted to proactively enforce those rules for IRA fiduciaries, according to IRS officials. DOL interprets the prohibited transaction rules that govern the conduct of fiduciaries to

[146]In an example of IRS taking steps to ensure IRA owners act in the interest of their IRA, in a Private Letter Ruling IRS authored in 1982, IRS ruled that a firm in the business of acting as trustee to IRAs could not use corporate funds to buy life insurance on behalf of the individuals who established IRAs with it. By prohibiting the transaction, the IRS prevented the possibility that the customer would keep the IRA at the firm even if it were not the best thing for the IRA, because the customer wanted the life insurance. See I.R.S. Priv. Ltr. Rul. 82-45-075 (Aug. 16, 1982).

[147]Private foundations served as the legislative model for the retirement provisions in 26 U.S.C. § 4975. See 26 C.F.R. § 141.4975-13 (providing definitions of “amount involved” and “correction”).

[148]See GAO-20-210.

IRAs and considers the excise tax to be the primary remedy for a violation of the IRC's prohibited transaction provisions.[149]

Currently, the scope of formal coordination on prohibited transactions between the agencies excludes IRS divisions well positioned to exercise IRS's enforcement authority over IRA fiduciaries. Our prior work on interagency collaboration identified key practices and considerations for implementing collaborative mechanisms. Those practices include ensuring relevant participants are included in a collaborative effort and developing and updating written guidance and agreements.[150] Without formal coordination, the agencies will continue to be unable to effectively oversee the obligation of IRA fiduciaries to either avoid conflicts of interest with IRAs or comply with an exemption.[151] Such effective oversight is a protection for retirement investors from conflicts of interest that can jeopardize their financial security in retirement, a protection covering trillions of dollars in IRA assets. By creating such an agreement, the agencies can effectively implement limits on conflicts of interest in federal statute and intended retirement investor protections.

[149]DOL's interpretations of the prohibited transaction rules have included IRAs for decades. In PTE 2002-13, DOL interpreted, after consultation with the IRS, the term "employee benefit plan" used in certain previously issued prohibited transaction exemptions to refer to the definition of a "plan" under 26 U.S.C. § 4975(e)(1), which includes an IRA. According to DOL's 2021 publication "Choosing the Right Person to Give You Investment Advice: Information for Investors in Retirement Plans and Individual Retirement Accounts" IRA fiduciaries must avoid transactions that involve conflicts of interest unless they qualify for and comply with the conditions of an exemption issued by DOL.

[150]GAO, Government Performance Management: Leading Practices to Enhance Interagency Collaboration and Address Crosscutting Challenges, GAO-23-105520 (Washington, D.C.: May 24, 2023).

[151]We reported on the process for obtaining exemptions for IRA prohibited transactions in 2019. The report covered the exemption process but not enforcement in the absence of an exemption. We made two recommendations to DOL and one recommendation to IRS. The agencies implemented our recommendations. See GAO, Individual Retirement Accounts: Formalizing Labor's and IRS's Collaborative Efforts Could Strengthen Oversight of Prohibited Transactions, GAO-19-495 (Washington, D.C.: June 7, 2019).

Financial Professionals May Not Have Information on Employer Plan Investment Options That Could Help Them to Better Advise Clients about IRA Rollovers

Information that financial professionals need to advise retirement investors about rolling over retirement savings from an employer plan to an IRA can be difficult to obtain, according to industry association representatives. Under an existing prohibited transaction exemption, investment advice fiduciaries may receive compensation that would otherwise violate the prohibited transaction rule provisions, provided certain conditions are met.[152] This includes advice to roll assets from an employer plan into an IRA. Specifically, the fiduciary must document the reasons their recommendation to roll over assets is in the best interest of the retirement investor, among other things. Rollovers from employer plans are a typical way for retirement investors to fund their IRAs. (See text box.)

Industry data and prior GAO work on rollovers

Industry data show that in 2022, 60 percent of U.S. households with traditional Individual Retirement Accounts (IRA) reported that they had rolled over savings into those accounts. As of mid-2022, assets in all IRAs represented 34 percent of all assets in the U.S. retirement market, totaling $11.7 trillion, compared to 24 percent two decades ago. The movement of large sums from employer plans into IRAs represents opportunities for financial professionals and firms recommending rollovers to earn compensation through brokerage or advisory services that capture the rollover assets. We reported in 2013 that participants' decisions to roll over employer plan assets may be influenced by financial professionals' and firms' guidance and marketing that favors IRAs. We also found that employer plan rollovers and growth on those assets are the primary funding for IRAs, rather than direct contributions by retirement investors. We made five recommendations in the 2013 report. We made two recommendations for the Department of Labor and Internal Revenue Service together, one recommendation for the Internal Revenue Service, and two for the Department of Labor. Four of the five recommendations have been implemented. One for the IRS was closed without implementation

Source: GAO analysis and Investment Company Institute, ICI Research Perspective, "The Role of IRAs in US Households' Saving for Retirement, 2022", vol. 29, no. 1 (February 2023) and ICI Research Report "The IRA investor Profile: Traditional IRA Investors' Activity, 2010-2018" (August 2021), GAO -13-30. | GAO-24-104632

When it issued the exemption, DOL stated that it expects financial professionals who recommend rollovers to make diligent and prudent efforts to obtain clients' information about a participant's existing investment options under their employer plan. However, financial professionals can find it difficult to access their clients' employer plan information from available sources, including directly from clients, according to four industry associations' representatives. Financial professionals may ask for employer plan information directly from their clients who participate in such plans, but their clients may not provide it. DOL prohibited transaction exemption guidance states that employment-

[152] New Fiduciary Advice Exemption: PTE 2020-02, "Improving Investment Advice for Workers & Retirees" Frequently Asked Questions, U.S. Department of Labor (Apr. 2021).

based retirement plan information should be available in a fee disclosure that plans must provide to participants.[153] Clients who participate in employer plans should receive this information annually, but industry representatives we interviewed said financial professionals still encounter difficulty obtaining it from their clients.[154]

If financial professionals cannot get retirement plan information directly from their clients, DOL guidance states the financial professional or firm should use publicly available information. According to DOL, plan information could be used to estimate the investment expenses, asset values, risk, and returns of the available in-plan investment options and then document the assumptions they used to compile the estimates and any limitations on the assumptions. DOL also suggests that information useful to developing estimates may be available publicly on the Form 5500 annual report that employer plans must submit to DOL.[155] The form's Schedule H line 4i requires plans to attach a schedule of assets the plan held for investment at the end of the year, information that would help a financial professional to develop estimates and compare a client's options.

DOL makes plans' Form 5500 attachments available online, including the Schedule H line 4i required Schedule of Assets. However, these are PDFs posted separately for each plan, so a professional would need to identify the correct plan and schedule in EFAST2 and then search through dozens of pages to find plan investments. DOL also makes available a public dataset of plans' Form 5500 information, but we found that dataset may not contain the information financial professionals need to develop estimates about their clients' employer plans' investment

[153]New Fiduciary Advice Exemption: PTE 2020-02, "Improving Investment Advice for Workers & Retirees" Frequently Asked Questions, U.S. Department of Labor (Apr. 2021).

[154]Many participants may not understand or appreciate the disclosure. We previously reported that 53 percent of participants surveyed did not say it would be helpful to receive administrative and plan investment fee information when considering a rollover. See GAO-21-357.

