

# Fiduciary Investment Advice

Regulatory Impact Analysis

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## Executive Summary

Tax-preferred retirement savings, in the form of private-sector, employer-sponsored retirement plans, such as 401(k) plans (plans), and Individual Retirement Accounts (IRAs), are critical to the retirement security of most U.S. workers. Investment professionals play an important role in guiding their investment decisions. However, these professional advisers<sup>1</sup> often are compensated in ways that create conflicts of interest, which can bias the investment advice that some render and erode plan and IRA investment results. In order to limit or mitigate conflicts of interest and thereby improve retirement security, the Department of Labor (the Department) is proposing to attach fiduciary status to more of the advice rendered to plan officials, plan participants, and beneficiaries (plan investors) and IRA investors.

The Employee Retirement Income Security Act of 1974 (ERISA)<sup>2</sup> and the Internal Revenue Code (IRC) together assign fiduciary status to any person who “renders investment advice for a fee or other compensation, direct or indirect” with respect to plan or IRA investments. The determination of who is a fiduciary is of central importance under this statutory framework. One of the primary ways ERISA protects employee benefit plans and their participants and beneficiaries is by requiring fiduciaries to comply with fundamental obligations rooted in the law of trusts. In particular, ERISA requires fiduciary advisers to plan investors to manage plan assets prudently and with undivided loyalty to the plan’s participants and beneficiaries. In addition, ERISA and the IRC together forbid fiduciary advisers to both plan and IRA investors from engaging in broadly-defined prohibited transactions (PTs) in which the advisers’ and investors’ interests might conflict. Under ERISA, plan fiduciaries are personally liable for plan losses stemming from breach of these duties, and under the IRC, both plan and IRA fiduciaries are liable for excise taxes imposed under the IRC when they engage in PTs.

While fiduciary advisers generally must avoid conflicts of interest, ERISA and the IRC provide certain parallel statutory prohibited transaction exemptions (PTEs) that allow some transactions that involve conflicts of interest provided that adequate consumer protections are in place. One statutory PTE allows fiduciary advisers to receive compensation from third parties as long as the compensation does not vary depending on the investments chosen or the advice is generated by a computer model that is independently certified to be unbiased and certain other conditions are met. The Department has the authority to issue additional administrative PTEs for transactions it finds are in the interest of plan participants and IRA investors and protective of their rights. A current class PTE (PTE 86-128) allows fiduciary advisers to receive brokerage commissions for executing transactions they recommend.

The Department also has authority to issue rules under both ERISA and the IRC that determine when persons rendering advice on the investment of plan or IRA assets must act as

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<sup>1</sup> By using the term “adviser,” the Department does not intend to limit its use to investment advisers registered under the Investment Advisers Act of 1940 or under state law. For example, as used herein, an adviser can be an individual or entity who can be, among other things, a representative of a registered investment adviser, a bank or similar financial institution, an insurance company, or a broker-dealer.

<sup>2</sup> 29 U.S.C. § 1001 et seq. (2000) (hereinafter cited as ERISA).

fiduciaries. The current rule, issued in 1975 (1975 rule),<sup>3</sup> narrowly limits fiduciary status; it was written forty years ago when IRAs had just been created and the vast majority of consumers were not managing their own retirement savings or relying on investment advice to do so. The 1975 rule provides a five-part test for determining whether an adviser is a fiduciary. Before a person can be held to ERISA's fiduciary standards with respect to their investment advice, he or she must: (1) make recommendations on investing in, purchasing or selling securities or other property, or give advice as to the investments' value; (2) on a regular basis; (3) pursuant to a mutual understanding that the advice; (4) will serve as a primary basis for investment decisions; and (5) will be individualized to the particular needs of the plan. An investment adviser is not treated as a fiduciary unless each element of the five-part test is satisfied for each instance of advice. Subsequent Department interpretive guidance further narrowed fiduciary status by ruling that advice to plan participants to roll over assets from a plan to specific new investments in an IRA does not constitute fiduciary investment advice unless the advice is provided by someone who already is a fiduciary.<sup>4</sup>

The ERISA and IRC rules governing advice on the investment of plan and IRA assets are separate from provisions of federal securities laws, such as the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940, and rules issued by the Securities Exchange Commission (SEC) that govern the conduct of Registered Investment Advisers (RIAs) and broker-dealers (BDs), who advise retail investors. Congress, as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act<sup>5</sup> (Dodd-Frank Act), directed the SEC to consider a uniform fiduciary standard for RIAs and BDs who advise retail customers. The SEC staff in January 2011 issued a report recommending that the Commission pursue such reform (SEC Dodd-Frank Study).<sup>6</sup> As part of the analysis supporting its recommendation, the report included a detailed discussion of the scope and limits of current regulation of RIAs and BDs.<sup>7</sup> The Commission in March 2013 issued a Request for Information seeking data to further inform its consideration of these issues, and received numerous responses, which it is currently reviewing.<sup>8</sup> As further discussed in section 3.6, below, in November 2013, an Investor Advisory Committee established by section 911 of the Dodd-Frank Act issued a recommended framework for a uniform fiduciary duty governing BDs

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<sup>3</sup> 29 C.F.R. 2510.3-21(c), 40 Fed. Reg. 50843 (Oct. 1975); available at: <http://www.gpo.gov/fdsys/pkg/CFR-2011-title29-vol9/pdf/CFR-2011-title29-vol9-sec2510-3-21.pdf>.

<sup>4</sup> DOL Advisory Opinion 76-65A (June 7, 1976).

<sup>5</sup> Pub. Law No. 111-203, 124 Stat. 1376 (2010).

<sup>6</sup> U.S. Securities and Exchange Commission, "Study on Investment Advisers and Broker-Dealers, As Required by The SEC Dodd-Frank Study 2011, 65 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 2011); available at: <http://www.sec.gov/news/studies/2011/913studyfinal.pdf>.

<sup>7</sup> Although the Department discusses the securities law's regulation of BDs and RIAs in Section 3.6 below, the SEC Dodd-Frank Study includes a much more exhaustive discussion of the scope, terms, and limits of the securities laws in this regard, including investor confusion about financial service provider's obligations and standards of conduct; the content of the best interest and suitability standards; regulation of compensation; licensing and registration requirements; the availability and limitations on private rights of actions; requirements for proof of scienter in private actions; FINRA arbitration; and other matters. The reader is generally referred to the SEC Dodd-Frank Study for a more complete discussion of the securities laws' regulatory framework for advice.

<sup>8</sup> U.S. Securities and Exchange Commission, SEC Release No. 69013, IA 3558, "Duties of Brokers, Dealers and Investment Advisers (Mar. 1, 2013); available at: <http://www.sec.gov/rules/other/2013/34-69013.pdf>.



and RIAs under the securities laws.<sup>9</sup> This new framework, if adopted, would not alter the obligation of BDs and RIAs to comply with their separate obligations under ERISA and the IRC when giving advice on tax-preferred retirement investments. In addition, there are many transactions involving retirement savings (such as advice to purchase some insurance annuity and bank products) to which federal securities laws do not apply, but ERISA and the IRC do.

Since the Department issued its 1975 rule, the retirement savings market has changed profoundly. Financial products are increasingly varied and complex. Individuals, rather than large employers, are increasingly responsible for their investment decisions as IRAs and 401(k)-type defined contribution plans have supplanted defined benefit pensions as the primary means of providing retirement security. Plan and IRA investors often lack investment expertise and must rely on experts – but are unable to assess the quality of the expert’s advice or guard against its conflicts of interest. Most have no idea how “advisers” are compensated for selling them products. Many are bewildered by complex choices that require substantial financial expertise and welcome advice that is marketed as free, without knowing that the adviser is compensated through third party payments creating conflicts of interest or that hidden fees over the life of the investment will reduce their returns. The risks are growing as baby boomers retire and move money from plans, where their employer has both the incentive and the fiduciary duty to facilitate sound investment choices, to IRAs, where both good and bad investment choices are more numerous and much advice is conflicted. These “rollovers” are expected to approach \$2.5 trillion over the next 5 years.<sup>10</sup> Because advice on rollovers is usually one-time and not “on a regular basis,” it is typically not covered by the 1975 standard, even though rollovers are often the most important financial decisions that many consumers make in their lifetime. An ERISA plan investor who rolls her retirement savings into an IRA could lose 12 to 24 percent of the value of her savings over 30 years of retirement by accepting advice from a conflicted financial adviser.<sup>11</sup> Timely regulatory action to redress advisers’ conflicts is warranted to avert such losses.

In the retail IRA marketplace, growing consumer demand for personalized advice, together with competition from online discount brokerage firms, has pushed brokers to offer more comprehensive guidance services rather than just transaction support. Unfortunately, their traditional compensation sources – such as brokerage commissions, revenue shared by mutual funds and funds’ asset managers, and mark-ups on bonds sold from their own inventory – can introduce acute conflicts of interest. Brokers and others advising IRA investors are often able to calibrate their business practices to steer around the narrow 1975 rule and thereby avoid fiduciary

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<sup>9</sup> U.S. Securities and Exchange Commission Recommendation of the Investor Advisory Committee: Broker-Dealer Fiduciary Duty (Nov. 2013); available at: <http://www.sec.gov/spotlight/investor-advisory-committee-2012/fiduciary-duty-recommendation-2013.pdf>.

<sup>10</sup> Cerulli Associates, “Retirement Markets 2014: Sizing Opportunities in Private and Public Retirement Plans,” 2014.

<sup>11</sup> For example, an ERISA plan investor who rolls \$200,000 into an IRA, earns a 6% nominal rate of return with 3% inflation, and aims to spend down her savings in 30 years, would be able to consume \$10,204 per year for the 30 year period. A similar investor whose assets underperform by 1 or 2 percentage points per year would only be able to consume \$8,930 or \$7,750 per year, respectively, in each of the 30 years. The 1 to 2 percentage point underperformance comes from a careful review of a large and growing body of literature which consistently points to a substantial failure of the market for retirement advice. The literature is discussed throughout this RIA. Also see Burke et al. (2014) for a review.

status and the prohibited transaction rules for accepting conflicted compensation. Many brokers market retirement investment services in ways that clearly suggest the provision of tailored or individualized advice, while at the same time relying on the 1975 rule to disclaim any fiduciary responsibility in the fine print of contracts and marketing materials. Thus, at the same time that marketing materials may characterize the financial adviser's relationship with the customer as one-on-one, personalized, and based on the client's best interest, footnotes and legal boilerplate disclaim the mutual agreement, arrangement, or understanding that the advice is individualized or should serve as a primary basis for investment decisions that is requisite for fiduciary status. What is presented to an IRA investor as trusted advice is often paid for by a financial product vendor in the form of a sales commission or shelf-space fee, without adequate counter-balancing consumer protections that are designed to ensure that the advice is in the investor's best interest. In another variant of the same problem, brokers and others receiving conflicted compensation recommend specific products to customers under the guise of general education to avoid triggering fiduciary status and responsibility.

Likewise in the plan market, pension consultants and advisers that plan sponsors rely on to guide their decisions often avoid fiduciary status under the five-part test, while receiving conflicted payments. For example, if a plan hires an investment professional or appraiser on a one-time basis for an investment recommendation on a large, complex investment, the adviser has no fiduciary obligation to the plan under ERISA. Even if the plan official, who lacks the specialized expertise necessary to evaluate the complex transaction on his or her own, invests all or substantially all of the plan's assets in reliance on the consultant's professional judgment, the consultant is not a fiduciary because he or she does not advise the plan on a "regular basis" and therefore may stand to profit from the plan's investment due to a conflict of interest that could affect their best judgment. Too much has changed since 1975, and too many investment decisions are made based on one-time advice rather than advice provided on a regular basis for the five-part test to be a meaningful safeguard any longer.

To be clear, many advisers do put their customers' best interest first and there are many good practices in the industry. But, there are also many instances when consumers receive bad advice based on conflicts of interest.

To deal with these issues and update the 1975 rule for application to the current business environment, in October 2010, the Department proposed amendments to the 1975 rule that would have broadened the definition of fiduciary investment advice under both ERISA and the IRC, making more advisory activities fiduciary in nature.<sup>12</sup> Under the 2010 proposal, advice could be fiduciary if given just once (rather than on a "regular basis"). Advice would be fiduciary if it were agreed that the advice "may be considered" as a basis for investment decisions (rather than as a "primary basis" for such decisions), or if the adviser otherwise was or claimed to be a fiduciary to the plan or IRA or was an RIA. The 2010 proposal also generally would have treated advice, appraisals or fairness opinions concerning the value of securities or other plan or IRA assets, including company stock purchased by employee stock ownership plans (ESOPs), as fiduciary advice. Recommendations made as part of certain sales pitches, however, would not have

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<sup>12</sup> DOL "Proposed Definition of the Term 'Fiduciary,'" 75 Fed. Reg. 65263 (Oct. 2010); available at: <http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=24328>.

constituted fiduciary investment advice under the 2010 proposal. In addition, the proposal requested comment on whether advice to rollover plan assets to IRAs should be considered fiduciary advice on the investment of plan assets. The 2010 proposal did not include any new prohibited transaction exemptions. However, the Department expressed its willingness to consider granting exemptions from ERISA's prohibited transaction rules by soliciting public comments regarding the number of transactions that would have to be restructured due to the prohibited transaction rules, whether existing prohibited transaction exemptions would be available for such transactions, and the number of new applications for exemptions that the Department could expect to receive regarding the transactions. In response, many commenters stated that new and amended prohibited transaction exemptions would be necessary under a broader fiduciary investment advice definition.

The 2010 proposal elicited extensive comments and prompted vigorous debate. While many championed the goals of the proposal and some feedback was positive, other stakeholders also expressed concerns during the notice and comment period and at a public hearing. Some commenters rejected the premise that conflicts pose any dangers to plan or IRA investors, asserting that the Department had not provided adequate evidence of tainted advice or adverse consequences. Recurrent themes from the comments were that the Department should wait until the SEC completes its consideration of related reforms and that the Department's regulatory impact analysis was inadequate, because it neglected to consider the impact the rule would have on the IRA market. Some comments predicted that the 2010 proposal would have highly negative impacts on IRA investors with small balances. Many asked the Department to issue PTEs that would allow advisers to continue their current compensation practices, which would otherwise be PTs if they engaged in them as fiduciaries. Recognizing the need to study the issue in greater detail, the Department announced in September 2011 its intent to withdraw the 2010 proposal and develop and issue a new proposal in due course.

The Department is now issuing a new and revised proposal to amend the 1975 rule. The new proposed definition of fiduciary investment advice generally covers specific recommendations on investments, investment management, the selection of persons to provide investment advice or management, and appraisals in connection with investment decisions. Persons who provide such advice would fall within the proposed regulation's ambit if they either (a) represent that they are acting as an ERISA fiduciary or (b) make investment recommendations pursuant to an agreement, arrangement, or understanding that the advice is individualized or specifically directed to the recipient for consideration in making investment or investment management decisions regarding plan or IRA assets.

The new proposal specifically includes as fiduciary investment advice recommendations concerning the investment of assets that are rolled over or otherwise distributed from a plan. This would supersede guidance the Department provided in a 2005 advisory opinion,<sup>13</sup> which concluded that such recommendations did not constitute fiduciary advice.

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<sup>13</sup> DOL Advisory Opinion 2005-23A (Dec. 7, 2005).

The new proposal also provides that an adviser does not act as a fiduciary merely by providing plan or IRA investors with information about plan distribution options, including the tax consequences associated with the available types of benefit distributions.

Critics of the 2010 proposal identified a number of activities and circumstances that they believed would have been unjustifiably swept into fiduciary status. In response, the new proposal more clearly distinguishes situations in which plans, plan participants, and IRA investors should expect adherence to a fiduciary standard of impartiality and trust, from those arm's length transactions that do not warrant such an expectation, by excluding the following:

- Sales pitches involving large plan clients (refining the 2010 proposal's similar exclusion);
- Counterparties in certain swap transactions;
- Parties known as "platform providers" who merely make available a roster of investment options that plan officials can use to populate 401(k) plan investment menus;
- Consultants who merely provide investment data or identify investments that meet objective criteria specified by plan officials;
- Recommendations made to plan sponsors by their own employees;
- Valuations provided for reporting and disclosure purposes rather than in connection with transactions; and
- Financial education that does not include specific investment recommendations.

Also in response to criticism, the new proposal does not include the 2010 proposal's provision that would have deemed all plan and IRA investment advice rendered by RIAs to be fiduciary investment advice.

The Department carefully considered the 2010 commenters' requests for additional exemptive relief, and reviewed existing exemptive relief available to fiduciary advisers, weighing both against the risks that adviser conflicts pose to consumers. Pursuant to this consideration the Department has adopted what it intends to be a balanced approach. The proposal narrows and attaches new protective conditions to some existing PTEs. At the same time, it includes new flexible, principles-based PTEs that apply to a broad range of compensation practices and include strong protective conditions. These elements of the proposal reflect the Department's effort to ensure that advice is in the best interest of consumers, while avoiding larger and costlier than necessary disruptions to existing business arrangements or constraints on future innovation.

In developing the new proposal, the Department conducted an in-depth economic assessment of current market conditions and the likely effects of reform. As further discussed below, the Department found that conflicted advice is widespread, causing serious harm to plan and IRA investors, and that disclosing conflicts alone would fail to adequately mitigate the conflicts or remedy the harm. By extending fiduciary status to more advice and providing flexible and protective PTEs that apply to a broad array of compensation arrangements, the new proposal will mitigate conflicts, support consumer choice, and deliver substantial gains for retirement investors and economic benefits that more than justify its costs.

Advisers' conflicts of interest take a variety of forms and can bias their advice in a variety of ways. For example, advisers often are paid more for selling some mutual funds than others, and to execute larger and more frequent trades of mutual fund shares or other securities. Advisers can reap price spreads from principal transactions, so advisers may be encouraged to recommend larger

and more frequent trades. These and other adviser compensation arrangements introduce direct and serious conflicts of interest between some advisers and retirement investors. Advisers often are paid substantially more if they recommend investments and transactions that are highly profitable to the financial industry, even if they are not in investors' best interests. These financial incentives can and do bias the advisers' recommendations. Many advisers do not provide biased advice, but the harm to investors from those that do can be large.

Following such biased advice can inflict losses on investors in several ways. They may choose more expensive and/or poorer performing investments. They may trade too much and thereby incur excessive transaction costs. They may chase returns, and may incur more costly timing errors, which are a common consequence of chasing returns.

A wide body of economic evidence supports a finding that the impact of these conflicts of interest on investment outcomes is large and negative. The supporting evidence includes, among other things, statistical analyses of conflicted investment channels, experimental studies, government reports documenting abuse, and economic theory on the dangers posed by conflicts of interest and by the asymmetries of information and expertise that characterize interactions between ordinary retirement investors and conflicted advisers. A careful review of this data, which consistently points to a substantial failure of the market for retirement advice, suggests that IRA holders receiving conflicted investment advice can expect their investments to underperform by an average of 100 basis points per year over the next 20 years. The underperformance associated with conflicts of interest – in the mutual funds segment alone – could cost IRA investors more than \$210 billion over the next 10 years and nearly \$500 over the next 20 years. Some studies suggest that the underperformance of broker-sold mutual funds may be even higher than 100 basis points. If the true underperformance of broker-sold funds is 200 basis points, IRA mutual fund holders could suffer from underperformance amounting to \$430 billion over 10 years and nearly \$1 trillion across the next 20 years. While the estimates based on the mutual fund market are large, the total market impact could be much larger. Insurance products, Exchange Traded Funds (ETFs), individual stocks and bonds, and other products are all sold by brokers with conflicts of interest.

Disclosure alone has proven ineffective to mitigate conflicts in advice. Extensive research has demonstrated that most investors have little understanding of their advisers' conflicts of interest, and little awareness of what they are paying via indirect channels for the conflicted advice. Even if they understand the scope of the advisers' conflicts, many consumers are not financial experts and therefore, cannot distinguish good advice or investments from bad. The same gap in expertise that makes investment advice necessary and important frequently also prevents investors from recognizing bad advice or understanding advisers' disclosures. Recent research suggests that even if disclosure about conflicts could be made simple and clear, it would be ineffective – or even harmful (Loewenstein, Cain, and Sah 2011).<sup>14</sup>

This proposal aims to ensure that advice is in consumers' best interest, thereby rooting out excessive fees and substandard performance otherwise attributable to advisers' conflicts, producing gains for retirement investors. Delivering these gains will entail some compliance cost – namely, the cost incurred by new fiduciary advisers to avoid PTs and/or satisfy relevant PTE

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<sup>14</sup> See also Section 7.6.1.

conditions. However, investor gains are estimated to be very large relative to compliance costs, and the Department therefore believes this proposal is economically justified and sound.

The Department expects the proposal to deliver large gains for retirement investors. Because of data limitations of the academic literature and available evidence, only some of these gains can be quantified. Focusing only on how load shares paid to brokers affect the size of loads IRA investors holding load funds pay and the returns they achieve, the Department estimates the proposal would deliver to IRA investors gains of between \$40 billion and \$44 billion over 10 years and between \$88 and \$100 billion over 20 years. These estimates assume that the rule will eliminate (rather than just reduce) underperformance associated with the practice of incentivizing broker recommendations through variable front-end-load sharing; if the rule's effectiveness in this area is substantially below 100 percent, these estimates may overstate these particular gains to investors in the front-load mutual fund segment of the IRA market. The Department nonetheless believes that these gains alone would far exceed the proposal's compliance costs, which are estimated to be between \$2.4 billion and \$5.7 billion over 10 years, mostly reflecting the cost incurred by new fiduciary advisers to satisfy relevant PTE conditions.

For example, if only 75 percent of the potential gains were realized in the subset of the market that was analyzed (the front-load mutual fund segment of the IRA market), the gains would amount to between \$30 billion and \$33 billion over 10 years. If only 50 percent were realized, the expected gains in this subset of the market would total between \$20 billion and \$22 billion over 10 years, still several times the proposal's estimated compliance cost. These gains, specifically estimated only for one segment of the IRA market, do not include additional potential gains to investors resulting from reducing or eliminating the effects of conflicts in IRA advice on financial products other than front-end-load mutual funds or the effect of conflicts on advice to plan investors on any financial products. The Department invites input that would make it possible to quantify the magnitude of the rule's effectiveness and of any additional, not-yet-quantified gains for investors.

The total gains to IRA investors attributable to the rule may be much higher than these quantified gains alone. The Department expects the proposal to yield large, additional gains for IRA investors, including potential reductions in excessive trading and associated transaction costs and timing errors (such as might be associated with return chasing), and improvements in the performance of IRA investments other than front-load mutual funds. As noted above, under current rules, adviser conflicts could cost IRA investors as much as \$410 billion over 10 years and \$1 trillion over 20 years, so the potential additional gains to IRA investors from this proposal could be very large, if the proposals eliminate even a fraction of the harmful impact of conflicts of interest on investment advice.

Just as with IRAs, there is evidence that conflicts of interest in the investment advice market also erode the retirement savings of plan participants and beneficiaries. For example, the U.S. Government Accountability Office (GAO) found that defined benefit pension plans using consultants with undisclosed conflicts of interest earned 1.3 percentage points per year less than other plans.<sup>15</sup> Other GAO reports have found that adviser conflicts may cause plan participants to

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<sup>15</sup> U.S. Government Accountability Office, GAO-09-503T, Private Pensions: Conflicts of Interest Can Affect Defined Benefit and Defined Contribution Plans (2009); available at: <http://www.gao.gov/new.items/d09503t.pdf>.

roll plan assets into IRAs that charge high fees or 401(k) plan officials to include expensive or underperforming funds in investment menus.<sup>16</sup> A number of academic studies find that 401(k) plan investment options underperform the market, and at least one study attributes such underperformance to excessive reliance on funds that are proprietary to plan service providers who may be providing investment advice to plan officials that choose the investment options.<sup>17</sup>

The new proposal's positive effects are expected to extend well beyond improved investment results for retirement investors. The IRA and plan markets for fiduciary advice and other services may become more efficient as a result of more transparent pricing and greater certainty about the fiduciary status of advisers and about the impartiality of their advice. There may be benefits from the increased flexibility that the new proposal's PTEs will provide with respect to fiduciary investment advice currently falling within the ambit of the 1975 rule. The new proposal's defined boundaries between fiduciary advice, education, and sales activity directed at large plans, may bring greater clarity to the IRA and plan services markets. Innovation in new advice business models, including technology-driven models, may be accelerated, and nudged away from conflicts and toward transparency, thereby promoting healthy competition in the fiduciary advice market.

A major expected positive effect of the new proposal in the plan advice market is improved compliance and the associated improved security of plan assets and benefits. Clarity about advisers' fiduciary status will strengthen the Department's ability to quickly and fully correct ERISA violations, while strengthening deterrence.

In conclusion, the new proposal has the potential to mitigate adviser conflicts and thereby improve plan and IRA investment results, while avoiding greater than necessary disruption of existing business practices, and it has the potential to deliver large gains to retirement investors and a variety of other economic benefits, which, in the Department's view, will more than justify its costs.

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<sup>16</sup> GAO Publication No. GAO-11-119, 36.

<sup>17</sup> See e.g., Pool, Sialm, Stefanescu 2014.





## 1. Introduction

Tax-preferred retirement savings, in the form of private sector, employer-sponsored retirement plans (plans) and IRAs, are critical to the retirement security of most US workers. It is therefore imperative that these savings are invested well. Investment professionals play a major and largely beneficial role in guiding the investment decisions of plan officials, plan participants and IRA investors. But many of these professionals are compensated in ways that may introduce conflicts of interest between them and the plan officials, plan participants and IRA investors they advise. If the conflicts taint the investment advice they render, underperformance could result and the retirement security of millions of America's workers and their families could be threatened. In economic terms, imperfect information may cause the market for investment advice to fail: plan officials, plan participants and IRA investors may sometimes unknowingly pay for and follow tainted advice and consequently suffer large but mostly hidden opportunity costs. The analysis that follows concludes that this is in fact occurring today.

ERISA and the IRC together provide that anyone paid to provide advice on the investment of plan or IRA assets is a fiduciary. As fiduciaries, they are subject to certain duties, including the general avoidance of conflicts of interest. However, a 1975 rule narrowly construed these ERISA and IRC provisions, effectively relieving many advisers of these duties.

The Department is proposing to revise the 1975 rule to expand the definition of fiduciary to include those who are not fiduciaries under the existing rule but should be based on their conduct ("new proposal"). The new proposal does not create new fiduciary duties; it extends the fiduciary duty to more advisers to remedy the failures in the present day marketplace and thereby improve plan and IRA investing for the long-term retirement security of participants and IRA investors.

Executive Orders 13563<sup>18</sup> and 12866<sup>19</sup> direct agencies to assess all costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing and streamlining rules, and of promoting flexibility. It also requires Federal agencies to develop a plan under which the agencies will periodically review their existing significant regulations to make the agency's regulatory program more effective or less burdensome in achieving regulatory objectives.

Under Executive Order 12866, "significant" regulatory actions are subject to the requirements of the Executive Order and review by the Office of Management and Budget (OMB). Section 3(f) of the Executive Order defines a "significant regulatory action" as an action that is likely to result in a rule: (1) having an annual effect on the economy of \$100 million or more, or adversely and materially affecting a sector of the economy, productivity, competition, jobs, the

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<sup>18</sup> Exec. Order No. 13563, 3 CFR 13563 (2011); available at: <http://www.gpo.gov/fdsys/pkg/FR-2011-01-21/pdf/2011-1385.pdf>.

<sup>19</sup> Exec. Order No. 12866, 3 CFR 638 (1993);, available at: <http://www.archives.gov/federal-register/executive-orders/pdf/12866.pdf>.

environment, public health or safety, or State, local or tribal governments or communities (also referred to as “economically significant”); (2) creating serious inconsistency or otherwise interfering with an action taken or planned by another agency; (3) materially altering the budgetary impacts of entitlement grants, user fees, or loan programs or the rights and obligations of recipients thereof; or (4) raising novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in the Executive Order. OMB has determined that this proposed rule is economically significant within the meaning of section 3(f)(1) of the Executive Order, because it would be likely to have an effect on the economy of \$100 million in at least one year. Accordingly, OMB has reviewed the rule pursuant to the Executive Order.

This regulatory impact analysis proceeds as follows: it first describes the ERISA and IRC provisions governing investment advice rendered to plan officials, plan participants and beneficiaries, and IRA investors, including the provisions of the Department’s new proposal. It then considers, separately for the IRA market and the plan market, the need for the Department’s regulatory initiative, and the gains to investors (including both benefits derived from economic efficiency gains and transfers from the financial industry) the new proposal has the potential to deliver. It goes on to assess the costs of the new proposal, review regulatory alternatives the Department considered, and discuss areas where the Department is uncertain regarding the impacts of the rule. The Department concludes that the new proposal’s gains to investors will justify its costs.

## 2. Legal Environment: ERISA and the IRC

In enacting ERISA in 1974, Congress established special consumer protections for tax-preferred retirement savings. These include ERISA and IRC provisions designed to ensure accountability and curb conflicts of interest among advisers to plan and IRA investors. The Department is responsible for interpreting these ERISA and IRC provisions. This Section describes the current ERISA and IRC legal environment, major intersections between these regimes and other laws, and the Department’s new proposal to its rule that implements the relevant ERISA and IRC provisions.

### 2.1 Statutory Provisions

ERISA established several provisions governing advice on the investment of plan and IRA assets. Some of these provisions were included in ERISA itself and made applicable to advice on the investment of plan assets only, while others were added to the IRC and made applicable to advice on the investment of both plan and IRA assets.

#### 2.1.1 Provisions Relating to Plans

Under both ERISA and the IRC, any person paid directly or indirectly to provide plan officials or participants with advice on the investment of plan assets is a fiduciary.<sup>20</sup> ERISA requires fiduciaries to discharge their duties prudently and solely in the interest of plan participants.<sup>21</sup> ERISA also generally requires fiduciaries to refrain from certain PTs, which may involve conflicts of interest. Under ERISA’s PT provisions, fiduciaries generally may not self-deal. In other words, they may not deal with plan assets for their own interest or account, or be paid by a third party in connection with a transaction involving plan assets.<sup>22</sup> Fiduciaries face personal liability

ERISA and IRC Provisions Governing Fiduciary Advice on the Investment of Plan and IRA Assets		
Statute	ERISA	IRC
<b>Fiduciary Advisers’ Duties</b>	Be prudent and loyal to participants’ interests. Avoid conflicts.	Avoid conflicts.
<b>Sanctions</b>	Personal liability for any loss arising from breach of duty	Excise tax
<b>Applies to</b>	Plans only	Plans and IRAs
<b>Rulemaking authority</b>	DOL	DOL
<b>Enforcement authority</b>	DOL	IRS

<sup>20</sup> ERISA § 3(21)(A)(ii) and IRC § 4975(e)(3)(B).

<sup>21</sup> ERISA § 404.

<sup>22</sup> ERISA § 406.

under ERISA for any loss of plan assets arising from breaches of these duties.<sup>23</sup> The IRC contains PT provisions parallel to ERISA.<sup>24</sup> Under these IRC provisions, fiduciary advisers who self-deal are subject to an excise tax equal to 15 percent of the amount involved, or, if the PT is not corrected in a timely fashion, 100 percent of that amount.

## 2.1.2 Provisions Relating to IRAs

ERISA does not apply to retail IRAs; however, the relevant IRC provisions do apply to them. Under the IRC, any person paid to provide advice on the investment of IRA assets is a fiduciary. As with plan fiduciaries, the IRC PT provisions generally prohibit such IRA fiduciaries from self-dealing, at penalty of an excise tax. ERISA's duties of prudence and loyalty do not apply to IRA fiduciaries nor are they liable under ERISA for losses arising from breaches of such duties or from PTs.<sup>25</sup> There is no private right of action for PT violations under the IRC. The authority to define who is a fiduciary and to interpret the IRC PT provisions (including the ability to draft exemptions from those provisions) is delegated to the Department under Reorganization Plan No. 4 of 1978.<sup>26</sup>

## 2.1.3 Permissible Self-Dealing

The foregoing statutory provisions of ERISA and the IRC generally prohibit investment advisers to plan and IRA investors from accepting compensation that introduces conflicts of interest. In practice, however, many such advisers are highly conflicted. They receive a wide variety of forms of compensation that vary depending on the investment decisions made pursuant to their advice. These forms of compensation include, but are not limited to, transaction-related commissions, mutual fund distribution fees known as 12b-1 fees, revenue sharing from various third parties with an interest in the investment decisions, such as RIAs managing mutual funds, and mark-ups on securities sold from (or mark-downs on securities bought by) their own or their affiliates' own accounts.

There generally are two different legal paths currently available to advisers who wish to accept variable compensation in connection with advice provided to plan or IRA investors. They can take advantage of one of many exemptions that are available from the otherwise applicable ERISA and IRC PT provisions, known as PTEs. Alternatively, they can calibrate their business practices to avoid being classified as fiduciary investment advisers under the 1975 rule. These paths are discussed below.

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<sup>23</sup> ERISA § 409.

<sup>24</sup> IRC § 4975.

<sup>25</sup> See Section 3.6 for a discussion of remedies under securities laws.

<sup>26</sup> Reorganization Plan No. 4 of 1978, 43 Fed. Reg. 47713 (Oct. 17, 1978), 92 Stat. 3790, 5 U.S.C. App. (2010); available at: <http://www.gpo.gov/fdsys/pkg/USCODE-2010-title5/pdf/USCODE-2010-title5-app-reorganiz-other-dup102.pdf>.

## 2.2 Exemptions from the PT Provisions

As noted above, advisers wishing to accept variable compensation in connection with advice on the investment of plan or IRA assets can take advantage of one or more PTEs. ERISA and the IRC each provide a limited, parallel set of statutory PTEs. The Department has the authority to issue additional class PTEs.

From a fiduciary's point of view, a PTE is permissive: it allows the fiduciary to engage in certain transactions, such as self-dealing, that would otherwise be prohibited. From the Department's perspective, a PTE must be protective. ERISA provides that class PTEs issued by the Department must be in participants' best interests and protective of participants' rights.<sup>27</sup> Because PTs generally involve potential conflicts of interest, the Department often attaches conditions to PTEs that are intended to ensure transparency, impartiality, and accountability, and to protect plan participants and beneficiaries and IRA investors. A fiduciary adviser who wishes to take advantage of a PTE must satisfy its conditions. Failure to satisfy the conditions can result in a non-exempt PT and associated sanctions, such as the PT excise tax.

Relevant current PTEs are discussed below.

### 2.2.1 Statutory Investment Advice Exemption

The Pension Protection Act of 2006 (PPA, P.L. 109-280) amended ERISA to establish a new statutory PTE for fiduciary investment advisers to plan participants and IRA investors.<sup>28</sup> This PTE permits advisers to receive indirect compensation from third parties in connection with the investment products they recommend to plan participants and IRA investors.

Congress recognized that such compensation can pose conflicts of interest that might taint advice. Consequently, relief under this PTE is subject to a number of protective conditions. For example, the advice must be provided under one of two types of "eligible investment advice arrangements." Under one permissible type of arrangement, any fees (including any commission or other compensation) received by the fiduciary adviser and the adviser's firm may not vary based on the investment products selected by the plan participant or IRA investor. Under the terms of the exemption, however, compensation paid to the fiduciary adviser's affiliates may vary. The other type of arrangement requires the adviser to provide (and not alter) the investment advice recommendation derived from a computer model meeting certain requirements, including a requirement that the model be independently certified to be unbiased in favor of investment options offered by the fiduciary adviser or related persons and for all investment options under the plan to be taken into account in specifying how a participant's account balance should be invested.<sup>29</sup>

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<sup>27</sup> ERISA § 408(a).

<sup>28</sup> ERISA §§ 408(b)(14) and 408(g).

<sup>29</sup> ERISA § 408(g)(2), in relevant part, states that both types of arrangements must be expressly authorized by a plan fiduciary other than the person offering the advice program, have an annual audit performed by an independent auditor who issues a written report to the authorizing fiduciary presenting specific findings regarding compliance of the arrangement with the statutory exemption, and the fiduciary adviser must provide detailed disclosures to plan participants and IRA investors.

## 2.2.2 Administrative PTEs

Since 1978 the Department has been solely responsible for interpreting and issuing exemptions from the PT provisions of both ERISA and the IRC.<sup>30</sup>

A number of existing class PTEs currently permit fiduciary advisers to engage in several classes of PTs in connection with the provision of fiduciary investment advice to plans, plan participants, or IRA investors.<sup>31</sup> These PTEs are named for the year and sequential order in which they were issued.

- PTE 84-24<sup>32</sup> covers transactions involving mutual fund shares, or insurance or annuity contracts, sold to plans or IRAs by pension consultants, insurance agents, brokers, and mutual fund principal underwriters who are fiduciaries as a result of advice they give in connection with these transactions. The exemption allows these investment advice fiduciaries to receive a sales commission with respect to products purchased by plans or IRAs. The exemption is limited to sales commissions that are reasonable under the circumstances. The investment advice fiduciary must provide disclosure of the amount of the commission and other terms of the transaction to an independent fiduciary of the plan or IRA, and obtain approval for the transaction. To use this exemption, the investment advice fiduciary may not have certain roles with respect to the plan or IRA such as trustee, plan administrator, fiduciary with written authorization to manage the plan's assets and employers. However it is available to investment advice fiduciaries regardless of whether they expressly acknowledge their fiduciary status or are simply functional or "inadvertent" fiduciaries that have not expressly agreed to act as fiduciary advisers, provided there is no written authorization granting them discretion to acquire or dispose of the assets of the plan or IRA.
- PTE 77-4 provides an exemption for the purchase or sale by a plan or IRA of mutual fund shares where the adviser for the mutual fund is also a fiduciary with respect to the plan or IRA, or an affiliate of such fiduciary, but is not an employer of employees covered by the plan. The exemption permits fiduciary advisers to receive certain fees for investment advisory services as a result of the plan's or IRA's investment in the mutual fund. As a condition to the exemption, a fiduciary who is independent and unrelated to the fiduciary/investment adviser or an affiliate thereof, must receive a current mutual fund prospectus and a full and detailed written disclosure of the investment advisory and other fees charged to or paid by the plan/IRA and the investment company. On the basis of the prospectus and disclosures, the independent fiduciary must approve the purchases and sales of the mutual fund shares consistent with the responsibilities, obligations, and duties

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<sup>30</sup> Reorganization Plan No. 4 of 1978, 43, 5 U.S.C. App. (2010).

<sup>31</sup> Some of these PTEs also provide relief to other fiduciaries in connection with other activities.

<sup>32</sup> Class Exemption for Certain Transactions Involving Insurance Agents and Brokers, Pension Consultants, Insurance Companies, Investment Companies and Investment Company Principal Underwriters, 49 FR 13208 (Apr. 3, 1984), amended at 71 FR 5887 (Feb. 3, 2006).

imposed on fiduciaries by Part 4 of Title I of ERISA. The independent fiduciary also must be notified of any change in the rates or fees.<sup>33</sup>

- PTE 75-1, Part IV, is available to fiduciary advisers who are “market-makers.”<sup>34</sup> Relief is available for the purchase or sale of securities by a plan or IRA, from or to a market-maker with respect to such securities, who is also a fiduciary adviser with respect to a plan or IRA, or an affiliate of such fiduciary. The PTE is subject to compliance with several detailed conditions, including a requirement that at least one person other than the fiduciary adviser is a market-maker with respect to the securities and the transaction is executed at a net price to the plan that is more favorable than that which the fiduciary reasonably believes to be available from all other market-makers with respect to the securities.<sup>35</sup>
  - ❑ Generally, the issuer of the securities must have been in continuous operation for not less than three years;
  - ❑ As a result of purchasing the securities, the fair market value of the aggregate amount of securities owned directly or indirectly by the plan for which the market-maker is a fiduciary must not exceed three percent of the fair market value of the assets for which the market maker is a fiduciary as of the last day of the most recent fiscal quarter of the plan prior to the transaction;
  - ❑ The fair market value of the aggregate amount of all securities for which the fiduciary is a market-maker that are owned, directly or indirectly, by the plan and with respect to which the fiduciary is a fiduciary must not exceed 10 percent of the fair market value of the assets of the plan as of the last day of the most recent fiscal quarter of the plan before the transaction;
  - ❑ At least one person other than the fiduciary must be a market-maker with respect to the securities;
  - ❑ The transaction must be executed at a net price to the plan for the number of shares or other units to be purchased or sold in the transaction that is more favorable to the plan than that which the fiduciary, acting in good faith, reasonably believes to be available at the time of such transaction from all other market-makers with respect to such securities; and
  - ❑ The plan must maintain, or cause to be maintained, for a period of six years from the date of the transaction, such records as are necessary to enable employees of the Department, IRS, plan participants and beneficiaries and their employer, and any employee organization whose members are covered by the plan to determine whether the conditions of the exemption have been met.

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<sup>33</sup> PTE 77-4, 42 Fed. Reg. 18732 (Apr. 8, 1977). The Department confirmed that PTE 77-4 applies to IRAs in AO 93-26A.

<sup>34</sup> The term "market-maker" is defined as any specialist permitted to act as a dealer, and any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis.

<sup>35</sup> PTE 75-1, 40 Fed. Reg. 50845 (Oct. 31, 1975).

- PTE 86-128 provides relief for a fiduciary adviser's use of its authority to cause a plan or IRA to pay a fee to such fiduciary or its affiliate for effecting or executing securities transactions. The exemption also provides relief for a fiduciary adviser to act as the agent in an agency cross transaction for both the plan and one or more other parties to the transaction, and to receive reasonable compensation therefor from one or more other parties to the transaction.<sup>36</sup> The PTE imposes conditions on advisers to employee benefit plans<sup>37</sup> to provide certain disclosures and confirmations to, and obtain authorization from, an independent plan fiduciary. In particular, the annual portfolio turnover must be disclosed.
  - ❑ An independent authorizing plan fiduciary must provide the fiduciary adviser with an advance written authorization for the transactions;
  - ❑ The fiduciary adviser must provide the authorizing fiduciary with information necessary to determine whether an authorization should be made, including a copy of the exemption, a form for termination, a description of the fiduciary adviser's brokerage placement practices, and any other reasonably available information regarding the matter that the authorizing fiduciary requests;
  - ❑ The fiduciary adviser must provide the authorizing fiduciary with an annual termination form, at least annually, explaining that the authorization is terminable at will, without penalty to the plan, and that failure to return the form will result in continued authorization for the fiduciary to effect or execute securities transactions on behalf of the plan;
  - ❑ The fiduciary adviser must provide the authorizing fiduciary with either (a) a confirmation slip for each individual securities transaction within 10 days of the transaction, or (b) a quarterly report containing certain financial information including the total of all securities transaction-related charges incurred by the plan;
  - ❑ The fiduciary adviser must provide the authorizing fiduciary with an annual summary of the confirmation slips or quarterly reports, containing all security transaction-related charges, the brokerage placement practices if they have changed, and a portfolio turnover ratio; and
  - ❑ A fiduciary adviser who is a discretionary plan trustee must provide the authorizing fiduciary with an annual report showing separately the commissions paid to affiliated brokers and non-affiliated brokers, on both a total dollar basis and a cents-per-share basis.

As a result of these PTEs, many fiduciary advisers to plan officials, participants, and IRA investors can and do receive indirect and sometimes variable compensation in connection with investments that they recommend.

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<sup>36</sup> PTE 86-128, 51 Fed. Reg. 41686 (Nov. 18, 1986), as amended at 67 Fed. Reg. 64137 (Oct. 17, 2002).

<sup>37</sup> The conditions provided in the exemption do not apply to transactions involving IRAs.



## 2.3 The 1975 Rule

In 1975, the Department and the IRS issued parallel rules that narrowed the statutory ERISA and IRC definitions of fiduciary investment advice (“1975 rule”). The 1975 rule established five conditions, all of which must be satisfied in connection with each instance in which advice is rendered before the person rendering the advice will be classified as having acted as a fiduciary in rendering that advice. As discussed above, the five conditions require that the adviser:

- (1) Make recommendations on investing in, purchasing or selling securities or other property, or give advice as to their value;
- (2) On a regular basis,
- (3) Pursuant to a mutual understanding that the advice;
- (4) Will serve as a primary basis for investment decisions; and
- (5) Will be individualized to the particular needs of the plan.

An investment adviser does not act as a fiduciary unless each element of the five-part test is satisfied for each instance of advice. Therefore, if a plan official hires an investment advice professional on a one-time basis to provide advice on a large complex investment, the adviser is not acting as a fiduciary, because the advice is not given on a “regular basis” as the regulation requires. Similarly, if an adviser provides individualized, paid advice to a worker nearing retirement on the purchase of an annuity, the adviser is not acting as a fiduciary, because the advice is not provided on a regular basis. This is the result even though the advice may involve the investment of a worker's entire IRA or 401(k) account balance, or defined benefit plan balance.

If the adviser is not acting as a fiduciary, the self-dealing and conflict of interest PT provisions of ERISA and the IRC do not apply. Therefore, an adviser to a plan official, participant, or IRA investor is free to self-deal by accepting variable compensation that introduces a conflict of interest into the advisory relationship. ERISA’s additional fiduciary duties of prudence and loyalty likewise do not apply and the adviser faces no liability for breaches of such duties.

Advisers may often deliberately calibrate their business practices to avoid satisfying one or more of the 1975 rule’s conditions in the course of rendering advice on the investment of plan or IRA assets. Materials describing those practices for current and prospective plan and IRA clients, such as customer agreements or advertisements, may specifically disclaim satisfaction of one or more elements of the 1975 rule.<sup>38</sup>

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<sup>38</sup> For example, one large financial services company included the following language in the fine print of its print and television advertisements specifically offering to provide one-on-one investment advice to individuals: “[g]uidance provided . . . is educational in nature, is not individualized, and is not intended to serve as the primary basis for your investment and tax-planning decisions.” Notwithstanding such disclaimers, whether the conditions are met depends on the facts and circumstances associated with each instance where advice is rendered. For example, if an IRA investor and his or her financial adviser in fact mutually understand that certain advice will serve as the primary basis for an IRA investment decision, then the third and fourth conditions are met, notwithstanding any disclaimer to the contrary that might be included in a customer agreement.

## 2.4 Relevant Advisory Opinions

From time to time, the Department issues “Advisory Opinions” (AOs). These are written interpretive statements issued by the Department to an applicant or his or her authorized representative that interpret and apply Title I of ERISA to a specific factual situation presented by the applicant. Some of these AOs have in effect further narrowed the scope of what is considered to be fiduciary investment advice under ERISA.

### 2.4.1 AO 76-75A ESOP appraisals

In AO 76-75A, the Department opined that valuations of employer securities in connection with ESOPs are not considered investment advice. As a result, under the current regulatory structure, neither the Secretary nor plan participants can hold the appraiser directly accountable for disloyal or imprudent advice about the purchase price. The sole recourse available to the Secretary and plan participants is against the trustee who relied on the advice, rather than against the professional financial expert who rendered the valuation opinion.

### 2.4.2 AO 97-15A (Frost Bank) and 2005-10A (Country Bank)

In AO 97-15A (May 22, 1997) to Frost Bank, the Department opined that, where a fiduciary advises a plan to invest in mutual funds that pay additional fees to the advising fiduciary, the advising fiduciary generally would violate ERISA section 406(b)(1). However, to the extent that the fiduciary uses every dollar of fees the mutual funds pay the fiduciary to offset fees that the plan is otherwise legally obligated to pay the fiduciary (e.g., for trustee services), section 406(b)(1) will not be violated because the fiduciary is not considered to be dealing with plan assets for his or her own account. The Department noted that the bank would be an ERISA fiduciary to the extent it would advise plan sponsors on which mutual funds to invest in or to make available to participants, or reserve the right to add or remove mutual funds that it makes available to the plans.

In a subsequent opinion, 2005-10A (May 11, 2005) issued to Country Bank, the Department confirmed that the "fee leveling or offset" approach may be applied where advisory services are delivered to an IRA and where fees are paid from either affiliated or unaffiliated mutual funds. In this case, the bank advised its clients on how to invest IRA assets in a manner consistent with five model investment strategies.

### 2.4.3 AO 2001-09A (SunAmerica), Investment Advice Programs

In Advisory Opinion 2001-09A (Dec. 14, 2011) issued on behalf of SunAmerica Retirement Markets, Inc., the Department concluded that a financial institution could offer an investment advice program to plan investors under which it would pay an independent financial expert to formulate investment recommendations using a computer model that the financial institution would furnish to plan participants to allocate their account assets among collective investment vehicles (funds) that would in turn pay varying, and therefore potentially greater, investment advisory fees to the financial institution and its affiliates without violating ERISA’s prohibited transaction rules.

As represented by the financial institution, the program worked as follows: A plan fiduciary independent of the financial institution, and its affiliates, would determine whether the plan should participate in the program and designate the investment alternatives to be offered under the plan with respect to which the financial institution would furnish recommendations to participants regarding allocations. The plan’s independent fiduciary would be provided detailed information concerning, among other things, the program, and the role of the financial expert in the

development of the asset allocations under the program. In addition, the plan's independent fiduciary would be provided, on an on-going basis, a number of disclosures concerning the program and the designated investments under the plan, including information pertaining to performance and rates of returns on designated investments, and with respect to funds advised by the financial institution designated under the arrangement, the expenses and fees of the funds, and any proposed increases in investment advisory or other fees charged.

The financial institution's decisions regarding whether to retain the financial expert were represented to be independent of the revenue generated by the asset allocations under the program. The independent financial expert's compensation would not be dependent on allocations among investment alternatives under the plan. The annual gross income of the financial expert from the financial institution and its affiliates would not exceed 5 percent of its total income.

The independent expert would have sole control over development and maintenance of the computer model that would formulate the recommendations for participants in the form of model portfolio asset allocations. The recommended allocations would reflect solely the input of participant information into computer programs utilizing methodologies and parameters provided by the financial expert and neither the financial institution, nor its affiliates, would be retained as computer programmers to formulate the model or be able to change or affect the output of the computer programs.

The Department concluded that the individual investment recommendations provided under the program would not be the result of the financial institution's exercise of authority, control, or responsibility for purposes of section ERISA 406(b) and the applicable regulations, based on (1) the fully informed approval of participation in the program by the plan's independent fiduciary, (2) the financial expert's sole discretion over the development, maintenance and oversight of the methodologies producing the investment recommendations, and the financial institution's lack of discretion over the communication to, or implementation of, investment recommendations under the program, and (3) the absence of any compensation or arrangements that were tied to the recommendation made under the program.

After the Department issued AO 2001-09A, some investment providers told the Department and Congress that they wanted to develop their own computer models and use them to provide advice to participants and beneficiaries rather than employing an independent financial expert to develop and apply the model. In response, Congress recognized the potential conflict of interest that was involved when firms used their proprietary computer models and, therefore, enacted the investment advice statutory exemption with appropriate safeguards and conditions as part of PPA.<sup>39</sup> As discussed in section 2.2.1, above, the PPA statutory exemption allows fiduciary advisers to receive indirect compensation for advice generated by their own computer models so long as certain requirements are met, including requiring an independent investment expert to certify that a computer model operates in a manner that is not biased in favor of investments offered by the investment advice provider before the computer model is used, and for an independent auditor to perform an annual audit of the arrangement for compliance with the conditions of the statutory exemption.

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<sup>39</sup> ERISA §§ 408(b)(14) and 408(g) and IRC §§ 4975(d)(17) and 408(f)(8).

#### 2.4.4 AO 2005-23A Regarding Rollovers

In AO 2005-23A, the Department addressed whether a recommendation that a participant take a distribution from his or her DC plan and roll over the funds to an IRA was subject to ERISA’s fiduciary standards and associated PT provisions of ERISA and the IRC. Specifically, the AO addressed whether a recommendation that a participant roll over an account balance to an IRA to take advantage of investment options not available under the plan would constitute “investment advice” with respect to the plan or the participant. AO 2005-23A concluded that advising a plan participant to take an otherwise permissible plan distribution, even when that advice is combined with a recommendation as to how the distribution should be invested, does not by itself constitute “investment advice” within the meaning of the 1975 rule. The Department opined that a recommendation to take a distribution is not advice or a recommendation concerning a particular investment (i.e., purchasing or selling securities or other property) as contemplated by the 1975 rule, and that any investment recommendation regarding the proceeds of such a distribution would be advice with respect to funds that are no longer plan assets. However, in instances where a plan officer or someone who is already a plan fiduciary responds to participant questions concerning the advisability of taking a distribution or the investment of amounts withdrawn from the plan, the Department opined in AO 2005-23A that the fiduciary is exercising discretionary authority respecting management of the plan and must act prudently and solely in the interest of the participant.

### 2.5 Interpretive Bulletin on Investment Education

With the increase in the number of participant-directed individual account plans and the number of investment options available to participants covered by such plans, plan sponsors and service providers have increasingly recognized the importance of providing participants and beneficiaries with information designed to assist them in making investment and retirement-related decisions appropriate to their particular situations. Concerns were expressed to the Department, however, that providing educational information to participants and beneficiaries may be viewed as rendering “investment advice for a fee or other compensation,” thereby giving rise to fiduciary status and potential liability under ERISA for investment decisions of plan participants and beneficiaries.

In response to these concerns, the Department issued Interpretive Bulletin 96-1 (IB 96-1),<sup>40</sup> which identifies the following four categories of investment-related educational materials that can be provided to participants and beneficiaries without providing fiduciary investment advice: (1) Plan Information; (2) General Financial and Investment Information; (3) Asset Allocation Models; and (4) Interactive Investment Materials. Each category of information is discussed below.

- **Plan Information** is defined as information and materials that inform a participant or beneficiary about the benefits of plan participation, the benefits of increasing plan contributions, the impact of preretirement withdrawals on retirement income, the terms of the plan, or the operation of the plan; or information regarding investment

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<sup>40</sup> Interpretive Bulletin 96-1 — Interpretive Bulletin Relating to Participant Investment Education, 29 C.F.R. § 2509.96-1 (June 11, 1996), available at: [http://www.dol.gov/ebsa/regs/fedreg/final/96\\_14093.pdf](http://www.dol.gov/ebsa/regs/fedreg/final/96_14093.pdf).

alternatives under the plan (e.g., descriptions of investment objectives and philosophies, risk and return characteristics, historical return information, or related prospectuses).