[155]In establishing requirements for the Form 5500, DOL shares responsibility with the IRS and the Pension Benefit Guaranty Corporation. DOL is responsible for storing and publishing the Form 5500 data.

options.[156] Specifically, our analysis of DOL's Form 5500 data from plan year 2021 found that it did not contain information on plans' Schedule H line 4i attachments—where plans report their investment information.[157] In 2014, we reported that stakeholders experienced challenges collecting and extracting information from the Form 5500's Schedule H line 4i attachments because DOL does not require plans to use a standard, data-searchable format to prepare the attachments. We also reported that the Form 5500 lacks detail and unique identifiers for plan investments. This lack of detail presents challenges for users such as financial professionals who need to find plan information such as share classes and expenses to determine whether an investment option offered by both the employer plan and an IRA presents the better option for their clients.

According to DOL, it can be difficult for financial professionals to justify recommending an employer plan-to-IRA rollover to clients without considering the clients' existing employer plan investment options.[158] Two ERISA attorneys and one industry association representative told us that because other sources about employer plan investment options—such as from the client or Form 5500—are not readily available, financial professionals may rely on industry benchmarks to estimate the investment options offered by their clients' employer plans. However, general industry benchmarks to estimate a specific client's employer plan investment options might not fully account for the investment selection and value offered by the plan. In contrast, if the financial professional had complete and readily available information on the client's employer plan

[156]The Department of Labor (DOL) publishes Form 5500 filings on the *ERISA Filing Acceptance System II* (called EFAST2), a website that allows users—such as financial professionals—to search for Form 5500s by plan name, Employer Identification Number, and other identifiers. In addition, DOL uploads Form 5500 data to a public dataset. Each plan year has a separate Form 5500 dataset.

[157]We analyzed the 2021 plan year dataset because the 2022 plan year data were not yet complete. Accessed online at: www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/reporting-and-filing/form-5500. We previously reported that when plan assets are invested in indirect investments, plan sponsors file a Schedule D, which lists the plan's interests in each indirect investment; the indirect investment's filing then provides a breakdown of assets in its own Schedule H. GAO, *Private Pensions: Targeted Revisions Could Improve Usefulness of Form 5500 Information*, GAO-14-441 (Washington, D.C, June 5, 2014.) DOL requires all such plans to submit a Schedule D, regardless of size, while generally requiring only those plans with 100 or more participants to submit a Schedule H with their Form 5500 filing.

[158]DOL, *Prohibited Transaction Exemption 2020–02, Improving Investment Advice for Workers & Retirees*, 85 Fed. Reg. 82,798, 82,800 (Dec. 18, 2020).

investments, the financial professional could better determine whether a rollover would serve the client's interests.

DOL has authority to promulgate regulations and issue corresponding guidance to plan fiduciaries specifying information the Form 5500 should include and how it should be reported.[159] In 2014, we recommended that DOL, Treasury, and the Pension Benefit Guaranty Corporation consider revising the Form 5500 Schedule H plan asset categories to provide more transparency into plans' investments and revise the Schedule of Assets to create a standard searchable format.[160] DOL has taken some actions to modernize the Form 5500, but it has not yet revised the Schedule H plan asset categories or required the line 4i Schedule of Assets attachments to be filed in a manner that makes them searchable online.

DOL's instructions to plans for submitting their investment information in Schedule H line 4i attachments do not ensure that plans are submitting the attachments in a way that results in quality information the public can access on DOL's public website that receives and displays Form 5500 annual reports—or its annual datasets. For example, DOL's instructions do not require the plans' investment schedules to be filed a standardized electronic reporting format. Rather, the schedules are filed as PDF and plain text files, which makes the individual plan's investments more difficult to search and identify.

In September 2021, DOL published a proposal to modernize the Form 5500's annual reporting requirements, including some changes to Schedule H to improve the availability of investment data.[161] DOL's proposed changes to the contents and format of the line 4i Schedule of Assets are intended to improve the consistency, transparency, and usability of the reported information on plan investments offered by a

[159]DOL, "Instructions for Form 5500," 2021. DOL coordinates with the Pension Benefit Guaranty Corporation and the Internal Revenue Service to maintain and update the Form 5500 requirements.

[160]GAO-14-441. We made two recommendations each to DOL, Treasury, and the Pension Benefit Guaranty Corporation. We closed both recommendations as implemented for Treasury and the Pension Benefit Guaranty Corporation and one for DOL. DOL has partially addressed one recommendation.

[161]DOL, Proposed Revision of Annual Information Return/Reports: Notice of proposed forms revisions, 86 Fed. Reg. 51,488 (Sept. 15, 2021). The proposal also cited DOL-Office of Inspector General work identifying that the line 4i Schedule of Assets should use a searchable reporting format. The notice describes some similar changes that DOL proposed in 2016 and states that a final rule was not issued on the 2016 proposal.

plan. The proposal would also require that the schedules are filed electronically through the EFAST2 in a standardized electronic reporting format. Subsequently, DOL's fall 2023 regulatory agenda suggested that the changes are at the proposed rule stage and that DOL anticipates issuing a Notice of Proposed Rulemaking in September 2024.

We continue to believe that that our 2014 recommendation to DOL to revise to the Form 5500 Schedule H plan asset categories and Schedule of Asset attachments—which DOL's 2021 proposed revisions address—would improve the usefulness and comparability of the data and increase transparency into plan investments. Better Form 5500 information on plan investments would also help ensure that financial professionals are able to obtain the information they need to offer prudent advice to retirement investors, including about rollovers from an employer plan to an IRA.

Conclusions

Conflicts of interest are a common part of many financial transactions involving products recommended to retirement investors. The mechanisms in place to help identify or explain conflicts of interest, such as required disclosures and discussions with financial professionals, may not fully explain the risk and challenges posed by conflicts of interests. Despite obligations to mitigate and eliminate certain conflicts, conflicts of interest persist and can negatively impact retirement investors. Only IRS can enforce the excise tax on prohibited transactions which safeguards the retirement security policy objectives of the federal tax expenditures on IRAs, but IRS has no process to do so. There are billions in such annual tax expenditures supporting trillions in savings for the retirements of millions of Americans. By developing a process to identify prohibited transactions by IRA fiduciaries and using its enforcement authority to assess the applicable excise tax, IRS can apply appropriate limits on conflicts of interest and ensure it collects any excise tax revenues owed by IRA fiduciaries.

IRS also has the authority to make sure the IRS divisions best positioned to enforce the excise tax can directly coordinate with DOL, which is jointly responsible for administering the prohibited transaction rules with IRS. IRS coordinates with DOL regularly about prohibited transactions in employer plans through a formal MOU, but the MOU does not cover IRAs that are not sponsored by an employer. By creating a formal coordination mechanism to cover prohibited transactions of IRA fiduciaries, IRS can improve the probability that prohibited transactions in IRAs do not go unnoticed and can be effectively enforced.