- **General Financial and Investment Information** is defined as information and materials that inform a participant or beneficiary about: (i) general financial and investment concepts, such as risk and return, diversification, dollar cost averaging, compounded return, and tax deferred investment; (ii) historic differences in rates of return between different asset classes (e.g., equities, bonds, or cash) based on standard market indices; (iii) effects of inflation; (iv) estimating future retirement income needs; (v) determining investment time horizons; and (vi) assessing risk tolerance.
- **Asset Allocation Models** is defined as information and materials (e.g., pie charts, graphs, or case studies) that provide a participant or beneficiary with models, available to all plan participants and beneficiaries, of asset allocation portfolios of hypothetical individuals with different time horizons and risk profiles.
  - The models must be based on generally accepted investment theories that take into account the historic returns of different asset classes (e.g., equities, bonds, or cash) over defined periods of time, and all material facts and assumptions on which such models are based (e.g., retirement ages, life expectancies, income levels, financial resources, replacement income ratios, inflation rates, and rates of return) must accompany the models.
  - The asset allocation models may identify specific investment alternatives available under the plan, as long as the model is accompanied by a statement indicating that other investment alternatives having similar risk and return characteristics may be available under the plan and identifying where information on those investment alternatives may be obtained.
- **Interactive Investment Materials** is defined as questionnaires, worksheets, software, and similar materials that provide a participant or beneficiary with the means to estimate future retirement income needs and assess the impact of different asset allocations on their retirement income.

## 2.6 Intersections with Other Governing Authorities

Many comments to the 2010 rulemaking emphasized the need to harmonize the Department's efforts with rulemaking activities under the Dodd-Frank Act, in particular, the SEC's standards of care for providing investment advice and the Commodity Futures Trading Commission's (CFTC) business conduct standards for swap dealers. In addition, commenters questioned the adequacy of coordination with other agencies regarding IRA products and services. They argued that subjecting SEC-related investment advisers and broker-dealers to a special set of rules for IRAs could lead to additional costs and complexities for individuals who may have several different types of accounts at the same financial institution.

In the course of developing the new proposal and related proposed prohibited transaction exemptions, the Department has consulted with staff of the SEC and other regulators on an ongoing basis regarding whether the proposals will subject investment advisers to requirements that conflict with their obligations under other federal laws. As part of this consultative process, SEC staff has provided technical assistance and information with respect to the agencies' separate regulatory provisions and responsibilities, retail investors, and the marketplace for investment

advice. As the Department moves forward with this project in accordance with the specific provisions of ERISA and the Code, it will continue to consult with staff of the SEC and other regulators on its proposals and their impact on retail investors and other regulatory regimes. One result of these discussions, particularly with staff of the CFTC and SEC, is the new provision at paragraph (b)(1)(ii) of the proposed regulations concerning counterparty transactions with swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants. Under the terms of that paragraph, such persons will not be treated as ERISA fiduciaries merely because, when acting as counterparties to swap or security-based swap transactions, they give information and perform actions required for compliance with the requirements of the business conduct standards of the Dodd-Frank Act and its implementing regulations.

In pursuing these consultations, the Department has not aimed to make the obligations of fiduciary investment advisers under ERISA and the Code identical to the duties of advice providers under the securities laws, nor could it. Even if each of the relevant agencies were to adopt an express definition of “fiduciary” that was in all respects identical, the legal consequences of the fiduciary designation likely would vary between agencies because of differences in the specific duties imposed by the different federal laws at issue. ERISA and the Code place special emphasis on the elimination or mitigation of conflicts of interest and adherence to substantive standards of conduct, as reflected in the prohibited transaction rules and ERISA’s stringent standards of fiduciary conduct. These rules complement, rather than contradict, the securities laws. The specific duties imposed on fiduciaries by ERISA and the Code stem from legislative judgments on the best way to protect the public interest in tax-preferred benefit arrangements that are critical to workers’ financial and physical health. The specific duties imposed on advisers by the SEC stem, in large part, from antifraud provisions. Accordingly, certain conflicts of interest are not themselves violations as long as they are disclosed in order to ensure that the implied representation of fairness is not misleading. In contrast, ERISA and the Code place greater emphasis on the elimination or mitigation of conflicts of interest. Thus, under ERISA and the Code, fiduciary advisers are generally prohibited from making recommendations with respect to which they have a financial conflict of interest unless the Department of Labor first grants an exemption with conditions designed to protect the interests of plan participants and IRA owners. This is true regardless of whether the fiduciary has disclosed his or her conflicts of interest to their plan or IRA customer.

Accordingly, in pursuing this rulemaking, the Department has taken great care to honor ERISA and the Code’s specific text and purposes. At the same time, however, the Department has worked hard to understand the impact of the proposed rule on firms subject to the securities laws and other federal laws, and to take the effects into account by appropriately calibrating the impact of the rule on those firms. The proposed regulation and exemptions reflect these efforts. In the Department’s view, the proposals neither undermine, nor contradict, the provisions or purposes of the securities laws. Instead, the Department has sought to draft the proposals to work in harmony with other federal laws. The Department has coordinated -- and will continue to coordinate -- its efforts with other federal agencies to ensure that the various legal regimes are appropriately harmonized to the fullest extent possible.

The Department has also consulted with the Department of the Treasury and the IRS, particularly on the subject of IRAs. Although the Department has responsibility for issuing regulations and prohibited transaction exemptions under section 4975 of the Code, which applies to IRAs, the IRS maintains general responsibility for enforcing the tax laws. The IRS' responsibilities extend to the imposition of excise taxes on fiduciaries who participate in prohibited transactions.<sup>41</sup> As a result, the Department and the IRS share responsibility for combating self-dealing by fiduciary investment advisers to tax-qualified plans and IRAs. Paragraph (e) of the proposed regulation, in particular, recognizes this jurisdictional intersection.

When the Department announced that it would issue a re-proposal, it stated that it would consider proposing new and/or amended prohibited transaction exemptions to address the concerns of commenters about the impact of the 2010 Proposal on the fee practices of brokers and advisers. Commenters had expressed concern about the applicability of longstanding exemptions granted by the Department allowing advisers to receive commissions in connection with mutual funds, securities and insurance products. As explained more fully below, the Department is also publishing in the notice section of today's Federal Register proposed prohibited transaction class exemptions to address these concerns. The Department believes that existing exemptions and these new proposed exemptions will preserve a wide variety of common fee arrangements under conditions that protect plan participants, beneficiaries and IRA owners from abusive practices and conflicted advice.

Investment advice, and the institutions and individuals who render it, are subject to a variety of other governing authorities. The accompanying diagram provides a simplified illustration of where some different authorities apply, and overlap. Whether ERISA and the IRC apply depends on whether the advised client is a plan, plan participant, or IRA investor (and whether the five conditions of the 1975 rule are met). Whether the Investment Advisers Act of 1940 (Advisers Act) and related SEC rules apply, and whether the Securities Exchange Act of 1934 and related rules of the Financial Industry Regulatory Authority (FINRA) apply, depends on the activities and business practices of the entities and individuals rendering the advice. Moreover, other authorities govern the recommending and selling of various bank and insurance products.

All of these authorities impose some standards of conduct (often including some limits on, or requirements to, disclose certain conflicts of interest) and execute and/or make available to consumers mechanisms for remedying harms arising from violations of such standards. However, to the Department's knowledge none include anti-conflict provisions approximating the PT provisions of ERISA and the IRC. Only the Advisers Act (as interpreted by courts) reliably establishes a fiduciary duty for RIAs approaching the fiduciary duties of care and loyalty established by ERISA for investment advisers to plan officials.<sup>42</sup> It appears that in enacting ERISA (and thereby establishing fiduciary duties under ERISA and PT provisions under both ERISA and the IRC) Congress established separate, and in important respects, higher protections against conflicted advice for designated, tax preferred retirement savings in the form of plans and IRAs.

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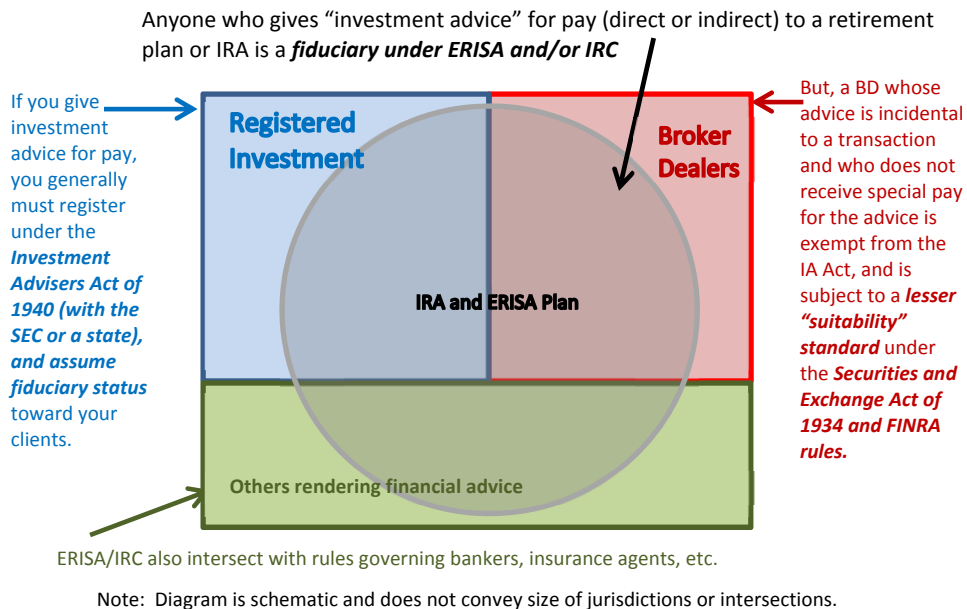
<sup>41</sup> Reorganization Plan No. 4 of 1978, 5 U.S.C. App. 214 (2010).

<sup>42</sup> "[B]roker-dealers are generally not subject to a fiduciary duty under the federal securities law." SEC Dodd-Frank Study, iv, 54-55.



**Figure 2.6-1**

### **ERISA, IRC Intersect with Other Federal Laws Governing Financial Services**



A large proportion of the financial professionals that provide investment advice to plans, plan participants, and IRA investors are either BDs or RIAs. Congress created different standards of care under the federal securities laws for BDs and RIAs.

BDs are regulated under the Securities Exchange Act of 1934. They also generally are required to become members of FINRA a self-regulatory organization (SRO). FINRA Rule 2111 establishes a "suitability" standard of conduct for BDs, which requires them to "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the [firm] or associated person to ascertain the customer's investment profile."<sup>43</sup> Although brokers are not generally subject to a fiduciary duty, under the suitability standard, as described by FINRA and the SEC, a broker's recommendations must be "consistent with the best interests of his customer." SEC Dodd-Frank Study at 60.

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<sup>43</sup> Financial Industry Regulatory Authority, *FINRA Manual*, Rule 2111, available at: [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=9859](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859). Under FINRA Rule 2111, a customer's investment profile would generally include the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs and risk tolerance. The rule also explicitly covers recommended investment strategies involving securities, including recommendations to "hold" securities. The rule, moreover, identifies the three main suitability obligations: reasonable-basis, customer-specific, and quantitative suitability. Activities such as excessive trading and churning have been found to violate quantitative suitability obligations, but not the others (SEC Dodd-Frank Study, 65).



While BDs are generally not subject to a fiduciary duty under the federal securities laws, courts have applied a fiduciary duty standard to certain actions by a BD. For example, a BD who handles a discretionary account for a customer has often been held to a fiduciary duty standard.<sup>44</sup> Such fiduciary duty may also arise in some circumstances under common law that varies by state. SEC Dodd-Frank Study at 51. In most circumstances, however, BDs are required to deal fairly with their customers and to observe high standards of commercial honor and equitable practices.

In some circumstances FINRA may also impose a “heightened” suitability standard on BDs. Rule 2330, for example, requires BDs to carefully determine the suitability before selling a variable annuity to a customer, based on such factors as the customer’s age, the likelihood of the customer being able to benefit from various features of the annuity and to take into account surrender charges.

Court decisions and SEC guidance also require a BD’s compensation for services generally to be fair and reasonable based on all the relevant circumstances. FINRA rules and guidance also prohibit charging customers unfair compensation. Charging an unfair commission would be viewed violating principles of trade under FINRA Rules.

The SEC generally must prove scienter in order to establish a violation of this duty. Thus, as noted in the SEC Dodd-Frank Study, “[t]o establish a violation of the antifraud provisions of the Securities Act Section 17(a); Exchange Act Section 10(b) and Rule 10b-5 thereunder, the Commission must establish that the broker’s unsuitable recommendation was a misrepresentation (or material omission) made with scienter (i.e., with a mental state embracing intent to deceive, manipulate or defraud,” although scienter can include reckless misconduct,” such as highly unreasonable conduct or conduct with represents “an extreme departure from the standards of ordinary care.” SEC Dodd-Frank Study at 61 (citations omitted). FINRA does not require scienter, but violations of the Self-Regulatory Organization (SRO) rules do not give right to a private cause of action (in contrast to violations of Exchange Act Section 10(b) and Exchange Act Rule 10b-5). However, customers can seek redress in arbitration proceedings.

RIAs are regulated under the Advisers Act, which generally requires anyone who is paid to provide investment advice to register with the SEC or a state and adhere to specified rules. BDs that provide investment advice are exempt from the Advisers Act as long as the provision of advice is solely incidental to a transaction and they receive no special compensation for the advice.<sup>45</sup> While the term “fiduciary” is not used in the Advisers Act, the United States Supreme Court held that section 206(2) of the Advisers Act<sup>46</sup> “reflects a Congressional recognition ‘of the delicate fiduciary nature of an investment advisory relationship’ as well as a Congressional intent to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser –

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<sup>44</sup> See *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F.Supp. 951 (E.D. Mich. 1978). A discretionary account is one in which an investor allows the broker-dealer to purchase and sell securities without having to give his or her consent for each transaction. In a nondiscretionary account the broker-dealer buys and sells securities only as ordered by the investor.

<sup>45</sup> 15 U.S.C. § 80b-2(a)(11).

<sup>46</sup> 15 U.S.C. § 80b-6(2). This is an anti-fraud provision that prohibits investment advisers from engaging “in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.”

consciously or unconsciously – to render advice which is not disinterested.”<sup>47</sup> 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 and thus to achieve a high standard of business ethics in the securities industry.”<sup>48</sup>

According to the SEC, “the Investment Advisers Act imposes on RIAs an affirmative duty to their clients of utmost good faith, full and fair disclosure of all material facts, and an obligation to employ reasonable care to avoid misleading their clients.”<sup>49</sup> As fiduciaries, RIAs owe their clients a duty to provide only suitable investment advice. This duty generally requires a RIA to determine that the investment advice it gives to a client is suitable for the client, taking into consideration the client’s financial situation, investment experience, and investment objectives.<sup>50</sup> RIAs must employ reasonable care to avoid misleading clients and must eliminate, or at least disclose, all conflicts of interest that might incline them to render advice that is not disinterested. If RIAs do not avoid a conflict of interest that could impact the partiality of their advice, they must provide full and frank disclosure of the conflict to their clients. They cannot use their clients’ assets for their own benefit or the benefit of other clients, except with their clients’ consent.<sup>51</sup> These Advisers Act standards are in some important respects not as stringent as standards found in ERISA and the IRC. In particular, the Advisers Act generally permits self-dealing transactions that would largely be prohibited under ERISA and the IRC, as long as the RIA fully discloses the conflict to the client. Further, because many of the Adviser Act standards are outgrowths of the antifraud provisions of federal securities law, a private action to establish a violation of those provisions generally requires proving that the adviser acted with the intent to deceive, manipulate, or defraud his or her customer. This is a much more difficult standard of proof than required under ERISA and the IRC.<sup>52</sup>

The agreement between a broker-dealer and a customer will generally require that the customer seek redress for disputes through the FINRA arbitration process except in cases when advisers are not FINRA members. RIAs are not required to use FINRA’s arbitration process, but FINRA members may do so, and it is not uncommon for RIAs to use arbitration, as a means of resolving disputes. The arbitrator can award monetary relief for an investor. Additionally, FINRA can suspend or cancel the registration of a brokerage firm or broker who does not comply with an arbitration award or settlement related to an arbitration or mediation. The broker or firm can legitimately delay paying an award, however, if it has filed a motion to vacate or modify the award in court. Arbitration may afford broader remedies than are available to investors in Federal court

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<sup>47</sup> SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963).

<sup>48</sup> Ibid., 186.

<sup>49</sup> Investment Advisers Act Release No. 1393 (Nov. 29, 1993). This Release references the Supreme Court decision in *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

<sup>50</sup> Investment Advisers Act Release No. 1406 (March 16, 1994).

<sup>51</sup> See “Information for Newly-Registered Investment Advisers,” prepared by the staff of the SEC’s Division of Investment Management and Office of Compliance Inspections and Examinations, available at: <http://www.sec.gov/divisions/investment/adoverview.htm>.

<sup>52</sup> The SEC can enforce breaches of fiduciary duties under Advisers Act Section 206, however, without proving scienter. In addition, some states permit claims based on breach of fiduciary duty, negligence, or fraud.

for careless investment advice. The Advisers Act provides limited remedies to individual investors.

Remedies available under State securities laws would not generally afford the same protection against conflicts of interest. As with federal securities laws, they focus more on issues of fraud, suitability or careless execution of transactions. Moreover, ERISA may preempt state contract and tort laws that might otherwise apply to fiduciary breaches involving investments by employee benefit plans.

Another significant difference between the standards applicable to BDs and RIAs under the federal securities laws involves principal trading. The Advisers Act prohibits RIAs from trading securities with clients out of their own account unless the RIA provides advance written disclosure to the client and obtains consent.<sup>53</sup> The Securities Exchange Act of 1934 does not impose a similar restriction on BDs.

Insurance regulation in the US resides primarily in the states. Certain retail insurance products known as variable annuities,<sup>54</sup> however, are also subject to federal regulation as mutual funds.

Insurance agents and brokers who advise retail customers generally are not held to fiduciary standards of conduct, although they may be subject to state laws and regulations. Insurance products' features and costs are highly complex. Insurance agents' and brokers' allegiances are variable and vague. The brokers hold large advantages over their customers in knowledge, power and sophistication, and are often highly conflicted. The relationship between insurance agents and retail investors is characterized by the same asymmetries of expertise and information as characterizes the relationship between broker-dealers and their retail customers.<sup>55</sup>

## 2.6.1 SEC Staff Dodd-Frank Study

The Dodd-Frank Act required the SEC to conduct a study to evaluate the effectiveness of existing legal or regulatory standards of care for providing investment advice to retail customers, and whether there are gaps, shortcomings, or overlaps in the protection afforded retail customers that should be addressed by rule or statute. In January 2011, the SEC staff published its study, which included recommendations to the Commission.

According to the study, the SEC staff's recommendations to the Commission are intended to make consistent the standards of conduct applying when retail customers receive personalized investment advice about securities from BDs or RIAs. The SEC staff recommends establishing a

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<sup>53</sup> 15 U.S.C. § 80b-6(3).

<sup>54</sup> The SEC defines the term "Variable Annuity" as a contract between the consumer and an insurance company, under which the purchaser makes a lump-sum payment or series of payments. In return, the insurer agrees to make periodic payments beginning immediately or at some future date. The purchaser can choose to invest the purchase payments in a range of investment options, which are typically mutual funds. The value of the account in a variable annuity will vary, depending on the performance of the chosen investment options. *See* <http://www.sec.gov/answers/varann.htm>.

<sup>55</sup> The above discussion is not intended as a full statement of the requirements of the federal securities laws and SEC and FINRA rules. See the SEC staff Study on Investment Advisers and Broker-Dealers (Jan. 2011) for a more complete description of relevant documents.

uniform fiduciary standard for RIAs and BDs when providing investment advice about securities to retail customers; the standard should be consistent with the current RIA standard. The recommendations also include suggestions to harmonize the BD and RIA regulatory regimes, with a view toward enhancing their effectiveness in the retail marketplace.

The SEC has not yet taken any position on its staff's recommendations. On March 1, 2013, the SEC formally requested data and other information from the public and interested parties about the benefits and costs of the current standards of conduct for BDs and RIAs when providing advice to retail customers, as well as alternative approaches to the standards of conduct.<sup>56</sup> The SEC is currently studying the responses it received in response to the request.

## 2.6.2 Relevant Dodd-Frank Provisions

Section 911 of the Dodd-Frank Act established a new Investor Advisory Committee (IAC) to advise the SEC on regulatory priorities, the regulation of securities products, trading strategies, fee structures, the effectiveness of disclosures, and on initiatives to protect investor interests and to promote investor confidence and the integrity of the securities marketplace. The Dodd-Frank Act authorizes the IAC to submit findings and recommendations for review and consideration by the SEC.

In November 2013, the IAC recommended a framework for a uniform fiduciary duty governing BDs and RIAs under the securities laws.<sup>57</sup> The IAC's favored approach is for the SEC to use its rulemaking authority under the Advisers Act to propose rules that narrow the Broker-Dealer Exclusion from the Advisers Act, while providing a safe harbor for brokers who do not engage in broader investment advisory services or hold themselves out as providing such based either on the titles they use or the manner in which they market their services.

The IAC stated that one benefit of this approach is that it would provide a firm assurance that the fiduciary standard for investment advice by BDs and RIAs would be the same and would be no weaker than the existing standard. It also "would ensure that the existing legal precedent, staff interpretations, and no-action positions developed under the Advisers Act and accompanying rules would also apply to investment advice by brokers."<sup>58</sup> A BD that wishes to take advantage of the safe harbor could do so by limiting itself to transaction-specific recommendations, avoiding holding itself out as an adviser or as providing advisory services, and making an affirmative disclosure that the BD is acting solely as a salesperson and not as an objective adviser.

The IAC also made an alternative recommendation for rulemaking pursuant to the Exchange Act, as amended by Section 913(g) of the SEC Dodd-Frank Study 2011, 65, to arrive at a rule based on the SEC Dodd-Frank Study 2011, 65 of the Dodd-Frank Act to incorporate an enforceable principles-based obligation to act in the best interest of the customer. The IAC

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<sup>56</sup> SEC Release No. 69103, "Duties of Brokers, Dealers and Investment Advisers" (March 1, 2013); available at: <http://www.sec.gov/rules/other/2013/34-69013.pdf>.

<sup>57</sup> SEC, "Recommendation of the Investor Advisory Committee: Broker-Dealer Fiduciary Duty" (Nov. 2013); available at: <http://www.sec.gov/spotlight/investor-advisory-committee-2012/fiduciary-duty-recommendation-2013.pdf>.

<sup>58</sup> *Ibid.*, 5.

acknowledged that the SEC Dodd-Frank Study 2011, 65 poses some “significant implementation challenges.”<sup>59</sup> The IAC stated that the SEC Dodd-Frank Study 2011, 65 includes provisions specifying that certain BD business practices — such as earning commissions, selling proprietary products, and selling from a limited menu of products — should not automatically be deemed to constitute a violation of the fiduciary standard. It intentionally avoids applying provisions of the Advisers Act with regard to principal trades to brokers, but without specifying how principal trades by brokers should be regulated under a fiduciary standard. Moreover, it specifies that brokers would not necessarily have an on-going duty of care after the advice is rendered. The IAC concluded that depending on how certain of these provisions are interpreted and enforced — particularly those regarding selling from a limited menu of products and the on-going duty of care — such an approach could result in a significant weakening of the existing Advisers Act.<sup>60</sup>

Nonetheless, should the SEC choose to conduct rulemaking under the Exchange Act, the IAC supports a three-prong approach:

- To ensure the standard is no weaker than the existing Advisers Act standard, any fiduciary rule adopted must incorporate an enforceable, principles-based obligation to act in the best interests of the customer.
- To ensure the continued availability of transaction-based recommendations, any standard adopted should be sufficiently flexible to permit the existence of certain sales-related conflicts of interest, subject to a requirement that any such conflicts be fully disclosed and appropriately managed.
- While some forms of transaction-based payments would be acceptable under a fiduciary standard, the SEC should fulfill the Dodd-Frank Act’s mandate to “examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the [SEC] deems contrary to the public interest and the protection of investors.”

The IAC also recommended that the SEC adopt a uniform, plain English disclosure document to be provided to customers and potential customers of BDs and RIAs at the start of an engagement, and periodically thereafter, that covers basic information about the nature of services offered, fees and compensation, conflicts of interest and disciplinary record. The IAC explained that disclosure alone is not sufficient to address the harm that can result when BDs act on conflicts of interest, but stated that it believes improved disclosure should be included as part any fiduciary rulemaking. The IAC suggested that the Form ADV provides a reasonable starting point for designing a new disclosure document, and encouraged the SEC to work with disclosure design experts to ensure that any document it develops is effective in conveying the relevant information to investors in a way that enables them to act on the information.

A BD’s or RIA’s status under the federal securities laws is not directly relevant to the determination of fiduciary status under ERISA and the IRC. Rather, fiduciary status under ERISA and the IRC is determined by the functions that BDs and RIAs perform with respect to plan and

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<sup>59</sup> Ibid., 7.

<sup>60</sup> Ibid.

IRA investors. A BD generally is not a fiduciary under federal securities laws. However, if the BD meets all five requirements of the five-part test and regularly advises a plan participant or IRA investor on specific investments, and all parties understand that the participant or IRA investor relies primarily on the BD's advice, the BD is an investment advice fiduciary under the 1975 rule. RIAs generally are fiduciaries under federal securities laws, but they are investment advice fiduciaries under ERISA or the IRC only if they advise plan participants or IRA investors and meet the 1975 rule's five-part test.

The intersections between ERISA and the IRC on one hand and federal securities laws on the other follow from terms in the statutes. Because the statutes differ in material ways, and reflect a deliberate Congressional choice to apply different standards, agency rules and other guidance, DOL and SEC rules will necessarily vary in substance, even as the agencies work to ensure consistency. Many RIAs and some BDs that provide services to plan officials currently understand that they are subject to both ERISA and relevant SEC rules and structure their practices to comply with both, often taking advantage of one or more available PTEs.

### **2.6.3 FINRA Conflicts of Interest Report**

FINRA began a conflicts of interest initiative in 2012 to review BDs' approaches to conflicts management and to identify effective practices. FINRA used firms' responses to a FINRA conflicts of interest letter, in-person meetings, and a follow-up compensation questionnaire to develop observations detailed in an October 2013 report.<sup>61</sup> One area of focus in the FINRA report is firms' approaches to identifying and managing conflicts with respect to compensating those acting as brokers to private clients. In response to FINRA's letter, firms summarized the most significant conflicts they face in their businesses. The firms identified potential conflicts of interest related to their retail and private wealth business that relate mostly to the pursuit of revenue by the firm or its registered representatives at a client's expense including the following:

- Firms offering, or promoting particular products or product providers because of their revenue or profit potential, such as through revenue sharing;
- Registered representatives offering or giving preference to certain products or services because of their income potential;
- Registered representatives recommending transactions in order to generate revenue without due regard to suitability;
- Firms offering incentive programs to employees; and
- Firms or employees giving preference to proprietary products.

The report highlights the following as examples of effective practices used by firms to mitigate instances where the compensation structure may potentially affect the behavior of registered representatives:

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<sup>61</sup> FINRA, "Report on Conflicts of Interest" (Oct. 2013); available at: <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p359971.pdf>.

- Avoiding creating compensation thresholds that enable a registered representative to increase his or her compensation disproportionately through an incremental increase in sales;
- Monitoring activity of representatives approaching compensation thresholds such as higher payout percentages, back-end bonuses, or participation in a recognition club, such as a President’s Club;
- Maintaining neutral compensation grids that pay the representative a flat payout percentage regardless of product type sold;
- Refraining from providing higher compensation or other rewards for the sale of proprietary products or products for which the firm has entered into revenue sharing arrangements;
- Monitoring the suitability of recommendations around key liquidity events in the investor’s lifecycle where the recommendation is particularly significant (e.g., when an investor rolls over his or her pension or 401(k) account); and
- Developing metrics for good and bad behavior (red flag processes) and using claw backs<sup>62</sup> to adjust compensation for employees who do not properly manage conflicts of interest.

The report states that conflicts also may arise in recommending the type of account a client should open with a firm. For example, firms that are dually registered as a BD and an RIA should consider whether a commission-based or fee-based account is more appropriate for a customer. The report notes that depending on the circumstances, fee-based accounts may be preferable for customers with a fair amount of trading activity or the desire for active account monitoring and ongoing advice, while commission-based accounts may be more cost-effective or appropriate for customers with low trading activity. The report recommends that firms examine their procedures to ensure that they are reasonably designed to monitor inappropriate behavior.

## 2.7 2010 Proposal

Since 1978, the Department has been solely responsible for issuing rules and other interpretations of the PT provisions of both ERISA and the IRC.<sup>63</sup> In October 2010, the Department proposed amendments to the 1975 rule that would have broadened the definition of fiduciary investment advice under both ERISA and the IRC, making more investment advisory activities fiduciary in nature (“2010 proposal”).<sup>64</sup> Under the 2010 proposal, advice could be fiduciary if it consisted of a single recommendation given once (relaxing the 1975 rule’s requirement that the advice be given on a regular basis). Advice would be fiduciary if it was

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<sup>62</sup> A “claw back” generally refers to a contractual clause allowing a firm to revoke some or all of an employee’s deferred compensation.

<sup>63</sup> Reorganization Plan No. 4 of 1978, 5 U.S.C. App. (2010).

<sup>64</sup> EBSA Proposed Rule, “Definition of the Term ‘Fiduciary,’” 75 Fed. Reg. 65263, (Dec. 22, 2010); available at: <http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=24328>. For an analysis of the proposed rule, see Munnell, Webb and Vitagliano (Working Paper 2013-4).



agreed that the advice may be considered in investment decisions, or if the adviser was otherwise a fiduciary to the plan or IRA, represented that he or she was a fiduciary, or was a RIA (relaxing the 1975 rule's requirement that the advice be mutually agreed to serve as a primary basis for investment decisions). The 2010 proposal also generally would have treated the valuation of plan or IRA assets (including employer securities held by ESOPs) as fiduciary advice, superseding AO 76-65A. Recommendations made as part of certain pure sales activities, however, would not have constituted fiduciary investment advice under the 2010 proposal.

The 2010 proposal was motivated by the Department's concern that conflicts of interest often compromised advice rendered to plan officials, participants, and IRA investors. In addition, the Department's experience enforcing the fiduciary provisions of ERISA had shown that abuses by plan advisers were numerous and difficult to remedy. By broadening the fiduciary definition, the 2010 proposal would have extended the ERISA and IRC PT provisions to cover more advice rendered to plan officials, plan participants and IRA investors, thereby limiting the self-dealing that can compromise that advice. It also would have extended ERISA's statutory fiduciary duties and liability for any breaches of such duties to more advice rendered to plan investors, thereby raising the standards of conduct applicable to the professionals rendering advice and holding those professionals accountable for adhering to the standards. In issuing the 2010 proposal, the Department presented a Regulatory Impact Analysis pursuant to Executive Order 12866, which concluded that the 2010 proposal's benefits would justify its cost.

The 2010 proposal elicited extensive comments and prompted vigorous debate. The Department heard from a very wide range of stakeholders in a variety of forums. Some feedback was positive, but financial services industry feedback was largely negative. Some of the negative feedback was specific, accepting at least some of the Department's premises and aims, but stating that particular proposed provisions were poorly calibrated or targeted to achieve the Department's stated aims. Some stakeholders requested the Department issue PTEs to permit certain existing business practices to persist that would involve prohibited fiduciary self-dealing under the 2010 proposal. Some of the negative feedback was broader. For example, some comments rejected the premise that conflicts of interest sometimes compromise advice, maintaining that the Department had not provided adequate evidence of the harm resulting from conflicted advice. Some commenters argued that the Department should take no regulatory action in connection with investment advice until the SEC completes its consideration of its staff's recommendations on a uniform fiduciary standard for BDs and RIAs under the securities laws. Some argued that the fiduciary duty of loyalty might conflict with an appraiser's duty to impartially assess value, and that treating appraisals as fiduciary advice would make valuations more costly for ESOPs and other plans. Some commenters complained that the Department's Regulatory Impact Analysis was inadequate, and that it neglected to consider certain potential major, negative impacts on the retail IRA market. Two formal written comments provided alternative analysis predicting that the 2010 proposal would have highly negative impacts on the IRA market and small investors.<sup>65</sup>

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<sup>65</sup> See Oliver Wyman report, "Assessment of the Impact of the Department of Labor's Proposed 'Fiduciary' Definition Rule on IRA Consumers," (Apr. 12, 2011) (data for Department use submitted Jan. 2012), available at: <http://www.dol.gov/ebsa/pdf/WymanStudy041211.pdf>; and Daniel R. Fischel and Todd D. Kendall, Comment To The Department Of Labor On A Proposed Rule Regarding Fiduciary Status Under ERISA,"(Apr. 12, 2011),



To obtain additional feedback on the 2010 proposal and associated policy questions, the Department held two full days of open public hearings on March 1 and 2, 2011, taking testimony from 38 witnesses and receiving more than 60 post-hearing written comments. The Department also met individually with many stakeholder groups that sought additional opportunities to explain their views. Along the way the Department heard from various members of Congress, representatives of many segments of the financial services industry, as well as plan sponsors, advocates for small investors, plan participants, service providers, and academics who study the roles of financial intermediaries and the effects of conflicts of interest between consumers and their expert advisers.

In response to this feedback the Department announced in September 2011 that it intended to withdraw the 2010 proposal and develop and issue a new proposal in due course. The Department also expressed its intention to provide a more thorough and robust regulatory impact analysis with the new proposal than was provided with the 2010 proposal and this document carries out that intent.

## **2.8 New proposal**

As compared with the 2010 proposal, the Department's new proposal is supported by a more robust economic analysis. Also unlike the 2010 proposal, the current proposed regulation includes proposed new and amended PTEs permitting fiduciary investment advisers to engage in certain limited types of self-dealing or other conflicted transactions, subject to conditions that are protective of the rights of plans, plan participants and beneficiaries, and IRA investors (collectively, "new proposal"). Like the 2010 proposal, the new proposal would revise the definition of fiduciary investment advice under both ERISA and the IRC, making more advisory activities fiduciary in nature. However, the new proposal differs from the 2010 proposal in many important details, reflecting the Department's consideration of comments received on the 2010 proposal. In addition, and also in response to comments, the new proposal is supported by this comprehensive economic analysis that takes into account the proposed rule's impact on the retail IRA market.

### **2.8.1 Amendments to 1975 Rule**

The new proposal distinguishes situations in which plan sponsors or other plan officials, plan participants or beneficiaries, or IRA investors generally would and should expect to receive impartial recommendations they can trust from situations where no such impartiality or trust should be expected. Based on public input and the economic evidence presented later in this document, the Department reasoned that the former situations generally merit the application of fiduciary standards, while the latter generally do not. Moreover, this distinction appears to be consistent with the relevant statutory provisions of ERISA and the IRC, which specify that a

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available at: <http://www.dol.gov/ebsa/pdf/1210-AB32-PH056.pdf>. A detailed response to these comments is provided in Chapter 4.

person who provides investment advice for a fee is a fiduciary rather than the interpretation contained in DOL's 1975 regulation and the succeeding AOs described earlier in this chapter.

The new proposal generally covers the following categories of advice: (1) investment recommendations, including a recommendation to take a distribution of benefits or as to the investment of securities or other property to be rolled over or otherwise distributed from a plan; (2) investment management recommendations, including recommendations as to the management of securities or other property to be rolled over or otherwise distributed from the plan; or (3) appraisals, fairness opinions, or similar statements whether verbal or written concerning the value of securities or other property provided in connection with a specific transaction (except in the context of ESOP valuations, which will continue to be excepted consistent with AO 76-75A); or (4) recommendations of persons to provide any advice described in 1-3 above for a fee or other compensation. Persons who provide such advice fall within the general definition of a fiduciary if they either (a) represent that they are acting as an ERISA fiduciary with respect to the advice; or (b) provide the advice pursuant to an agreement, arrangement, or understanding that the advice is individualized or specifically directed to the advice recipient for consideration in making investment or investment management decisions regarding plan assets.

Similar to the approach used in the 2010 Proposal, the new proposal specifies certain types of conduct that would not result in fiduciary status for an investment adviser under ERISA and/or the IRC. Specifically, the new proposal provides a series of carve-outs for communications that should not be viewed as fiduciary in nature, because they involve sales activities or investment education by individuals and entities who do not represent to plan sponsors, participants, and beneficiaries that they are acting as ERISA fiduciaries. Subject to specified conditions, these carve-outs cover the following:

- Statements or recommendations made to a plan fiduciary by a counterparty acting in an arm's length transaction with a plan with more than 100 participants or who the counterparty reasonably believes has responsibility for managing at least \$100 million in employee benefit plan assets;
- Offers or recommendations to plan fiduciaries to enter into a swap or security-based swap regulated under the Securities Exchange Act or the Commodity Exchange Act;
- Statements or recommendations provided to an ERISA plan fiduciary by an employee of the plan sponsor if the employee receives no fee beyond his or her normal compensation;
- Marketing or making available a platform of investment alternatives to be selected by a plan fiduciary for a participant-directed plan;
- The identification of investment alternatives that meet objective criteria specified by a plan fiduciary or the provision of objective financial data to the fiduciary;
- The provision of an appraisal, fairness opinion or statement of value to a collective investment vehicle or a plan for meeting reporting and disclosure requirements; and
- Information and materials that constitute "investment or retirement education" as set forth in the proposal.

## **2.8.2 Proposed PTEs**

The new proposal includes several proposed new and amended class PTEs, which together would permit fiduciary investment advisers to plan and IRA investors to engage in certain

specified types of transactions that would otherwise be prohibited subject to a number of protective conditions.

As discussed above, under the new proposal, a person would be an investment advice fiduciary if he or she provides a recommendation to a plan, plan fiduciary, plan participant or beneficiary or IRA investor regarding the advisability of acquiring, holding, disposing or exchanging securities or other property pursuant to a written or verbal agreement, arrangement or understanding that the advice is specifically directed to the advice recipient for consideration in making investment decisions with respect to securities or other property. Once a person is an investment advice fiduciary, the person is prohibited by the PT provisions from engaging in certain kinds of transactions involving the plan, including transactions in which the fiduciary affects or increases his or her own compensation or that of a person in which such fiduciary has an interest which may affect the exercise of the fiduciary's best judgment. Receipt by a fiduciary of certain common types of fees and compensation, such as brokerage or insurance commissions, in connection with investment transactions entered into by the plan, fall within the prohibition.

The Department recognizes the concerns expressed in the comments received from representatives of BDs and other IRA advisers regarding the potential disruption to current fee arrangements that would arise by applying the IRC PT rules more broadly in the retail IRA market. Therefore, simultaneous with the publication of these proposed regulations, the Department is proposing several new and amended PTEs that would allow certain currently common fee practices to persist subject to conditions provided in the exemption that protect plans, plan participants, and IRA investors from advisers' conflicts of interest.

#### **2.8.2.1 Best Interest Contract Exemption**

Many comments on the 2010 Proposal requested relief for the receipt by investment advice fiduciaries of a variety of fees and compensation resulting from agency transactions involving plans and IRAs. These transactions involve, according to the commenters, investments in mutual fund shares, collective trusts, insurance products, commodities, futures and private funds. The Department was urged to propose an exemption that would permit investment advice fiduciaries to continue to recommend investments historically used by plans and IRA investors.

In response to these comments, the Department is proposing the Best Interest Contract Exemption that would permit investment advice fiduciaries and certain related entities to receive compensation for services provided in connection with the purchase, sale, or holding by plan participants, beneficiaries, IRAs and small employee benefit plans of certain assets as a result of the investment advice. The Best Interest Contract Exemption would permit fiduciary advisers and their firms to receive fees such as commissions, 12b-1 fees, and revenue sharing in connection with investment transactions by the plan participants, beneficiaries, IRAs and small plans, thus preserving many current fee practices.

The exemption would require fiduciary advisers and their firms to enter into a written contract with the plan/IRA investor. The contract would not be permitted to contain exculpatory provisions disclaiming or otherwise limiting liability of the fiduciary adviser and firm for violation of the contract's terms. The imposition of the contract requirement would provide IRA investors with protections they do not otherwise have under ERISA or the IRC. Some of the main conditions of the exemptions state that:

- The contract must state that the adviser and firm are fiduciaries to the extent they make investment recommendations.

- The contract also must provide that the adviser and firm will adhere to impartial conduct standards including: acting in the “best interest” of the plan/IRA investor, charging no more than reasonable compensation and not making misleading statements.
- The adviser and firm must warrant in the contract that they will comply with applicable federal and state law related to the provision of advice and the investment transaction.
- The adviser’s firm must warrant in the contract that it has put in place policies and procedures to mitigate materials conflicts of interest and to ensure compliance with the impartial conduct standards. This includes a warranty that the firm does not allow employment incentives that would encourage advisers to violate the best interest standard.
- Under the best interest standard, advice must reflect the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person would exercise based on the investment objectives, risk tolerance, financial circumstances and needs of the plan or IRA Investor without regard to the financial or other interests of the adviser, firm, or any affiliate, related entity or other parties.
- The Best Interest Contract Exemption would also require that if firms limit recommendations based on proprietary products or receipt of third party payments or for other reasons they must disclose those limitations, and make a specific determination that the limitation does not prevent the adviser from providing investment advice that is in the best interest of the firm’s plan and IRA clients or otherwise adhering to the impartial conduct standards. The adviser must further notify the plan or IRA investor if the adviser does not recommend a sufficiently broad range of assets to meet the plan’s or IRA investor’s needs. Payments received by such firms must be reasonable in relation to a specific service rendered in exchange for the payment.
- The Best Interest Contract Exemption will require firms to provide customers a chart with respect to the recommended investment before execution of the purchase. Among other things, the chart would show the total cost of the investment, including the acquisition cost (such as commissions), ongoing costs, (such as revenue sharing), disposition costs and other costs that reduce the investment’s return. On an annual basis, the customer must receive a summary of the investments purchased or sold, and the adviser’s and financial institution’s total compensation as a result of the listed investments over the period.<sup>66</sup> Firms must

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<sup>66</sup> For securities, this disclosure regime is designed to supplement current SEC and FINRA disclosure requirements. For example, RIAs disclose whom they are compensated by in general with the Form ADV (Part 2A). SEC Dodd Frank Report (2011) at, 40, In addition, the fees and expenses related to a mutual fund are disclosed in the fund’s prospectus. FINRA rules also require disclosure of certain obvious conflicts such as if the BD is trading as a principal or acting as a market maker for the recommended security. Case law has determined that BDs should provide additional disclosures necessary for customers to evaluate a recommendation. *Ibid.*, 56. The chart described here, however, provides information on the dollar amount of costs that flow from the particular

also create a public webpage disclosing their compensation arrangements with the third parties whose products they recommend. Firms would also be required to retain specified data on investments and returns for six years to enable later analysis by the Department.

### 2.8.2.2 Principal Transaction PTE

Commenters responding to the 2010 Proposal also indicated that if the current regulation is amended, the entities that would be newly defined as investment advice fiduciaries would need exemptive relief for principal transactions between a plan or IRA and a fiduciary adviser. In this regard, both ERISA and the IRC prohibit a fiduciary from dealing with the assets of the plan or IRA investor in his or her own interest or for his or her own account. ERISA further prohibits a fiduciary from, in his or her individual or any other capacity, acting in any transaction involving the plan on behalf of a party (or representing a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries. As a result, the purchase or sale of a security in a principal transaction between a plan or IRA investor and an investment advice fiduciary, resulting from the fiduciary's provision of investment advice within the meaning of 29 CFR §2510.3-21 to the plan raises serious issues under ERISA and the IRC.

The Department recognizes that broker-dealers view the ability to execute principal transactions as integral to the efficient distribution of fixed income securities and it has carefully considered the commenters' requests for exemptive relief based on the 2010 Proposal. The Department notes that, as further discussed below, modifications to the 2010 Proposal may address some of the concerns originally voiced by the commenters. Moreover, there are existing statutory and administrative exemptions that provide prohibited transaction relief for some principal transactions.

As part of this regulatory package, the Department is proposing relief for principal transactions in certain debt securities between a plan or IRA and an investment advice fiduciary where the principal transaction is a result of the provision of investment advice to a plan or IRA by the investment advice fiduciary. While commenters requested relief with respect to a broad range of principal transactions (e.g., those involving equities, debt securities, futures, currencies, etc.), the Department has elected to propose relief solely with respect to debt securities. The Department believes that debt securities uniquely represent a category of investments that are widely and deeply held, yet are still reliant on principal transactions for the majority of executions. Like the Best Interest Contract Exemption, the Principal Transaction PTE would require that the firm and the adviser contractually commit to adhere to the impartial conduct standards, warrant as to compliance with applicable federal and state law, and the firm would further be required to warrant that it has adopted policies and procedures designed to mitigate the impact of material conflicts of interest and ensure that the individual advisers adhere to the impartial conduct standards. Certain

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transaction recommended by the provider. This customized information, together with the timing requirement should give retirement plan customers significant assistance in evaluating the cost of an investment and the adviser's and financial institution's potential conflicts.

disclosures would be required and the plan or IRA investor would be required to consent to the principal transaction.

### **2.8.2.3 PTE 75-1, Part V Amendment**

An existing class exemption, PTE 75-1, Part V, provides relief for extensions of credit to plans by BDs. Under the exemption, BDs who possess or exercise any discretionary authority or control (except as a directed trustee) with respect to the investment of the plan assets involved in the transaction, or render investment advice with respect to those assets, may not receive compensation in return for the extension of credit. Commenters responding to the 2010 proposal requested that the Department provide exemptive relief for compensation for extensions of credit to a plan or IRA investor by investment advice fiduciaries, because many BDs that have historically relied upon the relief provided by PTE 75-1, Part V, would not be able to rely on such relief if they became investment advice fiduciaries under the new proposal.

The Department is proposing to amend PTE 75-1, Part V, by adding a new section that would provide an exception to the requirement that fiduciaries not receive compensation under the exemption. The amendment would provide that an investment advice fiduciary may receive reasonable compensation for extending credit to a plan or IRA to avoid a failed purchase or sale of securities involving the plan or IRA subject to several conditions. The potential failure of the purchase or sale of the securities may not be the result of the action or inaction by the broker-dealer or any affiliate.

Additionally, the terms of the extension of credit must be at least as favorable to the plan or IRA as the terms available in an arm's length transaction between unaffiliated parties. Finally, the plan or IRA investor must receive written disclosure of certain terms prior to the extension of credit. This disclosure does not need to be made on a transaction-by-transaction basis, and can be part of an account opening agreement. The disclosure must include the rate of interest or other fees that will be charged on such extension of credit, and the method of determining the balance upon which interest will be charged. The plan or IRA must additionally be provided with prior written disclosure of any changes to these terms.

### **2.8.2.4 PTE 86-128 Amendment**

Another existing class exemption, PTE 86-128, provides relief for an investment advice fiduciary's use of its authority to cause a plan to pay a fee to such fiduciary or its affiliate for effecting or executing securities transactions. The exemption also provides relief for an investment advice fiduciary to act as the agent in an agency cross transaction for both the plan and one or more other parties to the transaction, and to receive reasonable compensation therefor from one or more other parties to the transaction.

The Department is proposing to amend PTE 86-128 to add a new covered transaction that would permit certain fiduciaries that are BDs (and who are not the principal underwriter for or affiliated with a mutual fund) to use their authority to cause plans or IRAs to purchase mutual fund shares in riskless principal transactions from the fiduciary and receive a commission in connection with the transaction. Relief for this transaction is currently available in a different class exemption, PTE 75-1, Part II (2). As the Department believes that this transaction should be engaged in pursuant to conditions set forth in PTE 86-128, it is proposing to move relief for this transaction to PTE 86-128 and to revoke PTE 75-1, Part II(2).

The Department also is proposing an amendment to PTE 86-128 that would eliminate relief provided by PTE 86-128 to fiduciary investment advisers to IRAs. The proposal reflects the



Department's view that the provisions of the Best Interest Contract Exemption better protect the interests of IRAs with respect to investment advice regarding securities transactions.

### 2.8.2.5 Proposed Amendment to PTE 84-24

The Department is proposing to amend PTE 84-24 to require all fiduciaries relying on the exemption to adhere to the same impartial conduct standards required in the Best Interest Contract Exemption and the Principal Transactions Exemption. At the same time, the proposed amendment would revoke PTE 84-24 in part so that investment advice fiduciaries to IRA owners would not be able to rely on PTE 84-24 with respect to (1) transactions involving variable annuity contracts and other annuity contracts that constitute securities under federal securities laws, and (2) transactions involving the purchase of mutual fund shares. Investment advice fiduciaries would instead be required to rely on the Best Interest Contract Exemption for compensation received in connection with these transactions. The Department believes that investment advice transactions involving annuity contracts that are treated as securities and transactions involving the purchase of mutual fund shares should occur under the conditions of the Best Interest Contract Exemption due to the similarity of these investments, including their distribution channels and disclosure obligations, to other investments covered in the Best Interest Contract Exemption. Investment advice fiduciaries to ERISA plans would remain eligible for relief under the exemption with respect to transactions involving all insurance and annuity contracts and mutual fund shares and the receipt of commissions allowable under that exemption and investment advice fiduciaries to IRAs could still receive commissions for transactions involving non-securities insurance and annuity contracts, but they would be required to comply with all the protective conditions, described above.

The proposed amendment to PTE 84-24 also would require the fiduciary engaging in a transaction covered by the exemption to maintain records necessary to enable the Department and IRA owners (and certain persons described in the proposed amendment) to determine whether the conditions of this exemption have been met. This requirement would replace the more limited existing recordkeeping requirement in the current exemption. The proposed recordkeeping requirement is intended to be protective of rights of plan participants and beneficiaries and IRA owners by ensuring they and the Department can confirm the conditions of the exemption have been satisfied.

### 2.8.2.6 Proposed Amendments to PTEs 75-1, Part III, 75-1, Part IV, 77-4, 80-83, and 83-1

The proposal would amend prohibited transaction exemptions 75-1, Part III, 75-1, Part IV, 77-4, 80-83, and 83-1. These exemptions provide the following relief:

- PTE 75-1, Part III permits a fiduciary to use its authority to cause a plan or IRA to purchase securities from a member of an underwriting syndicate other than the fiduciary, when the fiduciary is also a member of the syndicate;
- PTE 75-1, Part IV permits a plan or IRA to purchase securities in a principal transaction from a fiduciary that is a market maker with respect to such securities;
- PTE 77-4 provides relief for a plan's or IRA's purchase or sale of open-end investment company shares where the investment adviser for the open-end investment company is also a fiduciary to the plan or IRA;
- PTE 80-83 provides relief for a fiduciary's use of its authority to cause a plan or IRA to purchase a security when the proceeds of the securities issuance may be used by the issuer to retire or reduce indebtedness to the fiduciary or an affiliate;

- PTE 83-1 provides relief for the sale of certificates in an initial issuance of certificates, by the sponsor of a mortgage pool to a plan or IRA, when the sponsor, trustee or insurer of the mortgage pool is a fiduciary with respect to the plan or IRA assets invested in such certificates.

Each of these exemptions would be amended to incorporate the conditions set forth as the “impartial conduct standards” in the Best Interest Contract Exemption. The first condition (the best interest standard) would require an investment advice fiduciary to act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person would exercise based on the investment objectives, risk tolerance, financial circumstances, and needs of the plan or IRA investor when providing investment advice to the plan or IRA or managing the plan’s or IRA’s assets. Further, the fiduciary must act without regard to its financial interest or other interests, or those of any other party. The second condition would require all compensation received by the fiduciary and its affiliates in connection with the applicable transaction to be reasonable in relation to the total services they provide to the plan or IRA. The last condition would require statements about recommended investments, fees, material conflicts of interest, and any other matters relevant to a plan’s or IRA’s investment decisions to not be misleading.

## 2.9 Regulation of Financial Adviser Conflicts of Interest in Other Countries

Regulators in several countries have identified failures in their investment advice markets and have undertaken regulatory and legislative initiatives that directly address conflicted investment advice. One of the most far-reaching initiatives is taking place in the United Kingdom (UK), where the Financial Conduct Authority (FCA) (formerly, the Financial Services Authority) issued new regulations that were effective on January 1, 2013, called the Retail Distribution Review (RDR). This section provides an overview of the development and implementation of the RDR and the immediately known market impacts.

### 2.9.1 The UK RDR

The RDR is aimed at introducing more transparency and fairness in the investment industry in the UK allowing clients to see how much advice is costing them and, in turn, understand what benefit they derive from it. The most significant change is that financial advisers are no longer permitted to earn commissions in return for selling or recommending their investment products. Instead, investors now have to agree on the fees<sup>67</sup> with the adviser upfront. In addition, financial advisers now have to offer either “independent” or “restricted” advice and explain the difference between the two – essentially making clear whether their recommendations are limited to certain

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<sup>67</sup> The RDR requires firms to work out an appropriate charging structure for calculating the adviser charge in a standard form, rather calculating a tailor-made charge for each client (Conduct of Business Source Book (COBS) 6.1A.12G at <http://fshandbook.info/FS/html/handbook/COBS/6/1A>). Whether the charging structure is based on a fixed fee, an hourly rate or a percentage of funds invested will be up to the firm, provided it always bears in mind its duty to act in the client's best interests. When advisor charges vary inappropriately by the provider or product the best interest rule is not being met. Thus, firms are not able to charge more for recommending one particular product instead of another suitable product. Firms must base their charges on services they provide rather than on the type of products they sell.



products or product providers. The RDR eliminated commissions broadly to retirement and non-retirement accounts.

### 2.9.1.1 The Problem

The FCA began working on the RDR in June of 2006 to address persistent problems that emerged in the UK retail investment market. These include a series of commission-based mis-selling scandals by UK banks over a period of more than 20 years regarding sales of unsuitable products, ranging from home loans to pensions and, most notably, payment protection insurance, as well as other problems concerning product and provider bias, churning of products, and lack of access to financial advice.

The FCA also was concerned that (1) the commission-based compensation model incentivized advisers to sell products whose providers paid them the largest commissions rather than products that were in their clients' best interests, and (2) the lack of fee transparency hid the true cost of advice from consumers.

### 2.9.1.2 The Rule

The FCA worked extensively with the financial services industry and other stakeholders to identify areas that should be addressed by the RDR. After these consultations, the FCA developed three broad objectives for the RDR: (1) provide a clear definition of independent advice; (2) address the potential for remuneration bias; and (3) increase professional standards.