Recommendations for Executive Action

We are making the following two recommendations to IRS:

1. The Commissioner of the IRS should develop and implement a process independent of DOL referrals for identifying non-exempt prohibited transactions involving firms or financial professionals who are fiduciaries to IRAs and assessing applicable excise taxes. For example, IRS could check Form 5330 filing compliance during income tax audits of financial services firms. (Recommendation 1)

2. The Commissioner of the IRS should coordinate with DOL through a formal means, such as a memorandum of understanding, on non-exempt prohibited transactions involving firms and financial professionals who are IRA fiduciaries and owe excise tax. (Recommendation 2)

Agency Comments

We provided a draft of the report to DOL, Treasury, IRS, SEC, and FINRA, for review and comment. We received technical comments from DOL, SEC, and FINRA, which we have incorporated, where appropriate. Treasury did not have comments on the report. IRS provided written comments on the draft report, which are reproduced in appendix III.

In its written response, IRS agreed with our recommendation for IRS to develop and implement a process independent of DOL referrals for identifying non-exempt prohibited transactions involving firms and financial professionals that are fiduciaries to IRAs and assessing the applicable excise tax. IRS stated it will examine the processes and consider implementing additional measures to identify prohibited transactions as appropriate.

IRS also agreed with our recommendation for the Commissioner of the IRS to coordinate with DOL through a formal means, such as a memorandum of understanding, on non-exempt prohibited transactions involving firms and financial professionals who are IRA fiduciaries and owe excise tax. IRS stated it will explore opportunities to develop more formal means for coordination between IRS and DOL for prohibited transactions related to investment advice provided to IRA owners from financial services firms.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to the appropriate congressional committees, the Commissioner of Internal Revenue, the Chair of the Securities and Exchange Commission, the Secretary of Labor, the Secretary of the Treasury, and other interested parties. In addition, the report will be available at no charge on the GAO website at https://www.gao.gov.

If you or your staff have any questions about this report, please contact me at (202) 512-7215 or nguyentt@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix IV.

Tranchau (Kris) T. Nguyen,
Director
Education, Workforce, and Income Security Issues

Appendix I: Objectives, Scope, and Methodology

The objectives of this report were to examine (1) the changes industry reported making to address the Department of Labor's (DOL) 2016 rule; (2) conflicts of interest that can affect retirement investors, how they are communicated to investors, and their association with investment returns; and (3) the extent to which federal regulators oversee conflicts of interests and actions that could potentially improve their oversight.

Industry association interviews

To assess industry changes to address DOL's 2016 rule regarding conflicts of interest,[1] we gathered input from 15 national associations of financial professionals, asking some questions to all associations as well as questions that were specific to a given association. Our questions centered on changes association members made to their compensation, and products and services to comply with the DOL's 2016 regulation of conflicts of interest and changes made in those areas when the rule was vacated. We selected associations with broad national membership of professionals associated with retirement investors and investment advice, from a range of business models. Specifically, we selected three associations from each of five subgroups: Registered Investment Advisers (RIA), broker-dealers, insurance firms, retirement plan sponsors, and fiduciary compliance firms—firms that help clients who are fiduciaries to understand and comply with fiduciary requirements.

Associations identified for potential selection were drawn from those: cited as a source of industry data in DOL's Regulatory Impact Analysis for its 2016 rule, recommended by another selected association, found from internet searches for key words related to different business models, and known to GAO from prior retirement work. Several associations we selected represent professionals from different groups, such as one association whose members represent both a majority of the broker-dealer sector by revenue and also about half of assets in the assets under management business sector. Financial professionals and firms can be members of more than one association.

Although our analysis of association remarks identified general trends by business model and standards of care, the financial services industry is large and complex and the associations' reported views and experiences on the impact of the DOL's 2016 rule were mixed on various subjects. The associations provided input in various ways. Five associations chose to response to our questions in writing and we interviewed an additional

[1] 81 Fed. Reg. 20,946 (Apr. 8, 2016). The 2016 rule was vacated by the Court of the Appeals for the Fifth Circuit in 2018.

ten, some solicited responses from members, and others answered based on their experience representing members' interests connected to DOL's 2016 rule. Findings from the input we received are not generalizable. We also reviewed industry-sponsored surveys and reports provided by these associations to identify illustrative examples of topics discussed in our interviews. We reviewed those surveys and reports that focused on industry-reported changes related to the 2016 rule for information related to our research objective.

Industry research

To describe industry changes to address the 2016 rule, we reviewed additional research and articles by and about retirement and investment industry professionals. We identified these through our interviews and background research.

We cite survey data from the Plan Sponsor Council of America's annual survey of 401(k) and other profit-sharing plans. While the survey is not limited to 401(k) plans, 99 percent of responding plans in 2016 and 2020 were 401(k) or combined 401(k)/profit sharing plans, so we characterize the survey results as reflecting the experience of 401(k) plans. The survey results are from 590 401(k), 401(k)/profit-sharing combination, and profit-sharing type plans in 2016 and 518 in 2020. Plans responding to the survey vary in size in terms of plan participants, though 60 percent of plans responding to the survey had 200 or more participants in 2016 and in 2020. Survey results are not generalizable to all 401(k) plans.

To corroborate what associations told us about advice services provided to investors, we reviewed InvestmentNews' report "Benchmarking the Financial Performance of Advisory Firms: 2021 Pricing and Profitability Update". The report is based on data provided by a small, non-generalizable sample of financial professionals affiliated with independent advisory firms who subscribe to InvestmentNews. In 2021, 70,501 financial professionals were invited to participate in the study of which financial professionals representing 244 unique firms responded by returning a self-reported questionnaire. The questionnaire requested self-reported data and covered the domains of general information, assets and clients, services and pricing, income statements, overall staffing, roles and responsibilities, staff-development and compensation, partner management, compensation tables, and recruiting and retention for 2020. We identified the report through industry media as a source of adviser-reported compensation data. All findings used from this report were for 2020 and were not compared to previous reports or historic data. The self-reported survey data are not generalizable to all investment advisory firms.

Disclosure content analysis

To examine the conflicts that can affect retirement investors, we reviewed data disclosed on the Uniform Application for Investment Adviser Registration and Report by Exempt Reporting Advisers (Form ADV) Parts 1A, 2, and 3, applicable to SEC-registered investment advisers. We chose the Form ADV as a source of information on conflicts because of the extensive disclosure requirements applicable to RIAs registered with the Securities and Exchange Commission. Additionally, the firms serving non-wealthy investors, including retirement investors, are often actively doing business in multiple capacities and Form ADV data also includes questions on what other lines of business RIAs participate in.[2] Form ADV data on all RIAs is centrally available on SEC's website, lending it more readily to systematic analysis.

We analyzed quantitative data on RIAs collected on Form ADV Part 1A related to conflicts of interest, such as whether the RIAs receive soft dollar benefits, accept payments for client referrals, recommend a related broker-dealer, or sell products or provide services other than investment advice to their advisory clients. We also analyzed Form ADV Part 1A data on co-mingled lines of business and data on compensation mechanisms. We reviewed Form ADV Part 1A for questions related to conflicts of interest described as such on the form, Form ADV Part 2 instructions, or other SEC documentation. For example, Form ADV Part 1A, when asking about financial industry affiliations and activities, states that the information "identifies areas in which conflicts of interest may occur between you and your clients."

The Form ADV Part 1A uses a set of prescribed form questions to collect data on firm characteristics. The Form ADV Part 1A data we analyzed covered all federally registered investment advisers, which numbered over 15,000, as of September 2023. We used this analysis to describe the portion of non-wealthy investors who were clients of RIAs with characteristics related to conflicts of interest. This analysis also allowed

[2]We define "non-wealthy" in this report based on data SEC Form ADV Part 1A. SEC defines non-high net worth individual clients as individuals that are neither "qualified clients" under SEC rule 205-3 nor "qualified purchasers" as defined in section 2(a)(51)(A) of the Investment Company Act. "Individuals" are natural persons as well as "trusts, estates, and 401(k) plans and IRAs of individuals and their family members but does not include businesses organized as sole proprietorships." According to SEC staff, the definition might be a reasonable proxy for retail investor clients, although there are no investment or asset limits or thresholds for retail customers under Regulation Best Interest.

us to describe the extent to which a small number of large firms serve non-wealthy investors.

We analyzed qualitative data on conflicts disclosed in Form ADV Part 2, which consists of long-form brochures (brochure) that qualitatively described conflicts of interests, by creating a non-generalizable sample of 20 RIA firms. We constructed the sample using Form ADV Part 1A data from June 2021 to include a variety of compensation models. We constructed the following four categories of firms and within each category selected firms serving large numbers of non-high-net-worth individual investors.

- Commission: firms accept commission for advisory services.
- Asset-based: RIAs that receive asset-based compensation, but do not accept commissions for advisory services.
- Hourly and fixed: RIAs that do not receive asset-based or commission-based compensation, but hourly compensation. All the selected hourly firms also accepted fixed fee compensation, so we characterized these firms as “hourly and fixed fee” compensation type.
- Conglomerate: RIAs are actively doing business as both insurance brokers or agents and as broker-dealers.

We chose to select large firms rather than randomly select the firms, because a few large firms serve a substantial portion of all non-high-net-worth individual clients. RIAs with multiple advisory programs may have a brochure for each program, and we reviewed all the brochures when a firm had multiple brochures.

To analyze the ADV Part 2 brochures, we iteratively developed and refined a classification scheme that we documented in a codebook. We started developing the codebook based on examples of conflicts provided by the SEC in the Form ADV Part 2 and Part 3 Instructions, conflicts appearing in a pre-test of the content analysis, and SEC staff bulletins on conflicts of interest and account recommendations. We included in the codebook codes for conflict mitigation, and for conflict mitigation that was specific to retirement accounts.

To identify the material we coded, a GAO analyst conducted word searches for key terms (including “conflict”), reviewed the material for applicability to the codebook, and assigned the conflict to a code (for example, as being related to proprietary products and services) in NVivo

content analysis software. One GAO analyst assigned codes to the relevant text. A second GAO analyst then verified the content coded by the first analyst.

We analyzed the coded content in several ways. For example, we reviewed the frequency with which we found conflicts disclosed by the different firm types and ran queries on the coded content. We also cross-referenced the number of conflicts we identified with the length of a firm's brochure(s), to control for the relatively longer disclosures of firms with complex organizational structures and multiple lines of business. We analyzed the readability of the coded disclosure content to determine the average grade level at which they were written. We also analyzed qualitative data on conflicts of interest in Form ADV Part 3 Relationship Summaries from the same sample and with a similar analysis applied to the short-form, summary information on conflicts in the form.

Undercover phone calls

To assess how conflicts are communicated, we created a fictitious persona and placed undercover phone calls to financial professionals at a variety of firm types to discuss the prospective client's retirement savings. We contacted 102 financial professionals resulting in 75 completed tests. We considered a test complete if the financial professionals described their role and the nature of the relationship with the client and discussed the client's financial profile. The fictitious 60-year-old client was considering retirement and had retirement assets of about $600,000 in IRA and 401(k) accounts. Our process for reaching financial professionals to speak with involved selecting firms, selecting locations, and being referred to financial professionals.

To construct the sample of firms we selected, we used the same four categories of RIAs (Commission, Asset-based, Hourly and Fixed, and Conglomerate) that we used for the disclosure review, and added a fifth group, annuity providers. We selected 15 firms of each type. We chose RIAs within each type serving large numbers of non-wealthy individual clients. We screened RIAs' websites or disclosures and excluded RIAs that appeared unlikely to take our fictitious persona as a client, such as RIAs focusing on high-net-worth clients, institutional clients, a particular industry, or robo-advice. We selected leading annuity providers based on sales data on a variety of annuity types from an industry research firm.

We chose to contact commission, asset-based, conglomerate RIAs, and annuity providers in Florida, Pennsylvania, Ohio, and Texas. Because insurance is primarily regulated at the state level, we chose states with large quantities of annuity premium revenue, based on National

Association of Insurance Commissioners (NAIC) documentation. Between January and May of 2022, which was the period in which we placed the calls, Florida and Pennsylvania did not have annuity transaction rules in effect similar to the 2020 model standard developed by the NAIC, but Ohio and Texas did. We generally allocated the calls evenly across those states. There were an insufficient number of RIAs focusing on hourly and fixed fees to meet those geographic criteria, and we contacted those RIAs where they were located. We do not disclose the states in which we called RIAs focused on hourly and fixed fees to safeguard their identifies as some states had only one RIA focused on hourly and fixed fees operating in them.

We exercised as little discretion as possible when selecting a particular financial professional to speak with. For example, we used "contact us" forms, "find an adviser" functionality on firm websites, generic firm phone numbers or email addresses unconnected to a particular individual and were referred to financial professionals. When prompted for a location within the state, we selected the most populated city in each state. In a few cases, we used internet searches to identify a financial professional who met geographic criteria at a selected firm.

We steered the conversations toward subjects that would help us learn about potential conflicts of interest that might exist in the relationship. We brought up subjects conversationally, without using uniform language. In most cases, we explicitly asked about conflicts of interest, because regulators suggest doing so. In most cases, we discussed the term fiduciary, because it helped establish the nature of the relationship, facilitated a discussion of the investor protection standards that would be applicable, and because the definition of a fiduciary was the subject of DOL's 2016 rule regarding conflicts of interest. In most cases, we discussed variable compensation to financial professionals, because earning more from recommending one product, service, or company over another can be a source of conflicts of interest. Because we did not ask an identical set of questions of each financial professional, when we report on what we heard from a certain number of financial professionals on a particular topic, we also report a denominator indicating the number of conversations in which we discussed the topic.

We analyzed call transcripts for information obtained about conflicts of interest, including responses to questions about conflicts of interest, fiduciary protections, and variable compensation. We developed a codebook with topic definitions for this purpose. We tested inter-coder reliability (a numerical measure of the agreement between different

coders regarding how the same data should be coded) on a sample of transcript material and determined the coding to be sufficiently reliable for our purposes. To code the transcripts, one analyst read the transcripts and identified pertinent excerpts according to the codebook, and a second analyst reviewed those interpretations. In cases when the two analysts did not concur, a third analyst's interpretation confirmed the final interpretation of an excerpt. The data from the calls are not representative of any broader group of financial professionals and should not be generalized as such.