The RDR achieves these objectives by requiring "Independent Advisers" to: (1) consider a broad range of products and (2) provide unbiased and unrestricted advice based on a comprehensive and fair analysis of the relevant market. "Restricted Advisers," those who provide advice with respect to a limited range of products or providers, are required to meet suitability requirements<sup>68</sup> for the advice. Therefore, restricted advisers cannot recommend a product that most closely meets a client's needs from a restricted range of products when the product is not suitable for the client. If advice is not independent, then it must be described as restricted. This label covers firms that advise on their own products or on a limited range of products, such as bank advisers and other single-tied and multi-tied adviser firms.

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<sup>68</sup> Suitability is a well-established regulatory concept for the UK financial services industry. Principle 9 of the FCA's Principles for Businesses (PRIN 2.1) requires firms to take reasonable care to ensure the suitability of their advice and discretionary decisions for any customer who is entitled to rely upon their judgment. The Conduct of Business Sourcebook defines the FCA's rules and guidance on suitability. The suitability requirements seek to ensure that, where firms provide investment advisory or portfolio management services, they obtain enough information about their customers to be able to act properly for them, and that the business conducted for them, or on their behalf, is appropriate to their circumstances. Failure to obtain all the relevant information, or evaluate it properly, can lead to the recommended transaction or decision to trade being unsuitable. PRIN 2.1 is available at: <http://fshandbook.info/FS/html/FCA/PRIN/2/1>. This appears to be a similar standard to FINRA Rule 2111, which establishes a "suitability" standard of conduct for BDs, which requires them to "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the [firm] or associated person to ascertain the customer's investment profile."

The RDR requires Independent and Restricted Advisers to: (1) explicitly disclose and separately charge clients for their services (this means that commission payments to advisers will cease); (2) disclose to their clients whether they are providing independent or restricted advice; (3) subscribe to a code of ethics; and (4) hold an appropriate qualification; (5) carry out at least 35 hours of continuing professional development annually; and (6) hold a Statement of Professional Standing from an accredited body.

As stated above, the RDR prohibits financial advisers from receiving commissions when they advise clients to invest in a product. Instead, they must charge a fee, expressed either as a percentage of the amount invested, a fixed fee, or an hourly rate. Whether the charging structure is based on a fixed fee, an hourly rate or a percentage of funds invested will be up to the firm, provided it always bears in mind its duty to act in the client's best interests. The client should only pay ongoing charges if the firm is providing an ongoing, value-added service and that is properly disclosed to the client.<sup>69</sup> The fee can be paid directly by the client or can be taken from a product that they invest in, provided that clients know exactly what the charges are up-front. The rules provide exceptions, however, in situations where a client purchased a retail investment product before January 1, 2013. In such cases, the adviser can continue to receive ongoing "trailing commissions" in relation to the pre-RDR advice until the product matures or is terminated. Additionally, execution-only sales (where no advice or recommendation is given) also fall outside the adviser charging regime.

### 2.9.1.3 Market Impact

The UK experience has only limited application to this regulatory effort. The RDR differs in scope – affecting all financial services, not just those related to retirement savings – and content – banning commissions outright and setting qualification standards for advisers, two features that are not part of this regulatory effort. Nevertheless, there are some lessons to be learned from examination of UK experience with the RDR.

For example, concerns also were expressed about the establishment of an "advice gap" for those with small amounts to invest.<sup>70</sup> However, in July 2013, the FCA announced that six months after the effective date of the RDR, 97 percent of current advisers had attained the appropriate level of qualification. The remaining three percent were recent market entrants who are still studying within the timelines allowed by the RDR. Also, according to the FCA letter, a substantial decrease in the number of financial advisers did not occur. By the end of 2012, the number of advisers went from 35,000 to 32,100, a decline of less than 10 percent, which was in line with the FCA's expectations. The FCA has indicated that there are currently 31,500 advisers as of October 2014. External consultants to the FCA, Europe Economics, issued in December 2014 an independent post RDR review, which found that there is little evidence that investment advice has significantly decreased, with the majority of existing advisers willing and able to take on more clients. According to this report, it appears that in the year ending March 31, 2014 advisers dropped about 310,000 clients who whom they no longer found profitable to serve. On the other

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<sup>69</sup> FCA "Conduct of Business Sourcebook" (COBS) 6.1A.22R; 6.1A.26G, available at: <http://fshandbook.info/FS/html/handbook/COBS>.

<sup>70</sup> Letter from David Geale, FCA, UK to Joseph Piacentini, U.S. Department of Labor (2014).

hand 820,000 clients were gained in the same period. According to the authors, the net increase in customers served suggests that dropped clients who looked for replacement advisers were largely successful.

Related to this report, the FCA also commissioned research with Towers Watson to also address whether there is an investment advice gap between demand for investment advice and capacity to meet that demand. In December 2014 report, Towers Watson concludes that there is not an advice gap because there are sufficient advisers to meet the demand (approximately 30,000 advisers compared to the estimated 25,000 required to meet the demand).<sup>71</sup>

The FCA reported that although a number of banks have exited from the investment advice market for small accounts, it is not accurate to point to the RDR as the main cause. For example, the letter states that Barclays exited the advice market even before the RDR was passed, due to “a decline in commercial viability for such services over recent years.” Although some of the banks have pulled out of the investment advice market, FCA-commissioned research found that most retail investment advisers continue to serve clients with savings and investments between £20,000 and £75,000 and that a third of advisers continue to serve clients with less than £20,000. The FCA noted that the emergence of new ways to access advice using on-line technology has the potential to offer those with small amounts to invest an efficient and cost-effective means to receive advice.<sup>72</sup> The report issued by Europe Economics in December of 2014 discusses that there are some indications that a number of banks are looking to re-enter the market, perhaps with more technology-supported applications.<sup>73</sup>

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<sup>71</sup> Towers Watson, “Advice Gap Analysis: Report to FCA”, Dec. 2014, available at: <http://www.fca.org.uk/static/documents/research/advice-gap-analysis-report.pdf>.

<sup>72</sup> In a July 2014 report, the FCA stated that it has been discussing with its stakeholders options for low-cost, simpler ways of recommending retail investment products, particularly for customers with relatively modest amounts to invest and relatively straightforward investment needs. The FCA acknowledged that it is clear that there has been some reluctance on the part of firms to develop these models and that it is seeking to understand more about the barriers firms believe they face. It also stated that it is aware that firms offering retail investments without personal recommendations want greater clarity on how they can support customers in making informed decisions – increasingly via technology-rich solutions – without stepping over the boundary into providing a personal recommendation. While the FCA has found that firms are clear on the requirements for full advice and for execution-only business, they are struggling to navigate the options in between, such as simplified advice or limited advice services, and sales without personal recommendations that involve guiding the customer in some way. The FCA stated that it is aware of feedback from customers and the industry that this lack of clarity may be inhibiting the development of different investment sales models. Therefore, in the report, the FCA provides guidance clarifying the concepts of “regulated advice,” “generic advice,” and “personal recommendation.” The guidance provided detailed examples and the FCA’s view on whether they amount to personal recommendations; summarizes the results of thematic work carried out on firms using new technology to interact with customers; and reports on research examining how customers use services that do not provide a personal recommendation. See, “Retail investment advice: Clarifying the boundaries and exploring the barriers to market development,” (July 2014) available at: <http://www.fca.org.uk/static/documents/guidance-consultations/gc14-03.pdf>.

<sup>73</sup> Europe Economics, “Retail Distribution Review; Post Implementation Review,” Dec. 2014, 65, available at: <http://www.fca.org.uk/static/documents/research/rdr-post-implementation-review-europe-economics.pdf>.

### 2.9.1.4 Recent Events and Progress of the RDR

The FCA currently is engaged in a three-stage thematic review to assess investment advisory firms' approach to implementing the RDR. The first stage was completed in July 2013, and concluded the majority of firms have made progress and there is a willingness among them to adapt to the new rules.<sup>74</sup> The second stage of the FCA's thematic review assessed how firms have implemented the RDR in a March 2014 report.<sup>75</sup> The FCA requested information from 113 firms from a cross-section of the industry and found that of the 88 firms who stated that they offered independent advice, 12 were either not in fact acting independently or the FCA had doubts about their independence. The review focused on: (1) whether firms describing themselves as independent are offering independent services in practice, and (2) whether firms are being clear with customers about their charges, the scope of their service (independent or restricted), and the nature of the services they provide, both initially and on an ongoing basis. The RDR requires that where a firm states that it offers independent advice, it should not be restricted by product provider and should objectively consider all types of retail investment products, which are capable of meeting the investment needs and objectives of a client. The FCA said that a significant number of firms understand the new requirements, and that there were no indications that the firms were not acting independently in practice. In order to support the industry, the FCA clarified requirements in key areas and provided examples of good and poor practices. However, the FCA's findings with respect to the disclosure requirements were not as positive. In an April 2014 report,<sup>76</sup> the FCA stated that it found a high proportion of firms are failing to correctly disclose the cost of their advice to clients, the type of service they offer, and are not disclosing the ongoing services they provide as required by the RDR. According to the report, "73 percent of firms failed to provide the required generic information on how they charge for advice and/or failed to clearly confirm the specific cost of advice to their individual clients in a timely manner." Moreover, only 42 percent of firms gave their clients clear upfront generic information on how much advice might cost, and only half of the firms clearly explained how much advice would cost clients as individuals. The FCA expressed "disappointment" with the level of noncompliance and stated that the failure of firms to meet their regulatory requirements is "unacceptable" and could lead to poor outcomes for consumers.

The Financial Conduct Authority (the FCA) finished the third cycle of the thematic review in December, 2014, which focused on an assessment of firms' adviser fees and disclosures and how firms are delivering these services to clients in the UK in practice. The FCA sampled 110 firms to provide a representative sample of firms across the financial advice sector and to ensure the results were robust. Almost all of the 110 firms it reviewed offered their clients a type of ongoing service in exchange for an ongoing adviser charge. In around half of firms the regulator reviewed, over 90 per cent of their clients were paying to receive an ongoing service.

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<sup>74</sup> TR 13/15: FCA, "Supervising Retail Investment Firms: Being Clear about Adviser Charges and Services," (Apr. 2014); available at: <http://www.fca.org.uk/static/documents/thematic-reviews/tr14-06.pdf>.

This review contains the results of the FCA's first stage of its thematic review looking specifically at RDR implementation initially in a sample of 50 firms.

<sup>75</sup> TR 14/5: "Supervising Retail Advice: Delivering Independent Advice," (March 4, 2014); available at: <http://www.fca.org.uk/static/documents/thematic-reviews/tr14-05.pdf>.

<sup>76</sup> TR 13/15: FCA, "Supervising Retail Investment Firms" 2014.

Overall, the results were positive and show material improvements in how firms are complying with the RDR, including how they disclose the cost of their advice, their scope of service, and the nature of their services to clients. As a result, “clients should be in a better position to understand the nature of firms’ services and the charges that apply.”<sup>77</sup> The findings demonstrate that the sector has responded to two previous thematic reviews which found significant issues with the quality of the information given to those seeking advice. The improvements point to increasing professional standards and should mean those seeking advice are better placed to understand the nature of a firm’s services and how much they will cost. Specifically, the FCA found that professionalism of advisers is increasing in the financial sector and there was a material improvement in the way firms disclose the cost of their advice to clients. However, the review did show that some further improvements are needed, particularly in the way that costs, in cash terms, of ongoing services are disclosed. In particular, the FCA remains concerned that some firms are failing to provide individual clients with clear disclosure of the ongoing charges they will be paying for the firm’s ongoing service. The FCA found the 35 percent of firms failed to disclose the total adviser charge for ongoing services in cash terms relative to the individual client. This normally applies when a firm is applying a percentage based structure. Of firms using an hourly rate ongoing structure, 57 percent did not give an estimate of how long it would take to render each service. Additionally, some 23 percent of firms use a price bracket to indicate the cost in their generic disclosure.

#### 2.9.1.5 Comparison to Department’s Rule

Although, the Department’s new proposal and the RDR both are designed to mitigate conflicts of interest in the investment advice market, there are substantial differences. The RDR rules ban payments of commissions from product providers with respect to advised sales. The ban is intended to prevent advisers from making recommendations that are overly-influenced by the commission payable on the product. These rules apply very broadly to both retirement and non-retirement accounts in the UK. The RDR rules also imposed significant new qualification standards on advisers.

The Department’s regulation, on the other hand, is focused solely on retirement plans and accounts and does not prohibit advisers from receiving commissions. Instead, it protects ERISA plan participants and IRA investors from conflicts of interest and self-dealing by providing a clearer regulatory structure for determining when persons that provide investment advice are fiduciaries. ERISA safeguards plan participants by imposing trust-law standards of care and undivided loyalty on plan fiduciaries, and by holding fiduciaries accountable when they breach those obligations. In addition, fiduciaries to plans and IRA investors are forbidden from engaging in “prohibited transactions,” which pose special dangers to the security of retirement plans and IRA investors because of fiduciaries’ conflicts of interest with respect to the transactions. Under this regulatory structure, fiduciary status and responsibilities are central to protecting the public interest in the integrity of retirement assets, many of which are in tax-favored vehicles. The current rule does not include any qualification standards for advisers.

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<sup>77</sup> Financial Conduct Authority, Thematic Review, Retail Investment Advice: Advisor Charging and Services; December 2014.

## 2.9.2 Australian Legislation Impacting Financial Advice

In a similar development, the Australian government enacted the Future of Financial Advice (FOFA) legislation on June 25, 2012. The FOFA makes dramatic changes to the delivery and receipt of financial advice with the goal of mitigating conflicts of interest. The legislation was initiated as a government response to the Parliamentary Joint Committee on Corporations and Financial Services' Inquiry (PJC) into financial products and services due to the collapse of several financial services companies during the financial crisis of 2007-08, and a PJC report on the inquiry was issued in early 2012. The FOFA became effective on July 1, 2012. Compliance with the new measures was voluntary until July 1, 2013, and became mandatory thereafter.<sup>78</sup>

The FOFA imposes the following standards on financial advisers:

- Bans conflicted remuneration structures including commissions with respect to the distribution of advice on retail investment products, including managed investments;
- Requires financial advisers who charge ongoing fees to retail clients to provide a renewal notice every two years, in addition to an annual fee disclosure statement;
- Prohibits an on-going fee from being charged to clients if they do not renew by opting-in every two years (clients are presumed to have opted out if they do not opt-in);
- Prohibits licensees or representatives who provide financial product advice (personal and general) to retail clients, which could reasonably be expected to influence the choice of financial product recommended or the financial advice given, from accepting soft-dollar benefits over \$300 where it could be expected to have “influence” over the choice of financial product recommendation or the advice given to retail clients (limited exceptions apply for general insurance, execution-only services and other prescribed benefits); and
- Provides a new statutory duty for financial advisers to act in the best interest of their clients.

On December 20, 2013, the Australian Government announced a package of regulatory changes to FOFA (the Corporations Amendment Regulation of 2014) to reduce compliance costs and regulatory burden on the financial services sector under FOFA. The ban on commissions and conflicted remuneration for financial advisers was not amended to re-introduce commissions or conflicted remuneration for financial advisers. These regulatory changes were implemented on September 4, 2014 and scheduled to commence on January 1, 2015. However, the regulations were repealed by a Motion of Disallowance passed by the Senate on November 19, 2014. Therefore, the law reverts back to the original FOFA legislation.

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<sup>78</sup> The Treasury of Australia, “The Future of Financial Advice,” (2012); available at: <http://futureofadvice.treasury.gov.au/content/Content.aspx?doc=reforms.htm>. As stated above, FOFA became mandatory on July 1, 2013.



### 2.9.3 Is the RDR a Model for Wider European Regulation?

The RDR appears to be influencing the future of distribution of investment advice both within the regulatory bodies of the European Union and within several member states. In terms of EU-wide legislative change, the payment of commission to both retail and professional clients is dealt with in the new version of the Markets in Financial Instruments Directive (MiFID II). On October 26, 2012, the European Parliament approved a revised version of MiFID II which includes a ban on the acceptance of commissions in relation to advice or portfolio management services, but only where the firm has informed the client that the advice is given on an independent basis. MiFID II covers the sale and distribution of investment products such as investment funds in and structured bank-based products. However, this revised draft expressly permits Member States to adopt more restrictive measures. MiFID II is the subject of discussions between the European parliament, European Commission and European Council. Political agreement on the MiFID II proposals was reached on January 14, 2014, after several months of negotiations between the Commission, Parliament, and Council. Parliament endorsed the MiFID II on April 15, 2014, and the Council adopted the legislation on May 13, 2014.<sup>79</sup> Under the agreement, firms providing independent advice or portfolio management may not accept any fees, commissions, or monetary or non-monetary benefits from third parties in relation to the advice or service.<sup>80</sup> In the meantime, other EU countries have formulated their own specific policies. These are described below.

Additionally, the Insurance Mediation Directive (IMD2) of the European Union (EU) aims to improve the regulation of retail insurance sales and distribution practices across the single European market by adding measures requiring greater transparency and banning certain commission payments for non-tied advisers.<sup>81</sup> One of the goals of IMD2 is to improve consumer protection in the insurance sector through requirements for increased information provision and advice and by creating common standards for insurance sales. EU member countries would be allowed to impose higher standards if they wish. IMD2 will likely come into force in member states two years from the date it is adopted by the European Parliament. It was adopted in 2014 and is expected to come into force in member states in 2016.

In the meantime, national regulators throughout Europe have already taken tough measures to either ban certain third party payments or strictly limit them. The following provides a description of measures taken in several countries:

**Netherlands:** All commissions paid by a product issuer to an adviser relating to advice are banned beginning in 2013. The ban applies to investment, insurance, and mortgage and protection products. This ban resulted from high cost insurance policies that were mis-sold to consumers.<sup>82</sup>

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<sup>79</sup> MiFID II was published in the Official Journal on June 12, 2014 and entered into force on July 2, 2014, 20 days after publication. As a directive, MiFID II must be transposed into national law by Member States by July 3, 2016, and must generally apply within Member States by Jan. 3, 2017.

<sup>80</sup> Minor non-monetary benefits that could enhance the quality of service may be permitted, provided they are disclosed and do not impair compliance with the firm's duty to act in its client's best interest.

<sup>81</sup> "Non-tied" is defined by the Cambridge Business English Dictionary as someone who is paid by a financial organization to sell and give advice only on its investment products, not on those of its competitors.

<sup>82</sup> The deliberate, reckless or negligent sale of products or services in circumstances where the contract is either misrepresented, or the product/service is unsuitable for the customer's needs.

**Belgium:** Belgium banned payment of commissions for discretionary portfolio management and to independent financial advisers but not to tied or restricted advisers.

**Germany:** Changes to business practices in the financial advisory segment have been confined to information/disclosure requirements. Pending any changes in IMD2, the focus has been on permitting the payment of commissions subject to increased levels of transparency as to the cost of advice.

**Switzerland:** Although Switzerland is outside the EU, it may be influenced by European developments to ban certain commission practices. A recent court decision has confirmed that discretionary portfolio managers cannot retain commissions received from product providers.

**Italy:** Italy banned payment of commissions for discretionary portfolio management at the time of the initial introduction of IMD2.

**France:** France supports a ban on payment of inducements for discretionary portfolio management. The regulator has expressed concerns that a ban on retrocessions<sup>83</sup> will lead to increased churning of investment products. Instead, the regulator has focused on investor protection in the form of greater disclosure rules for all savings products.

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<sup>83</sup> This is the practice of one reinsurance company essentially insuring another reinsurance company by accepting business that the other company had agreed to underwrite.



### 3. IRA Market

Some of this proposal's most important effects will occur in the retail IRA marketplace. The current market for investment advice to IRA investors is replete with conflicts of interest between advisers and investors. Well qualified advisers compete vigorously for investors' business, but investors' high information costs – i.e., the fact that most investors lack the information and expertise necessary to evaluate the quality of advice – prevent this competition from producing efficient results. Many investors do not know how much they are paying for advice or whether the advice is of high quality. They cannot effectively discourage advisers from acting on their conflicts, for example, by taking their business to non-conflicted advisers. As a result, as the academic literature documents, many investors pay more and earn lower returns than they would in the absence of harmful conflicts in spite of the current regulatory regime. The proposed regulation aims to prevent conflicts of interest from compromising the quality and inflating the price of the investment advice that affected BDs and others provide to IRA investors. If this aim is achieved, the result will be lower fees, more appropriate risks, and higher risk-adjusted returns for many IRA investors.

As noted earlier, the new proposal would broaden the IRC definition of fiduciary investment advice rendered to retail IRAs. This would limit or mitigate conflicts of interest in such advice by subjecting more of it to the IRC PT provisions. Some conflicts would remain permissible, subject to protective conditions, pursuant to certain existing PTEs as well as proposed PTEs that are included with the new proposal.

#### 3.1 Affected Universe

The new proposal, as applied to the retail IRA marketplace, will directly affect two major groups: IRA investors and the professionals who render investment advice to them. It may indirectly affect others, such as vendors of financial products that IRA investors choose pursuant to advice. The Department examined a broad range of data and evidence on the affected universe to inform its development of this proposal.

##### 3.1.1 IRA Investors

Tax-preferred retirement savings, in the form of plans and IRAs, are critical to the retirement security of most US workers. These savings totaled nearly \$15.9 trillion at the end of 2014. Workers and retirees themselves are responsible in whole or part for directing the investment of the vast majority of these savings. Individual IRA investors currently direct the investment of approximately \$7.3 trillion in IRA assets, and can choose from a near endless variety of financial products, securities, or other property in the marketplace.<sup>84</sup>

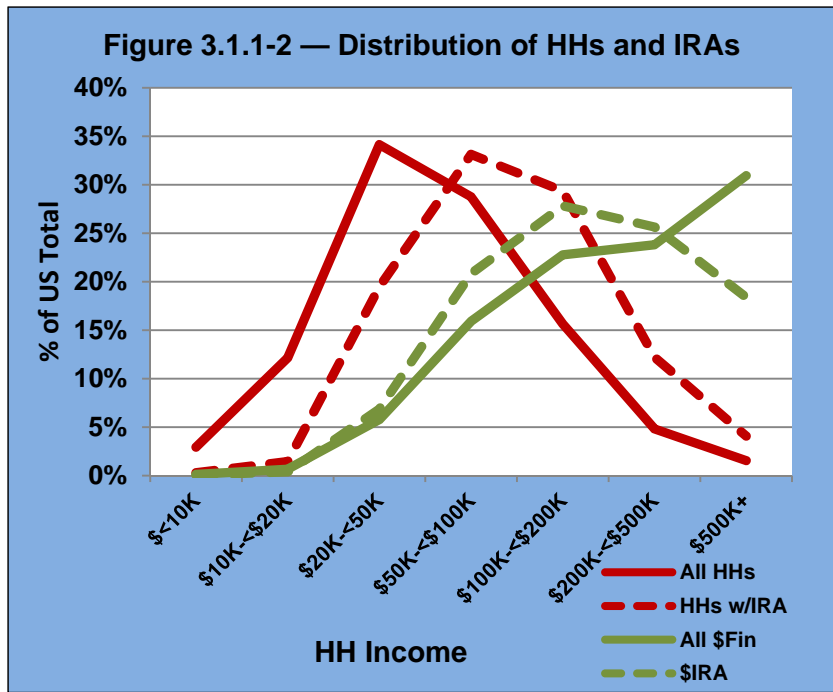
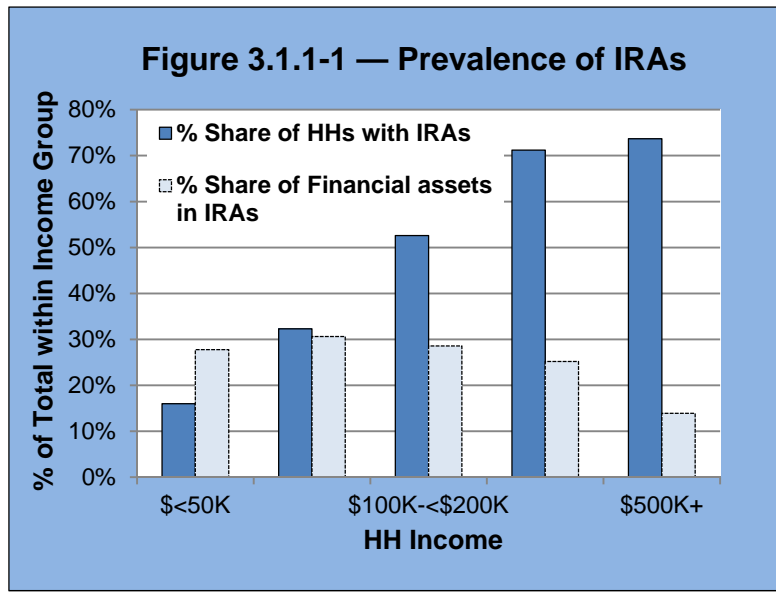
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<sup>84</sup> Board of Governors of the Federal Reserve System, "Financial Accounts of the United States: Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts: Fourth Quarter 2014," (Mar. 12, 2015) Federal Reserve Statistical Release Z.1, available at: <http://www.federalreserve.gov/releases/Z1/current/z1.pdf>.

IRAs play a major role in US households' retirement security. In contrast to plans, which are available to less than two-thirds of private-sector employees, IRAs are the only tax-advantaged retirement savings vehicle available to virtually all of America's workers.<sup>85</sup>

In 2013, 34 million households (28 percent of all US households) had an IRA, according to tabulations of the Survey of Consumer Finances (SCF) prepared for the Department (see Advanced Analytical Consulting Group 2014)). The median value of these accounts for such families was \$50,000 and the median household income for these families was \$93,000. Higher-income households are more likely to have IRAs, but middle and upper middle-income households on aggregate hold a larger share of their financial assets in IRAs. Viewed another way, IRA-owning households tend to have higher incomes than households overall. IRA assets are concentrated at still higher income levels, but are not nearly as skewed toward higher incomes as are financial assets overall (see Figure 3.1.1-1 and Figure 3.1.1-2).

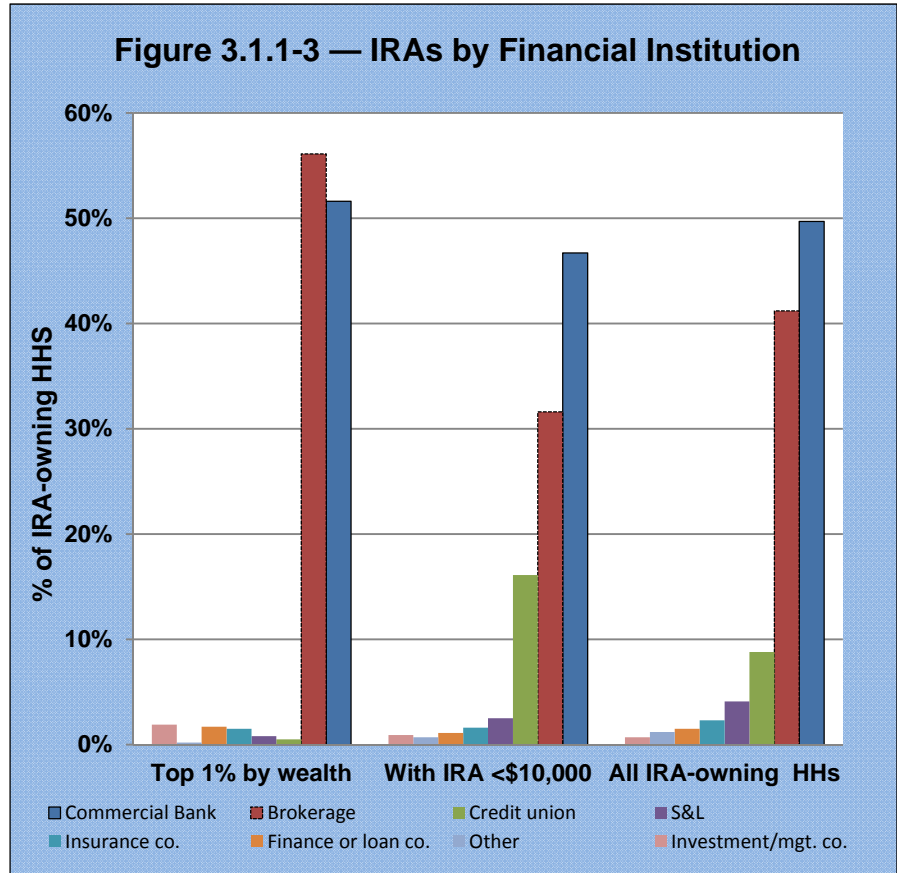
Significant shares of IRA investors belong to demographic groups that tend to be more susceptible to financial exploitation. As elaborated in Section 3.2.1.2 below, older and less educated investors generally are less able to distinguish good investment advice from bad. More than half of all IRA investors are age 55 or older, and 9 percent are 75 or older. Eight percent are widowed, and 14 percent



<sup>85</sup> IRA tax advantages, however, vary depending on income and plan participation. Taxpayers above certain income thresholds are not eligible to contribute directly to Roth IRAs. Taxpayers above other income thresholds cannot deduct IRA contributions if they are also plan participants, but can defer taxation of earnings on IRA investments until money is withdrawn.

are divorced. It is likely that over time IRA ownership will become more skewed toward more advanced ages, for two reasons: the DC pension system is maturing, and the population is aging.

Some comments on the 2010 proposal suggested that a large majority of IRAs, especially small IRAs, are held in brokerage accounts.<sup>86</sup> This claim seems to be based on a misleading comparison based on selected information of just two types of financial investment accounts: brokerage and advisory. However, more IRA-owning households report holding IRAs at commercial banks (50 percent) than at brokerages (41 percent). Among IRA-owning households with less than \$10,000 in their IRAs, 47 percent held IRAs at commercial banks, 32



percent at brokerages, and 16 percent at credit unions. Commission-based brokerage does not appear to dominate the small IRA market (*see* Figure 3.1.1-3).

Households with IRAs obtain financial advice from many sources. The most popular sources are Internet/online services (44 percent), financial planners (42 percent), friends and relatives (37 percent), and bankers (33 percent). Just 17 percent obtain financial advice from brokers, slightly fewer than from magazines, newspapers, and books (18 percent). Even households that hold IRAs with brokerages appear to rely less on brokers than on other sources for financial advice: 52 percent use internet/online services, 44 percent financial planners, 41 percent friends and relatives, and 25 percent bankers, compared with 23 percent consulting brokers.<sup>87</sup>

Other data sources, in addition to the SCF, paint a similar picture. The Investment Company Institute (ICI) reports that the median IRA investor in their database is 52 years old, has a household income of \$80,500, and an IRA balance of \$50,000. IRAs comprise 38 percent of

<sup>86</sup> See Oliver Wyman report (2011).

<sup>87</sup> Percentages do not add to 100 percent because multiple answers were allowed.

household financial assets for households with IRAs.<sup>88</sup> These assets are invested in a variety of investment vehicles: 64 percent of IRAs include investments in mutual funds, 40 percent of IRAs include investments in individual equities, and 31 percent of IRAs include investments in annuities. Smaller numbers of IRAs invest in bank accounts and bonds, as well as ETFs and other investment options.<sup>89</sup> According to the U.S. Federal Reserve Flow of Funds Report, in 2013, 82 percent of IRA assets were invested in mutual funds or other self-directed investments.<sup>90</sup>

Rollovers from employment-based plans account for most IRA funding. Almost half of all IRAs include at least some rollover funds. Rollovers may be due to job change, layoffs, or termination (72 percent of rollovers), retirement (30 percent), as well as other reasons (10 percent).<sup>91</sup> In 2011, new IRA rollover contributions amounted to \$292.4 billion. Cerulli Associates projects that by 2019, new IRA rollover contributions will total over \$540 billion per year.<sup>92</sup> According to the ICI IRA Owners Survey, 50 percent of IRA investors with rollovers consulted a professional financial adviser as their primary source of information, and 61 percent of IRA investors with rollovers consulted a professional financial adviser in some capacity regarding their rollover decision.<sup>93</sup>

RIAs and BDs are the two main types of advisory firms affected by the rule. As discussed previously, brokers and financial planners are the two biggest named professional sources of financial advice for IRA investors. Within the financial industry, many BDs market themselves with titles that give the impression of specialized advisory expertise, such as wealth adviser, wealth planner, financial planner, financial adviser, retirement planner, or investment adviser. In some cases, outside professional groups govern the terms and circumstances under which an individual can claim a designation, as in the case of the title “Certified Financial Planner.” In other cases, anyone can use the title, as in the case of “Financial Adviser.” For many of these titles, both BDs and RIAs (and others) can use them, which can confuse consumers.<sup>94</sup>

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<sup>88</sup> ICI Research Perspective, “The Role of IRAs in U.S. Households’ Saving for Retirement, 2014” (Jan. 2015), 8. Available at: <http://www.ici.org/pdf/per21-01.pdf>.

<sup>89</sup> ICI Research Perspective, “Appendix: Additional Data on IRA Ownership in 2014,” (Jan. 2015), 10. Available at: <http://www.ici.org/pdf/per21-01a.pdf>.

<sup>90</sup> Board of Governors of the Federal Reserve System, “Financial Accounts of the United States” Federal Reserve Statistical Release Z.1, Washington, D.C.: (Mar. 12, 2015), available at: <http://www.federalreserve.gov/releases/z1/current/data.htm>. The Federal Reserve Board’s Flow of Funds Report defines “other self-directed investments” to include securities held in brokerage accounts excluding money market fund and other mutual fund assets held by households through brokerage accounts (e.g., ETFs, equities, or bonds held at Fidelity or Vanguard).

<sup>91</sup> ICI Research Perspective, “The Role of IRAs, 2014,” 14.

<sup>92</sup> Cerulli Associates, “Retirement Markets 2013: Data & Dynamics of Employer-Sponsored Plans,” 2013.

<sup>93</sup> ICI Research Perspective, “The Role of IRAs, 2014,” 17-18.

<sup>94</sup> Consumer Financial Protection Bureau, “Senior Designations for Financial Advisers: Reducing Consumer Confusion and Risks,” (Apr. 18, 2013), available at: [http://files.consumerfinance.gov/f/201304\\_CFPB\\_OlderAmericans\\_Report.pdf](http://files.consumerfinance.gov/f/201304_CFPB_OlderAmericans_Report.pdf); and U.S. Government Accountability Office, *GAO-11-235, Consumer Finance: Regulatory Coverage Generally Exists for Financial Planner but Consumer Protection Issues Remain* (2011), available at: <http://www.gao.gov/new.items/d11235.pdf>.

### 3.1.2 RIAs

Over 11,000 RIAs are registered with the SEC. These SEC-registered RIAs managed more than \$62 trillion. In addition, there are more than 275,000 state-registered RIA representatives and more than 15,000 state-registered RIAs. Approximately 5 percent of SEC-registered RIAs are also registered as BDs, and 22 percent have a related person that is a BD. Additionally, approximately 88 percent of RIA representatives are also registered representatives of BDs. A majority of SEC-registered RIAs reported that over half of their assets under management related to the accounts of individual clients. Most RIAs charge their clients fees based on the percentage of assets under management, while others may charge hourly or fixed rates.<sup>95</sup> Depending on a RIA's particular customer base and business and compensation model, it may be materially affected by this rule.

### 3.1.3 Broker-Dealers

The SEC and FINRA oversee approximately 5,100 BDs with a median representative staffing level of 752.<sup>96</sup> As of the end of 2009, FINRA-registered BDs held over 109 million retail and institutional accounts. Approximately 18 percent of FINRA-registered BDs also are registered as RIAs with the Commission or a state.<sup>97</sup>

Most BDs receive transaction-based compensation. An industry survey conducted by the Financial Services Institute (FSI) found that 60 percent of all revenue received by BDs is commissions received from financial entities. An additional 31 percent of revenue is received in the form of asset management and advisory fees. About 13 percent of assets held by BDs are in securities held for resale. Most BD representatives service small books of business. Forty-five percent of representatives produce less than \$50,000 in revenue for their BDs annually,<sup>98</sup> while only two percent of representatives produce more than \$1 million. Additionally, 41 percent of BDs offer production bonuses and 68 percent of BDs have minimum production requirements for representatives.<sup>99</sup>

### 3.1.4 Mutual Funds and Other Product Providers

There are approximately 9,000 U.S. registered mutual fund companies holding approximately \$15 trillion in assets. Investment companies as a whole, a majority of which provide mutual funds, and their service providers, employ approximately 166,000 individuals.<sup>100</sup>

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<sup>95</sup> SEC "Dodd-Frank Study," 2011, iii.

<sup>96</sup> Financial Services Institute (FSI), "2013 Broker-Dealer Financial Performance and Compensation Study."

<sup>97</sup> Ibid., 149.

<sup>98</sup> While some of these BD representatives may derive their incomes entirely from the limited revenue they generate, others may earn additional fee income as RIAs or financial planners. Some may work part-time as BD representatives, possibly in addition to other paid work.

<sup>99</sup> Ibid.

<sup>100</sup> ICI "2014 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry," 54th Edition (May 2014), available at: <http://www.ici.org/research/stats/factbook>.

The Department expects a significant portion of some mutual funds and other product providers, such as insurance companies, to be significantly affected by the proposal. This is because many incentivize advisers to recommend particular mutual funds to their clients.<sup>101</sup> To the extent that the proposal is effective in mitigating conflicts of interest with respect to the advice given by brokers, mutual fund companies, and other product providers that currently sell their products by making payments to brokers may find it more profitable to employ different methods for selling their products.

### 3.2 Need for regulatory action

The Department collected and studied a wide range of evidence in order to determine with confidence whether there is a harmful failure in the market for IRA advice, and if so, what if any regulatory solution would be most beneficial. This evidence included public comments on the 2010 proposal; academic research papers related to conflicts of interest in the market for financial advice and the effects of disclosure, among other relevant topics; and government and industry statistics on the IRA marketplace, including information on financial products and services, vendors and intermediaries, and consumers. The Department also consulted with analysts at the SEC, FINRA, the Council of Economic Advisers, the National Economic Council, the Domestic Policy Council, the Office of Management and Budget, the Department of the Treasury, the Consumer Financial Protection Bureau, and the GAO, as well as with academic researchers in the field, the Financial Conduct Authority (previously, the Financial Services Authority) of the United Kingdom, and the Australian Securities & Investments Commission, among others. As elaborated below, the evidence supports the following conclusions:

- The IRA market warrants consumer protections beyond those applicable to other retail investment accounts.
- Material changes in the marketplace since 1975 have rendered the 1975 rule obsolete and ineffective.
- The IRA advice marketplace exhibits characteristics that economic theory suggests would lead to market failures and harmful to advice recipients. That is, because of agency conflicts between advisers and investors that reflect the way advisers are compensated and IRA investors' high information costs, IRA investors will sometimes receive and follow advice that subordinates their financial interests to their advisers', and consequently their net investment results will suffer.
- Such harm exists in the IRA marketplace even in spite of existing regulations, and can be expected to amount to at least tens and probably hundreds of billions of dollars over the next 10 years.
- Regulatory action that effectively mitigates advisers' conflicts and ensures that advice puts IRA investors' interests first can deliver large, welfare-improving financial benefits for IRA investors that more than justify associated costs.

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<sup>101</sup> See Section 3.2.3.1 for details on these practices.



### 3.2.1 IRAs Warrant Special Protection

IRAs warrant special protections in addition to those applicable to other retail accounts because of their importance to retirement security, their preferential tax treatment, and IRA investors' vulnerability to abuse. Congress recognized this when, in 1974, it amended the IRC to give fiduciary status to advice on the investment of IRA assets to the IRC's PT provisions. Under the narrow 1975 rule, however, IRA advisers generally can and do avoid fiduciary status, thereby stripping IRA investors of the protections the IRC's PT provisions were enacted to provide. There is convincing evidence that, notwithstanding other existing protections (*see* Section 2.6 above), advice conflicts inflict losses on IRA investors. The Department is responsible for ensuring that the special IRA protections ERISA added to the IRC are applied effectively.

A number of comments on the 2010 proposal questioned the need for Department action to regulate investment advice rendered to IRA investors. These comments argued that various other federal and state rules governing retail investment advice already provide sufficient consumer protections, and that subjecting such advice to the PT provisions of the IRC was therefore unnecessary. Some questioned whether the Department had any legitimate role in regulating advice to retail IRAs because they are not ERISA-covered retirement plans, and argued that another agency, primarily the SEC, is the proper regulator of retail investment advice.

The Department understands the roles of the SEC and other federal and state agencies in regulation of financial advice provided to retail investors. At the same time, however, the IRC PT provisions, as enacted by Congress as part of ERISA in 1974, specifically apply to IRA investment advice, and the Department is solely responsible for interpreting these provisions.<sup>102</sup> It is thus incumbent on the Department to protect IRA investors from harmful adviser conflicts. An examination of trends and evidence accumulated since 1974 suggests that such special protections, if anything, are even more critical today than when Congress first enacted ERISA more than 40 years ago. The Department's role in applying these protections is well established under law and in practice.

#### 3.2.1.1 Importance of IRA Investments

IRAs' important role in retirement security, which warrants special protections against conflicts in advice, underscores the need for the new proposal to ensure the broad application of these protections.

IRAs were established in 1974 as a vehicle to promote retirement savings. In supporting IRAs, lawmakers pointed to the need to provide tax preferences similar to those applicable to job-based pensions to workers who did not have access to such pensions. They also pointed to rollover IRAs' potential to make job-based pensions more portable.

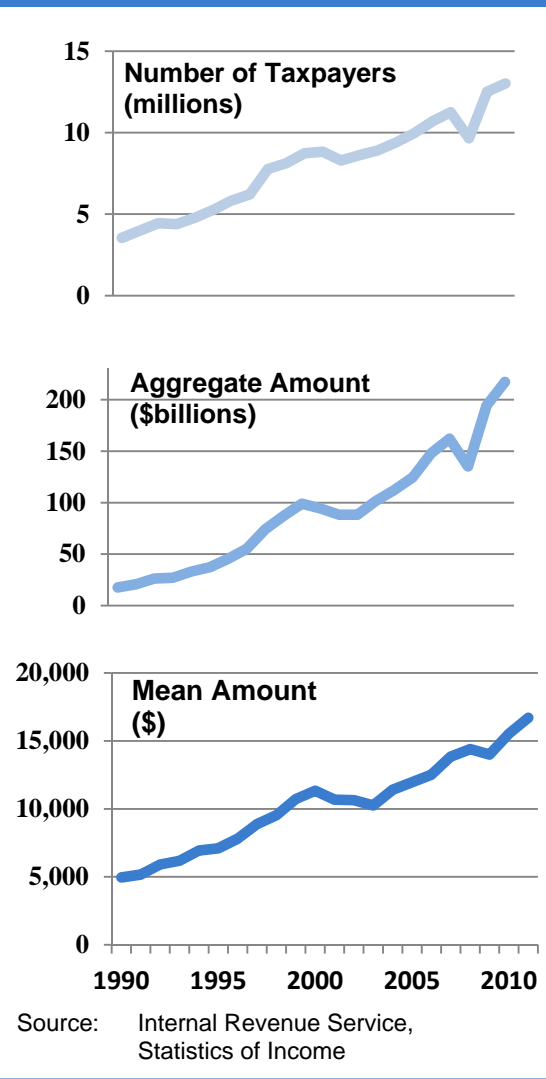
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<sup>102</sup> *See* Reorganization Plan No. 4 1978, 5 U.S.C. App. (2010).

The special protections for IRAs embodied in the IRC PT provisions are mirrored by the large tax subsidies IRAs enjoy under other IRC provisions. These subsidies amounted to \$16 billion in 2014 alone.<sup>103</sup> This figure dramatically understates the degree to which current IRA savings have been subsidized by taxpayers, however. Most of the savings flowing into IRAs comes not from direct contributions but from rollovers primarily from job-based retirement plans, mostly from DC plans including 401(k)s<sup>104</sup> – and much of the savings currently in these plans may eventually be rolled over into IRAs. The tax preference for DC plans amounted to \$45 billion in 2014. Moreover, these IRA and DC figures vastly understate the accumulated taxpayer subsidy in DC and IRA savings, reflecting only one-year’s subsidy.

IRA’s importance to retirement security in America is widely documented.<sup>105</sup> In aggregate dollar terms, IRAs now represent the single largest and fastest growing form of retirement saving, outstripping both private-sector DC and DB plans (*see* Section 3.2.2.1 below). Almost \$2.5 trillion is projected to be rolled over from plans to IRAs between 2015 and 2019.<sup>106</sup> As the baby boom generation begins to retire, IRA distributions represent a large and growing source of retirement income (Angelov, Iams and Purcell 2012). In 2011, 13 million taxpayers reported \$217 billion of income from taxable IRA distributions, up from 4 million reporting just \$18 billion in 1990. Taxable IRA distributions averaged \$16,705 per taxpayer in 2011, up from \$4,951 in 1990 (*see* Figure 3.2.1.1-1).

**Figure 3.2.1.1-1 — Taxable IRA Distributions**



<sup>103</sup> Joint Committee on Taxation, “Estimates of Federal Tax Expenditures for Fiscal Year 2014-2018,” (Aug. 2014), 36. Available at: <https://www.jct.gov/publications.html?func=startdown&id=4663>.

<sup>104</sup> ICI, “U.S. Retirement Market, Fourth Quarter 2014,” 2015, available at: [www.ici.org/info/ret\\_14\\_q4\\_data.xls](http://www.ici.org/info/ret_14_q4_data.xls).

<sup>105</sup> ICI Research Perspective, “The Role of IRAs, 2014,” Employee Benefit Research Institute (EBRI) Issue Brief, Number 399, “Individual Retirement Account Balances, Contributions, and Rollovers, 2012; With Longitudinal Results 2010–2012: The EBRI IRA Database,” (May 2014), available at: [http://www.ebri.org/pdf/briefspdf/EBRI\\_IB\\_399\\_May14.IRAs.pdf](http://www.ebri.org/pdf/briefspdf/EBRI_IB_399_May14.IRAs.pdf).

<sup>106</sup> Cerulli Associates, “Retirement Markets 2014,” Exhibit 9.06.



All of this suggests that IRAs have become critical to the retirement security of a large proportion of America's middle class, and therefore merit special protections beyond those applicable to other retail savings and investment accounts.

### 3.2.1.2 IRA Investors' Vulnerability

There is ample evidence that retail investors generally and IRA owners in particular are vulnerable to abuse. They face challenges in successfully navigating today's complex financial markets. Many cannot effectively assess the quality of the investment advice they receive or even the investment results they achieve. Disclosures often lack salience or suffer from complexity, so IRA investors often overlook or misunderstand them and often gloss over the information presented to them. Lastly, research documents that most cannot distinguish between the different types of advisers or the different standards of conduct to which different advisers must adhere, and this confusion is exacerbated by industry marketing and other practices, especially if the adviser is dually registered as a BD and RIA.

In addition, IRA investors, in particular, face unique circumstances that easily lend themselves to abuse. Because most IRAs are retirement income vehicles fed by job-based pension plans, balances tend to be highest at advanced ages, close before and after retirement. Households headed by individuals over age 55 held 79 percent of IRA assets in 2013. This contrasts with just 45 percent of job-based DC plan assets (Advanced Analytical Consulting Group 2014). Yet under current rules the former – the group more susceptible to abuse – typically lack the protection associated with a fiduciary standard of conduct, while the latter generally enjoys such protection.<sup>107</sup> Vulnerability is often particularly acute at the moment of retirement, as investors roll over large balances from more protected, job-based DC (or even DB) plans to less-protected IRAs. As noted in Section 2.4.4 above, under current Department guidance advice on such rollovers need not adhere to ERISA and IRC fiduciary standards. If such advice is tainted by conflicts, the participant may suffer serious negative consequences. For example, conflicts may lead an adviser to recommend that a plan participant retire earlier than planned in order to roll his or her balance into an IRA, offering unwarranted assurances that investment opportunities available there will adequately provide for their retirement income needs.

In a January 15 letter announcing its regulatory and examination priorities for 2015, FINRA stated that “a central failing [it] has observed is firms not putting customer's interests first. The harm caused by this may be compounded when it involved vulnerable investors (e.g., senior investors) or a major liquidity or wealth event in an investor's life (e.g., an inheritance or Individual Retirement Account rollover). Poor advice and investments in these situations can have especially devastating and lasting consequences for the investor.”<sup>108</sup>

There is evidence that, as investors age, they become more vulnerable to and targeted for abuse. By several measures, according to academic research, financial capability begins to decline around age 53 (Agarwal et al. 2009). Individuals over the age of 55 often “lack even a rudimentary understanding of stock and bond prices, risk diversification, portfolio choice, and

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<sup>107</sup> FINRA Regulatory and Examinations Priority Letter (Jan. 6, 2015), available at: <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p602239.pdf>.

<sup>108</sup> Ibid.

investment fees” (Lusardi, Mitchell and Curto 2009). While financial literacy falls at advanced ages, confidence in financial capability may actually increase, leading to poor investment decisions (Finke, Howe and Huston 2011) and vulnerability to fraud (Gamble et al. 2014).

SEC examinations of “free lunch” sales seminars found that these events often target older investors, offering attractive inducements to attend. The seminars commonly employ a variety of misleading and abusive sales practices. They are often promoted as educational workshops led by expert financial advisers. Attendees “may not understand that that the seminar is sponsored by an undisclosed company with a financial interest in product sales.”<sup>109</sup> Financial advisers often use “senior designations” – titles that denote special expertise in financial advice for older individuals – in these and other forums. The Consumer Financial Protection Bureau (CFPB) has found that these designations are confusing to consumers. A recent CFPB report documents older investors’ vulnerability to abuse, and explains how some advisers use senior designations to create an impression of unbiased expertise when their true aim is to sell products in which they have a financial interest. CFPB recommends improving standards for acquisition of senior designations and for the conduct of individuals holding such designations.<sup>110</sup> FINRA, noting that some BDs misleadingly purport to offer free, “no-fee” IRAs, recently opined that materials making such claims violate applicable advertising rules.<sup>111</sup>

All of this suggests that IRAs not only merit but also need special protections. By broadening the application of fiduciary provisions to more financial advice rendered to IRA investors, the new proposal will reduce or mitigate the adviser conflicts that can otherwise motivate abuse.

### 3.2.1.3 Current Protections

While certain other consumer protections currently apply to IRA investment advice, these other protections do not always limit or mitigate potentially harmful adviser conflicts as robustly as would the combination of these protections with those contained in the IRC PT provisions. As elaborated in Section 3.2.4, notwithstanding existing protections, there is convincing evidence that advice conflicts are inflicting losses on IRA investors. Therefore IRA investors could gain from extension of fiduciary standards to such advice.

As noted in Chapter 0 above, the rules governing retail investment advice can vary depending on the nature of the advice, the financial products that are being recommended, and whether the assets are held in an IRA. Under the 1975 rule certain advice rendered to IRA

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<sup>109</sup> SEC, “Protecting Senior Investors: Report of Examinations of Securities Firms Providing “Free Lunch” Sales Seminar,” (Sept. 2006); available at: <http://www.sec.gov/spotlight/seniors/freelunchreport.pdf>.

<sup>110</sup> See CFPB, “Senior Designations for Financial Advisers,” 2013 and GAO Publication No. GAO-11-235.

<sup>111</sup> See FINRA Regulatory Notice 13-23, “Brokerage and Individual Retirement Account Fees,” (July 2013), available at: <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p304670.pdf>. In the notice, FINRA stated that BD’s marketing campaigns often emphasize that fees are not charged in connection with their retail brokerage accounts and IRAs. Nevertheless, while certain types of fees may not be charged, others will be. For example, accounts offered by broker-dealers may be subject to fees for opening, maintaining or closing accounts. FINRA concluded that referring to an IRA account as a “free IRA” or “no-fee IRA” where costs exist would fail to comply with Rule 2210’s prohibition of false, exaggerated, unwarranted, promissory or misleading statements or claims.

investors is already subject to the PT provisions of the IRC. Retail advice on securities investing generally is governed by the Advisers Act, pursuant to which Advisers must register with the SEC or a state and adhere to fiduciary standards of care and loyalty to client interests. However BDs who render investment advice about securities to their clients are exempt from the Advisers Act if the advice is “solely incidental” to brokerage services, and the broker receives no special compensation for providing the advice. Instead such BDs and their representatives must register under the Securities Exchange Act of 1934, deal fairly with clients, recommend only suitable investments, and seek best execution of trades. The suitability standard is widely understood to be less exacting than the fiduciary duty to act in a customer’s best interest.<sup>112</sup> However in a January 2015 letter announcing its regulatory and examination priorities, FINRA stated that “irrespective of whether a firm must meet a suitability or fiduciary standard, FINRA believes that firms best serve their customers – and reduce regulatory risk – by putting customer’s interest first. This requires the firms to align their interests with those of its customers.”<sup>113</sup> Broker-dealers are generally not subject to a fiduciary duty under the federal securities law, and are subject only to the lower suitability standard.

Insurance agents recommending annuity products that are not securities must comply with state insurance rules governing their market conduct. They are typically held to only a negligence standard of care (Beh and Willis 2009). Still other federal or state rules may apply where bank representatives recommend bank products.

The protections provided under these different regimes vary substantially. Generally all but the IRC PT provisions permit advisers to provide advice where their own interests conflict with those of their clients. These regimes tend to rely heavily on disclosure to mitigate conflicts, but the degree to which and manner in which such conflicts must be disclosed to clients varies. The specific duties imposed on advisers by the SEC stem, in large part, from antifraud provisions. Accordingly, certain conflicts of interest are not themselves violations as long as they are disclosed in order to ensure that the implied representation of fairness is not misleading. In contrast, ERISA and the Code place special emphasis on the elimination or mitigation of conflicts. Absent an exemption designed to protect the interests of plan participants and IRA owners, an investment adviser subject to the prohibited transaction rules is forbidden from giving conflicted advice, regardless of whether he or she has fully disclosed the conflict of interest.

As elaborated below, conflicts of interest are widespread in retail investment advice services, disclosure appears to be largely ineffective in mitigating potential harm from such conflicts, and there is evidence that existing conflicts are associated with large costs in the aggregate to investors. Broader application of the IRC PT provisions would reduce and/or more effectively mitigate conflicts in advice rendered to IRA investors, and thereby prevent some harm that other regimes alone fail to prevent.

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<sup>112</sup> See e.g., Laby (2012, 707, 710, 725-744).