Multivariate regression analysis

To describe the effect conflicts can have on investment returns, we conducted a multivariate linear regression analysis of Morningstar mutual fund data to describe the relationship between financial incentives and fund performance. We used payments to broker-dealers, registered investment advisers who are likely dual-registered as broker-dealers (BD or RIA), including payments that may be shared with the financial professional making recommendations, as a proxy for conflicts of interest.[3]

Specifically, to estimate if funds with payments to BDs or RIAs are associated with lower monthly before-fee returns than funds that do not pay BDs or RIAs, we used mutual fund Morningstar Service Fee Arrangement data from January 2018 to December 2021.[4] The Morningstar data grouped mutual funds making such payments as either bundled or semi-bundled based on the types of fees involved, and grouped funds making no such payments as unbundled.[5] In our regression analysis, we used Morningstar fee group variables (bundled,

[3]The payments serving as proxies for conflicts are those received by intermediaries between retirement investors and mutual funds, not management fees received by mutual fund advisers. They are payments associated with semi-bundled and bundled funds, but not unbundled funds. They include 12b-1 fees, front-end and back-end loads, platform and access fees, sub-transfer agency fees, and revenue sharing.

[4]The data begin in 2009 but the regression analysis focuses on the years 2018 to 2021 because 2018 is the first year Morningstar began classifying funds as bundled, semi-bundled, and unbundled, which is our main measure of payments to BDs or RIAs. Morningstar applied this classification system to all funds that existed in 2018 and later, but not to funds that stopped existing before 2018. Additionally, the monthly before-fee return variable, our main measure of performance, is more complete starting in 2018.

[5]The Service Fee Arrangement classifications of bundled, semi-bundled, and unbundled are used by Morningstar. According to Morningstar, these classifications are likely not used by asset managers. Morningstar sells its research to investors who wish to buy it.

semi-bundled, and unbundled) as our primary independent variables and before-fee returns as our dependent variable.

Our regression analysis is modeled after a similar study, Reuter (2015), which utilized a different data source.[6] The Morningstar data are well suited for an updated analysis as the data include a fee group variable, which provides us with good coverage of the bundled, semi-bundled, and unbundled indicator variables, along with mutual fund characteristics that allowed us to identify the relevant sample of mutual funds and perform sensitivity analyses. For example, the Morningstar data classify mutual funds into 145 categories (e.g., U.S. Large Blend Fund), which we used to control for certain key fund characteristics, so our results compare similar funds to each other. The fund name and Morningstar category variables allowed us to identify the fund's mutual fund family (company name),[7] whether the fund is a domestic equity fund[8], and whether the fund is a municipal bond fund.[9] We also used the fund's net assets as weights in some of the regressions, to account for fund size.

For our sensitivity analyses to assess the robustness of our results, we used the mutual fund's management style (active versus passive management) as well as the fund's obsolete date to account for fund survivorship during our analysis period. We interviewed Morningstar officials regarding their data's reliability and their processes for ensuring the reliability of the data, reviewed related documentation, and conducted

[6]Our analysis compared the before-fee returns of mutual funds in different fee groups using Morningstar Service Fee Arrangement data from 2018 to 2021, while Reuter's analysis compared the after-fee and risk-adjusted returns of direct-sold funds and broker-sold funds using Lipper distribution channel data and Center for Research in Security Prices Survivor-Bias-Free U.S. Mutual Fund data from 2003 to 2012. See Reuter, Jonathan, *Revisiting the Performance of Broker-Sold Mutual Funds*, (2015).

[7]Fund families are not provided in the data. To create the mutual fund family names variable, first we extracted the first word or two words from the fund name and matched it to a list of 666 unique fund family names found on TD Ameritrade's website; we kept only the perfect matches. These matches were merged into the main data file. Second, for the funds that did not find a match (46 percent), we manually added the first word or two words from the fund name as the fund family. We checked that these results were reasonable by confirming the existence of these family names. We searched for the names, and if we found a related trading website, investment company, advising company, or insurance company, the name was kept. If the search did not return a trading website, it was removed. At the end, 99.7 percent of funds had a fund family.

[8]Domestic equity is identified in the data as funds with names or Morningstar categories with the terms "domestic" and "equity" or "U.S." and "equity."

[9]Municipal bonds are identified in the data as funds with names or Morningstar categories including the term "muni."

electronic testing to establish the data were sufficiently reliable for the purposes of our reporting objectives. Additionally, our analysis methodology and findings were reviewed by external parties with relevant expertise.

To examine the relationship between payments to BDs or RIAs and mutual fund performance, we estimated a regression where monthly before-fee return is the dependent variable and the independent variables are indicators for a mutual fund's fee group, where the comparison group is unbundled funds.[10] Our outcome variable is the before-fee return, rather than the after-fee return, to ensure the payments to BDs or RIAs themselves are not generating the underperformance in our results.[11] We conducted sensitivity analyses using monthly net returns and net returns plus the 12b-1 fee, in place of gross returns, which are presented in appendix II. The regression compares mutual funds within a Morningstar category within a month and within a year.[12] For example, the regression compares the before-fee returns of a bundled U.S. Large Blend fund in December 2019 to an unbundled U.S. Large Blend fund in December 2019.

Consistent with the literature, our regression analysis focuses on the sample of actively managed mutual funds, representing about 80 percent of funds weighted by assets in our data, which are likely to be in retirement accounts.[13] The findings we present in the main body of the report exclude passively managed mutual funds, to address concerns that the findings are a result of the management style, rather than a result of

[10]The indicator variables for bundled, semi-bundled, and unbundled funds take the value of 0 or 1 and are time-invariant. The unit of observation is a fund-share class month-year. For simplicity we refer to a fund-share class group as "fund" throughout.

[11]Payments to BDs or RIAs can directly lower a fund's performance when they are built into the expense ratio, because it is subtracted from a fund's gross return and reduces the fund's monthly net return. Payments to the BD or RIA that may be included in the recurring expenses deducted from the mutual fund's gross returns include the 12b-1 fees and may include sub-transfer agency fees, and platform access fees. Additionally, some fees are not included in the expense ratio, such as portfolio transaction fees or sales charges.

[12]The regression makes this comparison because it includes date-by-Morningstar category fixed effects, where date is a month-year. Our unit of analysis is a mutual fund-share class and the frequency of the data is monthly.

[13]See Reuter, Jonathan, *Revisiting the Performance of Broker-Sold Mutual Funds*, (2015), Del Guercio, Diane and Reuter, Jonathan, *Mutual Fund Performance and the Incentive to Generate Alpha,* (2014).

payments to BDs or RIAs.[14] We exclude municipal bonds from all specifications because municipal bonds are often tax deferred and are therefore generally not recommended to be in retirement accounts.[15] We also investigate the relationship between payments to BDs or RIAs and performance for the sample of funds that are typically only available through employer sponsored plans or are typically default mutual funds for auto-enrollment in retirement plans, presented in appendix II.

Our regression analysis estimated asset-weighted and equal-weighted results for the difference between the average before-fee return of bundled funds and unbundled funds, and the difference between semi-bundled funds and unbundled funds. Asset weighting adjusts the estimates to give funds with more assets more weight in the analysis. Not taking the mutual fund's net assets into account gives equal weight to all funds even though funds with many assets may make up a large portion of the mutual fund market. Consistent with literature in this field, we report asset-weighted estimates in the main body of the report because asset-weighting more accurately depicts how payments to BDs or RIAs affect investors' returns. The robust standard errors generated by the regression are clustered at the mutual fund family level to allow for the possibility that monthly before-fee returns are correlated within a mutual fund family.

To generate an illustrative example of how differences in returns between bundled and unbundled and semi-bundled mutual funds could affect the accumulation of retirement assets over time, we estimated a model based on the difference between bundled, semi-bundled, and unbundled mutual funds found in our regression analysis. We assumed a constant, inflation-adjusted annual rate of return for unbundled and semi-bundled mutual funds of 5.0 percent. Based on our regression analysis of active domestic equity funds, the annual rate of return for bundled funds is 4.11 percent (5.0 – 0.89).[16] To estimate the annual contribution amount, we used the median salary for each age between 21 and 67 years old from the 2022 Current Population Survey Annual Social and Economic Supplement. We

[14]We performed sensitivity analysis for fund management style by including an indicator for actively managed funds, instead of the sample restriction, described in appendix II.

[15]According to SEC staff, the interest on municipal bonds is often exempt from federal income tax and in some instances state and local taxes as well.

[16]Derived from the 0.89 percentage point difference in performance between bundled, semi-bundled, and unbundled funds in the asset-weighted regression analysis of active domestic equity funds.

assumed a starting balance of $0, a constant contribution rate of 6 percent,[17] and that contributions began at age 21. We also assumed the retirement portfolio followed a glide path[18] investment portfolio.[19] Outside of the different rates of return, the model assumes everything else between the funds remains the same.

Our findings do not establish a causal relationship between payments to BDs or RIAs and mutual fund performance. Variables we did not include in our model may correlate with both payments to BDs or RIAs and before-fee returns within a particular month and year, and within a particular Morningstar category. Our findings are not generalizable to all mutual fund investors. The results only apply to the returns of actively managed mutual funds and actively managed domestic equity funds for the years 2018 to 2021. Despite limitations, we believe our analysis provides valuable insight into the association between potential conflicts of interest and fund returns.

Literature review and other work

To examine how federal regulators oversee conflicts of interests and what actions could potentially improve their oversight, we interviewed agency officials and staff at DOL, the Financial Industry Regulatory Authority (FINRA), the Internal Revenue Service (IRS), and the SEC. The National Association of Insurance Commissioners did not respond to interview requests. We reviewed relevant laws and regulations, including DOL's 2016 rule and related statutory and administrative exemptions, including PTE 2020-02. We reviewed Regulation Best Interest and the National Association of Insurance Commissioners' Suitability in Annuity Transactions Model Regulation. We reviewed DOL advisory opinions on

[17]According to Vanguard, the estimated median contribution rate in 2022 was 6.4 percent. See Vanguard, *How America Saves 2023*, (2023).

[18]A glide path refers to an investment portfolio where the asset allocation mix changes as the investor approaches a target withdrawal date. Specifically, we assume the glide path proportion of equities will equal 100 minus age. For example, a 21-year-old would have 79 percent (100–21) of her portfolio invested in equities, and a 67-year-old would have 33 percent (100–67) of his portfolio invested in equities. We assumed 75 percent of the proportion of equities is invested in domestic equity, and the amount the investor contributes to domestic equity is proportional to the fraction of the portfolio invested in domestic equity at each age.

[19]The comparison group for bundled funds is all other funds (semi-bundled and unbundled together). We group semi-bundled and unbundled funds together because there is no statistically significant difference between the before-fee returns of semi-bundled and unbundled funds. That is, the results of the model would be the same if the comparison group were either semi-bundled funds or unbundled funds.

IRAs and employer plans interpreting the prohibited transaction rules, as well as Form 5500 and 5330 instructions.

We reviewed academic literature on conflicts of interest identified in a literature search by a GAO librarian, and other articles identified through background research and referrals by interviewees. We also interviewed three behavioral economists, three ERISA attorneys, three consumer advocates, three fiduciary compliance professionals, two academics authoring research on retirement investment conflicts of interest, and a few others including state regulators and other industry stakeholders.

We conducted this performance audit from November 2020 to July 2024 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. We conducted our related investigative work in accordance with standards prescribed by the Council of the Inspectors General on Integrity and Efficiency.

Appendix II: Technical Appendix for Regression Analysis

This technical appendix describes the results and sensitivity analyses we conducted for the analysis of the relationship between payments to broker-dealers (BD), registered investment advisers (RIA), or dual registrants (we describe all three firm-types as “BD or RIA”) and mutual fund performance.

Results

Table 3 presents the association between payments to BDs or RIAs and monthly before-fee returns for the period 2018 to 2021. Of all actively managed mutual funds, asset-weighted bundled funds underperformed unbundled funds by an average of .023 percentage points per month, or 0.28 percentage points annually. For actively managed domestic equity funds, asset-weighted bundled funds are associated with average lower before-fee returns of .074 percentage points per month (0.89 percentage points per year) relative to unbundled actively managed domestic equity funds. For non-domestic equity, bundled funds are not statistically significantly different from unbundled funds, demonstrating the effect is concentrated in domestic-equity funds. Asset-weighted semi-bundled funds underperformed unbundled funds, but the difference is not statistically significant for all active funds or active domestic equity funds.[1] For equal weighting, bundled domestic equity funds underperformed relative to unbundled, but there is no statistical difference for all active funds for the equal-weighted specification, suggesting that lower returns are driven by funds with more assets.

[1]This finding is in line with Christoffersen et al. (2013) who find that front-loads are associated with lower performance, but not revenue sharing. See Christoffersen, Susan EK, Richard Evans, and David K. Musto. *What do consumers’ fund flows maximize? Evidence from their brokers’ incentives,* (2013).

Table 3: Association between Payments to Broker Dealers or Registered Investment Advisers and Monthly Before-fee Returns

	Domestic Equity Equal-weighted	Domestic Equity Asset-weighted	Non-Domestic Equity Equal-weighted	Non-Domestic Equity Asset-weighted	All Active Equal-weighted	All Active Asset-weighted
Bundled	-0.045**	-0.074***	-0.002	-0.013	-0.005	-0.023**
	(0.020)	(0.024)	(0.008)	(0.013)	(0.008)	(0.012)
Semi-Bundled	-0.037*	-0.004	-0.000	-0.002	-0.003	-0.003
	(0.022)	(0.045)	(0.009)	(0.014)	(0.009)	(0.016)
Constant (Unbundled)	0.797***	0.894***	0.873***	0.898***	0.863***	0.898***
	(0.021)	(0.015)	(0.009)	(0.007)	(0.008)	(0.007)
Observations	120,539	120,344	952,837	951,545	1,073,377	1,071,890

Source: GAO analysis of Morningstar Data. | GAO-24-104632

Note: Standard errors in parenthesis are clustered at the family fund level. Date by Morningstar category fixed effects included in all specifications. Municipal bonds and index funds excluded from all specifications. Only years 2018+-2021 included. * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

Sensitivity analyses

Net returns. We found a more negative relationship between fee groups and returns when we used asset-weighted monthly net returns and net returns plus the 12b-1 fee as outcome variables (see table 4). For both types of net return, the estimates for bundled funds and semi-bundled funds are negative and the estimates for domestic equity are larger in magnitude than for all active funds. The difference between the average monthly net returns and the net returns plus the 12b-1 fee demonstrates that the presence of a 12b-1 fee can influence a fund's average return. This larger negative relationship between fee groups and net returns compared with gross returns reinforces the effect that fees can have on investors.