<sup>113</sup> FINRA Regulatory and Examinations Priority Letter, 2015. FINRA also has stated that suitability also requires consistency with a best interest standard. Also see FINRA Regulatory Notice 12-25, “Additional Guidance on FINRA’s New Suitability Rule” (May 18, 2012); available at: <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p126431.pdf>.

The wide variety of advisers' titles and business models and practices sows confusion among investors and thereby leaves them more vulnerable to harm and/or prone to expensive errors. The SEC has "expressed concern when specific regulatory obligations depend on the statute under which a financial intermediary is registered instead of the services provided."<sup>114</sup> SEC staff in 2011 concluded that investors "should not have to parse through legal distinctions," but instead should be "protected uniformly when receiving personalized investment advice."<sup>115</sup> Laby (2012) argues that because brokers routinely market their services as advisory, investors' reasonably expect advice loyal to their interests, and their expectations justify application of a fiduciary standard of conduct to their advisory activities. Broader application of the IRC PT provisions will provide strong, complementary protections for all investment advice regarding IRAs.

### 3.2.1.4 The Department's Role

The new proposal fits squarely within the Department's responsibility to regulate advice regarding IRAs, which was established in 1978<sup>116</sup> and underscored in 2006 by the PPA's addition to ERISA and the IRC of a statutory investment advice exemption.<sup>117</sup>

As noted above, since 1978 the Department has been solely responsible for interpreting and issuing exemptions from the PT provisions of both ERISA and the IRC. As discussed in the Legal Environment section above, since that time the Department has issued a number of regulations related to the IRC PT provisions, as well as a number of PTEs that grant fiduciary investment advisers certain relief from those provisions.

Notably, pursuant to certain provisions of the PPA,<sup>118</sup> the Department issued a number of regulations and exemptions related to fiduciary investment advice to IRA investors,<sup>119</sup> culminating in the 2011 promulgation of a final regulation implementing a statutory PTE for fiduciary investment advisers to plan participants and IRA investors.<sup>120</sup> The regulation includes strong safeguards to ensure that advice is not tainted by conflicts of interest. Generally, either the adviser's compensation must not vary depending on the IRA investor's investment choices, or the recommendations must be generated by a computer model that was independently certified to be

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<sup>114</sup> SEC Release No. 69013, IA-3558, "Duties of Brokers, Dealers and Investment Advisers" (2013), 5.

<sup>115</sup> SEC "Dodd-Frank Study" (2011), 101.

<sup>116</sup> See Reorganization Plan No. 4 1978, 5 U.S.C. App. (2010).

<sup>117</sup> ERISA §§408(b)(14) and 408(g) and IRC § 4975(d)(17) and 408(f)(8) as added by PPA.

<sup>118</sup> Ibid.

<sup>119</sup> See IB 96-1, in which the Department identified categories of investment-related information and materials that do not constitute investment advice; AOs 97-15A and 2005-10A, in which the Department explained that a fiduciary investment adviser could provide investment advice with respect to investment funds that pay it or an affiliate additional fees without engaging in a prohibited transaction if those fees are offset against fees that the plan otherwise is obligated to pay to the fiduciary; and AO 2001-09A in which the Department concluded that the provision of fiduciary investment advice, under circumstances where the advice provided by the fiduciary with respect to investment funds that pay additional fees to the fiduciary is the result of the application of methodologies developed, maintained and overseen by a party independent of the fiduciary, would not result in prohibited transactions.

<sup>120</sup> 29 C.F.R. §§ 2550.408g-1 and 408g-2.

unbiased, among other protections. In developing and issuing the regulation, the Department provided regulatory impact analyses that pointed to research on the potential for harm from conflicted financial advice as a reason why such strong safeguards were necessary and why the Department elected not to provide additional, administrative exemptive relief.<sup>121</sup> The Department also held a public hearing, in which several witnesses' testimony addressed the implications of the statutory PTE, the implementing regulation, and potential additional exemptive relief for investment advice regarding IRAs.<sup>122</sup>

Also of note, the PPA specifically charged the Secretary of Labor with determining whether relief under the statutory PTE could be used by fiduciary advisers in connection with IRAs.<sup>123</sup> To reach its determination, the Department obtained public input via a Request for Information published in the Federal Register,<sup>124</sup> direct outreach to major IRA custodians, and a public hearing.<sup>125</sup> In a 2008 report to Congress, the Department issued its determination,<sup>126</sup> thereby making the aforementioned relief available to fiduciary advisers in connection with IRAs.

As this history demonstrates, the Department's role regulating fiduciary investment advice to IRAs long predates the 2010 proposal – it was established 35 years prior and was recently explicitly recognized and expanded by the PPA in 2006. The new proposal fits squarely within the Department's scope of responsibility to interpret the IRC PT provisions and issue PTEs in connection with investment advice regarding IRAs.

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<sup>121</sup> 74 Fed. Reg. 60156 (Nov. 20, 2009); 76 Fed. Reg. 66136 (Oct. 25, 2011).

<sup>122</sup> A transcript of the hearing is available at: <http://www.dol.gov/ebsa/pdf/investmentadvicetranscript102108.pdf>.

<sup>123</sup> PPA § 601(b)(3)(B), P.L. 109-280, 120 Stat. 965.

<sup>124</sup> 71 Fed. Reg. 70427 (Dec. 4, 2006).

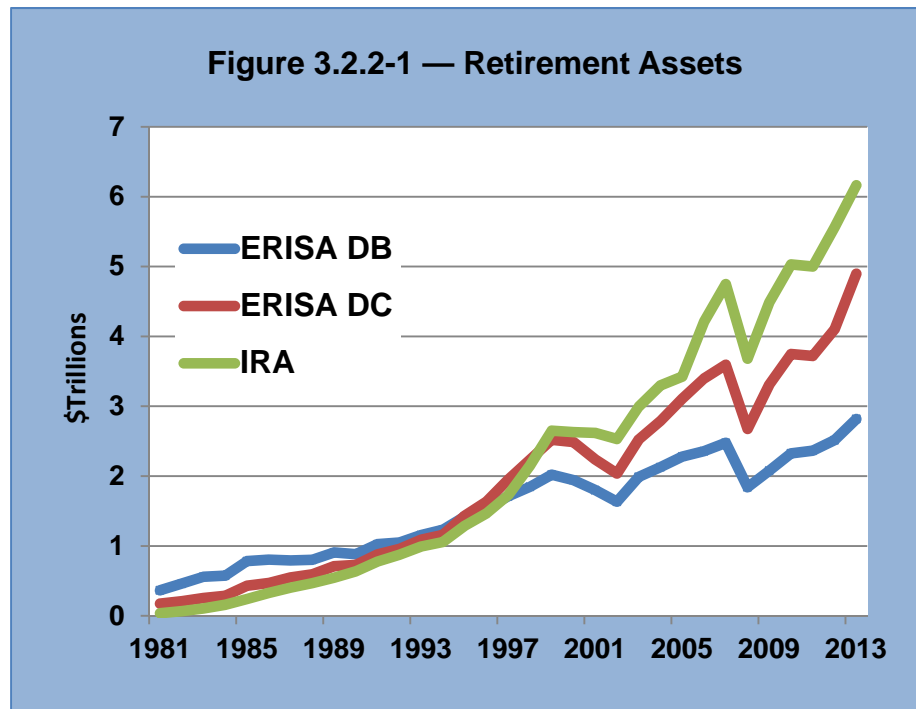
<sup>125</sup> 72 Fed. Reg. 34043 (June 20, 2007).

<sup>126</sup> DOL Report to Congress (Aug. 21, 2008), available at: <http://www.dol.gov/ebsa/publications/reporttocongress.html>.

### 3.2.2 Market Changes Since 1975

The 1975 rule has been overtaken by changes in the marketplace.

Retirement savings in 1975 existed mostly in the form of DB pensions<sup>127</sup> and DC plans in which investment choices were made mostly by plan managers and not participants.<sup>128</sup> IRAs had just been enacted. In the private sector, ERISA in 1974 established fiduciary duties for the individuals who chose



plan investments, and for individuals who advised with respect to such choices. The 1975 rule was drafted in an environment where its application was mostly to advice rendered to plan managers; that is, to institutional investors, not to consumers.

Today's retirement savings marketplace is dramatically different from that which existed when the 1975 rule was issued. Compared with 1975, America's workers and retirees today are far more responsible for providing for their own retirement security. At the same time, the investments available to them have grown in variety and complexity. Their need for investment advice or other effective support is great and growing.

The market for investment advice and other support is likewise changing rapidly. The types of help available are multiplying. Distinctions between the functions of different types of professionals have blurred. The web of relationships and revenue streams between product manufacturers, distributors, and advisers has become more intricate and less transparent, multiplying opportunities for conflicts of interest to taint advice. This growing complexity breeds confusion among consumers, making them more vulnerable to abuse.

<sup>127</sup> See Private Pension Plan Bulletin Historical Tables and Graphs, U.S. Department of Labor, Employee Benefits Security Administration (June 2013); available at: <http://www.dol.gov/ebsa/pdf/historicaltables.pdf>.

<sup>128</sup> The law creating 401(k) plans was not effective until Jan. 1, 1980.



### 3.2.2.1 Changes in Retirement Savings

The extent of an individual's responsibility for providing for his or her own retirement security depends on the type of retirement savings or benefit program he or she relies on to achieve that security. DB plans typically provide participants with a specified benefit – the worker or retiree has no responsibility for investment decisions. DC plan participants usually are responsible for investing their own accounts (although this was less common in 1975 than it is today<sup>129</sup>). However, their choice is usually limited to a menu of options pre-selected for them by a responsible plan fiduciary.<sup>130</sup> The menu often features a default option,<sup>131</sup> chosen by the fiduciary to be well suited to the needs of many participants. Investment advice provided to participants often is understood by the advisers to be fiduciary advice under the 1975 rule, comments on the 2010 proposal suggest.

IRA investors, in contrast, are fully responsible for choosing investments (or hiring a professional to choose for them) from among a near endless variety of securities, financial products, and other property in which they are permitted by law to invest their IRAs. There is no fiduciary responsible for constructing a menu or identifying an appropriate default option. And advisers generally do not consider the advice they render to IRA investors to be fiduciary advice under the 1975 rule, according to comments on the 2010 proposal.

The United States of America's workers and retirees today are far more responsible for providing for their own retirement security than they were in 1975, due to a major decline in the role of DB plans, a corresponding increase in the role of DC plans (and a shift toward more participant direction of investment in these plans), and an even larger increase in the role of IRAs. In 1975, IRAs had just been established (when ERISA was enacted in 1974). By 1984, IRAs still held just \$159 billion in assets, compared with \$589 billion in private-sector DB plans and \$287 billion in private-sector DC plans. By the end of the 2014 third quarter, in contrast, IRAs held \$6.3 trillion, far surpassing both DB plans (\$3.0 trillion) and DC plans (\$5.3 trillion).<sup>132</sup> If current trends continue, DB plans' role will decline further, and IRA growth will continue to outstrip that of DC plans, as the workforce ages and the baby boom generation retires and more DC accounts (and sometimes lump sum payouts of DB benefits) are rolled into IRAs. Almost \$2.5 trillion is projected to be rolled over from plans to IRAs between 2015 and 2019.<sup>133</sup>

IRAs' growth has made more middle- and lower-income families into investors, and sound investing more critical to such families' retirement security. As a result the pool of consumers needing expert financial advice or other support is growing to include more modest income families, who often lack financial expertise.

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<sup>129</sup> This is due to the fact that participants became more responsible for managing the investments in their accounts when 401(k) plans were created. The law creating them did not become effective until Jan. 1, 1980.

<sup>130</sup> Plan Sponsor Council of America's (PSCA), "56th Annual Survey Reflecting 2012 Plan Experience," Tables 67, 73 and 74.

<sup>131</sup> *Ibid.*, Table 118.

<sup>132</sup> Federal Reserve Board, "Financial Accounts of the United States, 1945–2014," Federal Reserve Statistical Release Z.1, (Mar. 2015).

<sup>133</sup> Cerulli Associates, "Retirement Markets 2014."

As more families have invested, investing has become more complicated. As IRAs grew during the 1980s and 1990s, their investment pattern changed, shifting away from bank products and toward mutual funds (*See* Figure 3.2.1.1-1 at the beginning of Section 3.2.2).<sup>134</sup> Bank products typically provide a specified investment return, and perhaps charge an explicit fee. Single issue securities lack diversification and have uncertain returns, but the expenses associated with acquiring and holding them typically take the form of explicit up front commissions and perhaps some ongoing account fees.<sup>135</sup> Mutual funds are more diversified (and in this respect can simplify investing), but also have uncertain returns, and their fee arrangements can be more complex, and can include a variety of revenue sharing and other arrangements that can introduce conflicts into investment advice and that usually are not fully transparent to investors. Further, the type and level of disclosure varies depending on whether the adviser is acting as a RIA or BD, but many retail customers do not understand the difference between the two regimes or know which regime their adviser is subject to.

The growth in IRAs and the shift in how IRA assets are invested point toward a growing risk that conflicts of interest will taint investment advice regarding IRAs and thereby compromise retirement security.

### 3.2.2.2 Changes in Advice Provision

As more of America's workers have become IRA investors, the types of investment advice services available to them have changed and multiplied.<sup>136</sup> Compared with 1975, today's services are more likely to involve a wider variety of conflicts of interest and to operate under a wider variety of rules, and therefore to saddle consumers with more confusion and risk of abuse.

Before 1975, brokerage and advisory services were relatively distinct. Brokerage mostly involved execution of trades. Execution involved substantial labor input, commissions were fixed in law, and BDs and their representatives could and did derive their revenue mostly from commission payments for execution. BD representatives' advice was limited and mostly truly incidental to transactions, and therefore was comfortably excluded from regulation under the 1940 Investment Advisers Act. Advisory services were understood to be different and separate from brokerage, and regulated under the Advisers Act. Advisers were compensated mostly by means of asset-based advisory fees, and generally were subject to a fiduciary standard of conduct toward their retail customers. Also at that time the investments on which advice was rendered were less likely to involve complex fee arrangements that can introduce a variety of less transparent conflicts into advice. For example, in 1975 there were just 426 US mutual funds holding \$46 billion in assets. In 2013, more than 7,700 mutual funds held more than \$15 trillion.<sup>137</sup> Almost contemporaneous with Congress's passage of ERISA, changes under the securities laws created

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<sup>134</sup> Federal Reserve Board, "Financial Accounts of the United States, 1945–2014," Federal Reserve Statistical Release Z.1, (Mar. 2015).

<sup>135</sup> The transparency of fees associated with single issue securities should not be taken to suggest that conflicts of interest are not a concern in this area. As discussed later, conflicts can be harmful even when the presence and magnitude of the conflict is known, and disclosure alone is rarely a sufficient remedy.

<sup>136</sup> For a fuller discussion of some of these changes, *see* Laby 2012, (726-731).

<sup>137</sup> ICI, "2014 Investment Company Fact Book."



competitive pressures that motivated BDs and their representatives to provide services in addition to transaction execution, including research and fuller financial advice. In 1975, the SEC and Congress deregulated fixed commissions. Discount brokers entered the business. As years passed, technological advances facilitated deeper discounts. Two-tier pricing emerged, consisting of high-priced, full-service brokerage bundled with personalized financial advice, and low-priced, discount brokerage with no or limited ancillary services.

In 1983, the FDIC made clear that banks are permitted to provide discount brokerage services. From 1980 to 1992, discount brokers' market share of retail commissions grew from 1.3 percent to 12.9 percent.<sup>138</sup> The available commission rates for retail customers fell substantially. Through the mid-1990's, commissions for a 100-share trade with a full-service BD ranged from \$75 to \$150. By 1996, discount brokers introduced online trading. Soon, online brokers were offering commissions as low as \$7 per trade (Bakos et al. 1999, 4).

As noted earlier, BDs who receive a special fee for investment advice generally must register with the SEC or a state pursuant to the Advisers Act and assume fiduciary duties.<sup>139</sup> The higher commissions associated with full service brokerage might appear to be (and arguably often function as) a special fee for advice. The SEC recognized this tension. It also recognized that BD representatives who give fuller financial advice and are compensated by transaction based commissions have an incentive to recommend higher trading volumes than would be optimal for their customers. To address both the legal tension and the conflict, SEC proposed in 1999 to essentially waive the special-fee condition to avoid registration under the Adviser Act, by allowing fee-based brokerage accounts, and many BDs began collecting asset-based fees.<sup>140</sup> However, a group representing RIAs who objected to this policy successfully challenged it in court, and the rule was vacated.<sup>141</sup>

As advice services evolved, so did the means by which they were compensated<sup>142</sup> particularly for BD representatives recommending and selling mutual funds. In 1980, the SEC issued rule 12b-1, which permitted mutual funds to pay "distribution fees" to BDs to promote and sell the funds.<sup>143</sup> So-called 12b-1 fees largely precipitated the development of the different mutual fund share classes available today. Different classes generally carry different investor costs to buy, sell, or hold what is otherwise the same fund, and entail different compensation streams from the mutual funds to the BDs that distribute them. RIAs managing mutual funds also frequently share revenue with BDs who distribute the funds they advise. BDs in turn can share this compensation in various ways with their representatives who recommend the funds. Because of these various compensation practices, BD representative compensation can vary depending on what fund and what share class their customers select. This creates a conflict that can bias their

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<sup>138</sup> SEC, "Market 2000, An Examination of Current Equity Market Developments, Structure of the U.S. Equity Markets" (Jan. 27, 1994) at p. II-5, available at: <https://www.sec.gov/divisions/marketreg/market2000.pdf>.

<sup>139</sup> 15 U.S.C. § 80b-2(a)(11)(C).

<sup>140</sup> SEC Proposed Rule, "Certain Broker-Dealers Deemed Not to be Investment Advisers," 64 Fed. Reg. 61226, Release Nos. IA-1845, 34-42099; File No. S7-25-99, (1999).

<sup>141</sup> See *Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007).

<sup>142</sup> For a fuller discussion of some changes in adviser compensation, see Howat and Reid (2007).

<sup>143</sup> 17 C.F.R. § 270.12b-1.

recommendations. These conflicts often are not transparent to investors, even if they are financially sophisticated.

Compensation arrangements that create conflicts in advice are not limited to mutual funds, however. For example, BDs often sell securities, such as corporate bonds, to retail customers out of their own accounts at mark-ups that are not transparent.<sup>144</sup> Nor are such conflicts limited to BD representatives. For example, many RIAs receive variable compensation other than asset-based fees from mutual funds, and while this is disclosed in general terms to their customers, the disclosures generally do not quantify the conflict that pertains to a particular recommendation and often are not understood or even read by investors. Insurance agents and brokers who distribute and recommend products that are not securities typically are compensated by commission and may be otherwise rewarded for achieving various sales goals. The conflicts facing a particular adviser can become more numerous and complicated if that adviser is authorized to act in more than one capacity, as a BD representative, RIA, and/or insurance broker, a practice sometimes referred to as “hat-switching,” or if the adviser is affiliated with other advisers who wear different hats. This poses a particular problem to retail customers, many of whom are not aware of the differences in regulatory approaches for these entities and the differing duties that flow from them.

Many of the trends in retail investing since 1975 have been favorable to consumers. Discount brokerage in particular has reduced many investors’ trading costs. This, together with competition and growth in the mutual fund industry, has contributed to substantial declines in mutual fund loads and expense ratios<sup>145</sup> (although the total net effect on mutual fund investor results is less certain<sup>146</sup>). In recent years, new technologies and innovations in financial products appear to be making advice and other potentially effective investment support more affordable and available to many consumers. Some of these newer business models lean toward independence in advice, but absent policy changes such as those included in the new proposal, they likely will face the same competitive pressures that have led more conflicted models to prevail so far.

Notwithstanding these positive developments, however, the major changes in advice and compensation arrangements and associated conflicts of interest since 1975 compel the Department to reexamine the 1975 rule. All of the trends discussed directly affect IRAs and therefore retirement security. The increasing complexity and variety in advisory services, and related compensation arrangements and consumer protections, causes confusion among consumers – a

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<sup>144</sup> Ferrell (2011) reports that, in the market for lower-priced, less liquid equities, mark-ups and mark-downs have decreased in size over the last 40 years. However, he also finds that a BDs’ principal status and solicitation of trades are associated with larger mark-ups. It is not clear whether his finding would hold in the very different market for investment grade corporate bonds, where IRA investors are more likely to be active. The BDs’ financial incentive to maximize mark-ups is facially the same in both markets, however, which raises concern that, because of BD conflicts, IRA investors may sometimes pay more than fair prices for corporate bonds.

<sup>145</sup> ICI 2014 Investment Company Fact Book, “Chapter 5: Mutual Fund Expenses and Fees,” available at: [http://www.icifactbook.org/fb\\_ch5.html](http://www.icifactbook.org/fb_ch5.html).

<sup>146</sup> Investor results are further affected by fund performance and timing of trades, and is generally known to lag the performance of funds themselves. Dalbar “2014 Quantitative Analysis of Investor Behavior,” available at: <http://www.dalbar.com/ProductsServices/AdvisorSolutions/QAIB/tabid/214/Default.aspx>.

conclusion reached by GAO,<sup>147</sup> the CFPB,<sup>148</sup> and supported by a carefully researched study by RAND for the SEC (Hung et al. 2008). Palaveev (2008) describes how BD representatives have adopted a new role as advisers who control client relationships, and “the center of the relationship has shifted from the product to the skills of the adviser.” Conflicts of interest associated with many of these relationships raise serious concerns that advice will sometimes be biased and IRAs will be vulnerable to abuse. Palaveev recommends that advisers who produce revenue for BDs should be aware of BDs’ “hidden profit centers,” that stem from “marketing fees from mutual funds and investment management funds,” which can “represent a conflict of interest, because BDs have an incentive to promote such funds and programs even if they aren’t in the long-term interest of clients.” Palaveev’s article reveals how BDs and their producing advisers compete with each other for revenue and profit, often at investors’ expense. Senior citizens are particularly vulnerable to misleading advice from financial professionals. The report by SEC, NASAA and FINRA indicates that free lunch sales seminars often target seniors and approach senior citizens using the terms that suggest special credentials certification such as “Certified Senior Adviser,” or “Elder Care Asset Protection Specialist”, when there is in fact no regulatory qualification that recognizes such expertise.<sup>149</sup> The Massachusetts Securities Division (MSD) finds that the use of various designations and credentials targeting seniors has increased, leading to adopt regulations addressing this type of misconduct targeting senior citizens in 2007.<sup>150</sup>

### 3.2.3 The IRA Advice Market

IRA advisers’ conflicts are likely to harm IRA investors. According to academic literature, it is likely that advisers’ conflicts will often bias their advice, and IRA investors will often follow biased advice. This will result in social welfare losses – IRA investors will make suboptimal decisions about their purchases of advice and, following biased advice, about their investments. Suboptimal investment decisions may allocate capital inefficiently in the national economy. It will also result in transfers, as advisers and producers of the products they recommend capture surplus from IRA investors. Both of these effects would erode IRA investors’ retirement security.

The market for IRA advice exhibits at least three noteworthy characteristics, which together may render IRA investors vulnerable to harm from advisers’ conflicts. First, conflicts are widespread in the market even in spite of the existing regulatory framework (*See* Section 3.2.3.1 below). Second, advisers incur substantial costs pursuing IRA customers, and IRA investors ultimately bear such cost (*See* Section 3.2.3.2 below). Third, and almost certainly underlying the other two, IRA investors face high “information costs” – i.e., they face barriers in evaluating the quality of advice (*See* Section 3.2.3.3 below).

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<sup>147</sup> GAO Publication No. GAO-11-235.

<sup>148</sup> *See* CFPB “Senior Designations for Financial Advisers,” 2013.

<sup>149</sup> SEC, NASAA, FINRA, September 2007, “Protecting Senior Investors: Report of Examinations of Securities Firms Providing “Free Lunch” Sales Seminars.” Accessed at: <http://www.sec.gov/spotlight/seniors/freelunchreport.pdf>.

<sup>150</sup> Mass. Code Regs. 12.204(2)(i) (2007); 950 Mass. Code Regs. 12. 205(9) (c) (15)(2007), accessed at: <http://www.sec.state.ma.us/sct/sctpropreg/propreg.htm>.

### 3.2.3.1 Existence of Conflicts

Conflicts of interest are widespread and often acute in the market for IRA investment advice. In an October 2013 report, FINRA stated that “conflicts of interest can arise in any relationship where a duty of care or trust exists between two or more parties, and, as a result, are widespread across the financial services industry.” The report goes on to review many types of conflicts that can bias retail investment advice. Broker compensation structures typically favor some products over others. Many include production thresholds that trigger large rewards that can encourage mis-selling or churning. FINRA reviews various strategies to mitigate conflicts, including the adoption of less variable compensation structures, and monitoring advisers’ sales for evidence of bias, particularly near compensation thresholds and at major investor lifecycle events, such as rollovers at retirement. The FINRA report also notes that brokers often are conflicted with respect to investors’ choice between commission- or fee-based relationships. Finally, it summarizes regulation of broker conflicts in the US and abroad, noting strong bars against conflicts that have been implemented or proposed in some jurisdictions.<sup>151</sup> FINRA also has expressed concerns about broker conflicts that can arise from recruitment compensation practices that can encourage mis-selling or churning.<sup>152</sup>

Many IRA advisers, including many BDs, RIAs, insurance agents, and bank representatives, are conflicted, as depicted in Figure 3.2.3.1-1.<sup>153</sup> Advisers often have an interest in recommending products that are proprietary to their employers or their or their employers’ affiliates, or that generate greater revenue for themselves, their employers, or affiliates.<sup>154</sup>

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<sup>151</sup> FINRA “Report on Conflicts of Interest,” (Oct. 2013), last accessed at:

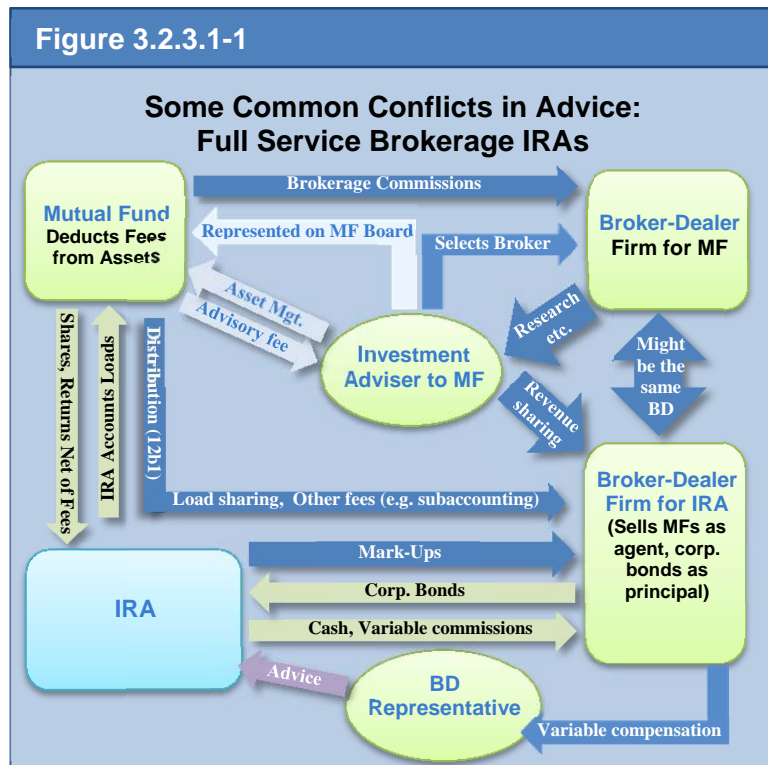
<https://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p359971.pdf>

<sup>152</sup> FINRA Regulatory Notice 13-02, “Recruitment Compensation Practices,” (Jan. 2013), available at:

<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p197599.pdf>.

<sup>153</sup> See Section 3.2.3.3.3 for an explanation of the color scheme used in Figure 3.2.3.1-1.

<sup>154</sup> This discussion is not intended to be exhaustive with respect to compensation arrangements that may introduce conflicts into investment advice. For some additional discussion of the types of conflicts affecting such advice, see Howat and Reid (2007), Hung et al. (2008), Turner and Muir (2012), and Robinson (2007).



BDs and their representatives often have a financial stake in the investment decisions that IRA investors make pursuant to the representatives' advice. BDs and their representatives often stand to gain if IRA investors trade more, buy or hold certain mutual funds or other products, or buy securities out of the BD's own inventory. The attendant conflicts often play out at two levels: variation in the revenue received by the BD, and variable compensation paid by the BD to its representatives who render IRA advice. The accompanying diagram provides a simplified representation of some of the common payments and relationships that can give rise to such conflicts.

Mutual funds compensate the BDs that distribute them in various ways, and RIAs advising mutual funds also often share revenue with BDs who distribute the funds they advise. BDs share this compensation in various ways with their representatives who recommend funds to IRA investors and other retail clients.

Many of the mutual fund shares distributed through BDs are so-called "class A" shares, which charge a front-end sales load. The mutual fund typically shares most of this load with the BD who distributed the shares. Many mutual funds deduct so-called 12b-1 fees from shareholder accounts to pay distribution costs. Some of this fee often is paid to the distributing BD, perhaps as compensation for selling the shares, sometimes called a "trailing commission," or for promoting the fund to customers, sometimes called a payment for "shelf space." The mutual fund might pay the distributing BD to perform services, such as "sub-accounting," where the BD aggregates many customer accounts to act as one large shareholder, relieving the mutual fund from administering many small accounts. The mutual fund also pays a RIA to manage the fund's assets, and that adviser may share some of that revenue with BDs who distribute the fund. Different mutual funds provide different combinations of these payments, in different amounts, to distributing BDs, so the BDs' revenue will be increased if IRA investors select mutual funds that provide more and larger payments.

Additional conflicts can arise if the distributing broker also executes trades for the mutual fund. The mutual fund's adviser may cause the mutual fund to pay the BD higher commissions in nominal exchange for providing the adviser with research or other services that help the adviser manage the fund's assets, in a practice known as "soft dollars" (because there is no explicit or "hard dollar" fee paid for the service).

BD conflicts are not limited to those associated with the distribution of mutual funds. BDs' revenue can likewise vary in connection with their distribution of other financial products, such as annuities. Their revenue is also affected by so-called "principal transactions," where the firm acts as a dealer, or "principal," rather than as a broker or agent, and executes the transaction between the customer and its own account. In one common transaction, a BD sells corporate bonds to an IRA investor from its own inventory, charging some mark-up over the bonds' market value as compensation for its dealer service. Of course, executing securities transactions as an agent, for example buying equity shares on a stock exchange for a customer's account, also generates revenue, in the form of commissions, for a BD.

Importantly, many of the aforementioned types of BD revenue increase with their customers' trading volume. More trades can generate more load sharing, more mark-ups, and more commissions.

BDs typically pass much of their variable revenue on to their representatives who recommend the mutual funds, as different types of variable compensation. One common type of compensation known as payout generally amounts to a specified fraction of the revenue that the representative produces for the BD. The fraction often increases with the representative's production, and may be different for different asset classes, different products, and products from different vendors.<sup>155</sup> Depending on the payout formula, BD representatives, like BDs, often stand to gain if IRA investors trade more, buy or hold certain mutual funds or other products, or buy securities out of the BD's own inventory. Some BD representatives receive higher compensation for distributing the BD's proprietary or affiliated mutual funds rather than a competitor's funds.<sup>156</sup>

Prentice (2011) lists common conflicts by which financial advisers can profit at investors' expense, including churning, reverse churning, excessive mark-ups and commissions, failing best execution, failing to disclose market-maker status, price manipulation, unauthorized trading, selling unsuitable securities, and operating boiler rooms.<sup>157</sup>

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<sup>155</sup> Hung et al. (2008) reports that "a common source of compensation is payout, the amount that a broker receives from total revenue that he or she generated for the firm. The payout percentage depends on the type of relationship between the firm and the broker, the level of production, the products involved, and the broker's rank in the firm ... In general, payouts are structured to increase incrementally as production increases" (29-30).

<sup>156</sup> Hung et al. (2008) also document complex webs of affiliations (41 and 59) and revenue streams (25-26) among financial products and services firms. For example, "fund companies pay the broker-dealers a certain percentage of the sales that brokers bring in, on top of the commissions that investors pay the broker" (25). These affiliations and revenue streams create myriad potential conflicts. The authors were unable to fully examine such affiliations and revenue streams, however. Although the authors "had access to extensive databases based on regulatory filings," gaps, "inaccuracies" and "inconsistencies" in such filings make it "difficult to make systematic and conclusive comparisons between different types of firms." (59-61).

<sup>157</sup> Brokers set up "boiler rooms" where a small army of high-pressure salespeople use banks of telephones to make cold calls to as many potential investors as possible. These strangers hound investors to buy "house stocks"—



Conflicts of interest likewise often arise in connection with compensation arrangements common to RIAs, insurance agents and brokers, and bank representatives who advise IRA investors.

A RAND study for the SEC found that RIAs who provide investment advice to retail clients are often highly conflicted. The study notes that RIAs often face “conflicts” arising from “various practices in which an adviser may have pecuniary interest (through, e.g., fees or profits generated in another commercial relationship, finder’s fees, outside commissions or bonuses) in recommending a transaction to a client.” According to the study, 13 percent of SEC-registered RIAs with individuals as clients received commissions. Many engaged in so-called “hat switching”: 7 percent were BDs, 12 percent were also BD representatives, and 16 percent were insurance agents or brokers. Thirty percent sold products or provided services other than investment advice to advisory clients. Twenty-two percent were affiliated with a BD, 11 percent with an investment company, 9 percent with a bank, and 17 percent with an insurance company or agency. An even larger fraction conducted discretionary business with BDs: 61 percent determined and 78 percent recommended the BD for some client account transactions. Sixty percent received products or services other than execution from a BD (Hung et al. 2008).

Nearly all RIAs with individuals as clients – 97 percent – received some compensation in the form of a fee tied to assets under management. This form of compensation is free of many of the types of conflicts described above but may introduce other potential conflicts. Reliance on asset-based fees might discourage a RIA from recommending the purchase of a fixed annuity or real property, thereby removing assets from the account under management. Asset-based fees also have sometimes raised concerns about the potential for “reverse-churning,” or charging an ongoing fee that is excessive because the account investor rarely trades and the adviser provides little ongoing service to the investor. (RIAs, however, generally are fiduciaries under securities law and acting on such conflicts could breach their fiduciary duty.)

Insurance agents and brokers also often face conflicts when advising IRA investors. They generally are compensated by commission. Insurance product commissions are often substantially higher than BDs’ mutual fund load sharers or securities commissions. Commissions on indexed annuities average 6.3 percent of the principal payment, according to one expert.<sup>158</sup> US life insurers’ aggregate commission payments accounted for 7 percent of aggregate total expenses and amounted to 9 percent of total premiums in 2013.<sup>159</sup> Moreover, insurance product commissions can vary widely across both products and insurers. Such high and variable commissions can encourage agents and brokers to recommend products that are not suitable for

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stocks that the firm buys or sells as a market maker or has in its inventory. (See, <http://www.sec.gov/answers/boiler.htm>.)

<sup>158</sup> Scism, Leslie. "Insurance Fees, Revealed," *Wall Street Journal*, March 30, 2012.

<sup>159</sup> Department calculations based on “American Council of Life Insurers: Life Insurers Fact Book 2014,” last accessed at: <https://www.acli.com/Tools/Industry%20Facts/Life%20Insurers%20Fact%20Book/Documents/FB14TableContents.pdf>. These figures include all life insurers’ product lines. Commissions are not reported separately for individual annuity products.

their customers and/or to favor one suitable product over others that would better serve their customers' interest (Schwarcz 2009).

Scholars and regulators recently have singled out so called “contingent commissions” as concerning and warranting special scrutiny. Contingent commissions are essentially cash or in-kind bonuses awarded to independent insurance agents or brokers by insurers for meeting specified volume or profitability goals. Their size and structure vary widely, introducing a complex variety of potential conflicts. For example, an insurance broker could be rewarded for steering customers toward insurers whose production goals they are approaching, or for steering higher risk customers away from insurers who pay bonuses contingent on profitability (net of claims) (Schwarcz 2007; Schwarcz and Siegelman 2015, forthcoming; Beh and Willis 2009). Contingent commissions and the attendant potential conflicts generally are not transparent to retail customers. Published sources of information on contingent commissions identified by the Department generally focus on commercial insurance lines and/or retail property-casualty insurance lines, and not retail life insurance products such as annuities. It is therefore unclear whether or to what degree contingent commissions might affect IRA investors.

Potential conflicts of interest in advisers' recommendations concerning insurance products are not limited to those associated with insurance product commissions. Insurance brokers, like BD representatives and RIAs, often engage in hat-switching, and/or are affiliated with vendors or distributors of products other than insurance products. Moreover, because variable annuities, likely the insurance product most widely marketed to retail investors, are regulated as securities, the advisers who distribute them are BD representatives, whose potential conflicts are documented immediately above in this section.

Bank representatives who distribute bank products, such as certificates of deposit, to IRA investors, generally are bank employees who distribute only proprietary products. Many banks, however, have affiliates that provide or distribute investment products that are not bank products, and bank employees may be encouraged to direct customers to such distributors and products.

The U.S. financial services industry itself widely acknowledges that potential conflicts of interest are pervasive among professionals who provide investment advice to IRA investors. This is borne out in public comments on the 2010 proposal. Many of the comments specifically reference compensation arrangements such as commissions and revenue sharing that can pose conflicts. The major role such compensation arrangements play in the current market for IRA investment advice appears to be a primary motivation for many of the industry's objections to the 2010 proposal. Many comments question whether various conflicts impact advice, arguing that countervailing market forces, business practices designed to make advice impartial, and/or various rules governing advice effectively prevent existing conflicts from tainting advice. Some argue that compensation arrangements that can pose conflicts also have other, positive market effects, such as helping to extend investment advice and encouragement to save to lower-income market segments. But the comments uniformly affirm the prevalent use of a wide variety of compensation arrangements that have the potential to introduce bias into investment advice regarding IRAs.<sup>160</sup>

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<sup>160</sup> See for example 2010 NPRM comments from LPL (“For example, the broker-dealer would be unable to effect principal transactions or offer credit interest programs. The broker-dealer may also be prevented from receiving



Economic theory predicts that adviser conflicts such as those enumerated above can bias advice and harm advice recipients.

For example, Stoughton, Wu, and Zechner (2011) model a market where financial advisers act as intermediaries between individual investors and portfolio managers, and find that non-conflicted financial advisers improve the welfare of investors. However, when conflicts of interest are introduced – the authors model a “fee rebate” or “kickback” from the portfolio manager to the financial adviser – individual investors are harmed. The investors are now not only worse off than they were without the conflict of interest, they are worse off than they would have been if the investment adviser did not exist at all. The authors find that, “*kickbacks are always associated with higher portfolio management fees and negatively impact fund performance.*” Some in the industry have made the claim that although fees are hidden and advice is conflicted, consumers are still better off in these advice arrangements than getting no advice at all. Results like those from Stoughton, Wu, and Zechner (2011) cast doubt on that assertion.

### 3.2.3.2 Costly Pursuit of Customers

IRA advisers (and their employers and affiliates) pursuing IRA advice customers incur costs to produce marketing materials, place advertisements, hold seminars, or make “cold” phone calls or knock on doors to speak with potential customers. Unfortunately, these costs are unlikely to yield commensurate benefits for IRA customers.

Some BD representatives (and insurance agents and brokers) are compensated entirely or primarily by commissions resulting from product sales. This creates an incentive to aggressively maximize sales, which is likely to result in costly and economically inefficient efforts to attract new customers. The average BD representative working for an independent BD firm receives 63 percent of his/her compensation through commissions.<sup>161</sup> Cerulli Associates determined that RIAs and BD representatives spent 18 percent of their time acquiring new clients in 2013,<sup>162</sup> and that this time share has increased from 15 percent in 2008.<sup>163</sup>

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certain of the common forms of compensation it currently receives for services, such as Rule 12b-1 fees or other compensation from third parties.”), SIFMA (“With some changes, PTE 77-4 will permit the broker fiduciary to recommend its affiliated open end mutual funds or affiliated bank deposits but there is no exemption that would allow it to receive trailers, fees or commissions from the mutual fund if the fund is purchased on an agency basis.”), ICI (“The Department should analyze whether the proposed rule will change how advisers in the IRA market are compensated and whether this will ultimately harm or benefit IRA investors. For example, while it is uncommon for front-end commissions to be charged in 401(k) plans, they are used routinely in retail accounts,” Insured Retirement Institute (“Annuities often have a lifetime income component, so they buy and hold investments that are usually best paid for via a commission or transaction based compensation.”), ACLI (“Guaranteed lifetime income products are a “buy and hold” investment on which an ongoing wrap fee would not be a good fit. As annuities are sold on a commission basis, they are generally not available under a wrap program.”) Comment Letters are available at: <http://www.dol.gov/ebsa/regs/cmt-1210-AB32.html#comments>.

<sup>161</sup> Financial Services Institute, “2011 Broker Dealer Financial Performance Study,” 27.

<sup>162</sup> Cerulli Associates, “Advisor Metrics 2013: Understanding and Addressing a More Sophisticated Population” (2013), Exhibit 5.15.

<sup>163</sup> Cerulli Associates, “Cerulli Quantitative Update: Retail Investor Provider Relationships 2011,” (2011), Exhibit 6.05.

In efficient, competitive markets, advertising should be used as a means to reduce information costs and promote transparency (Sirri and Tufano 1998). However, in the U.S., mutual fund advertisements rarely highlight one of the best predictors of performance—fees (Gallaher, Kaniel, and Starks 2006; Barber, Odean, and Zheng 2005). Both theory and ample empirical evidence show that fees are strong predictors of future fund performance, while past performance is not. Active investing generally is a zero-sum game: for each investor who wins, a counterparty investor must lose. If securities markets are efficient, securities prices immediately reflect all information and there is very little mispricing to be found and exploited. It turns out that the excess cost of active management – trying to identify and buy (sell) underpriced (overpriced) securities – is almost always higher than any gain in performance over a lower-cost, passive management approach. As a result, past superior performance by an active manager more often reflects luck than skill (Sharpe 1966; 1991; and 2013; Fama and French 2010; French 2008).

Instead, advertisements often focus on performance, or even suggest that advice is “free” (when it is not) or that 401(k) accounts are “old” relative to the retail mutual funds available in an IRA. That advertisements’ focus on poor predictors of future results, rather than on fees (a strong predictor), is indicative of a costly pursuit of customers that does not promote welfare gains – but the advertisements do seem to achieve their aim of promoting particular products.<sup>164</sup>

Inderst and Ottaviani (2009) develop a theoretical model of a sales transaction where an agent of the seller must pursue customers and provide advice to those customers. This agency setup is representative of much of the financial industry where insurance agents sell insurance products and BD representatives sell securities and mutual funds, etc. The researchers find that as agents require more effort to pursue customers, harm to the customer increases. These costs can only be offset by firms lowering their advice standards. They explain the implications of their result:

“[T]his suggests that one should expect the standard of advice to be lower when the roles of consumer acquisition and advice provision are performed by the same agent, and when performance cannot be easily measured and rewarded in isolation by separating the two tasks. We should expect the need for policy intervention to increase when incentives for customer acquisition become more important to firms. Intuitively, the more agents are expected to actively prospect for new customers, the more scope there is for mis-selling to occur at the advice stage, even when consumers are wary and product providers directly bear costs following unsuitable advice (Inderst and Ottaviani 2012, 509; Inderst and Ottaviani 2009, 893 – 895).

### 3.2.3.3 Obstacles to Distinguishing Good and Bad Advice

It is sometimes argued that, under certain conditions, reputational concerns might compel conflicted advisers to act in their customers’ interest. This theoretical result, however, rests on the assumption that customers can distinguish impartial advice from biased advice. The importance of this assumption to the theory of reputational effects is detailed in Section 3.2.3.3.1 below.

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<sup>164</sup> Evidence indicates that past performance has little or no signaling power in predicting future performance – though it does have power to influence fund flows (Jain and Wu 2000).

There is compelling evidence that most IRA investors are ill equipped to assess the quality of advice they receive, or even the investment performance they achieve. Most do not understand what they pay for advice and for investments, how their advisers are compensated and regulated, the conflicts their advisers might face, nor how those conflicts might affect their advice (*see* Section 3.2.3.3.3 below). Investors have a difficult time understanding whether their adviser is acting as a broker-dealer or as a RIA, and generally do not know which regulatory regime applies. As a result, advisers have both an opportunity and an incentive to preferentially recommend products that increase their profits, and/or those of the vendors whose products they recommend, at IRA investors' expense, without fear that their reputation or market share will suffer much if at all.

There is also compelling evidence that additional or different disclosure practices are unlikely to fill in these gaps in IRA investors' skills and knowledge. Many investors ignore disclosures. Many simply lack the financial sophistication and/or the time and attention necessary to master the complex information such disclosures would have to communicate. Moreover, there is no clear basis on which even sophisticated, attentive IRA investors could translate a thorough understanding of recommended and other available investments and their advisers' compensation and conflicts into optimal decisions about advice and investing. In particular, it is unclear how an IRA investor could determine whether or how a conflict has influenced her adviser's recommendation. And there is reason for concern that disclosure of conflicts can even have negative, unintended consequences. Section 7.6 summarizes the bases for these conclusions.

Under these circumstances, conflicts in IRA advice can harm IRA investors.

### **3.2.3.3.1 Obstacles to Assessing Advice Quality**

Detecting lapses in the quality of investment advice is not easy.<sup>165</sup> IRA investors typically have access only to information on their own experience – the advice they received, the investments they chose, and perhaps the results they achieved. In all likelihood they can neither directly observe the quality of the advice, nor infer it from their investment results. Moreover, IRA investors often do not know what they pay for advice. Without a good understanding of the quality and price of advice, they cannot make optimal decisions about purchasing it, and are vulnerable to paying too much for bad advice and to incurring financial losses by following it.

Almost certainly, the great majority of IRA investors cannot directly assess the quality of the investment advice they receive. It is the nature of an advisory relationship that the adviser has an informational advantage over the advisee. Bluethgen, Meyer, and Hackethal (2008) note that, “as financial advice is an expert service just as the ones provided by lawyers or doctors, the ordinary investor will hardly be able to determine the quality of the advice given even ex-post because the investor simply lacks the knowledge or the information to assess the quality of the advice.” Lusardi, Mitchell and Curto (2009, 15) found that older Americans “lack even a

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<sup>165</sup> One of the obstacles of assessing advice quality is the time and cost of investigating the advice. Individuals often purchase advice so that they don't have to worry about their investments. Those individuals, whose time-cost of investing is such that they choose to purchase advice, likely also have a prohibitively high time-cost of investigating that advice.

rudimentary understanding of stock and bond prices, risk diversification, portfolio choice, and investment fees.”

While gaps in IRA investors’ financial sophistication alone provide sufficient basis to conclude that most cannot directly assess the quality of advice, available empirical evidence lends additional support. In one study, auditors were trained to mimic actual advice clients and to record their advice interactions. The auditors were not trained to evaluate advice quality, however, and it appears that they overwhelmingly failed to recognize problems with the advice. Advisers failed to mention fees to one-half of auditors, failed to recommend index funds to 92 percent, and tended to recommend that auditors chase returns and/or choose actively managed funds. Yet 70 percent of the auditors said they would go back to the adviser with their own money (Mullainathan, Noeth and Schoar 2012). In a study of actual retirement investment advice interactions in Australia, investors “rarely were able to tell whether the advice they received had a reasonable basis.” In most cases where the Australian authority found “major shortcomings in the advice,” the investors “thought the advice was satisfactory and said they intended to follow it.”<sup>166</sup>

Agnew et al. (2014), in an experimental setting, found that clients’ opinions of adviser quality are easily manipulated. If an adviser first provides good advice on a financial decision that is easy to understand, the client will subsequently trust bad advice on a more difficult or complicated topic. Clients rely too much on advisers’ stated credentials. The authors offer policy recommendations: credentialing should be improved, advisers’ interests should be aligned with their clients’, and all advisers should be subject to a uniform fiduciary standard of conduct.

Inferring advice’s quality based on the investment results is also problematic, for several reasons.

First, the investment results themselves often are not transparent to the IRA investor. FINRA’s suitability rules<sup>167</sup> do not require BDs to disclose their customer’s personal rates of return. Many account statements show only transaction details and beginning and ending asset values for specified periods. Translating these into rates of return requires sophisticated calculations, well beyond the capability of all but the most sophisticated IRA investors. For example, Lusardi and Mitchell report that only one-half of individuals aged 50 and older in the United States can correctly answer two simple financial questions that involve calculations. Many respondents failed to correctly conclude that \$100 would grow to more than \$102 after five years if interest accrues at 2 percent per year, while others were unable to determine that an account earning interest at 1 percent while inflation was 2 percent would lose buying power (Lusardi and Mitchell 2011).

Second, even if the IRA investor knows her rate of return, she will be hard pressed to determine whether it is favorable. Selecting an appropriate benchmark for comparison requires financial sophistication about asset classes, among other things. Yet only about one-half of individuals age 50 or older correctly state that a single stock is usually riskier than a stock mutual

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<sup>166</sup> Australian Securities and Investment Commission, “Shadow Shopping Survey on Superannuation Advice,” ASIC Report 69, 2006.

<sup>167</sup> FINRA Rule 2111.

fund.<sup>168</sup> In addition the investor may have followed only some of the adviser's recommendations, in which case the results of followed recommendations would be blended with other results, and the results of recommendations not followed (and possibly not remembered) would be invisible to most investors. Finally, if the investor simply follows a recommendation to buy and hold a mutual fund, the fund's disclosure will report its returns net of fees and provide benchmark for comparison. But even in this simple case, the investor might need to adjust for loads paid, and if she buys or sells shares during the reporting period, her personal, asset-weighted return will differ from the time-weighted return reported by the fund, sometimes substantially.

Third, even if the IRA investor can determine whether her rate of return was favorable, this is not tantamount to determining whether her adviser gives good advice. Investment returns are noisy, and even several years of experience cannot reveal with high confidence whether the performance difference between an adviser's recommendations and a benchmark are due to chance or skill, unless the difference is substantial and persistent.

For these reasons, IRA investors are unlikely to successfully assess the quality of their advisers' recommendations based on past investment results.

In addition, investors often do not know what they pay for advice. Hung et al. (2008, 95-97) reports that many investors exhibit confusion about fees. For example, in one survey, among investors who receive advisory services from an advisory firm that is not also a brokerage firm, 23 percent report paying for the services by commission, while 19 percent report paying a fee specified as a percentage of assets. This appears to conflict with information provided by the firms themselves. Among SEC-registered advisory firms that are not also brokerage firms, 97 report that they are compensated with asset based fees, and only 10 percent report that they receive commissions. Substantial numbers of investors receiving advisory services from either advisory or brokerage firms either fail to report how much they pay for the services or report that they pay nothing for the services. Why do investors fail to understand what or even whether they pay for advice? Although fees and prices are not inherently complex financial concepts that require sophistication to understand, in practice, as elaborated earlier in this analysis (*see* Section 3.2.3.1 above), payments for investment advice are often highly complex, indirect, and not readily transparent. IRA investors who do not know what they are paying for advice cannot make sound decisions about which or how much advice to purchase.

Edelen, Evans, and Kadlec (2012) provide direct evidence that consumers have difficulty observing fees and accounting for them in their financial decisions. The authors observe that hidden fees have a more negative impact on returns than transparent fees. But hidden fees are less likely than transparent ones to chase investors away. The evidence shows that investment managers and brokers benefit from hiding fees – for example through commission bundling – at the expense of the consumer.

IRA investors are likely to be even more hard pressed to assess the quality of advice related to insurance products, mainly fixed and variable annuities. These products are notoriously complex. Their features vary widely across both products and insurers, making comparisons difficult for consumers. Their fees likewise are complex and difficult to interpret. Most IRA

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<sup>168</sup> These findings are affirmed by research funded by the FINRA Investor Education Foundation, 2009.

investors therefore have the ability to judge neither the suitability nor the price of any recommended product.

FINRA takes on this problem in an “Investor Alert” aimed at retail investors.<sup>169</sup> In three dense pages, it explains that variable annuities resemble mutual funds, but with additional features including tax-deferred earnings, a death benefit, and annuity payout options that can provide guaranteed income for life. It distinguishes the accumulation phase, during which premiums are allocated across subaccounts, from the distribution phase, and deferred from immediate annuities. It explains associated sales and surrender charges, and ongoing fees and expenses including mortality and expense risk charges, administrative fees, underlying funds’ expenses, and charges for special features such as stepped-up death benefits, guaranteed minimum income benefits, long-term health insurance, and principal protection. Noting that ongoing fees can exceed 2 percent of the annuities’ value annually, the Alert recommends that “If you don’t want or need these features, you should consider whether this is an appropriate investment for you.” It explains some tax considerations. It observes that “In an attempt to attract investors, many variable annuities offer bonus credits,” such as a 1 percent to 5 percent addition to each premium payment – but cautions that these are offset by other charges. It warns that promised guarantees “are only as good as the insurance company that gives them.” Finally, it provides special considerations for IRA investors (for whom investing in a variable annuity “may not be a good idea”), including that “a variable annuity will provide no additional tax savings” but will increase costs and profit the adviser, and that mandatory IRS withdrawals beginning at age 70 ½ might trigger surrender charges.

It is doubtful whether IRA investors can determine what value if any they should place on the insurance benefits associated with any particular variable annuity product. Consumers’ degree of aversion to various possible losses is subject to a number of behavioral biases (Schwarcz 2010) and vulnerable to manipulation by advisers. In addition, whether a consumer’s insurance coverage for any particular risk is adequate is often not apparent to the consumer until after a (potentially) insured loss occurs. It is possible that only a small fraction of investors will ever elect, or perhaps even qualify for, any particular benefit. For those that do, the ex post value of the benefit will vary widely (depending, for example, on age at death, or financial market conditions). For these reasons it will be difficult for an IRA investor to assess the quality of past recommendations, even after benefits are claimed (Schwarcz 2009).

According to Ben-Shahar and Schneider (2011), “[A]fter hearing an insurance agent go through mandated disclosures, many people have the agent make a decision ... Even sophisticated lawyers retire defeated.” Citing other sources (internal citations omitted here), the authors recount how “During oral argument of *Gerhardt v. Continental Insurance Co.* before the New Jersey Supreme Court, Chief Justice Weintraub looked at the insurance policy at issue and said, ‘I don’t know what it means. I am stumped. They say one thing in big type and in small type they take it away.’ Justice Haneman added, ‘I can’t understand half of my insurance policies.’ Justice Francis stated, ‘I get the impression that insurance companies keep the language of their policies deliberately obscure.’”