Table 4: Association between Payments to Broker-Dealers or Registered Investment Advisers and Monthly Net Returns

	Net Returns		Net Returns + 12b-1	
	Domestic Equity	**All Active**	**Domestic Equity**	**All Active**
Bundled	-0.122***	-0.068***	-0.094***	-0.045***
	(0.023)	(0.010)	(0.023)	(0.009)
Semi-Bundled	-0.035	-0.022	-0.034	-0.022
	(0.042)	(0.016)	(0.042)	(0.016)
Constant (Unbundled)	0.881***	0.869***	0.880***	0.870***
	(0.013)	(0.006)	(0.012)	(0.006)
Observations	120,578	1,074,413	120,578	1,074,413

Source: GAO analysis of Morningstar Data. | GAO-24-104632

Note: Standard errors in parenthesis are clustered at the family fund level. Date by Morningstar Category fixed effects included in all specifications. Municipal bonds and index funds excluded from all specifications. Asset weighted. Only years 2018-2021 included. * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

Volatility. To investigate the volatility across Morningstar fee group types, we used annual standard deviation and semi-standard deviation as the dependent variable in our regression. Table 5 shows the standard deviation and semi-standard deviation of bundled funds are not statistically significantly different from unbundled funds, meaning bundled funds do not have different volatility than unbundled funds. Domestic equity semi-bundled funds are associated with positive and statistically significantly higher standard deviation and semi-standard deviation, relative to domestic equity unbundled funds. The positive estimate implies that domestic equity semi-bundled funds are associated with more volatility than unbundled funds. These findings demonstrate that bundled fund and semi-bundled funds are not trading off lower return for lower risk.

Table 5: Association between Payments to Broker-Dealers or Registered Investment Advisers and Annual Standard Deviation and Semi-Standard Deviation of Gross Returns

	Standard Deviation		Semi-Standard Deviation	
	Domestic Equity	**All Active**	**Domestic Equity**	**All Active**
Bundled	0.044	-0.004	0.110	-0.018
	(0.063)	(0.059)	(0.070)	(0.071)
Semi-Bundled	0.196***	0.053	0.290***	0.054
	(0.066)	(0.037)	(0.082)	(0.048)
Constant (Unbundled)	2.978***	3.457***	3.459***	3.877***
	(0.017)	(0.015)	(0.021)	(0.020)
Observations	120,344	1,071,890	50,998	475,817

Source: GAO analysis of Morningstar Data. | GAO-24-104632

Note: Standard errors in parenthesis are clustered at the family fund level. Date by Morningstar Category fixed effects included in all specifications. Municipal bonds and index funds excluded from all specifications. Asset weighted. Only years 2018-2021 included. * p < 0.10, ** p < 0.05, *** p < 0.01.

Management style. To test the sensitivity of our results, we included an indicator variable for mutual fund management style, rather than restricting the regression sample to actively managed funds. We found that management style did not influence our results. The active management indicator variable is not statistically significant, but it is associated with lower average before-fee returns, shown in table 6. The estimates for bundled and semi-bundled funds are consistent with our results of active-only funds in table 3 above, demonstrating the sample restriction to actively managed funds is not driving our main finding that bundled funds are associated with underperformance.[2]

[2]We also restricted the regression to passively managed (index) funds only. We found a consistent negative relationship between bundled and semi-bundled funds and average monthly before-fee returns, although the estimates are not consistently statistically significant. This suggests payments to BDs or RIAs may impact passively managed funds as well but have more influence over performance in active funds.

Table 6: Association between Payments to Broker-Dealers or Registered Investment Advisers and Monthly Before-Fee Returns Controlling for Fund Management Style

	Domestic Equity	All Active
Bundled	-0.074***	-0.025**
	(0.024)	(0.012)
Semi-Bundled	-0.004	0.001
	(0.045)	(0.010)
Active Fund	-0.114	-0.019
	(0.123)	(0.016)
Constant	1.010***	0.956***
	(0.117)	(0.011)
Observations	128,599	1,124,106

Source: GAO analysis of Morningstar Data. | GAO-24-104632

Note: Standard errors in parenthesis are clustered at the family fund level. Date by Morningstar category fixed effects included in all specifications. Municipal bonds excluded from all specifications. Asset weighted. Only years 2018-2021 included * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

Survival bias. We investigated whether mutual fund survivorship was influencing our results and found that survivorship was not driving our findings. Since poorer performing funds are more likely to fail, and less likely to be present in the data, it is possible our findings are subject to survival bias. For example, if unbundled funds are more likely to fail than bundled funds, the performance of unbundled funds will be overstated (as only the best funds will survive), and it will appear like unbundled funds are better performers than bundled funds. To check for the sensitivity of our results to survival bias, we did two sensitivity tests: using only funds that survive the entire sample period and including an indicator variable for surviving funds.[3]

Table 7 shows the estimates for the sample of surviving funds from 2018-2021. If our results were being driven by survivor bias, we would expect that restricting the sample to surviving funds would make our results more precise. Among surviving funds, the estimates for bundled and semi-bundled funds are comparable, in magnitude and significance, to our results in table 3 above. As an additional test, table 8 presents the results of including an indicator variable for surviving funds in the regression. The coefficient on the indicator variable for if a fund survived is significant, but

[3]Our analysis covers a relatively short time period of 4 years, which will likely mitigate the effects of survivor bias, as there is a positive relationship between survivor bias in average performance and sample period length. See Carhart, Mark M., et al. "Mutual fund survivorship.*" The review of financial studies* 15.5 (2002).

the coefficients for unbundled and semi-bundled keep their significance and magnitudes, suggesting the negative correlation between payments to BDs or RIAs and before-fee returns is present even after controlling for fund survival.

Table 7: Association Between Payments to Broker-Dealers or Registered Investment Advisers and Monthly Before-fee Returns for Surviving Funds

	Domestic Equity	All Active
Bundled	-0.0705***	-0.0245*
	(0.0238)	(0.0125)
Semi-Bundled	0.0005	-0.0047
	(0.0457)	(0.0170)
Constant (Unbundled)	0.8979***	0.9078***
	(0.0152)	(0.0075)
Observations	104,620	940,788

Source: GAO analysis of Morningstar Data. | GAO-24-104632

Notes: Standard errors in parenthesis are clustered at the family fund level. Date by Morningstar category fixed effects included in all specifications. Municipal bonds and index funds excluded from all specifications. Asset weighted. Only years 2018-2021 included. Surviving Funds only. * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

Table 8: Association between Payments to Broker-Dealers or Registered Investment Advisers and Monthly Before-fee Returns Controlling for Fund Survival

	Domestic Equity	All Active
Bundled	-0.0722***	-0.0247**
	(0.0239)	(0.0123)
Semi-Bundled	-0.0008	-0.0050
	(0.0448)	(0.0163)
Survived	0.1291***	0.0979***
	(0.0469)	(0.0198)
Constant	0.7659***	0.8035***
	(0.0486)	(0.0198)
Observations	120,344	1,071,890

Source: GAO analysis of Morningstar Data. | GAO-24-104632

Notes: Standard errors in parenthesis are clustered at the family fund level. Date by Morningstar category fixed effects included in all specifications. Municipal bonds and index funds excluded from all specifications. Asset weighted. Only years 2018-2021 included. * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

Default funds for auto-enrollment and funds likely in employer-sponsored plans. To investigate whether default funds for auto-enrollment in retirement plans and funds likely subject to the more stringent ERISA fiduciary standard experience similar performance differences across fee groups, we restricted the analysis to funds in the retirement share class or target date funds.[4] The retirement share class does not capture all funds available to retirement plans, it captures all share classes only available to retirement plans. Additionally, target date funds make up only a small portion of IRA assets. Table 9 illustrates that bundled and semi-bundled funds in the retirement share class are not associated with lower before-fee returns than unbundled funds in the retirement share class. The estimates for all actively managed funds are close to zero, while the estimates for active domestic equity funds are not statistically significant and positive. Additionally, the constant terms are higher than the constant terms in Table 3, suggesting these are better performing funds on average. Employer sponsored plans are likely covered by ERISA, a stringent fiduciary standard.

Table 10 presents the findings for target date funds.[5] Bundled and semi-bundled mutual funds are associated with higher before-fee returns than unbundled funds for target date funds, and these estimates are statistically significant. The positive performance of bundled target date funds relative to unbundled target date funds could be because they have different underlying assets, such as more investments in foreign equity

[4]Funds in the retirement share class are typically only available through employer sponsored plans and offered to retirement plan participants usually without sales loads. Target date funds are popular default choices for auto-enrolled defined contribution retirement plans covered by ERISA, and are generally intended for retirement savings, similar to the retirement share class. A variable identifying the retirement share class is provided in the data. Funds available through the retirement share class are purchased by retirement plan participants usually without sales loads. Target date funds are identified in the data using the fund name or Morningstar category. The retirement share class and target date funds have different proportions of assets invested in bundled, semi-bundled, and unbundled funds. Target date funds have a larger share of assets in bundled funds and unbundled funds and a smaller share of assets in semi-bundled funds compared with all funds. The retirement share class funds have a larger share of assets in unbundled funds, a smaller share of assets in bundled funds, and around the same amount of assets in semi-bundled funds.

[5]Domestic equity is not presented separately for the analysis of target date funds because there are only 80 funds defined as both active domestic equity funds and target date funds in our data.

and fixed income, relative to other mutual funds.[6] Additionally, bundled fees may be more appropriate for buy-and-hold investments like target date funds because purchasing a product with a one-time fee might be better for the investor in the long run than a product with an annual fees.

Table 9: Association between Payments to Broker-Dealers or Registered Investment Advisers and Monthly Before-fee Returns of the Retirement Share Class

	Domestic equity	All active
Bundled	0.056	-0.004
	(0.063)	(0.021)
Semi-Bundled	0.110	-0.001
	(0.077)	(0.027)
Constant (Unbundled)	0.932***	1.002***
	(0.057)	(0.019)
Observations	23,895	228,280

Source: GAO analysis of Morningstar Data. | GAO-24-104632

Notes: Standard errors in parenthesis are clustered at the family fund level. Includes date by Morningstar category fixed effects. Municipal bonds and index funds excluded from all specifications. Asset weighted. Only years 2018-2021 included. Asset weighted. * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

[6]Target date funds tend to invest in more foreign equity when they are farther from the retirement date and broker-sold foreign equity has been shown to outperform direct-sold funds. See Bergstresser, Daniel, John M.R. Chalmers, and Peter Tufano, *Assessing the costs and benefits of brokers in the mutual fund industry The Review of Financial Studies* (2009) and see Reuter, Jonathan, *Revisiting the Performance of Broker-Sold Mutual Funds*, (2015). Additionally, a large portion of target date fund assets have gone to Collective Investment Trusts in recent years, which could affect our findings.

Table 10: Association between Payments to Broker-Dealers or Registered Investment Advisers and Monthly Before-fee Returns of Target Date Funds

	All Active
Bundled	0.073***
	(0.012)
Semi-Bundled	0.072***
	(0.021)
Constant (Unbundled)	0.854***
	(0.003)
Observations	113,608

Source: GAO analysis of Morningstar Data. | GAO-24-104632

Notes: Standard errors in parenthesis are clustered at the family fund level. Includes date by target date fixed effects, so the regression compares funds with the same target date in the same month and year. Municipal bonds and index funds excluded from all specifications. Asset weighted. Only years 2018-2021 included. Asset weighted. * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

Appendix III: Comments from the Internal Revenue Service

CHIEF TAX COMPLIANCE OFFICER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

July 12, 2024

Tranchau (Kris) Nguyen
Director, Education, Workforce, and Income Security
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Ms. Nguyen:

Thank you for the opportunity to review the draft report of the Government Accountability Office (GAO) entitled “Retirement Investments: Agencies Can Better Oversee Conflicts of Interest Between Fiduciaries and Retirement Investors” (GAO-24-104632, Job Code 104632).

The Internal Revenue Service (IRS) continually strives to enforce tax compliance with prohibited transactions involving Individual Retirement Accounts (IRAs). We share GAO’s concerns that conflicts of interest involving products recommended to retirement investment consumers present risks and challenges. We appreciate the acknowledgment in the report that the IRS examines self-directed IRAs and has tools to assist agents identify prohibited transactions. The report also confirms that the IRS has processes by which an IRA fiduciary may report and pay excise taxes for engaging in a prohibited transaction on Form 5330, Return of Excise Taxes Related to Employee Benefit Plans.

The IRS remains committed to the continuous improvement of tax compliance, and we appreciate the interest in this important topic. If you have questions, please contact me, or a member of your staff may contact Eric Slack, director, Employee Plans, at 202-317-8700.

Sincerely,

Heather C. Maloy
Digitally signed by Heather C. Maloy
Date: 2024.07.12 14:43:19 -04'00'

Heather C. Maloy

Enclosure

Enclosure

Recommendation 1
The Commissioner of the IRS should develop and implement a process independent of DOL referrals for identifying non-exempt prohibited transactions involving firms or financial professionals that are fiduciaries to IRAs and assessing applicable excise taxes. For example, IRS could check Form 5330 filing compliance during income tax audits of financial services firms.

Comment
We agree with this recommendation. We will examine the processes for identifying non-exempt prohibited transactions involving firms or financial professionals that are fiduciaries to IRAs and consider implementing additional measures to identify prohibited transactions as appropriate.

Recommendation 2
The Commissioner of the IRS should coordinate with DOL through a formal means, such as a memorandum of understanding, on non-exempt prohibited transactions involving firms and financial professionals who are IRA fiduciaries and owe exercise tax.

Comment
We agree with this recommendation. We will explore opportunities to develop more formal means for coordination between the IRS and DOL for prohibited transactions related to investment advice provided to IRA owners from financial service firms.

Appendix IV: GAO Contact and Staff Acknowledgments

GAO Contact

Tranchau (Kris) T. Nguyen, Director, (202) 512-7215 or nguyentt@gao.gov

Staff Acknowledgments

In addition to the contact named above, Tamara Cross (Assistant Director), Ted Leslie (Analyst in Charge), Kaitlyn Brown, Angie Jacobs, Nicholas Lessard-Chaudoin, Katherine McElroy, Catherine Morrissey, and Jeanine Navarrete made key contributions. Also contributing to the report were Andrew Bellis, Caitlin Cusati, Holly Dye, Wanjiku Gachugi, Michael Hoffman, Kathleen McQueeney, Jeffrey G. Miller, Trevor Osaki, Shelby Gullion, Sabrina Riddick, Daniel Setlow, Curtia Taylor, Kathleen van Gelder, Coleson Weir, Adam Wendel, and Christopher Zbrozek.

Related GAO Products

Government Performance Management: Leading Practices to Enhance Interagency Collaboration and Address Crosscutting Challenges. GAO-23-105520 (Washington, D.C.: May 24, 2023).

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