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<sup>169</sup> FINRA Investor Alert, “Variable Annuities: Beyond the Hard Sell,” 2012, available at: <http://www.finra.org/web/groups/investors/@inv/documents/investors/p125846.pdf>.

### 3.2.3.3.2 Lack of Reputation Effects

In economic theory, efficiency often requires perfect and costless information. The retail market for financial products and services, however, is beset by high information costs – i.e., investors are ill equipped to evaluate the quality of advice. Given the combination of high information costs and adviser conflicts, the potential for social welfare losses is high. IRA investors are likely to make inefficient decisions about their purchases of advice and/or, following suboptimal advice, about their investments. Suboptimal investment decisions erode risk-adjusted net returns for investors and allocate capital inefficiently in the national economy. Theory also predicts transfers, as advisers and producers of the products they recommend capture surplus from investors in IRAs characterized by conflicts of interest. Both of these effects can be expected to erode IRA investors' retirement security.

High information costs limit advisees' ability to act as a check on adviser misbehavior. The inability to act as a check on adviser misbehavior can manifest itself in different ways, relating to an advisee's lack of important information or the advisee's inability to interpret important information.

Bolton, Freixas, and Shapiro (2007) model a relationship between advisers and advisees where reputational concerns prevent advisers from acting on their conflicts of interest and ensure that advice is in the best interest of the client. However, their model reveals an important characteristic that can distinguish advisory markets with harmful conflicts from advisory markets with harmless conflicts. The authors explain:

“To model the reputational concern we assume that an [adviser] suffers a reputation loss... when a lie told to a customer leads to a purchase by that customer. This loss arises because the financial product is an experience good; the customer realizes a return from her investment and can compare that with the initial expected return promised her by the [adviser].”

In other words, the model assumes that soon after making an investment decision, the customer can determine whether the advice that was given was in her best interest. If the customer could not determine the quality of the advice in a timely manner, the adviser would not be bound by reputational concerns to act in the client's best interest. Thus, one key element in an advice market with harmful conflicts is the inability of the advisee to assess the quality of the advice soon after the advice is given. As previously noted, the data show that consumers are not able to make this type of an assessment in today's advice market.

Other models that also generate the conclusion that firms produce high-quality goods due to reputational concerns rely on similar assumptions. In MacLeod 2007's model, the buyer observes the seller's level of performance after the good is received (MacLeod 2007). Klein and Leffler (1981, 618-619) assume that, “*if a particular firm supplies less-than-contracted-for quality to one consumer, the next period all consumers are assumed to know.*”

Krausz and Paroush (2002, 57-58) don't assume that customers directly observe the quality of advice, but they do require that all customers are able to perform detailed financial calculations on their own:

“At the end of the period when the actual return is observed, the investor will assess whether her initial decision... was based on sound information. If the return is below [the reported expected return on the risky asset] then she has received a lower income than expected and if it is above then she has invested less than she would have liked to. ... She computes a new [proportion of wealth invested in the risky asset] by using the new information she has to update the expected [return], by giving a lower weight to reported expected return on the risky asset... the greater the



deviation of the actual realization from [the reported expected return on the risky asset], relative to the riskiness of the asset as announced by the adviser.”

Fischel and Kendall’s 2011 Comment Letter to DOL echo many findings on reputational and competitive effects from the academic literature in their post-hearing comment on the Department’s 2010 Definition of Fiduciary Investment Advice proposal. The authors do not put forth their own model of an advice relationship. Their conclusions necessarily presume, however, that IRA investors can police the quality of advice and make efficient decisions as to what advice to buy, how much to pay for it, and what investments to make pursuant to it. The Department rejects this presumption, based on the evidence to the contrary presented herein.

Rogerson (1983, 508-509) recognizes that the previous literature on reputational concerns had not accurately depicted markets where the customer has difficulty assessing the quality of service.

“Consumers are, however, often capable of performing only very partial and vague evaluations of the quality of professional services they receive from doctors, lawyers, banks, mechanics, opticians, etc. Furthermore, the quality of service from a given professional may vary from time to time. This combination of observer error and actual quality variance makes it difficult for consumers to evaluate correctly the quality of service that a firm produces.”

Rogerson’s model is relevant to the IRA market because it allows customers to make mistakes in assessing the quality of a good or service, such as advice. While the author’s conclusions are supportive of reputation effects in general, the model demonstrates that reputation effects fail in markets where customers have more difficulty assessing the quality of the service. The result is intuitive. If a customer mistakes poor service for quality service, they’ll likely return as a repeat customer and may even recommend the firm to others.

Inderst and Ottaviani (2012) present a second model which shows that harm to consumers depends on how “wary” they are of conflicts present in the market.<sup>170</sup> Wary consumers are unharmed because they recognize that advisers are more likely to recommend products for which they receive commissions and they discount those recommendations. However, the model requires that wary consumers “form rational expectations about the level of these payments and the resulting quality of advice.”<sup>171</sup> On the other hand, naïve customers – those who do not understand how a conflict of interest might bias the adviser’s recommendations – can be taken advantage of. This means that for a consumer to be considered wary, both of the following must be true: 1) commissions or other conflicting payments must be disclosed and must be salient at the time a decision is made; and 2) given this knowledge, the consumer must correctly adjust for the probability that the adviser will act on his or her conflicts at the consumers’ expense.<sup>172</sup>

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<sup>170</sup> Inderst and Ottaviani (2012), *supra*, at 494. Unlike the model by these authors discussed above, this model is not specific to transactions where the product is sold through an agent.

<sup>171</sup> *Ibid.*, 499.

<sup>172</sup> Inderst and Ottaviani (2012, 500) also allow for the possibility that a wary consumer could form rational expectations that are correct in equilibrium even when commissions are not disclosed. The Department agrees that the scenario is possible in theory, but recognizes that it is highly unrealistic.



A key question then becomes whether IRA investors are “wary.” As elaborated elsewhere in this analysis, most IRA investors lack attention to and understanding of their advisers’ compensation and attendant conflicts. Most are unable to assess effectively the quality of their advice and of consequent investment results. Moreover, research suggests that disclosure of advisers’ conflicts can backfire, leading both advisers and consumers to act contrary to consumers’ interests.<sup>173</sup> Therefore, it is highly likely that few IRA investors would qualify as “wary” consumers in this model – rather, most would be naïve and therefore vulnerable to abuse.

Based on the foregoing, one defining characteristic of harmful advice markets appears to be the advisee’s inability to act as a check on adviser misbehavior. The IRA advice market exhibits this characteristic, as elaborated immediately below.

### **3.2.3.3.3 Obstacles to Understanding Conflicts**

Similar to advice quality, IRA investors are equally hard pressed to understand the potential for bias associated with adviser conflicts. Even an IRA investor who knows exactly how and how richly his or her adviser is compensated is unlikely to understand the conflicts of interest that are associated with the adviser’s compensation arrangements or how such conflicts could affect the quality of the adviser’s service.

Adviser compensation often is not fully transparent, even to an attentive investor. In the earlier diagram depicting some common conflicts in advice (*see* Section 3.2.3.1 above), different adviser compensation streams and relationships are shown in different colors. Those shown in red generally are not disclosed and are invisible to IRA investors. Those shown in grey are disclosed in a mutual fund’s prospectus and therefore visible to IRA investors who read, understand and remember that document. Those shown in green are more directly visible to IRA investors. Not shown in the diagram are certain, more qualitative, disclosures. BDs are required under certain circumstances, such as when making a recommendation, to disclose material conflicts of interest to their customers, in some cases at the time of the completion of the transaction. A RIA that has a material conflict of interest must either eliminate that conflict or fully disclose to its clients all material facts relating to the conflict. But such disclosures tend to include only general descriptions of arrangements that do not illuminate the amount of adviser compensation that might be motivating a particular recommendation.

The potential conflicts affecting insurance intermediaries are likewise varied, complex, and difficult for consumers to discern. As Beh and Willis (2009) observe, “Determining what intermediaries do and for whom they work has not leant itself to easy answers; definitive characterizations have been elusive. The intermediary’s relationship with the insurer and the insured must often be determined on a case-by-case basis.” The authors describe how these relationships vary along several dimensions, each with implications for potential conflicts. These include their degree of independence v. exclusivity, the extent of their role in the distribution of various products (relative to alternative distribution channels), and their authority as an agent of either the insurer or the insured. Because of these variations, any characterization of insurance intermediaries’ loyalties and duties is “imperfect at best, because whether the insured or the

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<sup>173</sup> See Sections 3.2.1.2 and 7.6.1.

insurer serves as principal can depend on the actual tasks performed... The intermediary, the insured, and the insurer cannot be certain for whom the intermediary is working.”

Because most IRA investors cannot determine the quality of the advice they receive and often do not understand or beneficially react to their advisers’ potential conflicts, it seems unlikely that they could act as an effective check on adviser misbehavior. Therefore reputational concerns alone are unlikely to sufficiently mitigate adviser conflicts. Additional or different disclosure alone is unlikely to help much if at all.

### **3.2.3.3.4 Summary and Conclusions**

Based on the foregoing, it appears that the IRA advice market exhibits the characteristics that economic theory associates with harm from adviser conflicts. Serious, material conflicts are widespread. The supply chain devotes substantial resources to pursuing customers in ways that are not consistent with efficient price competition. IRA investors are ill equipped to police the quality of advice so reputational concerns cannot be expected to ensure adviser impartiality.

In light of these facts, it is safe to predict that conflicted investment advisers to IRA investors will act on their conflicts, and when they do, IRA investors will suffer as a result. The conflicts therefore likely offer advisers ample opportunities to secure large profits at IRA investors’ expense (while also causing further losses due to inefficient asset allocation).

### **3.2.3.4 Advisers Act on Their Conflicts**

The economic models discussed above share one assumption: advisers will act on their conflicts of interest when it is in their self-interest to do so. In reality, people do not always behave according to pure financial self-interest. For example, an adviser may provide advice that is in the best interest of a client because she genuinely cares about the client’s retirement security or feels a moral obligation to do so. However, empirical evidence indicates that financial advisers do act on conflicts in ways that harm IRA investors.

One strand of research literature looks directly at the recommendations made by advisers by asking advisees to record certain aspects of their interaction with the adviser. This allows for a direct examination of whether an adviser’s recommendation reflects his or her client’s best interest. A second examines how inflows to mutual funds are affected by the amount of commissions or revenue that they pass on to the advisers that recommend their funds. Other things equal, inflows that increase as commissions or revenue sharing increase would indicate that advisers are choosing to recommend the funds that provide more financial benefit to themselves, rather than to their clients.

### **3.2.3.4.1 Questionable Recommendations**

There is evidence that advisers often recommend investments that they should know are not the best alternative for their customer. Numerous academic studies have found that, as a group, passively managed mutual funds (i.e. index funds) consistently outperform actively managed funds, largely due to their low fees, (Gruber 1996; French 2008; Fama and French

2010). Therefore it is likely that IRA advisers who honor their customers' best interests would widely recommend index funds with low fees.

Yet there is evidence that advisers do not widely recommend diversified low-fee portfolios. One study's authors sent trained auditors<sup>174</sup> to financial advisers in the Boston area and observed whether the advisers acted in their own interest or in the interest of the client (Mullainathan, Noeth and Schoar (2012)). Auditors were each assigned one of four different styles of portfolios. One portfolio style in particular was designed such that the adviser could only profit by recommending an action that was clearly not in the best interest of the advisee. Auditors came into the session with a diversified portfolio of low-fee index funds. According to the authors, "Moving the low-fee portfolio to an actively managed portfolio with the same risk/return profile but average management fees would result in additional costs of about one percentage point per year, i.e., between U.S. \$ 500 and U.S. \$1,000 in our scenario."<sup>175</sup> However, the adviser would typically stand to profit only if the investor purchased an actively-managed fund that returned some commissions or revenue to the adviser's firm.

Presented with a client invested in index funds, the advisers overwhelmingly put their own interests ahead of their clients. Less than 3 percent of advisers were supportive of the auditor's existing portfolio, while 85 percent were against the strategy. Across all scenarios, less than 8 percent of advisers recommended index funds, while almost 50 percent of advisers recommended actively-managed funds. Put differently, in this study, for every adviser who provided advice that is likely to be in their client's best interest, there were seven who gave advice that likely is not in their client's best interest, but in their own best interest.

While the auditors did not present themselves as IRA investors, the study closely mimicked advice interactions that are typical of IRA investors. Auditors met face-to-face with actual advisers for about one hour, usually in the adviser's office, to seek advice on investing between \$45,000 and \$105,000. The advisers did not know the auditors were impersonating actual investors.

Research from Australia provides additional evidence to the same effect. The Australian Securities & Investments Commission (ASIC) recruited participants in Australia's retirement system who intended to seek out investment advice, and had the participants answer survey questions and provide written materials from the adviser following meetings.<sup>176</sup> Based on the

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<sup>174</sup> The auditors were professionals who were trained to impersonate regular customers seeking advice on how to invest their retirement savings outside of their 401(k) plan. To implement the actual logistics of the visits, a financial audit firm was hired that specializes in identifying and training auditors. To ensure that auditors were able to understand the advice that was given to them, they had to know at least some basics of financial products and received some guidelines on how to ask for specific advice. Auditors were trained first about basic financial literacy through an online manuscript. Then, they participated in a training session via video conference. Finally, audit candidates had to take a short online test to qualify for the study (about 10% of the pre-selected auditors failed and were excluded from this study).

<sup>175</sup> Ibid., 7.

<sup>176</sup> Australian Securities and Investment Commission, "Shadow Shopping Survey on Superannuation Advice," ASIC Report 69, 2006. Available at: [https://dv8nx270c159a.cloudfront.net/media/1347026/shadow\\_shop\\_report\\_2006.pdf](https://dv8nx270c159a.cloudfront.net/media/1347026/shadow_shop_report_2006.pdf).

information collected, researchers were able to determine 1) if the adviser had a conflict of interest, such as receipt of trailing commissions from the sale of a fund, and 2) if the advice given had a reasonable basis (as required by law). (It seems safe to assume that if the advice given did not have a reasonable basis, then it was also not in the client's best interest.) An adviser who had a conflict of interest was three to six times more likely to give advice that did not have a reasonable basis. Many advisers had a conflict of interest stemming from fees that the investor pays flowing back to the adviser. Of these 123 advisers, 35 percent gave advice that did not have a reasonable basis, whereas just 6 percent of the 139 advisers that did not have this conflict gave such advice. Another (potentially overlapping) set of advisers had a conflict of interest insofar as they recommended products that were associated with their employer. Out of these 96 advisers, 32 percent were judged to have given advice that did not have a reasonable basis, whereas out of the 161 advisers that did not have this conflict, only 11 percent gave advice that lacked a reasonable basis. Many clients of conflicted advisers were advised to switch funds, predominantly to funds with higher fees, or falsely told that further contributions could not be made to a current fund.

Additional, overseas audit-style studies reached similar conclusions with respect to insurance intermediaries. Intermediaries in Germany provided low quality information. Intermediaries in India provided little useful information and steered customers toward products that advanced their own interests' at their customers' expense (Schwarcz and Siegelman 2015 forthcoming).

Two other audit-style examinations provide further evidence that conflicts of interest negatively influence adviser recommendations. The SEC investigated a series of "free lunch seminars" which they concluded "were intended to result in the attendees' opening new accounts with the sponsoring firm and, ultimately, in the sales of investment products." In 23 percent of their targeted examinations, the SEC observed that recommendations from BDs and RIAs appeared "unsuitable" for the individual consumer.<sup>177</sup> These advisers were clearly providing advice that was not in the best interest of their customers, likely a direct result of their inherent conflict of interest as an employee of the firm sponsoring the seminar. An audit study of advisers in the United Kingdom found that 1 in 5 failed to recommend the optimal product for the customer, often instead recommending a product that returns higher commissions to the adviser (Charles River Associates 2002).

#### **3.2.3.4.2 Questionable Investments**

The audit study literature provides convincing evidence that conflicts of interest negatively influence adviser recommendations. Other studies using broader, nationwide data produce corroborating results by finding that investor dollars tend to flow toward mutual funds that send a large portion of their revenue back to the investor's adviser.

Christoffersen, Evans, and Musto (2013) find that payments to brokers influence the advice they provide to clients. The authors focus on two of the most common types of payments to brokers selling mutual fund shares: front-end load sharing and revenue sharing. The study

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<sup>177</sup> SEC, "Protecting Senior Investors: Report of Examinations of Securities Firms Providing "Free Lunch" Sales Seminar," 2007, p. 5.

includes all U.S. mutual funds from 1993 through 2009 that made one or both of these payments to brokers. For both revenue sharing and load sharing, the authors find that higher payments from mutual funds to brokers attract more investor dollars. Unaffiliated brokers, in particular, appear to be strongly influenced by these payments. “For each \$1 increment in the load payment to the broker there is a \$14.20 increase in flows.”

Other researchers arrive at a similar conclusion. Using data on U.S. equity, bond, and hybrid mutual funds from 1992 through 2001, Zhao (2008) finds that front-end loads and back-end loads paid to mutual funds are positively associated with flows into those funds. He interprets this finding to suggest that “brokers and financial advisers apparently serve their own interests by guiding investors into funds with higher loads.” Hackethal, Haliassos, and Jappelli (2012) find that advisers are influenced by conflicts of interest in Germany as well. In their dataset, customers who relied on advice traded more frequently and were more likely to purchase a product that helped the adviser reach a sales target. These results all indicate that the influence of conflicts of interest on brokers’ advice is widespread.

Taken together, the two strands of literature presented above provide ample evidence that conflicts of interest influence the advice provided to IRA investors. The audit study literature offers explicit examples of advisers who act in their own interest rather than the interest of their clients. The econometric literature shows that these are not isolated incidents and that conflicts of interest are sufficiently widespread to meaningfully alter flows into mutual funds on a national scale.

### 3.2.3.5 Eroded IRA Returns

There is substantial evidence that conflicts in advice lead to eroded IRA investment returns. Australia’s ASIC study discussed above projected inferior investment returns attributable to conflicted advisers’ recommendations that lacked reasonable bases. A series of academic papers finds lower returns for mutual fund share classes and distribution channels that are more prone to conflicts of interest.

ASIC found substantial harm to investors from conflicted advice.<sup>178</sup> The authors identify 40 cases where advisers recommended switching funds and the advice did not have a reasonable basis. In 23 of these cases, all of which involved a conflict of interest, the advisers provided sufficient information to calculate the cost of the fund. Projections suggest that the high fees charged by the recommended funds will reduce future retirement benefits for 20 of the 23 participants. If the projections bear out, the participants who received conflicted advice will have their future retirement benefits reduced by as much as 38 percent. The average projected benefit reduction is approximately \$37,000, or 16 percent of the participant’s future benefit. There are strong commonalities between the choices facing U.S. IRA investors and those facing Australians when they save for retirement, suggesting that conflicts of interest are likely to be similarly harmful in each arena.

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<sup>178</sup> Australian Securities and Investment Commission, “Shadow Shopping Survey on Superannuation Advice,” ASIC Report 69, 2006.

Bergstresser, Chalmers, and Tufano (2009) find inferior mutual fund performance in more conflicted distribution channels. Individuals can purchase mutual fund shares directly from a mutual fund company, (“direct channel”) or through an intermediary or broker (“broker channel”). The distinction is useful for assessing the impacts of advice because both conflicts and individualized investment advice are prevalent in the broker channel, but rare in the direct channel. The authors examine mutual fund returns between 1996 and 2004 without factoring in distribution costs (loads or 12(b)-1 fees). They find that funds distributed through the more conflicted broker channel perform worse. Domestic equity funds sold through the direct channel outperform brokered equity funds by between 0.33 percent and 0.88 percent on a risk adjusted basis. Likewise, bond funds and money-market funds sold through the direct channel outperform their full-service counterparts by 0.56 percent to 0.90 percent and 0.040 percent to 0.043 percent, respectively. In all three cases, it appears that the conflicted advice that is given by brokers has a harmful effect on the individual’s financial situation, including, in many cases, the individual’s retirement benefit. Unlike the other fund categories, foreign equity mutual funds sold through the broker channel outperform direct foreign equity funds by 1.53 percent to 2.05 percent, but this result may not be generalizable because it is attributable to favorable performance within just one large mutual fund family.

Overall, the authors calculate that the cost of using the broker channel, in terms of reduced returns alone, was \$4.6 billion in 2004. This cost is in addition to the estimated \$9.8 billion per year that the same customers paid in 12b-1 fees, and neither of these numbers includes the loads paid by customers who purchase funds through brokers.

Del Guercio and Reuter (2014) find that broker-sold funds underperform direct-sold funds by an average of 1.15 percentage points per year after accounting for risk and other factors. The authors identify misaligned incentives in the broker-sold market as the cause of the underperformance. In the direct-sold market, asset managers are incentivized to generate alpha (superior performance above and beyond that of the market). As a result, the authors find that within the direct-sold market, actively managed funds perform similarly to index funds. However, in the broker-sold market, asset managers are not sufficiently incentivized to produce alpha. In this market, actively managed funds underperform index funds by 1.12 – 1.32 percentage points per year.

Del Guercio, Reuter, and Tkac (2010) present similar evidence on mutual fund performance across distribution channels. In the sample of domestic equity funds between 1996 and 2002, direct channel funds outperform brokered funds by 0.08 percentage points to 0.12 percentage points per month, or about 1.0 percentage points to 1.5 percentage points per year.<sup>179</sup> The authors hypothesize that the returns difference is due to the lack of incentive for mutual funds in the broker channel to find and pay for top-quality portfolio management in order to maximize risk-adjusted investor returns. This hypothesis is supported by the finding that, while actively-managed funds perform poorly across the entire sample, within the direct channel, the performance of actively-managed funds is equal to that of index funds. Actively-managed funds in the direct channel, where investors as a group are more sophisticated or attentive to

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<sup>179</sup> The Department’s calculation assumes a 6.00 percent annual return for direct channel funds.

performance, have a strong incentive to invest in portfolio management, while actively-managed funds in the broker channel, where investors are less so, do not.

Harm from adviser conflicts is also evident in a comparison of returns across mutual fund share classes. Class A, B, and C shares all include one or more type of load and often a distribution fee. As described earlier, many of the dollars from these loads and fees end up being returned to the broker who advised the purchase of the fund. Where individualized investment advice is given, these loads and fees create a conflict of interest for the broker. There is evidence that load fund investors fare worse than no-load fund investors, which strongly suggests that conflicts harm IRA investors.

Morey compares the performance of load and no-load domestic equity mutual funds between 1993 and 1997 (Morey 2003). Without taking the load into account, no-load funds outperformed load funds 0.03 percentage points or 0.06 percentage points per month, or 0.43 percentage points to 0.82 percentage points per year on a risk adjusted basis. This result alone suggests that the conflicted advice received from brokers is harmful to individual investors, including IRA investors. However, adjusting for the actual loads that investors pay reveals that the magnitude of the problem is much larger. Factoring in the loads paid, load funds underperform no-load funds by 1.6 to 2.0 percentage points per year on a risk-adjusted basis.<sup>180</sup> The load-adjusted returns differences are a more complete estimate of the cost to consumers of harmful conflicted advice.

Friesen and Sapp (2007) investigate how actual investor performance (asset-weighted) in load and no-load funds combined differs from the performance reported in the funds' prospectuses (time-weighted). Additional estimates from what appear to be the same data are presented in a second paper with co-author Bullard (Bullard, Friesen, and Sapp 2008). In the sample of domestic equity fund returns between 1991 and 2004, actual investor performance generally lags the performance reported in the prospectuses because investors have poor timing – they tend to have more money invested in funds when returns are low and less money invested when returns are high.<sup>181</sup> For the purpose of this impact analysis, differences in performance between load and no-load funds are more of a focus than differences between actual investor performance and reported performance. However, the latter may play a part in the former if investor timing in load funds is better or poorer than investor timing in no-load funds. Bullard, Friesen, and Sapp (2008) find that the difference in performance between load and no-load funds has two components: first,

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<sup>180</sup> The Department's calculations are based on Morey (2003), Table 3, p. 1261.

<sup>181</sup> This phenomenon is sometimes characterized as a "disposition effect" whereby investors sell winning investments too soon and hold losing investments too long (Shefrin and Statman 1985; Odean 1998). Such investor tendencies have been well documented (Weber and Camerer 1998). The disposition effect is often explained by prospect theory and/or cognitive dissonance. Prospect theory suggests that investors value gains and losses relative to the initial purchase prices and investors become risk averse with respect to protecting gains but risk-seeking with respect to recouping losses (Della Seta and Gryglewicz 2014). Consequently investors sell the winners too soon and hold the losers too long. Cognitive dissonance suggests that investors are reluctant to realize their losses because they cannot admit that they made poor investment decisions. Thus they keep losers too long. This effect may be absent with respect to actively managed mutual funds, because investors may blame the fund manager rather than themselves for the poor result. It might be more likely to be manifest with respect to passive funds or single-issue stocks (Chang, Solomon, and Westerfield 2014).



the difference in prospectus returns across share classes; and second, an additional difference in investor returns resulting from differences in investor timing. Consistent with the other studies presented in this section, the researchers find that investors who use brokers have poorer investment results. Looking only at prospectus returns, no-load funds outperform Class A load funds by 0.03 percentage points to 0.06 percentage points per month, Class B load funds by 0.11 percentage points to 0.13 percentage points per month, and Class C load funds by 0.04 percentage points to 0.06 percentage points per month on a risk-adjusted basis. In addition to this underperformance, the researchers find that the gap between prospectus returns and actual (poorer) investor returns is larger for load funds (0.14 percentage points, 0.19 percentage points, and 0.11 percentage points per month for Class A, B, and C shares, respectively) than for no-load funds (0.07 percentage points per month).

This result sheds light on one of the paths through which conflicted advice can be harmful to IRA investors. Friesen and Sapp (2007) find that “timing underperformance is consistent with investor return-chasing behavior.” Conflicts in advice appear to exacerbate the tendency for IRA investors to chase returns and trade excessively, and the results presented here suggest that the consequences can be large. When prospectus returns and investor timing are both considered, the data reveal that investors in load funds underperform investors in no-load funds by 1.9 percentage points to 2.2 percentage points per year.

Christoffersen, Evans, and Musto (2013) (CEM) estimate the impact of load-sharing – payments from the mutual fund to the broker – on mutual fund returns. In contrast to the studies reviewed above that compare returns across distribution channels or across fund share classes, these authors compare returns within a particular share class – Class A, with front-end loads. The data reveal that as the size of the load-share increases, mutual fund returns decrease. This suggests that the greater the magnitude of the adviser’s conflict of interest, the worse off the IRA investor can expect to be. For “the average 2.3 [percentage points] payment to the unaffiliated broker” an IRA investor or other customer can expect “a 1.13 [percentage point] reduction in annual performance” of the mutual fund. If the payment to the broker is higher than 2.3 percentage points, as is often the case, the IRA investor will likely suffer even more.

The evidence discussed above on balance strongly supports the conclusion that individuals who seek advice from conflicted brokers have substantially worse outcomes than those who invest directly in mutual funds. There is also evidence that consumer harm from adviser conflicts extends to advisers other than BD representatives and to markets beyond the US.

Findings from Chen, Yao, and Yu (2007) suggest that brokers who are affiliated with insurers (and therefore are likely to be insurance agents as well) also act on conflicts at IRA investors’ expense. The authors investigate the performance of mutual funds managed by insurance companies. They note that “insurance funds are often cross-sold through the extensive broker/agent network of their parent firms.” This close relationship between the broker, who in many cases provides individualized investment advice, and the mutual fund, creates a conflict of interest, particularly when differential compensation is paid by the insurance company to the broker to promote the sale of one or more funds. In a sample of actively-managed domestic equity funds’ returns between 1990 and 2002, the authors identify funds owned by insurance companies and compare their returns to returns for the remainder of the funds in the sample. Note that this is not a clean comparison of funds that do and do not involve conflicts of interest in their distribution. Many of the non-insurance funds in the sample will also be distributed by brokers who face conflicts of interest. As such, any observed underperformance of insurance funds could be viewed as an underestimate of the harm to insurance fund investors from conflicted advice. The data show that insurance funds underperform non-insurance funds by 0.85 percentage points

to 1.4 percentage points per year on a risk-adjusted basis. The authors are able to confidently rule out the possibility that lower insurance fund returns are a result of insurance companies reducing systematic risk or that they reflect “rational learning about managerial ability,” and argue that they are due to “lack of investor oversight on poorly performing insurance funds.” This lack of oversight allows advisers to act on their conflicts of interest without negative market consequences, as discussed earlier. The authors conclude that “underperformance due to lack of investor monitoring is quite likely a universal problem in the fund business,” and advise that similar conflicts of interest “may affect mutual funds sponsored by other types of financial institutions, such as commercial banks and investment banks.”

Chalmers and Reuter (2014) study investment performance in the Oregon University System’s defined contribution retirement plan and find that participants who receive advice from brokers underperform relative to self-directed portfolios (by 1.54 percentage points) and also relative to the default target-date fund. The underperformance relative to self-directed portfolios costs each advice recipient an average of \$530 per year. The authors also find that the broker-advised portfolios are riskier than self-directed portfolios, despite the underperformance.

Hackethal, Haliassos, and Jappelli (2012) utilize datasets from a large German brokerage firm and from a large German commercial bank to investigate whether conflicted advice harms customers. The datasets, on the level of the individual customer, include portfolio performance between 2003 and 2005, demographic characteristics of the customer, and an indicator of whether the customer received investment advice. The data show that brokerage clients who receive investment advice have inferior portfolio returns relative to those who do not receive advice, in the amount of 5.0 percent per year after fees have been factored in. The demographic characteristics in the dataset allow the researchers to examine whether the underperformance could be caused by inherent differences between customers who seek advice and those who do not. However, after controlling for personal and regional characteristics, the estimated underperformance of advised accounts remained virtually unchanged. The authors also find evidence of churning among advised accounts; the average turnover rate is more than double that of self-managed accounts. Because advisers get commissions based on the volume of purchases, this churning can be viewed as additional evidence that the harm – the underperformance of advised accounts – is a result of conflicted advice. Finally, the authors find that the results from the commercial bank dataset are consistent with those from the brokerage firm dataset, pointing “to systematic negative effects of financial advisers rather than to statistical flukes or sample peculiarities.”

Biased recommendations regarding variable annuities can be especially costly for IRA investors. The SEC’s online “Investor Information” resources provide a consumer primer on variable annuities.<sup>182</sup> It punctuates the issues with 5 “Caution!” boxes that warn:

- Variable annuities may be disadvantageous as IRA investments,
- Various benefits add to costs, might not be needed, and might be available separately elsewhere at better prices,

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<sup>182</sup> SEC, “Variable Annuities: What You Should Know.” Available at: <http://www.sec.gov/investor/pubs/varannty.htm>.

- Exchanging one variable annuity for another may be disadvantageous,
- Bonus credits may cost more than they are worth, and
- Exchanging products to gain bonus credits is likely to be disadvantageous.

Schwarcz and Siegelman (2015 forthcoming) argue that insurance “agents can inefficiently withhold information and distort consumer choices by providing misleading information or operating in their own self-interests.” They conclude “that neither market forces nor legal or regulatory rules substantially constrain insurance agents’ capacity to advance their own interests by providing biased advice, though direct empirical evidence about the frequency of such misbehavior is limited.”

Before reaching any strong conclusions about harms caused by conflicts of interest, the Department considered other possible explanations for the underperformance of broker channel funds and load funds. In the same paper reviewed above, Bergstresser et al. discuss and ultimately dismiss several possible alternative explanations for the returns discrepancies (Bergstresser, Chalmers, and Tufano 2009).

First, brokers do not appear to provide for superior asset allocation advice across asset classes. All of the results presented above have examined the performance of mutual funds within broad asset classes, such as domestic equity, foreign equity, and bond funds. But brokers also provide advice on how to allocate assets across these asset classes over time. If broker channel assets are more often in equity funds when equity markets do well and more often in bond funds when equity markets do poorly, then customers, including IRA investors, will benefit. Moreover, the benefit to IRA investors will not show up in within-asset-class returns discrepancies. To the extent that brokers provide high quality asset allocation advice, the benefit to customers may offset or even outweigh the inferior returns generated within the asset classes. To test whether brokers provide superior asset allocation advice, (Bergstresser, Chalmers, and Tufano 2009) simulate the growth of direct channel and broker channel assets between 1981 and 2002 using the actual aggregate asset mix from each channel over the time period. Statistical tests on their data find no evidence that broker channel funds have superior asset allocation. Also, recall that for a sample of domestic equity funds, (Bullard, Friesen, and Sapp 2008) find that load fund investors have significantly poorer investment timing than no-load fund investors.

Second, brokers do not appear to recommend less expensive funds to their clients. Distribution fees, expense ratios, and loads are all generally higher for broker channel funds than for direct channel funds (Bergstresser, Chalmers, and Tufano 2009, 4148, Table 5).

Third, while brokers may serve a different set of customers, the differences appear to be limited and in any event seem unlikely to explain the observed results. As noted by Bergstresser, Chalmers, and Tufano (2009), a significant fraction of customers purchase mutual funds through both the direct channel and the broker channel.<sup>183</sup> The customers who choose only one channel or the other appear to not be very different across observable characteristics. Broker clients have slightly lower average incomes, they are a bit more risk averse, and have similar investing goals.

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<sup>183</sup> ICI Research Report, “Profile of Mutual Fund Shareholders, 2014,” (Feb. 2015), p. 19, available at: [http://www.ici.org/pdf/rpt\\_15\\_profiles.pdf](http://www.ici.org/pdf/rpt_15_profiles.pdf).

Bergstresser, Chalmers, and Tufano (2009) suggest that investors in the two distribution channels are more similar than different, stating that, “by any standard, mutual fund investors in both channels are disproportionately drawn from upper ranks of national wealth, income, and educational attainment.” Customers across the two channels may differ in other, non-observable ways, but the authors find that it is “problematic to explain how these traits lead investors to continue to accept poorer pre-distribution-fee investment performance.” Chalmers and Reuter (2014) find that measured underperformance of broker advised portfolios decreases by only 7 percent to 11 percent when controlling for observable, individual-level characteristics.<sup>184</sup> This result suggests that the difference in performance across distribution channels is not driven by differences in the individuals choosing each channel. Hackethal, Haliassos and Jappelli (2011) similarly find that the measured underperformance of advice recipients does not change after controlling for observable, individual characteristics.

Fourth, it appears that brokers fail to help investors overcome important “behavioral biases” that impair their financial decisions. Mullainathan, Noeth, and Schoar (2012) provide additional evidence, at the level of the individual adviser, that brokers intensify this same returns-chasing bias.

After ruling out the above explanations for the returns discrepancies presented in this section, there remains the possibility that broker customers receive some other benefit or benefits that are not observed by the researchers. These may include both non-financial benefits, such as peace of mind and time savings, and benefits with a financial component not directly related to the performance of a mutual fund, such as help understanding various investment options, estate planning, and help establishing savings goals. A 2006 ICI survey finds that all of these benefits are important to at least some customers of financial professionals.<sup>185</sup> (Bergstresser, Chalmers, and Tufano 2009) call these unobserved benefits “intangible benefits” and suggest that intangible benefits and conflicted advice are two alternative hypotheses that can explain the underperformance of broker channel funds. What evidence is there on each of these hypotheses?

There is a great deal of persuasive evidence to suggest that conflicts of interest are harmful to IRA investors. Much of that evidence is presented in the preceding sections. Conflicts of interest are prevalent in the market. The majority of investors are not sophisticated and do not have the necessary skill and information to act as a check on adviser misbehavior. Finally, there is substantial evidence that conflicts of interest do in fact influence adviser recommendations, as both the recommendations themselves and the investments made pursuant to them appear to be compromised in ways that harm IRA investors.

In contrast, evidence favoring the “intangible benefits” hypothesis is limited. As mentioned above, there is some industry-generated survey evidence to support the notion that broker customers receive additional benefits from dealings with brokers beyond mutual fund performance. The evidence indicates that survey respondents received some peace of mind, time

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<sup>184</sup> Across OLS (Fama-MacBeth) regressions, measured broker underperformance is 2.62% (2.52%) without controlling for investor characteristics and 2.44% (2.24%) with investor characteristics included – a difference of 0.18 (0.28) percentage points.

<sup>185</sup> ICI Research Fundamentals, “Why Do Mutual Fund Investors Use Professional Advisers?” (April 2007), available at: <http://www.ici.org/pdf/fm-v16n1.pdf>.

savings, help understanding various investment options, estate planning, or help establishing savings goals. In addition, Foerster et al. (2014) find that advised Canadian investors underperform primarily because they pay higher fees. In light of the underperformance, they conclude that investment advice services alone cannot justify the fees. However, they also find robust evidence that advice affects savings styles and levels, and suggest that the higher fees paid by advised investors might reflect payment for broader financial advice. Both the industry-generated investor survey results and Foerster et al.'s finding of savings impacts suggest that at least some of advised investors' excess fees (and associated underperformance) can be interpreted as fair payment for financial services that yield consumer benefits other than improved investment performance. Neither of these, however, challenges the more extensive and robust evidence, presented above, that investors do not understand the cost of their advisers' services and cannot determine whether the value of those services justify outweighed their cost. As such, both of these findings are consistent with the proposition that advised investors' higher fees and underperformance are excessive relative to the services their advisers provide.

Taken as a whole, the evidence strongly favors conflicts of interest as the primary cause of returns differences across distribution channels and share classes. That is not to say that benefits such as savings goals, estate planning, and time savings can be completely ruled out as factors contributing to returns differences. But to suggest that these unobserved benefits explain the entirety or large part of the returns differences and that conflicts of interest play little or no role would be to turn a blind eye to a robust body of evidence on conflicts of interest.

Furthermore, as discussed earlier, Christoffersen, Evans, and Musto (2013) find that even within a share class, larger conflicts of interest imply greater harm to the individual investor. For the results to be explained by benefits such as savings goals, estate planning, and time savings, these unobserved benefits would have to increase as load-sharing increases. However, it is hard to justify why that relationship should occur. Customers of brokers generally do not know the amount of load-sharing that is involved in their mutual fund purchases, and therefore have no mechanism to demand greater services from the broker. Higher load-sharing does not create any incentive for the brokers to provide a higher level of service. Or conversely, brokers have no incentive to reduce the load-share that they receive just because a customer requires a lower level of service.

In sum, the weight of the evidence supports the finding that biased advice, rather than unobserved benefits, is the primary cause of the inferior returns suffered by IRA investors in conflicted load/distribution channels.

### 3.2.4 Magnitude of Harm

Strong evidence ties adviser conflicts to investments in higher-load, more poorly performing mutual funds. Other evidence strongly suggests that adviser conflicts inflict additional losses, possibly of a similar magnitude, by prompting IRA investors to trade more frequently, which will increase transaction costs and multiply opportunities for chasing returns and committing timing errors. Adviser conflicts likely are also associated with excessive price spreads in principal trades between IRA investors and BDs. Other types of investments such as single-issue securities, banking or insurance products also are likely to be subject to underperformance due to conflicts (Evans and Fahlenbrach 2012).

**Table 3.2.4-1 – Literature comparing the performance of broker-sold and direct-sold mutual funds**

Paper	Sample	Methodology	Annual Impact
Bergstresser, Chalmers, and Tufano (2009)	Domestic equity, foreign equity, bond, and money market mutual funds; 1996-2004	Compares annual performance – prior to distribution fees – of broker-sold funds with direct-sold funds	<p>Broker-sold domestic equity funds underperform by 0.27-0.88 percentage points on an asset-weighted basis and by 0.93-2.50 percentage points on an equal-weighted basis.</p> <p>Broker-sold foreign equity <i>overperform</i> by 1.45-3.26 percentage points on an asset-weighted basis, but underperform by 1.13-2.08 percentage points on an equal-weighted basis.<sup>186</sup></p> <p>Broker-sold bond funds underperform by 0.14-0.90 percentage points on an asset-weighted basis and by -0.10-0.45 percentage points on an equal-weighted basis.</p>
Bullard, Friesen, and Sapp (2008)	Domestic equity mutual funds; 1991-2004	Investigates how load and no-load fund investor returns compare to a buy-and-hold strategy	Load funds underperform a buy-and-hold strategy by 1.82 percentage points, more than double the underperformance for no-load investors.
Chalmers and Reuter (2014)	Oregon University System’s defined contribution retirement plan accounts; 1996-2007	Estimate the causal impact of brokers on their clients’ portfolio	Broker clients underperform self-directed investors by 1.54 percentage points.

<sup>186</sup> The authors report that the asset-weighted broker-sold over-performance is “attributable to a small number of very large international funds sold through one specific broker-channel fund family.”

Christoffersen, Evans, and Musto (2013)	Mutual funds with front end loads; 1993-2009	Investigates the effect of load sharing and revenue sharing on performance	Every 100 basis points in load sharing paid to an unaffiliated broker reduces returns by 50 basis points.
Del Guercio, Reuter, and Tkac (2010)	Domestic equity mutual funds, 1996-2002	Compares returns for broker-sold funds with comparable direct-sold funds	Broker-sold actively-managed funds underperform direct-sold funds by approximately 1 percentage point.
Del Guercio and Reuter (2014)	Domestic equity mutual funds, 1992-2004	Compares returns for index funds with actively managed funds in the direct channel and comparable funds in the broker channel	Direct sold actively managed funds do not underperform index funds, but broker sold actively managed funds underperform index funds by approximately 1 percentage point.
Friesen and Sapp (2007)	Domestic equity mutual funds, 1991-2004	Investigates how load and no-load fund investor returns compare to a buy-and-hold strategy	Load funds underperform a buy-and-hold strategy by about 2 percentage points, approximately double the underperformance for no-load investors.
Hackethal, Haliassos and Jappelli (2011)	Customers of a large German brokerage firm and customers of a large German commercial bank; 2003-2005	Compares net returns of advised and self-managed accounts	Log annual returns for advised accounts are lower by approximately more than 4 percentage points.
Morey (2003)	Domestic equity mutual funds; 1993-1997	Compares out of sample performance of load and no-load funds before and after adjusting returns for loads paid.	Load funds underperform no-load funds by 0.4-0.8 percentage points, prior to adjusting for loads. After adjusting returns for loads paid, load funds underperform no-load funds by 1.3-2.0 percentage points. <sup>187</sup>

As discussed in the previous section, several independent academic studies have found that investments that are distributed to investors through broker channels or share classes more often associated with conflicts of interest underperform peer comparison investments. (On their own, the results from each of these studies are concerning. Each study identifies a performance gap that could cost IRA investors tens or hundreds of billions of dollars over a ten-year period. The table below summarizes the most relevant studies identified by the Department (Burke et al. 2014, 13).)<sup>188</sup>

<sup>187</sup> DOL calculations. Morey (2003) presents returns on a monthly, rather than annual, basis.

<sup>188</sup> Table 3.2.4-1 was adapted from (Burke et al. 2014).



The Department reviewed two papers that consider the performance difference across mutual fund distributions channels – the direct brokerage channel and the full-service brokerage channel – and three papers that consider performance differences between load funds and no-load funds. Beyond the groups that are compared, there are additional differences in the methodology of the academic studies. One paper (Morey 2003) accounts for the actual loads paid by load fund investors, while the others do not. One set of papers (Bullard, Friesen, and Sapp 2008; Friesen and Sapp 2007) investigates the timing gap – the difference between the performance of actual investors and the performance of the funds that is captured in the prospectus that is due to the general poor timing of investors – while the others do not. One paper Bergstresser, Chalmers, and Tufano (2009) measures returns differences on an asset-weighted basis thereby giving large funds more impact on the result relative to small funds, while the others do not. None of the papers adjust for the selection of investors into distribution channels or load/no-load funds, but one paper (Chalmers and Reuter 2014) has information on individual investors, and is able to control for observable investor characteristics. Finally, two papers (Bergstresser, Chalmers, and Tufano 2009; Christoffersen, Evans, and Musto 2013) include bond mutual funds and international equity mutual funds in their analysis, while the other papers estimate performance gaps for equity mutual funds only.

None of these papers attempts to detect some major possible sources of underperformance of IRA assets attributable to conflicts of interest. None accounts for other potential sources of loss from conflicts such as mark ups in principal transactions, transaction costs associated with the purchase of securities other than mutual funds, investment timing losses associated with such other securities, and excessive premiums and/or unfavorable mortality tables associated with insurance company products. If conflicted recommendations lead investors to trade mutual funds excessively and thereby pay more loads and incur more timing losses, it seems likely they would also lead investors to trade other securities excessively and thereby generate more mark ups or commissions. Investors' tendency to chase returns and pay insufficient attention to expenses, and advisers' incentives to exploit these tendencies for personal gain, likely are not limited to mutual fund sales and recommendations.

On the other hand, as discussed earlier, some of the performance gap identified in many of these papers may reflect the fair value of unobservable or intangible benefits. Also as discussed earlier, however, available evidence suggests that only a fraction of the performance gap can be attributed to fair compensation for services. The majority likely reflects harm from adviser conflicts, comprising transfers from IRA investors to conflicted advisers and others in the supply chain and social welfare losses from capital misallocation.

Available empirical evidence, while broadly consistent in finding that adviser conflicts harm investors, varies widely with respect to both the type of harm considered and the magnitude of such harm. Therefore, the Department developed a number of different estimates of the overall performance gap associated with conflicted advice, reflecting different assumptions and methods, all of which are grounded in one or more academic empirical studies.<sup>189</sup> The estimates are

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<sup>189</sup> Reviewing the same literature, the Council of Economic Advisors (CEA) generated estimates of similar magnitude for the underperformance associated with conflicted advice. *See* “The Effects of Conflicted

described briefly below and summarized in the accompanying table. A fuller explanation for these underperformance estimates is provided in Section 3.4.4.

Various studies (*see* Table 3.2.4-1 above) consistently show that broker-sold mutual funds underperform direct-sold mutual funds, and many of these studies estimate the underperformance to be approximately 100 basis points per year. Applying this performance gap to the current IRA marketplace implies an earnings deficit of \$18 billion per year, more than \$210 billion over 10 years, and nearly \$500 billion over 20 years. Some studies suggest that the underperformance of broker-sold mutual funds may be even higher than 100 basis points, possibly due to loads that are taken off the top and/or poor timing of broker sold investments. If the true underperformance of broker-sold funds were 200 basis points, IRA mutual fund holders could experience underperformance amounting to \$430 billion over 10 years and nearly \$1 trillion across the next 20 years. Put differently, if underperformance is between 100 and 200 basis points per year, an ERISA plan investor who rolls her retirement savings into an IRA could expect to lose 12 to 24 percent, respectively, of the value of her savings over 30 years of retirement by accepting advice from a conflicted financial adviser.<sup>190</sup>

Christoffersen, Evans, and Musto (2013) look only at broker-sold mutual funds with loads and finds that brokers direct clients to funds with unusually high payments to brokers. The authors also find that these mutual funds which pay high load-shares to brokers subsequently underperform other broker-sold funds with more moderate levels of load sharing. Every 100 basis points in load sharing paid to an unaffiliated adviser reduces future returns by 50 basis points while 100 basis points paid to a captive broker reduces future performance by about 15 basis points. Projecting these results onto the current IRA marketplace suggests that load fund holders could be down over \$10 billion per year in loads and underperformance as a result of these conflicts of interest. The accumulation of the loads and underperformance over time could cost load fund holders almost \$125 billion over 10 years and \$285 billion over 20 years. However, while the mutual fund industry has been trending away from front-end load mutual funds, it has not been trending away from conflicts of interest more generally. More and more of the conflicted revenue streams received by brokers come through channels that are not observed by IRA investors, regulators, or researchers. If the industry has simply shifted conflicted revenue streams, rather than reducing conflicts, these conflicts of interest could cost IRA mutual fund holders approximately \$26 billion per year, more than \$300 billion over 10 years, and more than \$700 billion over 20 years.

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Investment Advice on Retirement Savings,” Feb. 2015, available at:  
[https://www.whitehouse.gov/sites/default/files/docs/cea\\_coi\\_report\\_final.pdf](https://www.whitehouse.gov/sites/default/files/docs/cea_coi_report_final.pdf).

<sup>190</sup> For example, an ERISA plan investor who rolls \$200,000 into an IRA, earns a 6% nominal rate of return with 3% inflation, and aims to spend down her savings in 30 years, would be able to consume \$10,204 per year for the 30 year period. A similar investor whose assets underperform by 1 or 2 percentage points per year would only be able to consume \$8,930 or \$7,750 per year, respectively, in each of the 30 years.

### 3.2.5 Conclusion

This section has considered whether there is evidence of a need for regulatory action to reduce or mitigate conflicts of interest in advice on the investment of IRA assets. The foregoing analysis has established that IRAs have special importance and that IRA investors are vulnerable to abuse. Changes in the market have overtaken the 1975 rule, rendering obsolete its omission of much advice from coverage under ERISA and/or IRC fiduciary standards. The IRA advice market displays the characteristics economic theory indicates predict harm from adviser conflicts: serious conflicts are widespread, pursuing customers is costly, and IRA investors are poorly equipped to police advice. There is evidence that advice is biased, and that this bias hurts IRA investors. Losses to IRA investors from conflicted advice are expected to amount to tens or more likely hundreds of billions of dollars over the next ten years.

### 3.3 Gains to Investors

Under the new proposal, advisers to IRA investors generally must either avoid compensation arrangements that involve conflicts, or contractually bind themselves to act in their customers' best interests. The new proposal is likely to affect investors' investment choices, savings decisions, and use of advisory services. By limiting or mitigating IRA advisers' conflicts, the new proposal is intended to ensure that their advice is impartial and thereby reduce the IRA performance gap otherwise attributable to conflicted advice.<sup>191</sup> The Department expects the financial gain to IRA investors to amount to tens of billions of dollars or more over the next ten years.

The Department's focus in the retirement space, and a core part of the mission of the Employee Benefits Security Administration (EBSA), is to assure the security of retirement benefits, including those derived from account-based plans: defined contribution (DC) plans and IRAs. Excessive fees and substandard investment performance in DC plans or IRAs, which can result when advisers' conflicts bias their advice, erode benefit security. This proposal aims to ensure that advice is impartial, thereby rooting out excessive fees and substandard performance otherwise attributable to advisers' conflicts, producing gains for retirement investors. Delivering these gains will entail some compliance cost – namely, the cost incurred by new fiduciary advisers to avoid PTs and/or satisfy relevant PTE conditions. The Department expects investor gains to be very large relative to compliance costs, and therefore believes this proposal is economically justified and sound.

In the language of social welfare economics and reflected in OMB Circular A-4, the investor gains which are the aim of this proposal generally can be said to comprise two parts: pure social welfare “benefits” attributable to improvements in economic efficiency, and “transfers” of welfare to retirement investors from others. A full accounting of a rule's social welfare effects would encompass all of the rule's direct and indirect effects as would be manifest in general market equilibrium. Likewise, that full accounting would consider pure social welfare costs – that is, reductions in economic efficiency – which are not the same as simple compliance

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<sup>191</sup> Independent research demonstrates that the regulatory regime under which an investment adviser acts does in fact affect the advice given (Kozora 2013).

costs. The Department considered this proposal’s potential indirect effects and associated social welfare implications, particularly its potential supply and demand side impacts on the market for advisory services, and for financial products and services more generally. These topics are covered in Section 8.3 below.

The quantitative focus of this analysis, however, is on the proposal’s most direct, and directly targeted, effects: gains to retirement investors, and compliance costs to advisers and others. The available data does not allow the Department to fully quantify the expected gains to investors nor break down those gains into component social welfare “benefits” and “transfers.” Therefore, the Department has quantified a subset of the potential gains to IRA investors, which include both some pure economic efficiency gains (benefits)<sup>192</sup> and some transfers from the financial industry.<sup>193</sup>

### 3.3.1 Quantified Gains to Investors

There is a lack of comprehensive data on the potential harmful effects of conflicts of interest in the ERISA plan and IRA marketplaces. Industry sources have indicated to the Department that the data necessary to fully address this question would be prohibitively expensive

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<sup>192</sup> Impartial advice leads to better investment decisions. Better decisions in turn free some resources from sub-optimal uses in the financial sector (which may include excessive trading, and duplicative or sub-standard research or asset management) to other, more productive uses. They also lead to more optimal deployment of capital in financial markets (toward more productive enterprises), increasing overall returns to capital investment.

<sup>193</sup> Transfers to retirement investors will largely consist of reduced levels and/or volumes of fees paid for financial products or services. Other transfers to retirement investors will derive from improved trading decisions relative to counterparties from whom the transfers will come. The Department believes that transfers to IRA investors in conflicted advice arrangements are likely to come mostly from professional asset managers and others in the financial industry rather than from other retail investors (non-IRA retail investors and IRA investors that are not in conflicted advice arrangements). One possible impact of closer-to-optimal investment of the assets of conflicted-advice-receiving IRA investors is to lessen the opportunity for counterparties to take advantage of abnormally positive investment opportunities. However, to the extent that those counterparties are retail investors or mutual funds held by retail investors, those retail investors typically do not profit from such investment opportunities. Instead, the academic literature (e.g., Del Guercio and Reuter 2014)) finds the profit is captured by the retail investors’ advisers or their funds’ asset managers. Retail investors only break even relative to index investment. Therefore, retail investors likely will not experience much of a loss if such abnormally positive investment opportunities drying up. Instead, this transfer would come mostly from reduced opportunities for skilled asset managers. The Department invites evidence that would confirm or refute this conclusion and more generally allow for characterization of rule-induced transfers; of special interest would be data characterizing the subsets of society on opposite sides of the transfers.

to compile or obtain. The Department invites interested parties to provide data or analysis that might shed additional light on this question.<sup>194</sup>

In the absence of comprehensive data that would allow for an estimate of the total investor gains the rule, the Department has assessed the gains to investors attributable to the rule by specifically quantifying benefits in an area of the IRA market, namely front-end load mutual funds, where the conflicts are well measured. This segment of the IRA assets currently amounts to approximately 13 percent of overall IRA assets. Narrowly focusing only on how load shares paid to brokers affect the size of loads IRA investors holding load funds pay and the returns they achieve, the underperformance attributable to these practices alone amounts to more than \$80 billion over 10 years and almost \$200 billion over 20 years.

The new proposal has the potential to go a long way to reducing these losses by requiring fiduciary IRA advisers to forgo conflicted fee structures when providing fiduciary advice to IRA investors or to provide advice that is in their clients' best interest and impartial as a condition of relying on certain PTEs that provide flexibility to continue a wide range of compensation practices subject to protective conditions. Even taking into account the gradual movement of IRA assets into more optimal investments, and backing out improvements in cost-effectiveness that might be expected without the new proposal, the proposal itself will restore to IRA investors approximately \$40 billion over 10 years and almost \$90 billion over 20 years even in spite of existing regulations protecting investors. These quantitative estimates are calculated with an assumption that the rule will eliminate (rather than just reduce) underperformance associated with the practice of incentivizing broker recommendations through front-end-load sharing; if the rule's effectiveness in this area is substantially below 100 percent, these results may overstate rule-induced gains to investors in the front-load mutual fund segment of the IRA market. The Department nonetheless believes that these gains alone would far exceed the proposal's compliance cost. For example, if only 75 percent of anticipated gains were realized, the

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<sup>194</sup> On December 15, 2011, the Department sent a letter to six trade groups requesting that they voluntarily provide data that could help the Department evaluate the impact, if any, of conflicts of interest faced by brokers or others who advise IRA investors. The Department met with the groups to clarify the data request, and sent a follow-up letter on February 10, 2013, requesting the trade groups to notify the Department regarding whether they would be able to provide any of the requested data elements, and if so, when the Department could expect to receive such data. If the groups were not able to provide any of these requested data, the Department asked them to inform the Department of any other available data sources that could help the Department to evaluate the impacts of conflicts of interest.

None of the groups provided any relevant data in response to these requests. In general, their responses indicated that these data were not available and would be prohibitively expensive to collect or compile. Moreover, the groups asserted that even if such data were made available, these data would not allow the Department to determine whether conflicts bias advice and harm investors. Generally, they also did not provide the Department with any other data sources that could be used to assess the impact, if any, of conflicts of interests on IRA investors. The Department remains interested in receiving these data and hereby requests the industry or any other groups that have such data to provide it.

The Financial Service Institute sent its Broker-Dealer Financial Performance Study to the Department for several years. The Department used data from the study where relevant and appreciates receiving it. The study focuses on the operation and management of independent broker-dealer firms. However, the reports do not contain individual account data for IRAs or other products that could be used to access the impact, if any, of conflicts of interest on IRA investors.

quantified subset of such gains – specific to the front-load mutual fund segment of the IRA market – would amount to between \$30 billion and \$33 billion over 10 years. If only 50 percent were realized, this subset of expected gains would total between \$20 billion and \$22 billion over 10 years, or several times the proposal’s estimated compliance cost of \$2.4 billion to \$5.7 billion over the same 10 years. These gain estimates also exclude additional potential gains to investors resulting from reducing or eliminating the effects of conflicts in financial products other than front-end-load mutual funds. The Department invites input that would make it possible to quantify the magnitude of the rule’s effectiveness<sup>195</sup> and of any additional, not-yet-quantified gains for investors.

These potential additional gains include improvements in the performance of IRA investments other than front-load mutual funds and potential reductions in excessive trading<sup>196</sup> and associated transaction costs, and timing errors (such as might be associated with return chasing).<sup>197</sup>

The quantified gains for investors in IRAs currently characterized by conflicts of interest are composed of benefits to society as a whole and transfers of value between members of society. Fund underperformance, the reduction of which is key to the quantification about to be described, can result from transaction costs (associated with labor and other resources being used for excessive trading within a fund), and the freeing of these resources for other uses would be a benefit of this proposed rule. Fund underperformance may also represent sub-optimal allocation of financial capital in the national economy; improvement in this area would represent another investor gain (and social benefit) of the rule. On the other hand, fund underperformance can also result from assets being purchased at a relatively high price and sold at a relatively low price; the effect of the rule for the fund’s counterparties in these transactions would be a reduction in the abnormally good returns they currently experience, an effect that would be categorized, from the perspective of society as a whole, as a transfer. This chapter’s approach to quantification produces estimates of investor gains that do not distinguish between social welfare benefits and

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<sup>195</sup> The Department invites input that would aid in generating evidence-based estimates of effectiveness. For example, contracts exist in many contexts, so commenters might suggest extrapolations from academic literature on contracts that could be useful in assessing the Best Interest Contract PTE’s impact. As an additional example, enforcement of this proposal would increase advisers’ expected economic cost of rendering advice in their own interest. In order to answer the question, “how would the level of enforcement and magnitude of economic cost associated with enforcement risk for biased advice relate to the magnitude and incidence of investor gains,” the Department invites input that would help quantify this economic cost, its impact on advisers’ supply of biased versus impartial advice, and the associated relationship between this cost and investor gains.

<sup>196</sup> Excessive trading generally means trading at a level above that which generates optimal expected returns for the investor. Excessive trading sometimes takes the form of “churning,” or repeated recommendations to trade that are intended to generate more commissions for advisers rather than benefit investors. Such churning generally violates securities law. However, excessive trading can take other, generally smaller, forms that may not run afoul of securities law. For example, an adviser might recommend that an IRA investor construct a diversified portfolio by buying several mutual funds (and periodically trading to rebalance the portfolio) in circumstances where the same diversification and expected return could be achieved with less transaction cost by buying a single, internally-diversified fund that offers ongoing, internal rebalancing.

<sup>197</sup> The requirements that attach with a broker-dealer’s suitability obligation vary based on the facts and circumstances. Activities such as excessive trading and churning have been found to violate the suitability obligation in some circumstances, but not in others. [See SEC Dodd-Frank Study 2011, 65 Study, 65.]

transfers to investors from financial firms, and thus will be referred to with the term “gains to investors.”

The Department began its effort to quantify gains to investors by conducting a thorough review of the economic literature that investigates the relationship between retail investment advice and retail investment performance.<sup>198</sup> Across a broad array of data samples and methodologies, these papers consistently show that assets in retail accounts that are invested directly perform better than assets invested based on advice from a broker who gets paid (directly or indirectly) by the mutual fund. From the point of view of several of these studies, there exists the possibility that some or all of the reduced performance is effectively fair payment for the advice services rendered by the broker. However, one study clearly ties the reduced performance to conflicts of interest on the part of the adviser.

As discussed above, due to limitations in data availability, the Department has been able to quantify only a portion of the gains that are expected to accrue IRA investors under this proposal. Specifically, the Department quantified only those gains expected to accrue to IRA investments in front-end load mutual funds due to the remediation of only one type of advisers’ bias, namely, bias heretofore attributable to variations in load sharing.<sup>199</sup> Substantial additional gains are expected to accrue to IRA investors with respect to investments other than front-end-load mutual funds and with respect to the remediation of adviser bias heretofore attributable to conflict-laden compensation other than load shares. However, data limitations prevented the Department from confidently quantifying these gains so they are omitted from the estimates presented here.

Christoffersen, Evans, and Musto (2013) (CEM) find a significant relationship (statistically significant and economically meaningful) between the amount of sales load that the mutual fund shares with the broker (“load share”) and the inflows into the mutual fund.<sup>200</sup> In other words, the more the mutual fund pays the broker, the more likely the broker is to recommend that mutual fund to clients. This result is an immediate concern regarding conflicted advice – that the investment recommendations are influenced by conflicted payments, rather than strictly being constructed in the best interest of the IRA investor. The load share itself is harmful because the incentive provided to the broker tilts investment recommendations toward higher-load funds and helps to keep loads higher than what they otherwise would be. However, according to the Department’s estimates, higher-than-otherwise loads is likely to constitute only a small fraction of the total losses to IRA investors due to conflicted investment advice.

Investment underperformance also appears to be a result of conflicted investment advice as the authors find a significant, negative relationship between load shares and mutual fund

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<sup>198</sup> The Department’s efforts included an internal review by staff and an external review by the RAND Corporation. See Burke et al. (2014).

<sup>199</sup> A load is a fee paid to the mutual fund company by the investor in order to invest in (certain share classes of) the mutual fund. A load-share is the portion of the load that the mutual fund then pays to the broker-dealer that recommended the mutual fund.

<sup>200</sup> The authors find a similar result with regard to 12(b)-1 fees; larger 12(b)-1 fees are associated with higher levels of flows into a fund. The result is statistically significant when load-sharing is *not* included in the regression. When load-sharing is added into the regression, the 12(b)-1 fee result is no longer statistically significant, but the magnitude of the coefficient is still economically meaningful.



investment performance. Importantly, CEM find that conflicts of interest skew brokers' recommendations and that, as a result, such investment underperform, even in spite of existing regulations intended to protect investors against conflicts of interest. One explanation for this result is that a mutual fund company faces tradeoffs in incentivizing its brokers to recommend a product (e.g., by offering higher compensation for selling that product) or by investing in active management. Del Guercio and Reuter (2014) provide an empirical investigation of this relationship and demonstrate that funds providing broker compensation appear to invest less in active management.

The subset of expected gains to investors that the Department has quantified was estimated by comparing projections of front-end load mutual fund IRA assets under different scenarios: (1) a baseline scenario where the 1975 rule remains in place, and (2) a series of alternative reform scenarios where the new proposal is finalized and affects the market in particular ways. The scenarios do not differ with respect to contribution rates or rollover rates into IRAs or withdrawal rates from IRAs. (The question of whether or how contributions, rollovers, and withdrawals might be affected by the rule is discussed in Section 8.3 below.) The scenarios also do not differ with respect to the proportion of IRA assets invested in mutual funds. Finally, the scenarios do not differ by the percentage of mutual fund IRA assets that incur front-end loads.

The scenarios differ only in the net rate of return experienced by IRA investors in front-end load mutual funds. The net rate of return is higher in scenarios where the rule is promulgated for two reasons. First, under some of the reform scenarios, loads decrease at a faster rate than under the baseline because any incentive for a broker to place IRA clients in mutual funds with a higher load share is effectively mitigated. The second and larger reason is increased investment performance under the reform scenarios.

The baseline scenario includes a projection of loads that decreases over time, at a rate similar to that of recent years. Under the first reform scenario, loads decrease over time at the same rate as the baseline scenario. Under the second reform scenario, loads decrease over time at twice the rate of the alternative scenario. This is where removing the brokers' adverse incentive comes into play.

Historical data show loads have fallen over time, likely due to growing demand for less expensive investment options. However, a counterforce has kept loads from falling faster. CEM show that investment assets tend to flow away from funds with high loads, but toward funds with high load-shares. These pressures can act independently only when the load-share is a small fraction of the load. However, the data indicate that this is not the case: the average load share is 81 percent of the average load. Because load-shares (that is, the portion of the load paid to the distributing BD), in general, are a very high fraction of the load, the load-share cannot significantly increase without increasing the load. Likewise, the load cannot decrease without decreasing the amount of the load that is shared. The brokers' incentive to collect a high load-share tends to push loads up while demand for less expensive investment options pushes loads down. Recent history has shown that the downward force has outweighed the upward pressure. But removing the upward pressure, by mitigating the brokers' incentive, should cause loads to fall faster than they otherwise would.

Under the third reform scenario, loads paid by investors immediately fall to zero. Because the Department does not believe loads will disappear, this scenario represents an upper limit to the direct gains-to-investors that could accrue from the rule's impact on front-end mutual fund loads paid. It is also illustrative of the amount that IRA investors can expect to pay in loads over the next 10 and 20 years if no action is taken by the Department.

While this decrease in load size is important, the second and larger reason that the net rate of return is higher under the reform scenarios is increased investment performance for broker-sold mutual funds. By requiring advisers to act in the best interest of their IRA clients and including safeguards to that effect, the new proposal will ensure that adviser recommendations are not biased by load-sharing or other variable compensation. The estimates discussed below assume that the proposal’s exemption conditions will be fully effective in mitigating adviser conflicts of interest. Rather than reflecting the adviser’s interests, future recommendations will be based on factors that appropriately reflect investors’ interests with respect to risk and expected future returns of investment alternatives. This, in turn, will direct flows toward mutual funds that invest in performance, rather than relying on payments to advisers, to sell their product. The estimated magnitude of this effect on investment performance is the same across all three alternative scenarios.

The new proposal’s expected positive impact on broker-sold mutual fund performance constitutes a large majority of its partial, quantified gains to investors. Under the first reform scenario, there is no direct effect of the rule on loads, so the effect on investment performance is the entirety of the quantified investor gain. Under the second reform scenario, the effect on investment performance constitutes approximately 90 percent of the estimated gain.

The Department anticipates that the rule will immediately improve broker-provided investment advice and will consequently improve investment performance for IRA investors who seek new advice; however, the 10- and 20-year estimates the portion of IRA investors’ expected gains that the Department has quantified reflect the likelihood that the gains to investors will be back-loaded. When the rule is finalized, brokers will be required to adhere to new standards for any advice given from that point forward. As a result, some IRA investors will remain in underperforming, broker-sold funds after the rule is finalized. The farther removed from the effective date of the rule, the greater the number of IRA investors who will have received new advice, and the larger the benefits that will accrue from improved investment performance.

Table 3.3.1-1 presents the estimated, quantified portion of expected gains to investors by time horizon (10- and 20-year) and by alternative scenario (1, 2, and 3). Alternative scenario 1 generates 10-year estimated partial gains of \$40 billion and 20-year estimated partial gains of \$88 billion.<sup>201</sup> The Department considers this to be in many respects a conservative estimate of the quantifiable portion of IRA investor gains from the proposal. Alternative scenario 2, which includes an acceleration of the decline in loads, generates a 10-year gain of \$44 billion and a 20-year gain of \$100 billion. The Department considers this to

Table 3.3.1-1 -- Quantified subset of IRA investors' expected gains by time horizon and alternative scenario (\$ billion)			
	Alternative scenario		
Time horizon	1	2	3
10-year	39.8	44.1	65.6
20-year	87.6	99.7	135.1

<sup>201</sup> The Alternative Scenario 1 estimates can be thought of as the sum of counterparties’ reduced performance (transfer), asset allocation that is closer to optimal for society (benefit), and—because CEM measure underperformance net of most expenses—net real cost savings (i.e., resources previously used for management, or for excessive within-fund trading, being freed for other uses, minus resources newly used for seeking out higher returns).

be a reasonable high estimate of the quantifiable portion. Alternative scenario 3 projects a future where brokers no longer advise IRA investors to invest in front-end load funds. In this case, the quantified subset of IRA investors' expected gains is estimated to be \$66 billion over 10 years and \$135 billion over 20 years. The Department offers this as an illustration but does not expect the proposal to result in the elimination of all load funds from IRA recommendations.

This quantified subset of IRA investors' expected gains, as presented in Table 3.3.1-1, is expected to be achieved by requiring broker-dealers who engage in self-dealing to adhere to conditions designed to mitigate the impact of those conflicts of interest. While brokers will still be allowed to receive 12b-1 payments and other forms of revenue sharing, the exemption conditions will ensure that brokers are not incentivized to recommend products that provide the broker more revenue at the expense of the customer.<sup>202</sup> Currently, mutual fund companies are able to sell their product by enticing brokers to give recommendations that benefit the broker but are not in the best interests of the clients. The change in broker incentives will, in turn, force mutual fund companies to invest more in performance in order to sell their products.<sup>203</sup> The increased performance will result in gains for front-load mutual fund investors of \$40 billion over 10 years and \$88 billion over 20 years (under scenario 1).

The quantified subset of IRA investors' expected gains presented in Table 3.3.1-1 assumes that the proposal's exemption conditions will be fully effective in mitigating adviser conflicts of interest. The Department understands, however, that: (a) the industry may not achieve full compliance with the rule and exemption conditions, and (b) the combined rule and exemption conditions may not be fully effective at ensuring advisers' impartiality in the manner anticipated by the Department. If advisers identify ways to circumvent the protections in the rule, they would continue to impose costs on their customers and — because of their ability to continue subjugating their clients' interests to their own — the anticipated gains to investors would be reduced. For example, if only 75 percent of anticipated gains were realized, under scenario 1 the quantified portion of such gains would amount to \$30 billion over 10 and \$66 billion over 20 years. This question is addressed further in Section 8.2 below. Similar to other quantified estimates presented herein, this estimate — specific to the front-load mutual fund market segment — omits large, unquantified expected investor gains.

CEM “find load sharing, but not revenue sharing, to predict poor performance.” While CEM's evidence against load sharing is stronger than the evidence against ongoing conflicted payment streams such as revenue sharing, the CEM results, along with larger body of literature, suggests that ongoing conflicted payment streams are also harmful to IRA investors.

The CEM results should not be interpreted to absolve ongoing conflicted payment streams for several reasons. First, the signal from revenue-sharing may have been drowned out by noise. When CEM attempt to simultaneously evaluate the effects of load sharing and revenue sharing on investment results, they confidently identify a negative effect from load sharing. With respect to revenue sharing, their point estimate, or best guess, is that every 100 basis points in revenue sharing is associated with more than 100 basis points poorer performance. This revenue sharing

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<sup>202</sup> See the preambles to the proposal's exemptions for more details on the anticipated effects of the exemptions conditions.

<sup>203</sup> See Section 3.4.3.1 for a more detailed discussion of broker and mutual fund incentives.

finding, however, is not statistically significant – that is, its margin for error is too wide to rule out a zero effect.

This lack of statistical significance might mean that a relationship between revenue sharing and results is small and weak, or even absent. But it might instead mean that the signal from revenue sharing was simply drowned out by noise.

Second, CEM's measure of revenue sharing is incomplete. CEM did not directly test the effects of revenue sharing at all, but rather the effect of 12(b)-1 fees on performance. BD firms frequently receive other types of payments from mutual funds, such as sub-accounting fees, and frequently receive revenue sharing payments from investment advisers to the mutual funds. These other, non-12(b)-1, payments are not recorded on the SEC forms N-SAR that CEM use to estimate the load sharing and revenue sharing paid by mutual funds.<sup>204</sup>

Third, the sample used to generate the non-finding on revenue sharing was not representative of all funds with either 12(b)-1 fees or revenue sharing. That sample was restricted to funds with both positive load sharing and positive revenue sharing (as measured by 12(b)-1 fees) and amounted to less than 6% of CEM's original sample.<sup>205</sup> It is possible that funds with front-end loads systematically charge less in other fees and pay less to brokers in revenue sharing than broker-sold funds that don't charge front-end loads. For example, Class B and Class C funds often charge 12(b)-1 fees of 100 basis points, while Class A funds rarely charge 12(b)-1 fees of that magnitude (often charging 25 basis points instead). In that case, more meaningful revenue sharing activity would fall mostly outside the scope of the statistical test used by CEM to evaluate the relationship between revenue sharing and performance, so it would not be surprising that CEM did not find any revenue sharing effects. A study using more robust data on conflicted payments to brokers might find both a statistically significant relationship between those payments and underperformance and a stronger relationship than is suggested by the point estimates from the CEM study.<sup>206</sup>

The Department also notes that compensation paid one way today might be paid another tomorrow. If new rules or market developments were to reduce load sharing, revenue sharing might increase to take its place, and increased revenue sharing might have larger (and more easily detected) effects on investment results.

The quantified subset of IRA investors' expected gains are estimated relative to a baseline scenario in which (in the absence of Department action) that segment is expected to shrink over time and harmful conflicts of interest within the segment are expected to become less severe. Were the Department to project a baseline scenario where the IRA front-end load mutual fund segment retains its current market share and harmful conflicts of interest within the segment

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<sup>204</sup> The Form N-SAR is a semi-annual filing by mutual funds to the SEC containing information on mutual fund operations, including 12(b)-1 payments.

<sup>205</sup> By contrast, the sample used to generate the result tying load sharing to reduced performance was approximately 54% of CEM's original sample.

<sup>206</sup> To the extent that these other fees are correlated with load-sharing, they could introduce omitted variable bias into the regressions showing a relationship between load-sharing and underperformance. In either case (omitted variable bias or not omitted variable bias), the implication would be that higher levels of conflicted payments are associated with poorer performance.

maintain their current severity, the estimated gains would be significantly larger. Section 3.4 below provides a more detailed explanation of these estimates.

As discussed above, the quantified subset of IRA investors' expected -gains represent only part of the gains to IRA investors that the new proposal is estimated to deliver. First, the quantified gains pertain only to 13 percent of all IRA assets that are invested in front-end-load mutual funds, and only to the subset of conflicts associated with front-end loads. Second, as noted in Section 3.2.4 above, other evidence strongly suggests that adviser conflicts will inflict additional losses of a similar magnitude by prompting IRA investors to trade more frequently, which will increase transaction costs and multiply opportunities for losses from chasing returns. Third, adviser conflicts also are likely to be associated with excessive price spreads in principal trades between IRA investors and BDs. Finally, other types of investments such as single-issue securities, banking or insurance products could also be subject to underperformance due to conflicts. The new proposal, by limiting or mitigating all adviser conflicts, will help IRA investors by substantially reducing the more than \$210 to \$430 billion loss they might otherwise suffer over the next 10 years – and more than \$500 to \$1 trillion over 20 years.

The new proposal's benefits are expected to extend well beyond improvements in IRA investment results. The market for fiduciary advice and other services may become more efficient as a result of more transparent pricing and greater certainty about the fiduciary status of advisers and about the impartiality of their advice. There may be benefits from the increased flexibility that the new proposal's PTEs will provide with respect to fiduciary investment advice currently falling within the ambit of the 1975 rule. The new proposal would extend guidance on the boundaries between fiduciary advice and education, heretofore provided only with respect to plan participant investments, to plan distributions and thereby will not impair and may improve access to IRA investor educational services. Innovation in new advice business models, including technology-driven models, may be beneficially accelerated, and nudged away from conflicts and toward transparency, thereby promoting healthy competition in the fiduciary advice market. The Department believes that these benefits, together with gains to IRA investors (both those quantified here and others) will justify the proposal's compliance cost.

### **3.3.2 Qualitative Discussion**

The new proposal is designed to effectively limit or mitigate adviser conflicts without diminishing IRA investors' access to beneficial advice or other effective support for sound saving and investing decisions. It balances revisions to the 1975 rule that extend fiduciary status to essentially all personal advice on IRA investments (but not pure sales or educational activity) with PTEs that allow fiduciary advisers to receive compensation that can introduce conflicts subject to protective conditions designed to mitigate those conflicts so advice is impartial.

Under the new proposal, a person would be an investment advice fiduciary if he provides a recommendation to an IRA investor regarding the advisability of acquiring, holding, disposing of or exchanging securities or other property pursuant to a written or verbal agreement, arrangement or understanding that the advice is specifically directed to the advice recipient for consideration in making investment decisions with respect to securities or other property. As fiduciaries, pursuant to the IRC PT provisions, advisers to IRA investors generally would have to refrain from transactions that introduce conflicts of interest unless covered by a PTE. The proposed PTEs and proposed amendments to applicable existing PTEs carry strong protective conditions – in particular a requirement that the adviser be loyal to IRA investors' interests. Consequently, IRA underperformance otherwise attributable to adviser conflicts would be greatly reduced.

Many comments on the 2010 proposal express concern that as fiduciaries, advisers' cost to provide advice would be higher. Commenters argued that lower-income IRA investors, and or those with smaller IRA balances, would be unable to afford or unwilling to pay enough to cover that cost, so their access to advice would diminish, and their investment results would suffer. Moreover, they asserted that because advisers help IRA investors not only with investment decisions but also with setting and achieving savings goals – even with opening an IRA and beginning to save – retirement savings itself might suffer. Such negative consequences could more than offset the benefits of eliminating bias from advice, the comments said.

As discussed in Section 8.3 below, the Department believes the potential for such severely negative consequences is limited. The Department believes the market already shows the potential to serve small accounts with quality, impartial, affordable advice or other effective support for sound saving and investing decisions.<sup>207</sup> Under rules that largely ban adviser conflicts, advisers would compete to offer consumers better service at lower prices, and product vendors would compete to offer quality, low-fee products that advisers would recommend. This contrasts with today's market, where product vendors compete for advisers' shelf space at consumers' expense.

Nevertheless, the Department takes seriously the risk that banning adviser conflicts could reduce access to advice for some IRA investors, and that not only their investing but also their saving might suffer as a result. Even if the potential for this result is limited, its severity is sufficiently great that the Department agrees caution is required.

In addition, the Department is committed to harmonizing its rules with intersecting rules under securities law. Comments on the 2010 proposal argued that the Advisers Act may present an obstacle to BDs' provision of advice to IRA investors if adviser conflicts are banned. According to these comments, taking such direct, arguably "special" compensation for advice would force BDs to register under the Advisers Act as RIAs, and as RIAs they would be required to provide a higher level of service to small accounts than those accounts now receive or can afford.

In light of these considerations the Department has included certain proposed PTEs that allow fiduciary advisers to receive certain otherwise prohibited compensation subject to certain protective conditions. The new proposal will deliver its potential benefits if these PTEs provide sufficient flexibility to advisers to avoid substantial erosion of IRA investors' access to advice, and their protective conditions sufficiently mitigate any conflicts associated with compensation covered under the PTEs so that advice is impartial. As elaborated below, the Department believes that a large proportion of the performance gap attributable to adviser conflicts would be eliminated by the new proposal due to the calibrated scope of the exemptions and the strength of the attached conditions.

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<sup>207</sup> Concerns also were expressed regarding an "advice gap" within the UK when the RDR became effective. However six months after the effective date the FCA commissioned research showing that investment advisers continue to serve clients with savings and investments between £20,000 and £75,000 and that a third of advisers continue to serve clients with less than £20,000. For a further discussion, *see* Section 2.9.1.3, above.

Comments on the 2010 Proposal requested relief for the receipt by investment advice fiduciaries of various fees and compensation resulting from transactions involving plans and IRAs. The new proposal includes a “Best Interest Contract Exemption” covering the receipt of fees and compensation by an individual investment advice fiduciary, a financial institution with respect to which the individual is an employee or representative, and any affiliates and related entities, resulting from investment transactions engaged in pursuant to the fiduciary adviser’s advice. This proposed PTE also includes strong protective conditions to ensure that advice is impartial. Fiduciary investment advisers and their firms must enter into a written contract with the plan/IRA investor. The contract must provide that the adviser and firm will adhere to impartial conduct standards including acting in the best interest of the plan/IRA investor and the firm must warrant that it has put in place policies and procedures designed to mitigate material conflicts of interest and to ensure compliance with the impartial conduct standards. The conditions also require disclosure of conflicts and fees to customers and the public. Detailed data regarding adviser compensation and investment activity must be available to the Department for review.

Commenters responding to the 2010 Proposal also requested exemptive relief for principal transactions between a plan and a BD that is an investment advice fiduciary. Many BDs view the ability to execute principal transactions as integral to the economically efficient execution of a variety of transactions including fixed income securities. The new proposal includes a proposed PTE covering principal transactions in certain debt securities between a plan or IRA and a fiduciary adviser where the principal transaction is a result of the provision of fiduciary investment advice.

The new proposal also includes proposed amendments to existing adviser PTEs, attaching conditions to ensure advisers’ impartiality and narrowing scope of some to exclude IRAs. Together these proposed new and amended PTEs (*see* Section 2.2) would offer advisers targeted flexibility to structure compensation arrangements, including some of the more common forms of compensation available to brokers today, subject to conditions including a promise to act in the client’s best interest. As long as applicable conditions are met, advisers could offer customers the choice to compensate them via commissions, product-related fees, mark-ups on bond prices, or direct fees. Advisers also would have the option of avoiding PTs and with them any need to satisfy PTE conditions. IRA investors would continue to have access to advice and a more than adequate range of investment options.

At the same time, the calibrated scope of the proposed PTEs and the protective conditions attached to them should largely prevent covered compensation arrangements from biasing advice. Because of the targeted scope and strong protections provided in the proposed new and amended PTEs, the Department believes that the new proposal will deliver the quantified gains to investors and other positive effects qualitatively discussed in the preceding section. The Department intends to monitor compliance and market developments under the new rule to assess whether it is achieving its goals and inform possible future changes to the regulation and/or the PTEs’ scope or conditions.

Some of the IRA investor gains from this proposal will be realized quickly, while others will be realized more gradually. Some of the underperformance attributable to conflicts results from excessive trading and is manifested as excess loads, commissions and some timing errors associated with return chasing. This activity should immediately be reduced, delivering large gains to investors in the near term. The rest of the underperformance is associated with holding of “dominated” investments (insofar as available alternatives would promise higher returns without greater risk, or lower risk with equal or superior returns) such as those that are inadequately diversified or carry excessive fees. Some investors might be slow to swap these investments for



more efficient ones. They may be slow to seek, be offered, or follow advice to do so. Gains to investors associated with such swapping will be realized more gradually.

Separate from the benefits of more impartial advice, IRA investors and their service providers will benefit from additional clarity about which services need not conform to fiduciary standards and incur associated costs. For example, under the new proposal, IRA investment education that does not include specific personal recommendations would not be treated as fiduciary advice. Currently IB 96-1 clarifies this exception only for plan investment education, not for IRA investment education.

IRA investors also will benefit from the clarity and certainty that will be associated with the application of uniform standards to all professional advice on retirement investing, regardless of its source.

As noted later in connection with the benefits for plans, plan participants will benefit from wider availability of education on plan distribution options. The new proposal clarifies that such education is not fiduciary investment advice. IB 96-1 provides clarity only with respect to investment and savings education, not education regarding distribution options. Because the new proposal is expected to improve decisions about the disposition of plan distributions, its benefits will extend via roll overs to IRA investors as well.

Some additional benefits may accrue to existing fiduciary advisers – those who are fiduciaries under the 1975 rule – and to their plan and IRA clients, because of new flexibility available pursuant to the proposed PTEs.

Still another benefit is expected to be healthier development of business models that rely heavily on technology to generate and deliver advice and/or that build advice into financial products themselves, as is the case with target date funds. So-called “robo advisers” and products (such as target date funds) that minimize the need for complex advice are already rapidly gaining market share. They promise to make advice far more affordable for small investors, especially young investors who generally are more accustomed to technology-based tools. More traditional advisory firms are scrambling to develop, partner with, or acquire such innovative tools, and to combine these with more traditional services to deliver tailored services to more market segments at far lower cost than that historically associated with traditional approaches alone.<sup>208</sup> The new proposal will help ensure that these new approaches evolve toward less conflicted and more innately impartial business models, rather than succumbing to the competitive pressures that have led more conflicted models to dominate today’s highly imperfect marketplace.

A large impact of the new proposal will be a transfer of surplus from advisers, their employers, and suppliers of the financial products they recommend to investors in IRAs that are characterized by adviser conflicts of interest. This transfer will redistribute surplus to more closely approximate the distribution that would result from a more perfectly competitive market for financial advice and products – that is, one where the quality and price of advice is transparent

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<sup>208</sup> Joyce Hanson, *Investment News*, “Robo startup will work with advisers exclusively,” (July 15, 2014) and Steve Sandusky, *Investment News*, “The reasons why human and robo-advisers will soon converge,” (July 14, 2014). Because models are not susceptible to unhelpful human behavioral biases, model-based advice may be superior to that formulated by an adviser without benefit of a model (Gray 2014).

to investors and advisers consequently compete on advice quality and price. Moreover, the redistribution will promote IRA investors' retirement security.

The securities industry has itself identified certain important benefits of reform. These includes the benefits of ensuring that advice honors investor's interests, reducing investor confusion over what to expect from advisers, and promoting trust in advisers.<sup>209</sup> The Department expects that the new proposal would deliver all of these benefits for plan and IRA investors.

Consumers' strong support for a clear fiduciary standard for all advisers has been recognized by both consumer and some industry advocates.<sup>210</sup>

### **3.4 Bases for Estimates of Harm and Subset of Gains to Investors**

An overview of the methodology used to estimate a small subset of the proposal's expected gains to investors appears in Section 3.3.1 above. This section provides more detail on the calculations. Section 3.4.1 presents the projection of investment performance over the projection period for the baseline and alternative scenarios, while Section 3.4.2 presents the methodology and calculation of the estimates. Section 3.4.3 discusses each of the assumptions used in the projections in detail and offers a sensitivity analysis for many of the assumptions. Section 3.4.4 presents underperformance estimates and the assumptions required to generate those estimates.

#### **3.4.1 Investment Performance**

As discussed in Section 3.3.1, the alternative scenarios diverge from the baseline scenario solely on investment performance net of loads. The baseline projection assumes that investment returns are equal to 6 percent minus two values: 1) any front loads paid during the year, and 2) the effect of current and past loads on performance.

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<sup>209</sup> SIFMA October 11, 2013 comment to SEC, "Recommendations of the Investor as Purchaser Subcommittee on Broker Dealer Fiduciary Duty," available at: <https://www.sec.gov/comments/265-28/26528-39.pdf>.

<sup>210</sup> September 15, 2010 joint letter from AARP, Consumer Federation of America, Certified Financial Planner Board of Standards, Financial Planning Association, National Association of Professional Financial Advisers, Investment Adviser Association, and North American Securities Administrators Association to the SEC, transmitting survey results demonstration that a "vast majority" of U.S. Investors support a clear fiduciary standard, available at: <https://www.sec.gov/comments/4-606/4606-2748.pdf>.

Table 3.4.1-1 -- Calculation of investment performance net of loads for baseline and alternative scenarios

Year	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)	(L)	(M)
	Baseline average load paid by IRA holder (basis points)	Baseline average load- share paid to broker (basis points)	Alternative scenario 2 average load paid by IRA holder (basis points)	Alternative scenario 2 average load paid by IRA holder (basis points)	Baseline direct effect of loads on average performance net of loads	Alternative scenario 2 direct effect of loads on average performance net of loads	Effect of load paid in a given year on current and future performance	Baseline effect of current and past loads on performance in a given year	Alternative scenarios effect of past loads on performance in a given year	Baseline investment performance net of loads	Alternative scenario 1 investment performance net of loads	Alternative scenario 2 investment performance net of loads	Alternative scenario 3 investment performance net of loads
					$(E) = (B) * 16.8\%$	$(F) = (D) * 16.8\%$	$(G) = (C) * 0.4494$			$(J) = -6\% + (E) + (H)$	$(K) = -6\% + (E) + (I)$	$(L) = -6\% + (F) + (I)$	$(M) = -6\% + (I)$
2008	212	172	---	---	---	---	-0.78%	---	---	---	---	---	---
2009	206	168	---	---	---	---	-0.75%	---	---	---	---	---	---
2010	200	163	---	---	---	---	-0.73%	---	---	---	---	---	---
2011	195	158	---	---	---	---	-0.71%	---	---	---	---	---	---
2012	189	154	---	---	---	---	-0.69%	---	---	---	---	---	---
2013	184	150	---	---	---	---	-0.67%	---	---	---	---	---	---
2014	179	145	---	---	---	---	-0.65%	---	---	---	---	---	---
2015	174	141	---	---	---	---	-0.64%	---	---	---	---	---	---
2016	169	137	---	---	---	---	-0.62%	---	---	---	---	---	---
2017	164	134	155	155	-0.28%	-0.26%	-0.60%	-0.66%	-0.56%	5.07%	5.17%	5.18%	5.44%
2018	160	130	146	146	-0.27%	-0.25%	-0.58%	-0.64%	-0.45%	5.09%	5.28%	5.31%	5.55%
2019	155	126	138	138	-0.26%	-0.23%	-0.57%	-0.62%	-0.35%	5.12%	5.39%	5.42%	5.65%
2020	151	123	130	130	-0.25%	-0.22%	-0.55%	-0.60%	-0.26%	5.14%	5.49%	5.52%	5.74%
2021	147	119	123	123	-0.25%	-0.21%	-0.54%	-0.59%	-0.18%	5.17%	5.57%	5.61%	5.82%
2022	142	116	116	116	-0.24%	-0.20%	-0.52%	-0.57%	-0.11%	5.19%	5.65%	5.69%	5.89%
2023	138	113	110	110	-0.23%	-0.18%	-0.51%	-0.55%	-0.06%	5.21%	5.70%	5.75%	5.94%
2024	135	110	103	103	-0.23%	-0.17%	-0.49%	-0.54%	-0.02%	5.24%	5.75%	5.80%	5.98%
2025	131	106	98	98	-0.22%	-0.16%	-0.48%	-0.52%	-0.01%	5.26%	5.77%	5.83%	5.99%
2026	127	103	92	92	-0.21%	-0.15%	-0.46%	-0.51%	0.00%	5.28%	5.79%	5.85%	6.00%
2027	124	101	87	87	-0.21%	-0.15%	-0.45%	-0.49%	0.00%	5.30%	5.79%	5.85%	6.00%
2028	120	98	82	82	-0.20%	-0.14%	-0.44%	-0.48%	0.00%	5.32%	5.80%	5.86%	6.00%
2029	117	95	78	78	-0.20%	-0.13%	-0.43%	-0.47%	0.00%	5.34%	5.80%	5.87%	6.00%
2030	114	92	73	73	-0.19%	-0.12%	-0.42%	-0.45%	0.00%	5.36%	5.81%	5.88%	6.00%
2031	110	90	69	69	-0.19%	-0.12%	-0.40%	-0.44%	0.00%	5.37%	5.81%	5.88%	6.00%
2032	107	87	65	65	-0.18%	-0.11%	-0.39%	-0.43%	0.00%	5.39%	5.82%	5.89%	6.00%
2033	104	85	62	62	-0.18%	-0.10%	-0.38%	-0.42%	0.00%	5.41%	5.82%	5.90%	6.00%
2034	101	82	58	58	-0.17%	-0.10%	-0.37%	-0.41%	0.00%	5.42%	5.83%	5.90%	6.00%
2035	98	80	55	55	-0.17%	-0.09%	-0.36%	-0.39%	0.00%	5.44%	5.83%	5.91%	6.00%
2036	96	78	52	52	-0.16%	-0.09%	-0.35%	-0.38%	0.00%	5.46%	5.84%	5.91%	6.00%

Table 3.4.1-1 displays the projected average front-end load shares paid to brokers (column C) and average loads paid by IRA investors (column B) over the projection period. These load projections are generated using the average load observed in the CEM data and then scaling downward based on the trend in front loads paid, observed by the ICI.<sup>211</sup>

In a given year, only a fraction of IRA front-load mutual fund assets will turn over and incur a front load. Data from CEM suggest that this fraction is approximately 16.8 percent.<sup>212</sup> The direct effect of those loads on average investment performance (column E) is estimated to be the average front-end load paid by IRA investors in that year (column B) multiplied by 16.8 percent.

The indirect effect of front-end loads on performance in a given year is somewhat more complicated to calculate. An estimate from CEM suggests that for every 100 basis points of the load that go toward an unaffiliated broker’s load-share, an IRA investor can expect to experience a decrease in performance of 49.7 basis points. For every 100 basis points of the load that go toward a captive broker’s load-share, an IRA investor can expect to experience a decrease in performance of 14.5 basis points. Unaffiliated brokers constitute a large fraction of the advice market, so an asset weighted average of these effects results in an average decrease in performance of 44.9 basis points for every 100 basis points in load-share. Column (G) estimates this effect by multiplying the average load-share (Column C) by 0.449. But this is not the average effect on performance in a given year. For that, a distribution of purchase dates for front-end load funds owned in a given year is needed. The estimate that 16.8 percent of load funds turn over in a given year is a good place to start. Table 3.4.1-2 provides a distribution of purchase dates for IRA front-end load funds owned in a given year t. The baseline effect of current and past loads on performance (column H) is calculated by applying the purchase date distribution (Table 3.4.1-2) to the current year and previous 9 years in Column (G).

Table 3.4.1-2 -- Distribution of purchase dates for front-end-load assets owned in a given year	
Year	% of year t front-end-load assets purchased in each year
t-9	1.0%
t-8	3.0%
t-7	6.0%
t-6	8.0%
t-5	10.0%
t-4	12.4%
t-3	13.2%
t-2	14.2%
t-1	15.4%
t	16.8%
<b>Total</b>	<b>100.0%</b>

Finally, the baseline investment performance net of loads (Column J) is calculated as 6 percent minus the direct effect of loads (Column E) minus the effect of current and past loads on performance (Column H).

Alternative scenario 1 differs from the baseline only in the effect of loads on current and future performance. The effect on current and future performance is the same as the baseline for

<sup>211</sup> There is more discussion of this projection and other assumptions in Section 3.4.3: Assumptions and Uncertainty.

<sup>212</sup> DOL calculation uses CEM, Table 1. Inflows subject to load = 1.40 percent of TNA per month or 16.8 percent of TNA per year.

years 2008-2016 – the years before the requirements of the rule become applicable – but it drops to zero once the requirements take effect. As discussed previously, this downward pull on performance is eliminated because brokers are no longer incentivized to recommend particular funds. This in turn forces mutual funds to invest in performance rather than relying on payments to brokers to move their product. Column (I) estimates the effect of past loads on performance in a given year using the load effect in Column (G) and the purchase date distribution in Table 3.4.1-2. The alternative scenario load effect on performance remains fairly high (-0.56 percent) in 2017 because most of the assets owned in 2017 were purchased prior to the effective date of the rule. Gradually, as time moves further from the effective date of the rule, the alternative scenario load effect on performance goes to zero. The alternative scenario 1 investment performance net of loads (Column K) is calculated by subtracting the baseline direct effect of loads (Column E) and the alternative scenario effect of loads on performance (Column I) from 6 percent.

The effect of past loads on performance is the same across all three alternative scenarios; alternative scenario 2 differs from alternative scenario 1 because loads fall faster under the 2nd alternative. The average load projection for alternative scenario 2 is displayed in Column (D). As in the baseline scenario, the alternative scenario direct effect of loads on average performance net of loads (Column F) is the average load (Column D) multiplied by 16.8 percent, the estimate of front-end load assets turnover per year. The alternative scenario 2 investment returns net of loads (Column L) is 6 percent minus the alternative scenario 2 direct effect of loads minus the alternative scenario effect of past loads on performance.

Under alternative scenario 3, loads immediately go to zero when the proposal becomes effective, so there is no direct effect of loads on investment performance. As in the other alternative scenarios, there is still an indirect effect of past loads on performance. The alternative scenario 3 investment performance (Column M) is 6 percent minus the alternative scenario effect of past loads on performance (Column I).

The investment performance estimates in Columns (J), (K), (L) and (M) are the key factors in the 10- and 20-year quantified subset of IRA investors' expected gains causing asset accumulation to diverge across the scenarios.

### **3.4.2 Front-Load-Mutual-Fund-Gains-to-Investors Estimates**

The Department estimates the quantified subset of IRA investors' expected gains over 10- and 20-year periods beginning on January 1, 2017.<sup>213</sup> The estimates are derived by comparing alternative scenarios, under the rule, to the baseline scenario where no rule is finalized. Table 3.4.2-1 walks through the 10-year front-load-mutual-funds-gains-to-investors calculation for alternative scenario 1. Under all of the scenarios, IRA assets on January 1, 2017 are projected to total almost \$9 trillion.<sup>214</sup> Of the \$9 trillion, approximately 44.7 percent (about \$4 trillion) are

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<sup>213</sup> January 1, 2017 is a proxy for the date on which the requirements of the proposal become applicable. In contrast, the front-load-mutual-funds-gains-to-investors estimates are discounted back to January 1, 2016, a proxy for the date on which the final rule is published in the Federal Register. The proposed rule lists an effective date of 90 days after publication of a final rule and states that the requirements of the rule will be applicable eight months after publication in the Federal Register. See proposal on DOL website.

<sup>214</sup> Cerulli Associates, "Retirement Markets 2014."

invested in mutual funds, and of those IRA assets invested in mutual funds, approximately 27 percent incur a front-end load. The resulting pool of assets under consideration is \$1.087 trillion in 2017 (Table 3.4.2-1, Row B).

		2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
Baseline total IRA year-begin assets	(A)	8,964	9,776	10,649	11,585	12,581	13,651	14,784	15,996	17,276	18,640
Baseline year-begin front-load mutual fund assets	(B)	1,087	1,160.9	1,238	1,319	1,402	1,489	1,579	1,672	1,768	1,868
Scenario 1 year-begin front-load mutual fund assets	(C)	1,087	1,161.9	1,241	1,325	1,413	1,505	1,602	1,703	1,807	1,916
Baseline year-end front-load mutual fund assets	(D)	1,142.4	1,220	1,301	1,386	1,474	1,566	1,661	1,760	1,861	1,966
Scenario 1 year-end front-load mutual fund assets	(E)	1,143.5	1,223	1,308	1,398	1,491	1,590	1,693	1,801	1,912	2,027
Asset differential	(F)	1.1	3.3	6.7	11.3	17.1	24.0	32.0	40.9	50.5	60.6
Asset differential withdrawn	(G)	0.05	0.15	0.30	0.50	0.75	1.06	1.41	1.81	2.23	2.68
Asset differential carry-over	(H)	1.0	3.2	6.4	10.8	16.3	23.0	30.6	39.1	48.3	57.9
Discounted asset differential withdrawn	(I)	0.04	0.13	0.24	0.38	0.55	0.74	0.94	1.14	1.33	1.52
Discounted asset final asset differential	(J)	---	---	---	---	---	---	---	---	---	32.8
Total discounted quantified subset of IRA investors' expected gains											39.8

The alternative scenarios diverge from the baseline scenario over the course of calendar year 2017 due to improved investment performance. Beginning-of-year front-load mutual fund assets are in Rows (B) and (C) of Table 3.4.2-1 for the baseline and alternative 1 scenarios, respectively. Investment performance estimates from Columns (J) and (K) of Table 3.4.1-1 are then applied to generate end-of-year front-load mutual fund asset estimates of \$1.1424 trillion under the baseline scenario and \$1.1435 trillion under alternative scenario 1 (Rows D and E of Table 3.4.2-1). The “Asset Differential” (Row F) is simply the difference between these two amounts – \$1.1 billion in 2017. A small fraction, 4.42 percent of this differential is withdrawn, while most of the differential is carried over to 2018.<sup>215</sup>

Each year starts with a fresh baseline projection of total IRA assets (Row A). Baseline IRA front-end load mutual fund assets are calculated each year using the estimate that 44.67 percent of IRA assets are in mutual funds. The share of IRA mutual funds incurring a front end load is assumed to decline over the projection period from 27 percent in 2017 to 22 percent in 2026 and 18 percent in 2036. Unlike 2017, in 2018 and in subsequent years, the alternative scenarios begin the year with higher IRA front-end load mutual fund assets than the baseline scenario. The differential that is carried over from the previous year is added to the baseline IRA front-end-load mutual fund assets to estimate the alternative scenario IRA front-end load mutual fund assets. At the end of 2017, the asset differential carry-over was \$1.0 billion (Row H), so the 2018 alternative scenario IRA front-end load mutual fund asset amount is \$1.1619 trillion (Row C), \$1.0 billion more than the baseline amount of \$1.1609 trillion (Row B). The alternative scenarios diverge further from the baseline scenario in 2018 and in later years when end-of-year assets are again calculated. The carry-over of the asset differential from year to year ensures that the calculations take into account the compound nature of improved returns over multiple years. Each year a small fraction of the asset differential is withdrawn, while the majority of the asset differential is carried over to the following year.

<sup>215</sup> For simplicity, the calculations assume that all contributions and withdrawals occur at the very end of each calendar year.

The asset differential at the end of the 10-year period (2025, Row H) together with the portion of the asset differential withdrawn in each year (Row G) makes up the 10-year quantified subset of IRA investors' expected gains under alternative scenarios 1. However, before those numbers are summed, they are each discounted by the appropriate number of years at a rate of 5.3 percent (Rows I and J) so that the 10-year front-load-mutual-fund-gain-to-investors is expressed in January 1, 2016 dollars.

The 10- and 20-year quantified subset of IRA investors' expected gains under each of the alternative scenarios are estimated using a method identical to that presented in Table 3.4.2-1.

### 3.4.3 Assumptions and Uncertainty

Uncertainty is inherent in any forward-looking projection, and the Department's 10- and 20-year estimates of the quantified subset of IRA investors' expected gains are no exception. Every assumption that is required to generate the estimates adds another layer of uncertainty to the projections. The Department has investigated all of the assumptions used herein. This section discusses each of the assumptions, the assignments that the Department has chosen for each assumption, alternative assignments, and related evidence. Table 3.4.3-1 presents a summary of the assumptions and assignments.

Assumption	Assignment
Effect of loads on returns	44.94 basis point decline in performance per 100 basis points in load paid to broker
2013 average loads	
- front end load	183.94 basis points
- front load paid to broker	149.65 basis points
- broker share of load	81.36%
Annual rate of decline in average load	2.8%
Annual decline in average load - alternative scenario 2	5.6%
Purchase date distribution of load assets	Table 3.4.1-2
Average annual inflow subject to load	16.8%
Total IRA assets	Table 3.4.2-1, Row (A)
% IRA assets in equity, bond, and hybrid mutual funds	44.7%
% 2013 IRA mutual fund assets incurring front end load	29.6%
Annual decline in % assets incurring front load	2.1%
Discount rate	5.3%
Average investment return excluding load effects	6.0%
Fraction of year-end assets withdrawn	4.4%

#### 3.4.3.1 Effect of loads on returns

CEM investigate whether mutual funds that pay a higher load-share to brokers perform better or worse than those that pay a lower load-share. Using U.S. mutual fund data from 1993-2009, the authors compare the average load-share that a mutual fund pays to brokers to the future performance to the same mutual fund. The authors also control for a number of other variables that are predictive of performance, including inflows, redemptions, fund size, and fund family size.<sup>216</sup> The fourth regression treats unaffiliated and captive brokers separately. This regression may be the most appropriate to use because it allows for the data to demonstrate the effects of different incentives across the two main types of broker arrangements. In this fourth regressions specification, the data reveal that investment returns in the year following an inflow decrease by 49.7 basis points for every 100 basis points of load-share paid to an unaffiliated broker and by

<sup>216</sup> As the authors used data at the mutual fund level, they were unable to explicitly control for consumer sophistication by adding a variable to the regressions; however, the entire analysis was conducted *within* the broker-sold segment of the market, thereby controlling for differences in consumer sophistication across the broker-sold and direct-sold segments.



14.5 basis points for every 100 basis points of load-share paid to a captive broker.<sup>217</sup> Unaffiliated broker arrangements constitute approximately 83 percent of the load-share observations in the CEM data while captive broker arrangements constitute the remaining 17 percent. Furthermore, the average front load paid to unaffiliated brokers in the CEM data (2.30 percent) is higher than the average front load paid to captive brokers in the CEM data (1.73 percent). Weighting by both of these factors generates an average loss in performance of 44.94 basis points for every 100 basis points in load-share paid to brokers across all payments recorded in the data. The Department relies on these estimates to forecast future returns. In particular, the baseline scenario projection assumes that, in the future, investment returns will suffer by 44.94 basis points for every 100 basis points paid in load-share. There is uncertainty surrounding this projection for three reasons:

- (1) The CEM regression results estimate the impact of load-sharing on investment returns during the 12 months following the inflow, while the Department's related assumption applies to investment returns for the life of the investment.
- (2) The CEM results are only a single data point. The results may be specific to the period of the data, 1993-2009, and may not hold in the future.
- (3) Three other regression specifications, all of which fail to distinguish between captive and unaffiliated broker arrangements, estimate a decrease in performance of 33-35 basis points for every 100 basis points of load-share paid to the broker. Were the Department to assume a reduction of 34 basis points rather than 45 basis points, the estimated quantified subset of IRA investors' expected gains would decrease by 15 percent to 24 percent.

Each of these concerns suggest that the Department should be cautious in applying the assumption that investment returns will decrease by about 45 basis points for every 100 basis points paid in load-share. The Department has conducted further analysis of the related literature in order to test the assumption. Two themes emerged from this research:

- (1) The finance literature supports the hypothesis that investment returns suffer following load-sharing because the mutual fund lacks an incentive to invest in performance. This incentive is lacking, not only in the first year, but in all of the subsequent years that the IRA investor remains in the mutual fund. The literature suggests that the CEM results should hold for the life of the fund, not just the first year following an inflow.
- (2) Across a broad array of studies, broker-sold mutual funds underperform direct-sold mutual funds. Both the direction and the magnitude of the results are consistent with the CEM results, suggesting that the CEM results are not an outlier and are not dependent on the particular data or methodologies used.

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<sup>217</sup> CEM, Table V, Column 4.

### 3.4.3.1.1 Broker-sold underperformance as a result of mutual fund incentives

Del Guercio and Reuter (2014) (DGR) provide a helpful framework for interpreting the CEM results. The authors hypothesize that broker-sold, actively-managed funds underperform direct-sold, actively-managed funds because the direct-sold funds invest more in performance. In fact, the authors find that, in the direct-sold segment, active funds achieve high enough returns to make up for their higher costs. However, broker-sold actively-managed funds underperform direct-sold actively managed funds by over 100 basis points per year.

DGR provide several pieces of evidence suggesting that broker-sold mutual fund underperformance is caused by a lack of investment in alpha (superior performance above and beyond that of the market). Small cap stocks, by their nature, require more resources to investigate than large cap stocks, per investment dollar. If broker-sold mutual funds fail to invest in alpha, broker-sold fund underperformance will show up to a greater degree in the small-cap space, where more resources are required. The data reveal that the underperformance of broker-sold funds is more dramatic when focusing on small-cap growth funds (Table III, Panel B). The authors find direct “evidence that direct-sold funds are more actively managed than broker-sold funds,” by showing that actively-managed broker-sold funds track closer to indices than direct-sold funds. Broker-sold funds are also more likely to expose investors to higher systemic risk (beta), more likely to outsource portfolio management and less likely to hire asset managers with superior educational backgrounds. All of these pieces of evidence suggest that broker-sold funds invest less in alpha than direct-sold funds, but why?

All mutual funds want to attract inflows because revenues rise with assets under management. DGR find that inflows...

“in the direct-sold segment are significantly more sensitive to risk-adjusted returns than fund flows in the broker-sold segment. Specifically, while the estimated coefficients on lagged alpha are positive in both segments, the estimated coefficient for the direct-sold segment is larger (0.176 versus 0.021), significantly different from zero (p-value of 0.000), and significantly different from the coefficient for the broker-sold segment (p-value of 0.001). These coefficients imply that a one-standard deviation increase in alpha will increase fund size over the next 12 months by approximately 6.18 percent in the direct-sold and 0.59 percent in the broker-sold segments, or in dollar terms, by \$86.9 million and \$5.0 million, respectively. Since the typical actively managed fund’s management fee is approximately 75 basis points, this implies incremental annual revenue to the fund of \$651,660 for the average direct-sold fund and only \$37,445 for the average broker-sold fund. Thus, if families in the direct-sold segment could invest in the managers, analysts, or trading infrastructure that would generate this increase in alpha at lower annual cost than \$651,660 they would presumably do so, whereas families in the broker-sold segment have a much weaker incentive to make alpha-generating investments.”

Conversely, broker-sold mutual fund inflows respond more to raw (non-risk-adjusted) returns which can be increased without investing in performance – by taking on more systemic risk.

Recognizing the broker-sold mutual funds’ lack of incentive to invest in alpha is essential to interpreting the CEM results. CEM find that for every 100 basis points of load paid to the broker, returns in the first 12 months following the inflow decrease by 34 basis points. Importantly, this result arises in spite of the regulations in place at the time the study was

conducted to protect investors from conflicts of interest. The DGR results suggest that the underperformance is caused by a lack of incentive, on the part of the mutual fund, to invest in alpha. The lack of incentive for broker-sold mutual funds to invest in alpha persists for the life of the fund, well beyond the first 12 months following the inflow; funds that pay high load shares to brokers need not invest in performance to attract new inflows. Therefore, the underperformance in the first 12 months following the inflow (as estimated by CEM) can be expected to continue for as long as the IRA client holds the fund.

The DGR results and the subsequent interpretation of the CEM results are consistent with the theoretical financial economics literature on mutual funds. Berk and Green (2004) present a compelling model of mutual fund performance where fund managers exhibit high average skill, yet competitive allocation of investor assets reduces investor returns in actively managed funds to the level of returns in index funds. The construction and results of this model are consistent with the direct-sold segment of the market. Similarly, models that account for the conflicts of interest inherent in the broker-sold segment of the market produce theoretical predictions that are consistent with the underperformance of the broker-sold segment observed by DGR (Inderst and Ottaviani 2009; 2012).

### **3.4.3.1.2 Robust evidence of broker-sold mutual fund underperformance**

A deep pool of academic studies confirms the robustness of the result that broker-sold mutual funds underperform direct-sold mutual funds. Both the direction and the magnitude of the results in these studies are consistent with the CEM results, providing assurance that the CEM results accurately reflect the condition of the market. The literature comparing the performance of broker-sold and direct-sold mutual funds is discussed in Section 3.2.4 and summarized in Table 3.2.4-1. The CEM results imply that front-end load mutual funds in the broker-sold segment underperform no-load funds by approximately 1 percent per year, a magnitude typical of the results in Table 3.2.4-1.<sup>218</sup>

### **3.4.3.2 Load and performance projections**

The baseline load projections, in Column (B) of Table 3.4.1-1, begin with an assumption regarding average loads in the year 2013 – the most recent year for which strong mutual fund load data can be obtained. The estimate for average front loads paid by IRA investors in 2013 is generated by taking the average front load paid by investors in the CEM sample (1993-2009) and scaling it down based on the rate of decrease in loads in the data presented in the ICI Fact Book 2014.<sup>219</sup>

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<sup>218</sup> A sample average load-share of 220, multiplied by a 44.94 basis point decrease in performance for every 100 basis point increase in loads (*see* top of Section 3.4.3.1 above) results in average underperformance of 99 basis points ( $220 * 0.4494 = 99$ ).

<sup>219</sup> ICI “2014 Investment Company Fact Book.”

### 3.4.3.2.1 Average load paid by investors in 2013

The average front load paid by investors in the CEM sample is relatively straightforward. CEM Table 1 presents the average load paid by investors who receive advice from captive brokers (2.40 percent) and unaffiliated brokers (2.77 percent). The Department calculated average for the entire sample (2.71 percent) is simply the weighted average of these two numbers, weighted by the number of observations for captive (25,807) and unaffiliated (123,824) brokers.

While the CEM sample includes funds from, as early as 1993, through 2009, loads in the population have been shown to be decreasing over time. The ICI Fact Book 2014 lists average front-end sales loads actually paid for Equity, Hybrid, and Bond mutual funds for the years 1990, 1995, 2000, 2005, 2010, and 2013 (Figure 5.9, page 97). Meanwhile, the ICI U.S. Retirement Markets quarterly Excel spreadsheets list the amount of IRA assets in Domestic Equity, World Equity, Hybrid, and Bond mutual funds each year going back to 1990 (Table 16).<sup>220</sup> By imputing the front-end loads paid for all sample years, one can estimate the asset-weighted average front-load paid by IRA investors during the 1993-2009 period. This comes out to 138.8 basis points. Similarly, one can estimate the asset-weighted front-load paid in 2013 – 94.3 basis points – by the same method. The ratio of these two numbers –  $94.3/138.8 = 67.9$  percent represents the estimated decline in loads from the sample period, 1993-2009, to 2013. Applying this ratio to the average load paid by investors in the CEM sample generates an estimated 2013 average load paid by IRA investors of 184 basis points (271 basis points \* 67.9 percent = 184 basis points).

This raises two questions: Why is the asset-weighted average load paid, calculated using the ICI data (138.8 basis points), different from the average load paid by investors in the CEM sample (271 basis points)? Similarly, why not simply use the asset-weighted average front load for 2013 (94.3 basis points, calculated from the ICI data) in estimating the quantified subset of IRA investors' expected gains, rather than using the ICI data to scale down the CEM average load? It is not entirely clear why the CEM and ICI average loads differ to the extent that they do, but a portion of the difference may be attributable to the manner in which the averages are calculated. CEM averages appear to be equal-weighted averages, while ICI calculates their reported numbers on an asset-weighted basis.<sup>221</sup> This means that investors with large accounts – and small loads (load charges typically decrease as investment size increases) – have greater influence in the ICI averages. For example, consider two investors. One investor invests \$400,000 in a mutual fund and is charged a 1 percent sales load. The other (IRA) investor invests \$150,000 in the same mutual fund and is charged a sales load of 2.5 percent. The asset-weighted average sales load actually paid is approximately 1.4 percent ( $1 \text{ percent} / (400,000/550,000) + 2.5 \text{ percent} / (150,000/400,000) = 1.4 \text{ percent}$ ).

Under most circumstances, the asset-weighted average load would be the appropriate average to use in calculating an aggregate gains estimate; however, in this case it is problematic. The Department's estimates concern only loads paid by IRA investors for IRA investments. IRA accounts tend to have much smaller account balances, on average, than non-IRA accounts, including non-IRA mutual fund accounts. According to tabulations from the Survey of Consumer

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<sup>220</sup> ICI, "The U.S. Retirement Market, Fourth Quarter, 2014," 2015.

<sup>221</sup> DOL staff conversation with ICI analysts, Aug. 22, 2014.

Finances, the average IRA account balance is approximately \$149,000, compared to an average non-IRA mutual fund balance of \$387,000 and an average non-IRA taxable investment account balance of \$412,000 (*see* Advanced Analytical Consulting Group (2014) presenting 2013 household survey data on the IRA marketplace). Super-large accounts are limited to non-IRAs as Internal Revenue Service regulations place limits on both IRA and defined contribution retirement plan contributions (a primary source of IRA assets through rollovers). Investors with very large accounts can pay very low front-end loads to invest in mutual funds. These investors, which are exclusively non-IRA, can dramatically skew the average load when it is calculated on an asset-weighted basis.

In addition, the ICI front load averages appear to include some institutional funds. Page 96 of the Fact Book describes how the decline in loads partly “reflects the increasing role of mutual funds in helping investors save for retirement. Funds that normally charge front-end load fees often waive load fees on purchases made through defined contribution plans, such as 401(k) plans.” So the averages include large discounts enjoyed, not only by large taxable accounts, but also by large institutional investors.

The above discussion is not to say that the CEM sample average load is necessarily an accurate estimate of the asset-weighted average load paid by IRA mutual fund investors; there is uncertainty here. However, the CEM sample average load seems to be a more plausible estimate of the asset-weighted average load paid by IRA mutual fund investors than the ICI weighted average load. The ICI numbers clearly underestimate the asset-weighted average load paid by IRA investors, given the size of IRA accounts relative to taxable accounts. While the CEM sample average load may also include discounted loads paid by taxable account holders and institutional investors, the averages are calculated on an equal-weighted basis, and therefore are not skewed by these discounted, non-IRA loads. Using the less-relevant average 2013 front load of 94.3 basis points (the ICI asset-weighted average) instead of the more-applicable 183.94 basis points (the CEM sample average scaled to 2013) would cause the estimated quantified subset of IRA investors’ expected gains to appear to be only 51 percent of the current estimate.

#### **3.4.3.2.2 Average load paid to brokers in 2013**

Similar to the average front load paid by investors, the average front load paid to brokers in the CEM sample (load-share, 2.20 percent) is the weighted average of the average front load paid to captive brokers (1.73 percent) and the average front load paid to unaffiliated brokers (2.30 percent) weighted by the number of observations for each.

The ratio of load-share to front load paid (“broker share of load,”  $2.20/2.71=81.36$  percent) is assumed to remain constant throughout the projection period. Therefore, the average load paid to brokers in 2013 is assigned a value of 150 basis points ( $183.94 * 81.36$  percent = 149.65). This assumption may work to understate the estimated gains of the rule to investors. As previously discussed in Section 3.2.4, CEM finds that higher loads tend to decrease inflows while higher load-shares tend to increase inflows. These two forces acting in tandem would tend to increase the broker share of the load. It is quite possible – and in fact suggested by the evidence – that the broker share of the load is lower in the early part of the CEM sample and higher in the later part of

the sample.<sup>222</sup> It is further probable that the broker share of the load has continued to increase since 2009 and will continue to increase throughout the projection period in the absence of regulatory intervention. Because the underperformance of load funds is tied to the load paid to the broker, a higher broker share of the load would increase the underperformance in the baseline scenario, and, in turn, increase the estimated quantified subset of IRA investors' expected gains.

However, the extent to which the gains to investors are underestimated as a result of this assumption is limited. The broker share of the load has a theoretical maximum of 100 percent. If the broker share of load assumption were changed to 100 percent for the entirety of the projection period, estimated quantified subset of IRA investors' expected gains would increase by approximately 14 percent to 23 percent.

### **3.4.3.2.3 Decline in loads**

As mentioned above, data from ICI clearly show that loads have declined over the historical period 1990-2013.<sup>223</sup> The estimated subset of IRA investors' expected gains assume that, under the baseline scenario, average loads will continue to decrease at a rate of 2.8 percent per year, roughly the historical average decline in loads between 2000 and 2013. The baseline scenario load projection (Table 3.4.1-1, Column B), begins with the assigned 2013 average load paid by investors (Section 3.4.3.2.1 above), and projects future average loads by decreasing that value by 2.8 percent per year. In 2017, the start of the 10- and 20-year projection periods, the average load paid by IRA investors is projected to be 164 basis points, under the baseline scenario. In 2026 and 2036, the ends of the 10- and 20-year projection periods, baseline average loads paid by IRA investors are projected to be 127 and 96 basis points, respectively.

While average loads have clearly trended downward historically, there may be reason to believe that this trend will slow down or even stop in the near future. Front end loads are ostensibly for the purpose of compensating brokers for the services that they provide.<sup>224</sup> If level of service is in fact the primary determinant of loads, a significant decline in loads (as projected under the baseline scenario) would require a decrease in either the level of service provided per customer or the cost of providing those services. As such, some may not find the baseline projected decline in average IRA load, from 184 basis points in 2013 to 96 basis points in 2036, to be realistic. Cutting the assigned baseline rate of decline in loads in half (1.4 percent) increases the estimated subset of IRA investors' expected gains by 11 percent to 19 percent. Eliminating the baseline scenario decline in loads (assuming average IRA loads of 184 basis points throughout the projection period), increases the estimated subset of IRA investors' expected gains by 23 percent to 41 percent. In both cases, there is a larger impact on the 20-year estimated subset of IRA investors' expected gains (relative to the 10-year estimates).

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<sup>222</sup> Unfortunately, there are no reported results in the paper that identify whether this is true.

<sup>223</sup> ICI 2014 Fact Book, Figure 5.9, 97.

<sup>224</sup> *See*, for example, ICI Fact Book 2014, 96.



#### **3.4.3.2.4 Average annual inflow subject to load**

Columns (E) and (F) of Table 3.4.1-1 estimate the average direct effect of loads on performance for IRA investors, under the baseline and alternative 2 scenarios, respectively. Loads decrease performance because the load is taken out of the IRA investor's pool of money available for investment. The aggregate direct effect of loads on performance depends heavily on the frequency with which front-end load assets are turned over. Front-end loads are, of course, paid only when front-end load mutual funds are purchased. The more IRA investors buy and sell front-end load mutual funds, the more load charges they will incur.

In the CEM sample, Inflows Subject to Load averaged 1.4 percent of total net assets (TNA) each month (Table I), or about 16.8 percent per year. Assuming a net flow of zero, this inflow rate corresponds to front-end load assets being bought and sold approximately once every 6 years on average. The Department has not located any alternative data sources to estimate load fund turnover.<sup>225</sup> The projections assume that 16.8 percent of front-end load assets are turned over each year throughout the projection period, under all scenarios. Columns (E) and (F) of Table 3.4.1-1 are the product of the turnover assumption (16.8 percent) and the average load paid under the given scenario, Columns (B) and (C), respectively.

The assumption regarding the average annual inflow subject to load is closely tied to the assumed distribution of purchase dates for assets which incurred a front end load. Sensitivity analyses for these assumptions are presented at the end of the following Section 3.4.3.2.5.

#### **3.4.3.2.5 Distribution of purchase dates for assets which incurred a front-end load**

The average effect of current and past loads on performance (Columns H and I of Table 3.4.1-1) depends on when the front-end load mutual funds were purchased. In the absence of a rule (both under the baseline scenario and under the alternative scenarios for years prior to the finalization of the rule), loads decrease future performance by 44.9 basis points for every 100 basis points of load-share paid to the broker (*see* Section 3.4.3.1 above). However, loads are projected to decline over the projection period which implies a corresponding decline in the effect on performance. With the rule, the load effect on performance goes to zero because the conflicts of interest associated with the load are mitigated. All of these factors necessitate an assumption for the distribution of purchase dates for front-end-load asset that are owned in a given year. The assumption impacts the estimated subset of IRA investors' expected gains by determining how quickly assets are moved into better performing mutual funds once the requirements of the rule become applicable.

The construction of Table 3.4.1-2 begins with the assumption that 16.8 percent of IRA front-end load mutual fund assets are turned over each year. Therefore, 16.8 percent of front-end load mutual fund assets owned in a given year,  $t$ , were purchased in that same year. It is unclear what percentage of assets owned in a given year,  $t$ , would have been purchased in the previous year,  $t-1$ . If assets purchased in year  $t-1$  were equally likely to be sold again in year  $t$ , then one

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<sup>225</sup> ICI indicated they would send inflow data underlying Figure 5.10 (page 98) of ICI Fact Book 2014, but it has not yet been received.



could assume that 14.0 percent of assets owned in year t were purchased in year t-1. In this case, 16.8 percent of assets were purchased in year t-1, but then 16.8 percent of those were re-purchased in year t, so 16.8 percent – (16.8 percent \* 16.8 percent) = 14.0 percent of assets year t assets were last purchased in year t-1. However, it seems unlikely that load-incurring assets purchased in year t-1 would be equally likely to be sold again in year t. Why would one want to incur a load two years in a row? If no assets purchased in year t-1 were turned over in year t, the percentage of year t assets originally purchased in year t-1 would be 16.8 percent. This extreme again seems unlikely. The projections split the difference and assume that 15.4 percent of IRA front-end-load mutual fund assets owned in a given year, t, were purchased in the preceding year, t-1. The rest of Table 3.4.1-2 is constructed to ensure that the percentage of assets originating in a given year and prior years adds up to 100 percent and decreases in a somewhat smooth manner as one gets further and further removed from the given year, t.

The projections are modestly sensitive to the assumed average annual inflow subject to load and the assumed distribution of purchase dates for assets that incurred a front end load. Decreasing the assumed load-asset turnover rate to 12.6 percent and using the first set of alternative assignments for the distribution of purchase dates in Table 3.4.3-2 (middle column), decreases the estimated subset of IRA investors' expected gains by 3 percent to 14 percent. Conversely, increasing the assumed load-asset turnover rate to 21.0 percent and using the second set of alternative assignments for the distribution of purchase dates in Table 3.4.3-2 (rightmost column), increases the estimated subset of IRA investors' expected gains by 2 percent to 7 percent. The impact of these assumptions on the 10-year estimated subset of IRA investors' expected gains is larger than the impact on the 20-year estimates.

**Table 3.4.3-2 -- Alternative assignments for the distribution of purchase dates for front-end-load assets owned in a given year**

Year	First Alternative	Second Alternative
	Percentage of year t front-end-load assets purchased in each year	
t-9	7.6%	0.0%
t-8	8.1%	1.4%
t-7	8.6%	3.8%
t-6	9.1%	6.2%
t-5	9.6%	8.6%
t-4	10.2%	11.2%
t-3	10.8%	13.6%
t-2	11.4%	16.0%
t-1	12.0%	18.2%
t	12.6%	21.0%
<b>Total</b>	100.0%	100.0%

### 3.4.3.2.6 Average investment returns excluding load effects

Columns (E) through (I) of Table 3.4.1-1 estimate the impacts of loads both directly and through load-sharing, which can remove the mutual fund's incentive to invest in performance. In order to generate estimated subset of IRA investors' expected gains from these impacts, an investment return assumption is required. The projections assume that, before applying any load effects, nominal investment returns are equal to 6 percent for all scenarios throughout the projection period. This assumption has a small impact on estimated subset of IRA investors' expected gains. Decreasing the investment returns assumption to 4 percent decreases the estimated subset of IRA investors' expected gains by 6 percent to 12 percent. Conversely, increasing the investment returns assumption to 8 percent increases the by 6 percent to 15 percent. The impact of the investment returns assumption is larger with respect to the 20-year estimated subset of IRA investors' expected gains relative to the 10-year estimated subset of IRA investors' expected gains.

Until this point in Section 3.4.3, all of the assumptions discussed have contributed to projecting the performance of assets under a baseline and several alternative scenarios. The aggregate estimated subset of IRA investors’ expected gains also depends on the amount of front-load mutual fund assets.

### 3.4.3.3 Front-load mutual fund assets

The dollar amount of front-load mutual fund assets depends primarily on three factors: total IRA assets, percentage of IRA assets invested in mutual funds, and percentage of IRA mutual fund assets incurring a front end load. The second factor, percentage of IRA assets invested in mutual funds, appears to be relatively stable over the last 15 years, so a single assumption (44.67 percent) is used for all years in the projection period. Trends are observed in the other two factors. Total IRA assets appear to be increasing while the percentage of IRA mutual fund assets incurring a front end load is likely decreasing. For these factors, assumptions are generated for each year of the 10- and 20-year projections periods.

#### 3.4.3.3.1 Total IRA assets

Cerulli Associates projects IRA year-end asset levels for 2017-2020 of \$9.0 trillion, \$9.8 trillion, \$10.6 trillion, and \$11.6 trillion, respectively.<sup>226</sup> The Department projects IRA assets beyond year-end 2018 by continuing Cerulli’s projected growth trend. Table 3.4.3-3 displays the projected asset levels and growth rates.

#### 3.4.3.3.2 Percentage of IRA assets in mutual funds

While the Department is concerned about the impact of conflicts on all IRA assets, the subset of IRA investors’ expected gains projections focus on IRA assets in domestic equity, world equity, hybrid, and bond mutual funds. The projections take a narrower focus because this subset of IRA assets may be the best space to generate a reliable, quantitative estimate of a portion of the rule’s gains to investors. CEM find that load sharing is associated with decreased future performance in equity, international, fixed income, balanced, and municipal mutual funds. Money-market mutual funds do not appear to be part of the CEM sample (Table II). In order to appropriately apply the performance projections derived from the CEM estimates, money-market mutual fund and non-mutual fund IRA assets must be excluded. This exclusion should not imply that conflicts are not a problem in these areas nor that the rule

Year	Assets		
	(\$ billions)	Growth Rate	
2017	8,964	9.1%	Cerulli
2018	9,776	8.9%	
2019	10,649	8.8%	
2020	11,585	8.6%	
2021	12,581	8.5%	
2022	13,651	8.3%	DOL
2023	14,784	8.2%	
2024	15,996	8.0%	
2025	17,276	7.9%	
2026	18,640	7.7%	
2027	20,076	7.6%	
2028	21,602	7.4%	
2029	23,200	7.3%	
2030	24,894	7.1%	
2031	26,661	7.0%	
2032	28,527	6.8%	
2033	30,467	6.7%	
2034	32,509	6.5%	
2035	34,622	6.4%	
2036	36,837	6.2%	

<sup>226</sup> Cerulli Associates, “Retirement Market 2014.” Asset amounts presented in the source document are year-end, whereas amounts presented here are beginning of year assets.

will not produce substantial gains to individuals who hold these excluded assets in IRA accounts. It simply means that a quantitative estimate of the gains to investors in these areas is not available.

The ICI's U.S. Retirement Market quarterly spreadsheets list asset amounts for Total IRA Assets (Table 7) and Domestic Equity, World Equity, Hybrid, and Bond mutual funds in IRAs (Table 16).<sup>227</sup> Since 1999, the share of total IRA assets invested in mutual funds (excluding money-market funds) has fluctuated between 37 percent and 48 percent, with an average of 43.3 percent (DOL calculations). The fluctuation in the mutual fund share of IRA assets seems to correlate with movement in equity markets, but lacks a trend upward or down.

Because there is no discernable recent trend in mutual fund share of IRA assets, the estimates utilize the most recent data point (44.67 percent in 2014) and project the mutual fund share of IRA assets to remain constant throughout the projection period.

### **3.4.3.3.3 Percentage of IRA mutual fund assets incurring a front-end load**

Ideally, the projections would utilize a data source that looks within IRA accounts and measures the percentage of IRA mutual fund assets incurring a front-end load. This factor, combined with the two listed above, would generate an estimate for the dollar amount of IRA mutual fund assets incurring a front-end load in a given year. In the absence of this ideal data, another data source must be used to anchor the assumed percentage of IRA mutual fund assets incurring a front-end load over the course of the projection period.

The ICI Fact Book presents the total net assets of mutual funds by share class from 2004 to 2013 (Figure 5.11, page 99). In 2013, Front-end load assets were 29.6 percent of all non-annuity mutual fund assets excluding Institutional no-load funds (DOL calculation). Institutional no-load assets are excluded from the denominator of the calculation because IRA investors do not have access to institutional share classes.

The data show a decline in the percentage of mutual fund assets incurring a front-end load. In 2004, the earliest year in which data is available, Front-load assets totaled 35.7 percent of all non-annuity mutual fund assets excluding Institutional no-load funds. The 2013 share of 29.6 percent signals a decline of approximately 2.1 percent per year.

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<sup>227</sup> ICI, "The U.S. Retirement Market, Fourth Quarter, 2014," 2015.

The 2013 percentage of IRA mutual fund assets incurring a front load is assigned a value of 29.6 percent and that percentage is projected to decline by 2.1 percent per year through the 10- and 20-year projection periods. Table 3.4.3-4 presents the assigned percentage of IRA mutual fund assets incurring a front load in each year of the projection period (middle column). The historical data used to produce these assumptions is not specific to IRA mutual funds. Instead, an implicit assumption is made; the percentage of IRA mutual fund assets incurring a front-end load is assumed to be comparable to the percentage of all retail mutual fund assets incurring a front load. If IRA investors are especially unsophisticated, is it likely that the percentage of IRA mutual fund assets incurring a front-end load is higher than the percentage across all retail mutual fund assets; however, the Department has not found any data to verify this hypothesis.

Setting aside the above question of the rate of front-loads specific to IRA mutual fund assets, there remains uncertainty in the projections surrounding the rate of decline in the percentage of mutual fund assets incurring a front-end load. It is unclear what factors are driving the decline in front-loads. If investor demand is driving the decline in front-loads, the movement away from front-loads could be limited to the more sophisticated, high financially literate consumer base. In this case, the decline in front-loads might quickly slow or stop once that segment of investors has moved on. On the other hand, if advisers are driving the movement away from front loads, the decline could continue, or even accelerate. In fact, the rate of decline in front-load share of mutual fund assets has been even larger – 3.9 percent – in more recent years (2008-2013). While maintaining the baseline assumption that the 2013 front-load percentage of IRA mutual fund assets is 29.6 percent, eliminating the projected decline in this percentage increases the estimated subset of IRA investors’ expected gains by 21 percent to 36 percent. Conversely, increasing the projected decline in front-load percentage of mutual fund assets to 3.9 percent decreases the estimated subset of IRA investors’ expected gains by 15 percent to 23 percent.

The rightmost column of Table 3.4.3-4 displays the projected IRA mutual fund assets incurring a front load as a percentage of all IRA assets. This column is the product of the center column and the assumed mutual fund share of IRA assets (44.67 percent, *see* Section 3.4.3.3.2 above). The baseline scenario IRA front-load mutual fund assets (Row B of Table 3.4.2-1) are calculated by multiplying the baseline total IRA assets (Row A of Table 3.4.2-1) by the projected IRA mutual fund assets incurring a front load (rightmost column of Table 3.4.3-4).

<b>Year</b>	<b>Percentage of IRA mutual fund assets incurring a front end load</b>	<b>IRA mutual fund assets incurring a front end load as a percentage of all IRA assets</b>
2017	27.2%	12.1%
2018	26.6%	11.9%
2019	26.0%	11.6%
2020	25.5%	11.4%
2021	24.9%	11.1%
2022	24.4%	10.9%
2023	23.9%	10.7%
2024	23.4%	10.5%
2025	22.9%	10.2%
2026	22.4%	10.0%
2027	22.0%	9.8%
2028	21.5%	9.6%
2029	21.0%	9.4%
2030	20.6%	9.2%
2031	20.2%	9.0%
2032	19.8%	8.8%
2033	19.3%	8.6%
2034	18.9%	8.5%
2035	18.5%	8.3%
2036	18.1%	8.1%

### 3.4.3.4 Aggregation of yearly gains to investors

The aggregation of yearly front-load-mutual-fund benefits depends primarily on two variables: the discount rate, and the fraction of assets withdrawn from IRA accounts each year.

#### 3.4.3.4.1 Discount rate

The estimated subset of IRA investors' expected gains are weighted more heavily toward the ends of the 10- and 20-year projection periods because the effects of the rule will take time to filter through IRA front-end load mutual fund assets. When the requirements of the rule become applicable brokers who previously advised IRA accounts will not necessarily be required to review past advice in all circumstances. IRA assets in underperforming funds will only be affected when the IRA investor receives new advice. Therefore, the estimated subset of IRA investors' expected gains will grow as more and more time passes following the finalization of the rule.

Because the estimated subset of IRA investors' expected gains tends to be back-loaded, the assigned discount rate has a significant effect on the estimates. Office of Management and Budget Circular A-4 states that real discount rates of 3 percent and 7 percent should be used. Inflation (change in CPI-U) averages 2.3 percent for calendar years 2019-2025 in the assumptions underlying the Administration's FY2016 budget.<sup>228</sup> Combining the inflation projection and the 3 percent real discount rate implies a nominal projected discount rate of 5.3 percent throughout the projection period. Increasing the discount rate to 9.3 percent (reflecting a 7 percent real discount rate) throughout the projection period decreases the estimated subset of IRA investors' expected gains by 32 percent to 50 percent. Using the 9.3 percent nominal discount rate an estimated subset of IRA investors' expected gains of \$27 billion under Scenario 1. Conversely, decreasing the discount rate to 1.3 percent throughout the projection period increases the estimated subset of IRA investors' expected gains by 50 percent to 111 percent. As expected, the impact of the discount rate assumption on the 20-year estimated subset of IRA investors' expected gains is larger than the impact on the 10-year estimated subset of IRA investors' expected gains.

#### 3.4.3.4.2 Fraction of year-end assets withdrawn

Compound interest is a well-established financial principle and adds to the estimated subset of IRA investors' expected gains of a rule that helps IRA investors over time. Gains that accrue in one year can be carried over to the next and accrue additional benefits through reinvestment. The estimated subset of IRA investors' expected gains reflect this compounding effect. Most of the asset differential (difference between end-of-year assets under the baseline and alternative scenarios) is carried over to the following year. However, a portion of IRA assets are also withdrawn each year.

The ICI U.S. Retirement Market quarterly spreadsheets present the withdrawals from IRAs between 2000 and 2012. Withdrawals average 4.42 percent of total IRA assets each year. The subset of IRA investors' expected gains projections assume that withdrawals will equal 4.42

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<sup>228</sup> See Table 2-1, "Economic and Budget Analyses," 2015, available at: <https://www.whitehouse.gov/sites/default/files/omb/budget/fy2016/assets/spec.pdf>.

percent of the asset differential in each year of the projection period. This projection also relies on the additional assumption that IRA mutual fund assets incurring a front-end load are withdrawn at the same rate as the overall population of IRA assets.

The withdrawal rate assumption has relatively little impact on estimated subset of IRA investors' expected gains. If the assigned withdrawal rate were increased to 7 percent for the entirety of the projection period (the highest withdrawal rate in the 2000-2012 historical period was 6.5 percent in 2008), the estimated subset of IRA investors' expected gains would be reduced by less than 1 percent.

#### **3.4.3.5 Effects of proposed regulatory action on market trends**

The Department has estimated subset of IRA investors' expected gains of \$40 billion to \$44 billion over 10 years and \$88 billion to \$100 billion over 20 years relative to a baseline where the size of front loads and the proportion of assets subjects to front loads are projected to substantially decrease.<sup>229</sup> Removing both of these projected declines – assuming load sizes and assets subject to loads remain at their 2013 levels – increases the projected subset of IRA investors' expected gains to \$60 billion to \$67 billion over 10 years and \$167 billion to \$193 billion over 20 years. Which is the most appropriate baseline – one where loads maintain current levels or one where they decrease at a rate similar to the recent past?

If markets exist in a vacuum, decreasing loads would clearly be the most applicable baseline; however, regulatory action, and even the expectation of regulatory action, can have significant impacts on markets. The Department has been working on the project that has culminated in the re-proposal of this rule since 2008. The public has been aware of the project since work began, and the project has received widespread public and industry attention since the original proposal in October 2010. These dates line up quite well with the accelerated drop in mutual fund assets incurring a front-end load, though not as well with the decrease in the size of front loads.

To the extent that the Department's work on this project has generated downward pressure on the size and frequency of front-end loads, the failure of the Department to finalize a rule could have the expected effect of a rebound in those trends. It is unclear to what extent the recent decline in loads (sizes and rates) can be attributed to action on the part of the Department, but evidence on the impact of expected regulatory action suggests that the appropriate baseline scenario may be one where the decline loads decelerates or even disappears.

#### **3.4.4 Estimates of the Harm Due to Conflicted Advice**

Two sections in this RIA present projections that use a similar methodology to the estimated subset of IRA investors' expected gains. (Section 3.2.4 considers the gap in performance between broker-sold and direct-sold IRA assets as well as the underperformance which results from conflicts of interest. Section 4.2.2.2 contemplates the performance difference between accounts in employer-based retirement plans and IRAs that are subject to conflicted advice.) In all cases, the performance measures are presented as market aggregate dollar values

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<sup>229</sup> All estimated subset of IRA investors' expected gains in this section refer to alternative scenarios 1 and 2 only.



over 1, 10, and 20 years. This section details the assumptions required to generate the projections in these sections and the values assigned to those assumptions.

Section 3.2.4 presents several estimates for the amount of loads and underperformance that could result from conflicts of interest. Those estimates are summarized in Table 3.4.4-1. The assumptions used to generate all of the estimates in Table 3.4.4-1 differ from the above estimated subset of IRA investors' expected gains assumptions in the following ways:

- (1) The percentage of IRA mutual fund assets incurring a front-end load does not decline over the projection period.
- (2) The size of front-end loads does not decline over the projection period.
- (3) There is no phase in effect. The calculations count all underperformance due to conflicts of interest, including conflicted advice that occurs both before and after the requirements of the rule become applicable.

Additional variation in the assumptions used is detailed in Table 3.4.4-1.

Row	Projected Loss from Underperformance and Loads (\$ billion)			Assignments		
	1-year	10-year	20-year	Percentage of IRA assets in affected asset categories	Percentage of affected asset category IRA assets sold through conflicted channels	Average size of front-end load (2013 or historical)
(1)	7.2	84.2	191.7	44.67%	29.56%	183.94
(2)	10.5	124.2	285.3	44.67%	29.56%	183.94
(3)	17.9	208.4	472.7	44.67%	50.00%	270.61
(4)	26.1	309.0	710.0	44.67%	50.00%	270.61

Row (1) of Table 3.4.4-1 reflects an estimate of the underperformance directly attributable to loads as applied to the current IRA front-end-load mutual funds market. This projection uses the 2013 estimates for percentage of IRA assets in mutual funds (44.67 percent), percentage of IRA mutual fund assets incurring a front-end load (29.56 percent) and average size of front-end load (183.94 basis points). Row (2) adds in the direct cost of loads, analogous to Alternative Scenario 3 from the estimated subset of IRA investors' expected gains.

Row (3) acknowledges that fact that front loads have decreased over time and contemplates the possibility that, as front-loads have disappeared, harms from conflicts of interest have been shifted to other revenue streams rather than eliminated. In order to estimate harms in this situation, Row (3) projects the underperformance that would occur if all broker-sold mutual funds (50 percent) incurred a front-end load and the average size of front-end loads was that of the (Christoffersen, Evans, and Musto 2013) sample period (270.61 basis points). Row (4) adds in the direct cost of loads that would occur, given the assumptions.

Section 3.2.4 also presents estimates of the underperformance of broker-sold mutual funds relative to those on the direct-sold side of the market. These projections use some of the same methodology as the front-load-mutual-fund-gain-to-investors estimates. However, rather than projecting loads across the projections periods, these estimates simply take the assumed performance gap and apply it to the projected IRA assets, similar to Table 3.4.2-1.

Table 3.4.4-2 presents the assigned values for underperformance and projections over 1, 10, and 20 years. Row (1) assigns 100 basis points to the underperformance of broker-sold funds while Row (2) illustrates what would happen if underperformance were 200 basis points. Both rows assume that 44.67 percent of IRA assets are in non-money-market mutual funds and that 50 percent of mutual funds are broker-sold throughout the projection period.



Row	Projected Underperformance (\$ billion)			Assignment
	1-year	10-year	20-year	Underperformance of broker-sold funds
(1)	18.1	214.0	491.7	100 basis points
(2)	36.1	427.9	983.3	200 basis points

In addition to the market impact of conflicted-advice-related underperformance, Section 3.2.4 presents estimates for the effect of that same 100 or 200 basis point underperformance on an individual investor’s retirement savings. The section states that an ERISA plan investor who rolls her retirement savings into an IRA could lose 12 to 24 percent of the value of her savings over 30 years of retirement by accepting advice from a conflicted financial adviser. The estimates rely on three assumptions: a nominal return on investment rate of 6 percent; an inflation rate of 3 percent; and that the retiree will consume all of her savings in exactly 30 years. The resulting percentage-loss estimates do not depend on the amount of savings rolled into an IRA, but, for purposes of illustration, consider an investor who rolls over \$200,000. For each of the 30 years, the investor experiences a real return rate of 3 percent (6 percent nominal returns minus 3 percent inflation). After experiencing those returns, the investor withdraws \$X where X is determined such that the retiree consumes all of her savings in exactly 30 years. In the case of the retiree who experiences no underperformance, she consumes \$10,204 in real dollars each year and has a balance of \$0 at the end of the 30 year period.

However, if the retiree accepts investment advice that results in underperformance of 1 percent per year, the consumption possibilities are reduced. For each of the 30 years, the investor now experiences a real return rate of 2 percent (6 percent nominal returns minus 1 percent underperformance minus 3 percent inflation). The retiree is able to consume only \$8,930 per year while depleting her savings in exactly 30 years. The reduction in consumption due to the underperformance is 12 percent –  $(\$10,204 - \$8,930) / \$10,204 = 12$  percent.

If the investment advice results in underperformance of 2 percent per year, the consumption potential is more severely diminished. The retiree now is able to consume only \$7,750 per year for each of the 30 years. The reduction in consumption due to 2% underperformance is 24 percent –  $(\$10,204 - \$7,750) / \$10,204 = 24$  percent.

Section 4.2.2.2 presents estimates for the market impact of the underperformance of IRA rollover assets, in cases where advice is given. The projections assume that 50 percent of all IRA rollovers come from employer sponsored retirement plans and involve conflicted advice from a broker or other individual. The IRA rollover underperformance estimates are methodologically similar to the broker-sold mutual fund underperformance estimates presented in Table 3.4.4-2. The primary difference is the asset base.

Year	IRA Rollover Growth Rate	IRA Rollovers (\$ billion)	Cumulative Rollover Assets (\$ billion)
2017	1.054	491.9	491.9
2018	1.054	518.3	1010.2
2019	1.054	546.1	1556.3
2020	1.054	575.6	2131.9
2021	1.054	606.7	2738.6
2022	1.054	639.4	3378.0
2023	1.054	674.0	4052.0
2024	1.054	710.4	4762.3
2025	1.054	748.7	5511.0
2026	1.054	789.1	6300.2
2027	1.054	831.8	7131.9
2028	1.054	876.7	8008.6
2029	1.054	924.0	8932.6
2030	1.054	973.9	9906.5
2031	1.054	1026.5	10933.0
2032	1.054	1081.9	12015.0
2033	1.054	1140.4	13155.3
2034	1.054	1201.9	14357.2
2035	1.054	1266.8	15624.1
2036	1.054	1335.2	16959.3

Table 3.4.4-3 presents projections for IRA assets over the 1-, 10-, and 20-year projection periods. IRA rollover and IRA rollover growth rate projections for 2017-2019 come from The Cerulli Associates’ “Retirement Markets 2014” report.<sup>230</sup> For the remainder of the 10- and 20-year projection period, IRA rollovers are projected by extending the trend in the IRA rollover growth rate.

Table 3.4.4-4 presents the IRA rollover broker-sold mutual fund underperformance projections. These projections only consider rollovers that occur within the projection period. As a result, the 10-year underperformance is much more than 10 times the size of the 1-year underperformance, and the 20-year underperformance is significantly more than twice the size of the 10-year underperformance. Each year additional assets are rolled over into broker-sold mutual funds adding to the cumulative rollover total and rollovers that occurred previously during the projection period experience an additional year of underperformance. Row (1) of Table 3.4.4-4 assigns 100 basis points to the underperformance of broker-sold funds relative to the performance of employer-sponsored retirement plan assets, while Row (2) illustrates what would happen if that underperformance were 200 basis points.

Row	Projected Underperformance (\$ billion)			Assignment
	1-year	10-year	20-year	Underperformance of IRA rollover broker-sold funds
(1)	2.2	107.5	360.8	100 basis points
(2)	4.4	215.0	721.5	200 basis points

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<sup>230</sup> Cerulli Associates, “Retirement Markets 2014.”



## 4. ERISA-Covered Plans

As noted in the introduction, ERISA-covered plans are critical to the retirement security of most US workers. In March of 2014, about one-half – 48 percent – of private-sector employees were participating in a job-based retirement plan. Sixteen percent participated in defined benefit (DB) plans, and 42 percent participated in defined contribution (DC) plans. (Ten percent participated in both.)<sup>231</sup> These numbers are just a snapshot, so they understate the reach of the plans across employees' careers. Employees who are young, part-time or low-paid are less likely to participate. Over a full career many of these employees will at some point hold full time, higher-paying jobs that come with retirement benefits. In 2014, 58 percent of full-time employees participated in some form of retirement plan.

By the fourth quarter of 2014, plan assets totaled \$8.5 trillion, including \$3.1 trillion in DB and \$5.4 trillion in DC plans.<sup>232</sup> This also understates the plans' role in US workers' retirement security, because a large fraction of DC and some DB assets are transferred at some point, usually upon leaving a job, to IRAs, providing a large majority of the flows into such accounts. IRAs held \$7.3 trillion by the third quarter of 2014.<sup>233</sup>

Both plan officials and plan participants rely heavily on professional advisers to assist them with the investment of plan assets. DB plans, which promise a specific benefit to each participant based on a specified formula and manage assets centrally, typically hire external or internal asset managers to exercise their own discretion in making investment decisions. But plan officials often rely on advisers to help them select these asset managers and assess their performance. The asset managers, who themselves are plan fiduciaries, may also consult outside advisers for help with various investment decisions. DC plans, in which employers and/or employees contribute to separate employee accounts, often divide responsibility for investing plan assets between plan officials and participants. Officials typically select a menu of investment choices, often consisting of mutual funds or other diversified investment vehicles, and designate one of these options as the default. They may rely on advisers to help them construct the menu and select the default. Participants usually are responsible for allocating the assets in their accounts among the available options. They may seek help from plan-provided advisers, where available, or outside advisers, in making this allocation. They may also seek advice when they are eligible to withdraw assets from their accounts, such as when changing jobs or retiring, as to whether or not they should withdraw the assets, whether to transfer the assets to an IRA, and how to invest the assets after such a transfer. Both DB and DC plan officials sometimes rely on appraisers – essentially advisers who specialize in determining the value of assets for which no market price can be observed – to determine the price that should be paid or demanded for a hard-to-value asset that the plan will buy or sell.

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<sup>231</sup> U.S. Bureau of Labor Statistics, “National Compensation Survey: Employee Benefits in the United States, Table 2: Retirement benefits: Access, participation, and take-up rates, March 2014” (July 2014), available at: <http://www.bls.gov/ncs/ebs/benefits/2014/ownership/private/table02a.htm>.

<sup>232</sup> Board of Governors of the Federal Reserve System, “Financial Accounts of the United States, Fourth Quarter 2014,” Federal Reserve Statistical Release Z.1 (Mar. 2015).

<sup>233</sup> ICI, “The U.S. Retirement Market, Fourth Quarter 2014,” 2015.

## 4.1 Affected Entities

The new proposal would affect plan service providers who under its provisions would be fiduciary advisers. It would also affect the plans and plan participants that they serve.

### 4.1.1 Service Providers

The Department used data from Schedule C of the 2012 Form 5500 to estimate the universe of plan service providers that would be affected by the new proposal. Generally, plans with 100 or more participants are required to report persons who rendered services to or who had transactions with the plan during the reporting year if the person received, directly or indirectly, \$5,000 or more in reportable compensation in connection with services rendered or their position with the plan. The types of services provided by each service provider also must be reported. Based on these Schedule C service codes, the Department estimates that 5,800 unique service providers most likely provide investment and valuation-related services covered under the proposed rule that could cause them to be fiduciaries. In order to provide a reasonable estimate, service providers reporting service codes corresponding to recordkeeping, consulting (general and pension), insurance agents and brokers, investment advisory services (both plans and participants), brokerage (real estate and securities), valuation services and those providing participant communication were assumed to provide services that potentially could be covered by the new proposal.

Type of Service Provider	Number
<b>Recordkeepers</b>	1,800
<b>Consulting (general)</b>	1,100
<b>Consulting (pension)</b>	900
<b>Insurance agents and brokers</b>	400
<b>Investment Advisory (Participants)</b>	1,300
<b>Investment Advisory (Plans)</b>	2,600
<b>Real Estate Brokerage</b>	20
<b>Securities Brokerage</b>	400
<b>Valuation (appraisals)</b>	200
<b>Participant Communication</b>	600
<b>All Types</b>	5,800

Although some small plans file Schedule C, small plans generally are not required to complete Schedule C. Therefore, the Department's estimate could underestimate the number of covered services providers to small plans if any of these service providers only perform services for small plans. The Department, however, believes that its estimated number of covered service providers is reasonable, because most small plans use the same service providers as large plans.

## 4.1.2 Plans and Participants

The new proposal might not affect all plans because it is possible that not all plan investors receive fiduciary investment advice. However for purposes of this analysis the Department assumes that all plans and plan participants will be affected. This includes 676,000 plans, of which 43,000 are DB and 633,000 are DC plans. Gross participation in these plans totals 131 million, 40 million, and 91 million, respectively.

Some individuals participate in two or more plans, so the number of natural persons affected is smaller than gross participation.<sup>234</sup>

Many participants will be affected indirectly in connection with fiduciary advice rendered to plan officials. In particular, participants in the nearly 600,000 smaller plans (less than 100 participants) are likely to be affected indirectly. Smaller plans may be more exposed to conflicts of interest on the part of service providers, because they are less likely than larger plans to receive investment assistance from a service provider that is acting as a fiduciary. Smaller plans also often receive investment assistance from insurance brokers or BDs, who may be subject to conflicts of interest.<sup>235</sup> The conflicted advice received by smaller plans from service providers is particularly troubling in the context of the number of smaller plans, since smaller plans make up the vast majority of the retirement plan universe.

The 65.9 million participants in the nearly 506,000 plans that allow at least some participant direction may be more directly affected in connection with fiduciary advice rendered directly to them.

Although the vast majority of defined contribution plans allow participants to direct the investment of at least a portion of assets, only about 35 percent of plans offer investment advice to plan participants, and only 18 percent of plan participants with access to investment advice through their plans avail themselves of this advice.<sup>236</sup>

Participants with access to optional lump sum distributions also may be directly affected when they become eligible for such distributions. This includes participants in essentially all DC plans and approximately a quarter of DB plans.<sup>237</sup> When workers change jobs and receive distributions from their retirement plans, the average distribution is over \$30,000, while almost 85 percent of distributions are less than \$50,000.<sup>238</sup> (Almost nine in ten retiring workers who receive a lump sum distribution take their entire account balances as a distribution. For those workers, the

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<sup>234</sup> Detailed statistics on the universe of plans and participants are available on the Department's website.

<sup>235</sup> U.S. Government Accountability Office, *GAO-11-119, 401(K) Plans: Improved Regulation Could Better Protect Participants from Conflicts of Interest* (2011), available at: <http://www.gao.gov/products/GAO-11-119>.

<sup>236</sup> See page 59, 98 and 100 of the PSCA 56th Annual Report (2012 Plan Experience).

<sup>237</sup> See Table 33. Traditional defined benefit plans: Availability of lump sum benefits at retirement, private industry workers, National Compensation Survey, 2010.

<sup>238</sup> EBRI Notes, "Lump-Sum Distributions at Job Change," Vol. 30, No. 1 (Jan. 2009), available at: [http://www.ebri.org/pdf/notespdf/EBRI\\_Notes\\_Jan09\\_Rollovers.pdf](http://www.ebri.org/pdf/notespdf/EBRI_Notes_Jan09_Rollovers.pdf).

median account balance is over \$90,000.<sup>239</sup> For the retiring workers who take only a partial lump-sum distribution, the median distribution received is almost \$40,000.<sup>240</sup> Participants who take lump sum distributions also may be affected by this rule's application to IRAs. Almost 90 percent of retiring workers who receive a lump sum distribution choose to rollover at least some of the proceeds into an IRA, and 65 percent choose to rollover the entire distribution into an IRA.<sup>241</sup>

Participants who do not have target-date funds or who choose not to use target-date funds may be directly affected when they seek advice on alternative allocations for their retirement assets. Among workers of all ages, target-date funds comprise 9.5 percent of all 401(k) assets. The other 90.5 percent of assets may require investment advice. Further, when 401(k) assets are broken down by account holder age, retirement plan participants in their 20s invest 23.5 percent of their assets in target-date funds. All other age groups invest 13.5 percent or less in target-date funds.<sup>242</sup>

## 4.2 Need for Regulatory Action

As noted above, in 1975, the Department and the IRS issued parallel regulations<sup>243</sup> that define the scope and meaning of the term “investment advice” under ERISA. The 1975 rule substantially narrowed the broad statutory language conferring fiduciary status on all persons rendering investment advice to a plan or an IRA for a fee.<sup>244</sup>

In the decades since its issuance, the Department has observed that as a result of its narrow scope, the current regulation has effectively functioned as an “escape hatch” from fiduciary status for advisers to plan investors in instances where, for example, the investment advice was rendered to the plan on a single occasion, or in cases where the adviser has disavowed any understanding that the advice would serve as a “primary basis” for the plan’s investment decision. Therefore, as a result, the current regulation fails to provide adequate protection to plan participants and beneficiaries from the effects of conflicts of interest and self-dealing on the part of persons providing investment advisory services. The Department’s efforts to obtain satisfactory remedies on behalf of plan participants and beneficiaries whose retirement security has been jeopardized because of the misconduct of such advisers have been repeatedly thwarted.

The 1975 rule has been overtaken by subsequent dramatic changes in the design, operation, and marketing of employer-sponsored retirement plans. The variety and complexity of financial products have increased, widening the information gap between advisers and their clients

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<sup>239</sup> ICI Research Series, “Defined Contribution Plan Distribution Choices at Retirement: A Survey of Employees Retiring between 2002 and 2007,” (Fall 2008), 33. Available at: [http://www.ici.org/pdf/rpt\\_08\\_dcdd.pdf](http://www.ici.org/pdf/rpt_08_dcdd.pdf).

<sup>240</sup> Ibid.

<sup>241</sup> Ibid., 43.

<sup>242</sup> EBRI Issue Brief, “401(K) Plan Asset Allocation, Account Balances, and Loan Activity in 2010,” Number 366 (Dec. 2011); available at: [http://www.ebri.org/pdf/briefspdf/EBRI\\_IB\\_12-2011\\_No366\\_401\(k\)-Update.pdf](http://www.ebri.org/pdf/briefspdf/EBRI_IB_12-2011_No366_401(k)-Update.pdf).

<sup>243</sup> 29 C.F.R. § 2510.3-21(c); and 29 C.F.R. § 4975-9(c).

<sup>244</sup> The scope of the 1975 regulation was further limited by the Department in AO 76-65, in which it concluded that, under the facts described therein, a valuation of closely held employer securities that would be relied on in the purchase of the securities by an employee stock ownership plan (ESOP) would not constitute investment advice under the regulation.



and increasing the need for expert advice. Consolidation in the financial industry and innovations in products and compensation practices have multiplied opportunities for self-dealing and made fee arrangements less transparent to clients and regulators. At the same time, much of the responsibility for investing retirement savings has shifted from large private pension fund managers to individual DC plan participants, many with low levels of financial literacy. These trends were not foreseen when the existing regulation was issued in 1975. 401(k) plans did not yet exist when the 1975 rule was promulgated. Between 1975 and 2010, the share of total plan participation attributable to DC plans grew from 29 percent to 81 percent. In 2012, 82 percent of DC plan participation was attributable to 401(k) plans,<sup>245</sup> and 96 percent of 401(k) plan participants had responsibility for directing some or all of their account investments. Participants in 401(k) plans have more control over the investment of their retirement assets, but also bear the risk of loss from poor investment decisions.

## 4.2.1 Plan Level Advice

Plan sponsors generally have a fiduciary duty to ensure that plan assets are managed prudently and in the exclusive interest of plan participants. Many rely on professional advisers to help them discharge this duty. For example, DC plan sponsors may seek professional advice regarding the selection of investment alternatives that will be available to plan participants and beneficiaries. Plan trustees often rely on appraisers and valuation experts to attach fair values to so-called hard-to-value assets. DB plan sponsors often rely on consultants to help them oversee plan investments. Recently, concerns have been raised about the impartiality of the advice provided by service providers to plan officials due to conflicts of interest and confusion regarding the fiduciary status of their service providers. These issues are further discussed below.

### 4.2.1.1 Pension Consultants

Due to the increased complexity of investment opportunities available to DB plans, plan sponsors often seek investment advice from pension consultants regarding matters such as: (1) identifying investment objectives and restrictions; (2) allocating plan assets among various objectives; (3) selecting money managers to manage plan assets in ways designed to achieve objectives; (4) monitoring performance of money managers and mutual funds and making recommendations for changes; and (5) selecting other service providers, such as custodians, administrators and BDs. There also is a greater potential for conflicts of interest to exist in the DB pension plan service provider market than when the current regulation was promulgated. Many pension consulting firms provide services both to pension plan investors who are their advisory clients and to money managers, and many have added brokerage and/or money management affiliates, increasing the opportunities for self-dealing. As further discussed below, the Department's Consultant/Adviser Project (CAP) focused on the receipt of improper or undisclosed compensation by plan consultants and other investment advisers. Through the CAP program, the

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<sup>245</sup> See U.S. Department of Labor, Employee Benefits Security Administration, "Private Pension Plan Bulletin Historical Tables and Graphs," (November 2012), p. 9, p. 25, p. 31 and p. 32, available at: [www.dol.gov/ebsa/pdf/historicaltables.pdf](http://www.dol.gov/ebsa/pdf/historicaltables.pdf). Please note that the number of active participants in 1975 and 2010 are not directly comparable because of adjustments in the definition of a participant. This adjustment is explained in detail in the historical tables and graphs.

Department uncovered numerous cases where pension consultants and investment advisers abused their relationship of trust with plan investors by recommending investment managers or strategies in exchange for undisclosed compensation from third parties. The 1975 rule has impeded the Department's ability to redress what could be service provider abuses.

A 2005 SEC staff study<sup>246</sup> found that 13 of the 24 pension consultants examined, or their affiliates, provided products and services to pension plan advisory clients, money managers, and mutual funds on an ongoing basis without adequately disclosing these conflicts. The SEC staff also found that the majority of examined DB plan consultants had business relationships with BDs that raised a number of concerns about potential harm to plans. The report concludes that consultants with conflicts of interest may steer plan investors to hire certain money managers or other vendors based on a consultant's (or an affiliates') other business relationships and receipt of fees from these firms rather than because the money manager is best suited to the plan's needs. Using data from the SEC study and other DB pension data, a GAO study concluded that conflicts of interest that were not disclosed by pension consultants were associated with 130 basis points of underperformance.<sup>247</sup>

#### 4.2.1.2 Confusion about Service Providers' Fiduciary Status

The service providers that DB and DC plan officials engage to perform many types of plan services are subject to different regulatory regimes. For example, some plan investors work with RIAs that are subject to SEC jurisdiction under the Advisers Act. RIAs must seek to avoid conflicts of interest or, at a minimum, make full disclosure of material conflicts of interest.<sup>248</sup> Other service providers may not be subject to ERISA fiduciary duty requirements or SEC regulation, and therefore, may not be required to act in their clients' best interest or to disclose all conflicts of interest. GAO has reported that "there is a considerable amount of confusion among plan sponsors about whether or not they are receiving investment advice subject to ERISA fiduciary standards."<sup>249</sup> GAO found that plan sponsors are often not aware when a service provider is not an ERISA fiduciary and often assume that the advice they receive from the service provider is subject to ERISA standards and safe from harmful conflicts. "Consequently, plan sponsors may not be aware that service providers can have a financial incentive to recommend certain funds that would be prohibited if they were ERISA fiduciaries."<sup>250</sup> The problem is particularly acute for smaller plan investors, because, as GAO reported, "Smaller plans may be exposed to conflicts of interest on the part of service providers, because they are less likely than large plans to receive investment assistance from a service provider that is acting as a fiduciary."<sup>251</sup>

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<sup>246</sup> "SEC Staff Report Concerning Examination of Select Pension Consultants," (May 16, 2005), available at: <http://www.sec.gov/news/studies/pensionexamstudy.pdf>. The report's findings were based on a 2002 to 2003 examination of 24 pension consultants.

<sup>247</sup> GAO Publication No. GAO-09-503T.

<sup>248</sup> 15 U.S.C. § 80b-1 et seq.; *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963); General Instruction 3 to Part 2 of Form ADV.

<sup>249</sup> GAO Publication No. GAO-11-119, 28.

<sup>250</sup> *Ibid.*, 27.

<sup>251</sup> *Ibid.*, 28.

Another anomaly associated with the current regulation is that even persons who represent themselves to plan sponsors as fiduciaries in rendering investment advice may not be subject to ERISA’s fiduciary or prohibited transaction provisions if they fail to satisfy one or more elements of the five-part test. For example, a consultant could hold itself out as a plan fiduciary in a written contract with the plan, render investment advice for a fee, and still argue that its advice was insufficiently “regular,” was not mutually understood to serve as a “primary basis” for the investment decision, or otherwise failed to meet some element of the five-part test.

The current test also makes it easy for consultants to structure their actions to avoid fiduciary status. The SEC found evidence of this practice in its pension consultant examinations and made the following statement regarding this issue in its report: “[m]any pension consultants believe they have taken appropriate actions to insulate themselves from being considered a ‘fiduciary’ under ERISA. As a result, it appears that many consultants believe they do not have any fiduciary relationships with their advisory clients....”<sup>252</sup> GAO also found that many service providers structure their business arrangements “with a 401(k) plan to avoid meeting one or more parts of the current five-part test....”<sup>253</sup> For example, GAO states that some service providers providing investment advice “include a provision in their contract that states that the investment recommendations provided are not intended to be the primary basis for decision making.”<sup>254</sup> A report by the Department of Labor’s Office of Inspector General found that some service providers that have significant undisclosed conflicts of interest attempted to avoid ERISA fiduciary status under the current five-part test simply by stating in their investment adviser contract that they were not fiduciaries.<sup>255</sup> This problem confronts sponsors of both large and small pension plans.

#### 4.2.1.3 Platform Providers

Plan sponsors often retain financial advisers to assist in the provision of investment alternatives to participants in 401(k) plans. For example, many plan sponsors seek advice from “platform providers,” who are service providers, such as record keepers and third-party administrators, that make available a menu of investments from which a plan sponsor typically selects a more limited menu that will be available as designated investment alternatives under participant-directed DC plans. The provider may simply offer a “platform” of investments from which the plan sponsor selects those appropriate for the plan, or alternatively may select or assist the plan fiduciary in selecting the plan’s designated investment alternatives.<sup>256</sup>

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<sup>252</sup> See SEC Staff Report on Select Pension Consultants, 2005, 6.

<sup>253</sup> GAO Publication No. GAO-11-119, 24.

<sup>254</sup> Ibid.

<sup>255</sup> DOL Office of Inspector General, “EBSA Needs to Do More to Protect Retirement Plan Assets from Conflicts of Interest” Report No. 09-10-001-12-121 (Sept. 30, 2010), available at: <http://www.oig.dol.gov/public/reports/oa/2010/09-10-001-12-121.pdf>.

<sup>256</sup> The new proposal provides a limitation for platform providers that makes clear that persons would not act as investment advice fiduciaries simply by marketing or making available a platform of investments without regard to the individualized needs of the plan or its participants and beneficiaries, as long as they disclose in writing that they are not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity. Similarly, a separate provision recognizes certain common activities that platform providers may carry out to assist plan fiduciaries in selecting and monitoring the investment alternatives that they make available to plan

These platform providers vary significantly in their compensation arrangements. Some work on a fee-only basis and receive compensation only directly from plans or sponsors for the direct services they provide to the plan investors; others may receive indirect third-party revenue sharing payments<sup>257</sup> from other service providers, such as an investment fund provider, rather than (or in addition to) direct payments from the plan sponsor for plan services. These fee arrangements among providers can introduce conflicts of interest. Some platform providers include on their platform proprietary products, and/or products that are proprietary to an affiliate. The inclusion of proprietary or affiliated products in platforms can also introduce conflicts.

Platform providers may have a financial incentive to recommend that their proprietary funds be included as designated investment options on DC plan menus. Researchers have found evidence that platform providers act on this conflict of interest, and that plan participants suffer as a result. In a study examining the menu of mutual fund options offered in a large sample of DC plans, underperforming non-propriety funds are more likely to be removed from the menu than propriety funds. Similarly, the study found that platform providers are substantially more likely to add their own funds to the menu, and the probability of adding a proprietary fund is less sensitive to performance than the probability of adding a non-proprietary fund. The study also concluded that proprietary funds do not perform better in later periods, which indicates that they are left on the menu for the benefit of the service provider and not due to additional information the service provider would have about their own funds (Pool, Sialm, Stefanescu 2014).<sup>258</sup>

The GAO has found that revenue sharing is a widespread practice among 401(k) plan service providers. GAO stated that consequently, service providers that assist plan investors with selecting funds to be included in a 401(k) menu “may suggest funds that have poorer performance or higher costs for participants compared with other available funds.”<sup>259</sup> According to GAO, the financial impact of conflicts of interest can be substantial; fees for plans that have been managed

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participants. Therefore, merely identifying offered investment alternatives meeting objective criteria specified by the plan fiduciary or providing objective financial data regarding available alternatives to the plan fiduciary would not cause a platform provider to be a fiduciary investment adviser.

<sup>257</sup> Payments can take several forms, for example 12b-1 fees, sub-transfer agency fees that reimburse the plan’s record keeper for services that otherwise would be provided by a mutual fund, or payment of the mutual fund investment adviser’s compensation to the financial adviser, its firm or an affiliated firm for promotion, marketing, or distribution.

<sup>258</sup> Other researchers have found that controlling for risk and other factors, evidence indicates that 401(k) plan funds outperformed what random selection across all funds would generate by more than 50 basis points annually. However, the authors found that those selections would underperform analogous index funds by 31 basis points (Elton, Gruber, and Blake 2013). Other studies have found evidence that menu selection as a whole is sometimes less than optimal, with sponsors offering an inadequate range of funds and index funds that are more expensive than investors select in other settings (Elton, Gruber, and Blake 2006). The authors study the characteristics of plans that are associated with adequate investment choices, and find that for 62 percent of plans, the selection offerings are inadequate. Additionally, when examining one category of investment choices, S&P 500 index funds, they found that the index funds chosen by 401(k)-plan administrators are on average inferior to the S&P 500 index funds selected by the aggregate of all investors. *See also* Tang et al. (2010).

<sup>259</sup> GAO Publication No. GAO-11-119, 16.

by service providers with conflicts of interest could be reduced by 30 percent or more.<sup>260</sup> These arrangements can be harmful to plan sponsors and plan participants, because the plan may pay excessive fees for the provided services, which could lower returns. Participants in participant-directed 401(k) plans are especially vulnerable in these situations, because they must rely on the assets in their individual accounts to meet their retirement income needs.

## 4.2.2 Plan Participant Advice

As discussed above, with the growth of participant-directed DC plans, a substantial proportion of plan participants now direct the investment of their pension plan assets and assume more responsibility for ensuring the adequacy of their retirement income. At the same time, there has been an increasing interest on the part of the Department, employers, and others to ensure that participants have sufficient ability or support to make their own sound investment decisions. This is especially true in the areas of asset allocation and the disposition of assets that are rolled over or distributed from a plan.

Many participants and beneficiaries receive information and assistance regarding asset allocation and rollovers from plan service providers. In some cases, service providers may steer participants toward purchasing products that benefit the service provider but are not in the participants' best interest. These issues are further discussed below.

### 4.2.2.1 Advice Regarding Asset Allocation

Plan participants often receive assistance from plan service providers regarding how to allocate their 401(k) plan assets among their plans' designated investment alternatives. This assistance is provided through a variety of sources, such as brochures and other print materials, call centers or help desks, group seminars, one-on-one sessions, and computer models. If service providers deliver investment advice to participants, they are fiduciaries under the 1975 rule. However, if service providers provide only investment education, they are not fiduciaries. As previously stated, in IB 96-1<sup>261</sup> the Department identified four specific categories of information and materials – plan information, general financial and investment information, asset allocation models, and interactive investment materials – that would be considered investment education and not result in rendering fiduciary investment advice within the meaning of the 1975 rule if they are furnished to plan participants or beneficiaries alone or in combination.

IB 96-1 allows a suggested asset allocation using specific investment alternatives available under the plan to be treated as investment education as long as the model or asset allocation is accompanied by a statement indicating that other investment alternatives having similar risk and return characteristics may be available under the plan and identifying where information on those alternatives may be obtained.<sup>262</sup> When the Department issued IB 96-1, it addressed concerns that such use of investment alternatives available in the plan could allow service providers effectively to steer participants to specific investment alternatives by identifying only one particular fund in

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<sup>260</sup> Ibid., 30.

<sup>261</sup> 29 C.F.R. §2509.96-1(d).

<sup>262</sup> 29 C.F.R. §§ 2509.96-1(d)(3)(iii) and (4)(iv).

connection with an asset allocation example. To address this concern, the bulletin encourages plan sponsors to identify other investment alternatives within an asset class as part of an example when possible.

GAO has raised concerns about potential steering abuses in cases where specific plan investment alternatives are used in asset allocation examples pursuant to IB 96-1. GAO found in its 2011 report that, under this practice, “funds in which a service provider has a financial interest can be highlighted and participants may perceive this information as investment advice.” GAO concluded that “[p]articipants who confuse investment education for impartial investment advice may choose investments that do not meet their needs, pay higher fees than with other investment options, and have lower savings available for retirement.”<sup>263</sup> In a subsequent report, GAO stated that “[e]ven with disclosure statements as required in [IB 96-1], participants may interpret information about their plans’ providers’ retail investment products contained in their plans’ educational materials as suggestions or recommendations to choose those products.”<sup>264</sup>

Both investment education and impartial, expert fiduciary investment advice can help participants make sound investment decisions. However, if a service provider, as part of an education program, singles out specific investment alternatives in which it has a financial interest, there is a risk that participants will suffer.

#### 4.2.2.2 Advice Regarding Plan Distributions

Plan participants also seek advice from plan service providers and other advisers regarding whether to take a distribution from their plan account and roll over the distributed amounts into an IRA. Under the 1975 rule, participants often do not receive adequate protection from conflicted advice about distributions and rollovers.

In 2005, the Department issued AO 2005-23A, which addressed whether a recommendation that a participant take a distribution from his or her DC plan and roll over the funds to an IRA was subject to ERISA’s fiduciary standards and associated PT provisions of ERISA and the IRC. Specifically, the AO addressed whether a recommendation that a participant roll over an account balance to an IRA to take advantage of investment options not available under the plan would constitute “investment advice” with respect to the plan or the participant. AO 2005-23A concluded that advising a plan participant to take an otherwise permissible plan distribution, even when that advice is combined with a recommendation as to how the distribution should be invested, does not by itself constitute “investment advice” within the meaning of the 1975 rule. The Department stated that the 1975 rule defines when a person is a fiduciary by virtue of providing investment advice with respect to assets of an employee benefit plan. The Department expressed the view that a recommendation to take a distribution is not advice or a recommendation concerning a particular investment (i.e., purchasing or selling securities or other property) as contemplated by the 1975 rule, and that any investment recommendation regarding the proceeds of such a distribution would be advice with respect to funds that are no longer plan assets. However, in instances where a plan officer or someone who is already a plan fiduciary

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<sup>263</sup> GAO Publication No. GAO-11-119.

<sup>264</sup> U.S. Government Accountability Office, *GAO-13-30, 401(K) Plans: Labor and IRS Could Improve the Rollover Process for Participants* (2013), available at: <http://www.gao.gov/products/GAO-13-30>.

responds to participant questions concerning the advisability of taking a distribution or the investment of amounts withdrawn from the plan, the Department opined in AO 2005-23A that the fiduciary is exercising discretionary authority respecting management of the plan and must act prudently and solely in the interest of the participant.

As a result of the Department’s position in AO 2005-23A, many plan participants are vulnerable to being harmed by conflicted advice when they receive recommendations regarding whether to take a plan distribution and rollover the assets into an IRA. This problem is especially acute, because most IRA assets are attributable to rollover distributions,<sup>265</sup> and the amount of assets rolled over to IRAs is large and projected to increase substantially. In 2014, new IRA rollover contributions amounted to more than \$400 billion, and by 2019, new IRA rollover contributions are projected to total almost \$550 billion.<sup>266</sup> Given the structural advantages of retirement plans – larger investible asset balances may provide access to better asset management and lower cost – plan participants often can expect lower net returns after rolling their account into an IRA. Performance is especially likely to suffer when the rollover choice and asset selection results from conflicted advice. The sheer magnitude of current and future rollovers renders any loss in performance economically impactful. If plan participants who receive conflicted rollover advice suffer on average by 1 percentage point on future returns, a single year’s worth of rollovers would cause participants to lose out on more than \$2 billion in returns over that year. Rollovers accumulating over ten years could lose out on more than \$100 billion over that time period, while rollovers accumulating over 20 years could lose out on more than \$350 billion over those 20 years. If conflicted rollover advice instead causes performance to suffer by 2 percentage points on average, the losses would double to \$4 billion, more than \$200 billion, and more than \$700 billion over one, ten, and 20 years, respectively.<sup>267</sup>

Moreover, many plan sponsors and participants are not aware that participants lose important protections after rolling over funds into an IRA. As IRA investors, they no longer have the benefit of a plan fiduciary, such as the plan sponsor, representing their interests in selecting a menu of investment options or structuring advice arrangements. They also are not able to sue fiduciary advisers under ERISA for losses arising from fiduciary breaches, nor can the Department sue on their behalf.

GAO confirmed the perils faced by plan participants in this area in a 2013 report where it found that plan participants may not be adequately protected from plan service providers who provide distribution recommendations that subordinate participants’ interests to the advisers’ own interests.<sup>268</sup> For example, non-fiduciary plan service providers can recommend that participants take distributions from their 401(k) plan and roll over their funds into the service providers’ products outside the plan, thereby increasing the service provider’s compensation without violating ERISA. According to GAO, “much of the information and assistance participants receive is through the marketing efforts of service providers touting the benefits of IRA rollovers

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<sup>265</sup> ICI, “The U.S. Retirement Market, Fourth Quarter, 2014,” 2015.

<sup>266</sup> Cerulli Associates, “Retirement Markets 2014,” Exhibit 9.06.

<sup>267</sup> See Section 3.4.4 for details on the calculation of these estimates.

<sup>268</sup> GAO Publication No. GAO-13-30.



and is not always objective.”<sup>269</sup> In many cases, rolling over funds into these products might not be in the participant’s best interest, because the products are not appropriate for the participant’s needs or have higher fees than products that are available within the 401(k) plan. In the 2013 report, GAO also discussed the practice of steering participant rollovers into IRAs from plan service providers’ call centers. The report states that “service providers may offer their call center representatives financial or other incentives for asset retention when separating plan participants leave their assets in the plan or roll over to one of the providers’ IRA products, which could lead to representatives promoting the providers’ products over other options.”<sup>270</sup>

GAO describes how 401(k) service providers sell non-plan products and services, such as IRA rollovers to participants outside their 401(k) in a practice known as “cross-selling,” sometimes steering workers towards higher cost funds.<sup>271</sup> The amount of additional fees that are attributable to these rollovers can be substantial. For example, in its 2011 report, GAO stated that according to an industry professional, “cross-selling” IRA rollovers to participants provides an important source of income for service providers, and “a service provider could earn \$6,000 to \$9,000 in fees from a participant’s purchase of an IRA, compared with \$50 to \$100 in fees if the same participant were to invest in a fund within a plan.”<sup>272</sup>

FINRA also has opined that recommendations regarding whether to take a distribution and roll over plan assets into an IRA present an inherent conflict of interest. In a regulatory notice issued in December 2013, FINRA stated that “[f]irms and their registered representatives that recommend an investor to roll over plan assets to an IRA may earn commissions or other fees as a result. In contrast, a recommendation that an investor leave his plan assets with his old employer or roll the assets to a plan sponsored by a new employer likely results in little or no compensation for a firm or registered representative.... Thus, a financial adviser has an economic incentive to encourage an investor to roll plan assets into an IRA that he will represent as either a broker-dealer or an investment adviser representative.”<sup>273</sup>

In the Notice, FINRA urges broker-dealers to review their retirement service activities to assess conflicts of interest, and requires them to supervise these activities to reasonably ensure that conflicts of interest do not impair the judgment of a registered representative or another associated person about what is in the customer’s best interest.

In a January 2014 letter announcing its 2014 regulatory and examination priorities, FINRA stated that it will evaluate securities recommendations made in rollover scenarios to determine whether they comply with the suitability standards under FINRA Rule 2111.<sup>274</sup>

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<sup>269</sup> Ibid., 22.

<sup>270</sup> Ibid., 25-26.

<sup>271</sup> GAO Publication No. GAO-11-119, 36.

<sup>272</sup> Ibid.

<sup>273</sup> FINRA Regulatory Notice 13-45, “Rollover to Individual Retirement Accounts” (Dec. 2013); available at: <https://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p418695.pdf>.

<sup>274</sup> FINRA “2014 Regulatory and Examinations Priorities Letter” (Jan. 2. 2014); available at: <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p419710.pdf>.

In a related development, the SEC Office of Compliance Inspections and Examinations also has announced that its 2014 enforcement priorities will include (1) examining BDs and RIAs for conflicts when recommending the movement of assets from a retirement plan to a rollover IRA account in connection with a client's change of employment, and (2) examining broker-dealers and investment advisers for possible improper or misleading marketing and advertising conflicts, suitability, churning, and the use of potentially misleading professional designations when recommending the movement of assets from a retirement plan to a rollover IRA account in connection with a client's change of employment.<sup>275</sup>

Research shows that many individuals making contributions to an IRA spend very little time scrutinizing disclosure statements.<sup>276</sup> Thus, plan participants may not understand the differences between fees they would incur if they left their money in the plan compared to the fees they would incur if they rolled over the funds into an IRA. Moreover, even when presented with information on the difference in fees among 401(k)-type plans and IRAs, participants may have difficulty understanding the information or the implications for their retirement income security.

A substantial body of academic research suggests that consumers pay inadequate attention to mutual fund fees; that their advisers, and RIAs managing the mutual funds their advisers recommend deliberately exploit this tendency (Cici and Boldin 2010);<sup>277</sup> and that consumers' returns suffer as a result.

In fact, many service providers do not make fee information accessible and understandable for participants and beneficiaries that are considering IRA rollovers. In a 2013 report, GAO reviewed websites of numerous large IRA providers to locate fee information and concluded that IRA fee information was "generally scattered across the providers' websites in multiple documents, making it difficult to identify all applicable fees."<sup>278</sup> GAO noted that in one rollover

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<sup>275</sup> SEC National Exam Program, "Examination Priorities for 2014," Office of Compliance Inspections and Examinations (Jan. 9, 2014); available at: <http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf>.

<sup>276</sup> Press Release on LIMRA Study, "Many Americans Don't Fully Read Retirement Plan Disclosures; Few Know What Fees they Pay," (Dec. 18, 2014); available at: <http://www.limra.com/newscenter/newsarchive/archivedetails.aspx?prid=259>.

<sup>277</sup> The authors found that a measurable number of investors select index funds with excessive fees and uncompetitive returns. They identify a naïve group of investors who seem to be unduly influenced by brokers and financial advisers. *See also* Choi, Laibson, and Madrian (2010). In their experiments, subjects selecting among similar index funds overwhelmingly fail to minimize fees, even when fee information is costless. They reject the hypothesis that subjects buy high-fee index funds because of bundled non-portfolio services. *See also* Palmiter and Taha (2008). They find that mutual fund investors are unaware of the basics of their funds, pay insufficient attention to fund costs, and chase past performance despite little evidence that high past fund returns predict future returns. *See* Houge and Wellman (2007). The authors find that as the industry becomes more adept at segmenting customers by level of investment sophistication, load mutual fund companies take advantage of this ability and charge higher expenses to their target customer: the less knowledgeable investor. No-load fund companies, which tend to attract the more sophisticated investor, offer lower expenses. *See* Gil-Bazo and Ruiz-Verdu (2009). They present evidence consistent with this strategic fee setting argument. Mutual funds with worse before-fee performance charge higher fees. The authors posit that funds expected to perform poorly (or that have performed poorly in the past) raise fees and target less performance sensitive (less sophisticated) investors, often through increased marketing efforts (which increase distribution costs).

<sup>278</sup> GAO Publication No. GAO-13-30, 34.

application, the schedule of fees was located in the last section of a 49 page document, and the fee information was covered over four-and-one-half pages in eight-point typeface.<sup>279</sup> GAO concluded that “misleading statements make it difficult to understand IRA fees” and presented an example where GAO investigators made calls to 401(k) service providers, most of whom offer IRA products, and found that “7 of 30 call center representatives (representing firms administering at least 34 percent of IRA assets at the end of the 1st quarter in 2011) said that their IRAs were ‘free’ or had no fees with a minimum balance, without clearly explaining that investment, transaction, and other fees could still apply, depending on investment decisions.”<sup>280</sup> GAO also reviewed ten IRA websites, and found that “5 providers ... made similar claims, often with certain conditions such as a \$50,000 minimum balance or consent to receive electronic statements explained separately in footnotes. For example, an IRA provider’s website [GAO] reviewed stated that the provider would waive annual custodial fees if the balance exceeded an unspecified amount and only referred vaguely to other fees that might still apply, which were disclosed in multiple separate documents available on request. Accurate information on when IRA providers will waive fees and what fees they will waive can be difficult for participants both to locate and understand.”<sup>281</sup>

FINRA shares GAO’s concern that BDs’ marketing campaigns on television and radio, print, websites, and social media may not be fair and balanced and could be misleading, because they frequently emphasize that fees are not charged in connection with their IRAs, but only disclose in a footnote that certain fees apply. In July 2013, FINRA stated that “referring to an IRA account as a ‘free IRA’ or ‘no-fee IRA’ where costs would fail to comply with [FINRA] Rule 2210’s prohibition of false, exaggerated, unwarranted, promissory or misleading statements or claims.”<sup>282</sup> FINRA concluded that a “headline statement to the effect that a firm does not charge annual maintenance fees should include an explanation in close proximity to the headline of the conditions associated with the offer and the other fees that would apply.” In a January 2014 letter announcing its 2014 regulatory and examination priorities, FINRA stated that reviewing firms’ rollover practices was an examination priority, and that it will examine firm’s marketing materials and supervision in this area.<sup>283</sup> The SEC Office of Compliance Inspections and Examinations also has announced that its 2014 priorities included examining the sales practices of investment advisers targeting retirement-age workers to rollover their employer-sponsored 401(k) plan into higher cost investments, including whether advisers are misrepresenting their credentials or the benefits and features of IRAs and other alternatives.<sup>284</sup> More recently, in a January 2015 letter announcing its regulatory and examination priorities, FINRA stated that it will continue to focus on IRA rollovers. FINRA also provided guidance regarding specific steps firms should take if they do not intend to provide security recommendations as part of rollover transactions or only intend to provide educational materials with respect to such transactions. In this regard, FINRA

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<sup>279</sup> Ibid., 34-35.

<sup>280</sup> Ibid., 36.

<sup>281</sup> Ibid., 37.

<sup>282</sup> FINRA Regulatory Notice 13-23, 2013. FINRA Rule 2210 requires broker/dealer communications to be fair and balanced and not omit not omit material information that would cause them to be misleading.

<sup>283</sup> FINRA “2014 Regulatory and Examinations Priorities Letter,” 2014.

<sup>284</sup> SEC “Examination Priorities for 2014.”

stated that “[i]f a broker-dealer does not intend for its registered representatives intend to provide securities recommendations as part of the IRA rollovers of their customers, then the broker-dealer should have policies, procedures, control and training reasonably designed to ensure that no recommendation occurs. Similarly, if registered representatives are authorized to provide educational information only, a firm’s supervisory procedures should be reasonably designed to ensure that recommendations are not made.”<sup>285</sup>

### **4.2.3 Department Enforcement Challenges**

The 1975 rule’s narrow approach to fiduciary status sharply limits the Department’s ability to protect plan investors from conflicts of interest that may arise from the diverse and complex fee practices existing in today’s retirement plan services market and to devise effective remedies for misconduct when it occurs. In recent years, the Department has observed in its investigations that certain non-fiduciary service providers – such as consultants, appraisers, and other advisers – have abused their relationships with plan investors by recommending investments in exchange for undisclosed kickbacks from investment providers, engaging in bid-rigging, misleading plan fiduciaries about the nature and risks associated with plan investments, and by giving biased, incompetent, and unreliable valuation opinions. Yet, no matter how egregious the abuse, plan consultants and advisers have no fiduciary liability under ERISA, unless they meet every element of the five-part test.

In instances where a plan has relied upon abusive investment advice from a self-dealing consultant concerning an investment product on a single occasion, the Department generally cannot bring an action for fiduciary breach against the consultant, because the “regular basis” element of the current regulation’s five-part test is not satisfied. For example, a plan’s purchase of annuity contracts is a major transaction, but it may occur only in connection with the plan’s termination. Accordingly, one-time advice on the expenditure of virtually all of a plan’s assets on the purchase of an annuity to cover all of the plan’s obligations is not treated as fiduciary advice despite its clear importance to the plan participants who depend upon the annuity for their retirement benefits. As a result of the five-part test, rather than focus on the impartiality or prudence of advisers’ recommendations, investigators must first gather evidence on a series of factors that are not set out in the text of the statute and have little or nothing to do with the legitimate interest of plan investors in being able to rely on the recommendations of persons who hold themselves out as trustworthy advice professionals.

#### **4.2.3.1 EBSA Consultant/Adviser Project**

EBSA seeks to protect plans and their participants and beneficiaries by concentrating significant enforcement resources on carefully selected areas with significant potential for abuse. The evaluation and determination of fiduciary status was particularly important to one of EBSA’s major enforcement projects: the Consultant/Adviser Project (CAP). CAP focused on the receipt of improper or undisclosed compensation by employee benefit plan consultants and other investment advisers. EBSA’s investigations sought to determine whether the receipt of such

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<sup>285</sup> FINRA Regulatory and Examination Priorities Letter, 2015.

compensation, even when disclosed, violates ERISA because the adviser/consultant may have leveraged its position with a benefit plan to generate additional fees for itself or its affiliates.

One of the most critical elements in bringing enforcement actions under the CAP initiatives was establishing whether a service provider is a fiduciary. In order to make a fiduciary determination, investigators must gather evidence to support a finding for each element of the five-part test. In all cases, the analysis necessary to determine fiduciary status is very fact-intensive and requires extensive review of plan documents and contracts, client files, emails, investment documentation, accounting records, and interview statements to be obtained from service providers and their affiliates. Consequently, EBSA investigators routinely devote considerable time and resources to establishing all elements of the five-part test, rather than focusing on the actual misconduct at issue in particular cases.

In recent years, the Department has uncovered numerous cases of pension consultants and investment advisers abusing their relationship with plan investors by recommending investments in exchange for undisclosed compensation, misleading plan fiduciaries about the true risks associated with plan investments, and by giving biased investment advice. These cases typically involve the production of extensive documents and the conduct of many interviews, because the services must be evaluated for each plan client. Since fiduciary status must be established on a transaction by transaction basis, individual client files must be reviewed against all five parts of the fiduciary test to evaluate whether advice was given based on the particular needs of the plan. Production and review of the individual client files is a time-consuming process but one that is essential to provide evidentiary support for the five-part test.

The requirement under the 1975 rule that the plan consult the adviser “on a regular basis” presents one of the greatest obstacles to holding investment advisers to fiduciary standards. This is because plan investors often hire investment managers, advisers, or consultants to render advice for specific investment decisions. Despite the size or nature of the transaction, if the adviser did not provide advice on a “regular basis,” the adviser will not be deemed a fiduciary no matter what percentage of plan assets were involved in the transaction.

The current fiduciary regulation also creates a significant barrier to establishing fiduciary status by requiring that advice be rendered pursuant to a “mutual agreement, arrangement, or understanding that the advice will serve as a primary basis for investment decisions.” The Department must devote considerable resources in order to meet the burden of proof that the parties had a mutual understanding that the advice would be a “primary” basis for investment decisions. Absent such proof, the adviser cannot be deemed a fiduciary, regardless of the plan’s or participants’ actual reliance on the advice. In cases where prudent fiduciaries consult multiple advisers, or the advisers include boilerplate disclaimers of any “mutual understanding” as to the primacy of the advice, the test serves only to defeat legitimate plan expectation -- and to impose one more set of investigative hurdles for holding advisers accountable for biased or imprudent advice.

#### 4.2.3.2 Valuation

Flawed appraisals have been central to numerous Department investigations and enforcement actions. The Department has uncovered abuses reflecting flawed valuation methodologies, internally inconsistent valuation reports, the use of unreliable and outdated financial data, the apparent manipulation of numbers and methodologies to promote the preferred prices of selling shareholders (who are usually corporate insiders), and tax abuse.

Losses often cannot be fully recovered and abuses cannot be fully redressed because valuation service providers who provide plan investors with critical advisory services cannot always be held to fiduciary standards under ERISA. Employee benefit plan participants and sponsoring employers – especially small employers – are ill-served when such advisers cannot be held accountable for failing to properly discharge their responsibilities.

The 2010 proposal would have treated ESOP valuations as fiduciary advice, superseding earlier Department guidance to the contrary. The Department continues to believe that regulatory action is needed to combat abuse in ESOP valuations. However, as elaborated in Section 7.4 below, the Department has elected to defer action on this issue, pending consideration of potential alternative approaches, such as a rulemaking to more clearly define what constitutes “adequate consideration” under ERISA in connection with relevant ESOP transactions.

The new proposal, like the current regulation which includes “advice as to the value of securities or other property,” continues to cover certain appraisals and valuation reports. However, it is considerably more focused than the 2010 Proposal. Responding to comments, the new proposal in paragraph (a)(1)(iii) covers only appraisals, fairness opinions, or similar statements that relate to a particular transaction. The Department also expanded the exception for general reports or statements of value provided to comply with the disclosure requirements of ERISA and the Code to include the reporting and disclosure requirements of other Federal, state and self-regulatory organization (e.g., FINRA). In this manner, the new proposal focuses on instances where the plan or IRA investor is expecting the appraiser to provide advice regarding the market value of an asset that the investor is considering to acquire, dispose, or exchange.

### **4.3 Impact on Plan Participants of New Proposal**

Plan participants gain value when a plan’s investment advisers, in competition to provide the best value to the plan, deliver high quality advice in plan participants’ exclusive interest at competitive prices. Harm can result, however, if advice is tainted by unmitigated conflicts of interest, which may occur when a plan’s advisers strike deals with other service providers for additional consideration at the plan’s expense or subordinate the plan participants’ interest to someone else’s.

Participants in participant-directed DC plans also benefit from various kinds of support for their own decisions about the investment of the assets in their own accounts. As detailed above in the discussion of IRAs, most consumers are not financially sophisticated and are prone to costly investment errors. Consequently, they can benefit from personalized, competitively priced fiduciary investment advice. They also can benefit from investment education that does not provide specific, individualized investment recommendations.

The new proposal includes a number of measures calibrated to ensure that investment advice is aligned with plan participants’ interests, without impairing plan sponsors’ ability to make available investment education. These measures are found in the major proposed revisions to the 1975 rule and in conditions attached to the accompanying proposed PTEs.

The new proposal also provides important limitations carve-outs that apply to activities the Department believes Congress did not intend to include as fiduciary “investment advice,” because they do not present dangerous opportunities for service providers to self-deal and are not characterized by a relationship of trust where clients reasonably expect service providers to act solely in the client’s interests.



### 4.3.1 Promoting Good Advice and Education

Under the new proposal, more of the investment advice that plan officials and participants rely on will be treated as fiduciary advice under ERISA and the IRC. As a result, much more advice will have to be prudent, loyal to participants' interests, and free from bias. Such good advice will promote sound investment decisions and better retirement security results. The new proposal also includes measures to promote financial education, including education that supports plan participants' decisions about plan distributions.

#### 4.3.1.1 Advice to Plan Sponsors and other Plan Officials

As discussed above, investment advice rendered to plan sponsors and other plan officials is sometimes conflicted, and these conflicts sometimes bias the advice. Sponsors and plan officials following biased advice may make poor investment decisions, which can compromise participants' retirement security. The new proposal includes a number of measures calibrated to ensure that advice to plan sponsors and officials is prudent, loyal to participants' interests and unbiased.

The new proposal would substantially relax certain parts of the 1975 rule's five-part test. Under the new proposal, advice could be fiduciary in nature if it consists of a single recommendation given once (relaxing the 1975 rule's requirement that the advice be given on a regular basis). Advice would be fiduciary if it was arranged or understood that the advice is individualized or directed at a particular plan or individual for consideration in investment decisions, or if the adviser represented that he or she was acting as a fiduciary (relaxing the 1975 rule's requirement that the advice be individualized and mutually agreed to serve as a primary basis for investment decisions). Plan sponsors and officials will gain value from these provisions, because they would reduce the potential for harm from biased advice being provided to them. Plan sponsors and officials sometimes rely on recommendations that are presented, implicitly or explicitly, as trustworthy advice, but where the advice is not provided regularly, or where the adviser maintains that there is no mutual agreement, arrangement, or understanding that the advice will be individualized or intended to serve as a primary basis for investment decisions. This is especially true in the current investment marketplace where plans invest not only in stocks and bonds but also in more sophisticated investment products such as partnerships, private equity funds, real estate, and hedge funds.

As noted above, because under the 1975 rule such recommendations currently are not fiduciary advice under ERISA or the IRC, the adviser providing the recommendations may be conflicted, and the advice may be biased. The adviser owes no fiduciary duty of prudence and loyalty to participants' interests, and faces no liability under ERISA for harm that may result from the individual following biased investment advice. Under the new proposal such recommendations would constitute fiduciary advice under ERISA and the IRC. The adviser would have to avoid conflicts, or mitigate them by satisfying the protective conditions of an applicable PTE, and would owe plan sponsors, officials, participants, and beneficiaries duties of prudence and loyalty. If the adviser breaches these duties, plan sponsors, officials, participants, beneficiaries, or the Department could hold the adviser accountable for any resultant losses.

The provisions also would ensure that advice that is sold as fiduciary advice can be trusted to be so. The 1975 rule applies the five-part test even to persons that have held themselves out to plan sponsors as fiduciary advisers. Thus, an adviser can hold itself out as a plan fiduciary in its written contract with the plan sponsor, render advice about investments for a fee, and still argue that its advice was insufficiently "regular," "primary," or otherwise failed to meet each and every



one of the five elements of the test. The new proposal provides that an adviser is a fiduciary if it directly or indirectly represents or acknowledges that it is acting as a plan fiduciary with respect to providing investment advice. This will produce value for plan sponsors and plan participants by ensuring they can rely on the expert guidance provided by consultants and other advisers who represent that they are fiduciaries providing impartial investment advice, without being concerned that the adviser will disavow fiduciary status if something goes wrong.

The new proposal also would treat as fiduciary advice certain recommendations of investment managers or investment advisers. As noted previously, the SEC has documented numerous instances in which pension consultants recommended investment managers with whom they did business to plan sponsors without disclosing these conflicts, and GAO found that these conflicts were associated with 130 basis points of underperformance. While the Department has made special efforts to target such abusive situations for enforcement action, these efforts have been impaired by the difficulty of establishing the consultants' fiduciary status under the 1975 rule. This provision of the new proposal will produce value for plan sponsors by ensuring that consultant recommendations of investment managers are unbiased and by holding consultants accountable for ensuring that such recommendations are prudent and loyal to plan sponsors' and participants' interests.

Finally, the new proposal would clarify that AO 76-65A, which ruled that certain ESOP valuations are not fiduciary investment advice, does not apply outside the context of ESOP valuations, providing instead that certain valuations of plan assets in connection with transactions do constitute such advice. Under the new proposal, persons performing relevant valuations would be considered investment advice fiduciaries and thus, required to be prudent, loyal to participants' interests, and unbiased. Plan investors could therefore more confidently buy and sell hard-to-value assets at fair prices for which no market price can be observed.

According fiduciary status to certain service providers that provide investment advice to plan officials, and subjecting them to the full extent of remedies under ERISA, would create more beneficial arrangements in the pension plan service provider market by ensuring that advice is prudent, loyal to participants' interests and unbiased. The new proposal will produce value for plan sponsors and participants by enabling more optimal decisions regarding plan investments as the risk of receiving and then acting on conflicted advice will be lessened. In instances where advisers commit abuses, the new rule will additionally produce value for plan sponsors and other plan fiduciaries by making it possible to recover losses from the advisers rather than solely from the plan fiduciaries that in good faith relied on the advice.

#### **4.3.1.2 Advice to Plan Participants**

Many plan participants currently are at risk of receiving and following biased investment advice. They are especially vulnerable to being harmed by conflicted advice when they receive recommendations on whether to take a plan distribution and roll over plan assets into an IRA, because the Department, in AO 2005-23A, interpreted the 1975 rule to provide that such recommendations generally do not constitute fiduciary investment advice under ERISA.

To ensure that plan participants are protected from conflicted advice with respect to one of the most important financial decisions regarding their retirement assets, the new proposal specifically includes recommendations concerning the investment of assets to be rolled over or otherwise distributed from the plan. Participants will gain value from this provision, because it will limit their exposure to harm caused by advisers' conflicts of interest by clearly placing recommendations to take distributions (and thereby withdraw assets from existing plan

investments) or to entrust plan assets to particular money managers, advisers, or investments within the scope of covered investment advice.

Additionally, the new proposal draws a critical distinction between fiduciary investment advice and non-fiduciary investment information and educational materials by clearly stating that an adviser does not provide fiduciary investment advice if it merely provides participants with information about plan distribution options, including the tax consequences associated with the available types of benefit distributions. This will ensure that participants continue to receive common types of distribution-related information that they find useful. Such educational support will benefit plan participants by helping them make better decisions about plan distributions and achieving better investment outcomes.

Plan participants are also vulnerable because a provision in IB 96-1 provides that educational programs that identify specific investment products as examples of sound investment strategies do not constitute fiduciary investment advice, but rather are purely educational. Such recommendations and examples sometimes reflect service providers' own interests, and compromise participants' retirement security. In order to protect plan participants from these conflicts, the new proposal supersedes the IB by removing the provision that allowed specific examples to be considered education rather than fiduciary advice. This will produce value for participants and beneficiaries by ensuring that neither plan service providers nor outside advisers steer participants and beneficiaries toward investment products that benefit the advisers at their expense. It also will ensure that fiduciaries will have to avoid conflicts or adhere to fiduciary standards in order to promote their products.

The new proposal also produces value for plan participants by preserving the IB's provisions that facilitate general investment education. Therefore, the furnishing of plan information, general investment and financial information, asset allocation models, and interactive investment materials to a plan, plan fiduciary, participant or beneficiary will not constitute the rendering of investment advice, irrespective of who provides the information (e.g., plan sponsor, fiduciary or service provider), the frequency with which the information is shared, or the form in which the information and materials are provided (e.g., on an individual or group basis, in writing or orally, or by way of video or computer software).

### **4.3.2 More Effective Enforcement**

By amending the 1975 rule to broaden the scope of plan services that would be considered fiduciary investment advice, the new proposal would enhance the Department's ability to redress service provider abuses that currently exist in the market, such as undisclosed fees, misrepresentation of compensation arrangements, and biased appraisals of the value of employer securities and other plan investments. It would also allow the Department to more effectively and efficiently allocate its enforcement resources. More effective Department activity would benefit plan fiduciaries, participants and beneficiaries, both by deterring abuse and by improving loss recoveries when abuse does occur. The new proposal also would empower other plan fiduciaries and plan participants to exercise their own legal rights to redress more adviser abuses, thereby further deterring abuse and improving loss recoveries.

#### **4.3.2.1 Redressing Valuation Abuses**

As discussed above, valuation abuses have inflicted serious losses on plans and affected plan participants. However, a Department AO which held that certain ESOP-related valuations are not fiduciary investment advice has impaired the Department's efforts to hold accountable the professional appraisers who commit such abuses. The new proposal would clarify that this AO

does not apply outside the context of ESOPs, and thereby treat relevant valuations as fiduciary investment advice, making appraisers accountable.<sup>286</sup> As stated in Section 4.2: Need for Regulatory Action above, EBSA's CAP focuses on the receipt of improper, undisclosed compensation by pension consultants and other investment advisers, and whether the receipt of such compensation violates ERISA, because the adviser/consultant acted as a fiduciary and used its position with a benefit plan to generate additional fees for itself or its affiliates. EBSA's enforcement actions are impeded by the need to establish that all elements of the 1975 rule's five-part test are met. Investigators spend an inordinate amount of time gathering evidence to satisfy all elements of the five-part test rather than focusing on the misconduct involved in a particular case.

The new proposal would largely remove this impediment by relaxing major elements of the 1975 rule's five-part test. Under the new proposal, fiduciary advice need not be provided on a regular basis pursuant to a mutual agreement, arrangement or understanding that the advice would be a primary basis for investment decisions, and would include recommendations of asset managers or investment advisers. These amendments would simplify the determination of fiduciary status by eliminating difficult factual questions relating to what constitutes a "regular basis," a "mutual agreement," a "primary basis," or "individualized" advice. For example, when making a complex investment decision, a plan fiduciary may need to consult multiple advisers with different areas of investment expertise in order to make a prudent decision, and, therefore, it may be difficult to establish which advice serves as a "primary" basis for the transaction.

In relaxing these elements of the 1975 rule's five part test, the new proposal comports with the broad, statutory ERISA and IRC provisions that attach fiduciary status to any paid advice on the investment of plan assets. For all the reasons set out above, the new proposal is better adapted to ERISA's statutory framework and the Department's enforcement responsibilities.

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<sup>286</sup> In response to commenters' concerns about the scope of the 2010 proposal's related provision, new language has been added to make clear that appraisals and fairness opinions covered by the proposed regulation only include those that relate to a particular plan transaction. Further, the Department expanded the limitation contained in paragraph (c)(2)(iii) of the 2010 Proposal regarding general reports or statements setting forth the value of an investment of a plan or of its participants or beneficiaries provided to comply with the reporting and disclosure requirements of ERISA. The new limitation provides that the provision of advice or recommendations, including valuations or appraisals, to a plan, plan participant, or beneficiary solely for purposes of compliance with any reporting and disclosure provisions under the Act, the Code, and regulations, forms, schedules issued thereunder, or any applicable reporting or disclosure requirement under a Federal or state law, rule or regulation or self-regulatory organization rule or regulation will not, in and of itself, result in fiduciary status. The new proposal contains an entirely new limitation for valuations or appraisals provided to an investment fund, such as a collective investment fund or pooled separate account, holding assets of various investors in addition to at least one plan or IRA. Custodians of such vehicles typically must perform periodical valuations for purposes such as setting unit values, but the valuation statements need not be associated with any particular investment decision and the appraisers performing such valuations typically have no contractual relationship with the fund's investors. These provisions will produce value for appraisers by placing important limitations on the scope of appraisal and valuation services that will constitute fiduciary investment advice.



## 5. Cost

The Department estimates that the compliance cost associated with the proposal will total between \$2.4 billion and \$5.7 billion over 10 years, mostly reflecting the cost incurred by new fiduciary advisers to satisfy relevant PTE conditions.

### 5.1 Background

As discussed above, the 2010 Proposal prompted over 200 comments. Several of the comments asserted that the Department's economic analysis did not provide a robust estimate of the likely costs that would be imposed on the financial services industry, particularly broker-dealers (BDs), if the proposal were adopted. On several occasions, the Department requested data from the regulated community that would allow it to quantify these costs. The Department's objective in making such requests was to have quality data needed to develop the economic analysis. To date, however, the Department generally has not received such data.<sup>287</sup>

On March 1, 2013, the SEC similarly released a request for data and other information (RFI) relating to the benefits and costs that could result from various alternative approaches regarding the standards of conduct and other obligations of broker-dealers and investment advisers.<sup>288</sup> The SEC received a significant response to the RFI, and the Department reviewed the comments in developing the economic analysis for the new proposal to ascertain whether any relevant data were provided by the industry that would inform the Department's cost analysis of the new proposal.

The Department found two comment letters to be particularly relevant.<sup>289</sup> The first from SIFMA provided estimated costs that would be incurred by broker-dealers if the SEC promulgated a regulation establishing a uniform fiduciary standard pursuant to the SEC Dodd-Frank Study 2011, 65. These estimates were based on a survey of 18 of its members. The second comment letter from the Investment Adviser Association (IAA) reported costs that are incurred by its RIA members to comply with the 1940 Act based on a recent survey of investment advisers. As discussed more fully below, the Department used these data as a basis to estimate a range for the likely aggregate costs of the proposal. However, while the Department used the data obtained from the SIFMA comment letter, the data appear to significantly overstate the cost of compliance. The reasons are discussed in detail below. While acknowledging the incentives to overstate cost estimates presented to a regulator, there is still useful information contained in the provided estimates. An adjustment is made to correct for some, but not all of the upward bias.

The Department believes the higher end of the estimated cost range represents an over-estimate, because it implicitly assumes that existing business models will change only as necessary to come into compliance, and will retain their existing market shares, when in fact new, more cost-

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<sup>287</sup> The Financial Services Institute sent its Broker-Dealer Financial Performance Study to the Department for several years. The Department used data from the reports where relevant and appreciates receiving the reports.

<sup>288</sup> SEC Release No. 69013, IA-3558, "Duties of Brokers, Dealers and Investment Advisers," 2013.

<sup>289</sup> SIFMA Oct. 5, 2011 comment and Investment Adviser Association July 3, 2013 comment on SEC RFI for fiduciary standard; available at: <http://www.sec.gov/comments/4-606/4-606.shtml>.

effective business models are already gaining market share, and the new proposal is likely to encourage such market improvements (*see* Section 8.3.5 below). The lower end of the estimated range incorporates lower available bases, but should not be interpreted as a lower bound because it likewise neglects such ongoing market improvements and the new proposal's positive effects thereon.

## 5.2 Affected Entities

As a first step in estimating the cost of the new proposal, the Department estimated the number of firms and individuals that will be affected by the rule. To improve accuracy in the estimates, the firms and individuals were grouped by size and market segment serviced. This Section discusses how the Department estimated the number of BDs, RIAs, and ERISA plan service providers that are affected by the rule.

### 5.2.1 BDs and RIAs

The SEC informed the Department that 4,410 BDs were registered with them as of year-end 2013. The SEC also reported that about 600,000 BD registered representatives have registered with the agency. According to the SEC Dodd-Frank Study, more than 11,000 RIAs are registered with the SEC and more than 15,000 RIAs are registered with the states. Further, there are approximately 275,000 state-registered RIA representatives.<sup>290</sup>

Counts of RIAs and BDs contain considerable overlap. According to the SEC Dodd-Frank Study, about five percent of the SEC-registered RIAs are also registered as BDs, and about 88 percent of RIA representatives are also registered as BD representatives. Approximately eighteen percent of FINRA-registered BDs are also registered as RIAs.

### 5.2.2 ERISA Plan Service Providers

Other service providers,<sup>291</sup> primarily for ERISA plans, also will be affected by the rule and accompanying exemptions. Using data from the 2012 Form 5500 Schedule C, the Department estimates that there are approximately 5,760 service providers to ERISA-covered plans that could be affected.<sup>292</sup>

### 5.2.3 Dividing Firms into Small, Medium, and Large Categories

The Department expects that firms will incur different costs to comply with the requirements of the re-proposed rule and related exemptions based on their size. Therefore, to improve accuracy in these cost estimates, the Department grouped firms and individuals by size and market segment serviced. The Department divided the 4,410 BD firms into large, medium, and small categories. While a preferred measure on which to measure a firm's size would be

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<sup>290</sup> SEC "Dodd-Frank Study," 2011.

<sup>291</sup> In order to provide a reasonable estimate, service providers with reported service codes corresponding to recordkeeping, consulting (general and pension), insurance agents and brokers, brokerage (real estate), brokerage (stocks, bonds, commodities), valuation appraisals, participant communications, investment advisory (participants and plans) were used.

<sup>292</sup> Form 5500 data last accessed Dec. 5, 2014, <http://www.dol.gov/ebsa/foia/foia-5500.html#2011>.

revenue, that information was not available. Therefore the Department based its assessment of firm size on a firms' capital using data reported by the SEC in the 2011 FOCUS Report.<sup>293</sup> While there is more than one way to group the firms based on the FOCUS Report, the Department believes it took a reasonable approach by categorizing firms with capital greater than \$1 billion as large, firms with capital between \$50 million and \$1 billion as medium-sized, and firms with less than \$50 million in capital as small. Because the BD firm counts provided by the SEC were from year-end 2013 and the FOCUS Report data were from 2011, the Department used the percent of firms in each category from the 2011 FOCUS Report to allocate the 4,410 broker-dealers (from 2013) into large, medium, and small firm groupings. As reported in Table 5.2.3-1, this results in 42 large firms, 233 medium firms, and 4,135 small firms.

The Department also divided the 30,000 RIA firms into large, medium, and small categories. The Department based these size categories on a firm's assets under management using data reported by the SEC from the 2014 Investment Adviser Information Report.<sup>294</sup> While there is more than one way to group the firms based on this report, the Department believes it took a reasonable approach by categorizing firms with more than \$100 billion in assets under management as large, firms with between \$1 billion and \$100 billion in assets under management as medium-sized, and firms with less than \$1 billion in assets under management as small. The Department considers the number of all RIAs that register with the states to be small. However, current data on the total number of RIAs registered with the states were not available. Because the total RIA counts were from 2010 and the Investment Adviser Information Report data were from 2014, the Department used the percentage of firms in each category to allocate the 30,000 RIAs into large, medium, and small firm categories. As reported in Table 5.2.3-1, this results in 132 large firms, 3,539 medium firms, and 26,329 small firms.

Dividing ERISA plan service providers into size categories posed challenges. While the Form 5500 Schedule C contains fee information, it does not include all revenue sources. Therefore, the Department assumed a size distribution for service provider firms of 5 percent large, 15 percent medium, and 80 percent small. This distribution is more skewed towards large firms than the distribution used for BDs and RIAs.

Not all BDs and RIAs serve plan or IRA investors. A survey conducted by the Investment Adviser Association found that 40 percent of RIAs advise ERISA plans or are pension consultants, while 19 percent advise retail individuals.<sup>295</sup> The Department has not been able to ascertain how much overlap there is between these two groups, and what share of RIAs actually advise IRA investors. To provide a conservative estimate, the Department assumes that there is no overlap and therefore 59 percent of firms advise either an ERISA plan or IRA investors and will be affected by the rule.

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<sup>293</sup> Under SEC Rule 17a-5, broker-dealers are required to file with FINRA reports concerning their financial and operational status using SEC Form X-17A-5, also known as a Financial and Operational Combined Uniform Report or "FOCUS" Report. The Department used FOCUS Report data contained in the SEC's Financial Responsibility Rules for Broker-Dealers (78 Fed. Reg. 51824, 51869 (Aug. 21, 2013)).

<sup>294</sup> SEC Investment Adviser Information Reports (June 2, 2014); available at: <http://www.sec.gov/foia/docs/invafoia.htm#.U6negzYpC73>.

<sup>295</sup> Investment Adviser Association, "2013 Investment Management Compliance Testing Survey," 2013.



To calculate the number of firms servicing the ERISA and IRA markets, the Department further assumes that all large RIAs will service both markets. In other words, the Department assumes that 100 percent of large firms service both markets, but only 59 percent of the firms in the medium and small categories serve those markets. Similar data were not available for BDs, so they were assumed to have similar shares of this market as RIAs.

<b>Table 5.2.3-1 Affected Firms</b>			
	<b>Firms Divided into Large, Medium and Small</b>	<b>Firms not Serving ERISA or IRAs Removed</b>	<b>Double Counting Removed</b>
<b>Large BD</b>	42	42	42
<b>Medium BD</b>	233	137	137
<b>Small BD</b>	4,135	2,440	2,440
<b>Large RIAs</b>	132	132	124
<b>Medium RIAs</b>	3,539	2,088	2,063
<b>Small RIAs</b>	26,329	15,534	15,095
<b>Large Plan SP</b>	142	142	145
<b>Medium Plan SP</b>	427	427	427
<b>Small Plan SP</b>	2,275	2,275	2,275

As discussed above, 18 percent of BDs are dually registered as RIAs. While both BDs and RIAs will have to make changes, the Department expects that BDs will have higher compliance costs. For dually registered firms, the costs for each part of its business are not mutually exclusive—therefore, they can be shared as both parts of the firm will have to comply with the same regulations and exemptions. Also, as discussed above, 88 percent of RIA representatives are dually registered as BD representatives. If a firm is dually registered, the Department counted it as a BD for compliance cost-estimating purposes and assigned it the higher costs associated with BDs. Similarly, the 470 service providers reported on Schedule C as providing securities brokerage services are counted as BDs.

### **5.3 Methodology for Cost Estimates**

As discussed above, due to the lack of other data sources on which the Department could base its cost estimates for the new proposal, the Department used estimates submitted by SIFMA, IAA, and Charles Schwab to the SEC in response to its request to estimate costs. The SEC RFI assumes that a new fiduciary standard would require BDs to provide disclosure in the form of a general relationship guide similar to Form ADV Part 2A that is delivered at the time of entry into a retail customer relationship. In its response, SIFMA provided estimates of the cost to implement a uniform fiduciary standard for brokers-dealers in two specific ways. The estimates were derived from a survey of 18 SIFMA member firms (12 large broker-dealers, 6 regional broker-dealers). SIFMA reported that 17 of the 18 members responded to the survey. The Department used data from the SIFMA response to estimate per-firm costs for broker-dealers. In November 2014, the Department requested to receive a copy of the survey instrument from SIFMA. In response,

SIFMA provided excerpts from the instrument containing certain questions but not the entire survey instrument.

The first estimate was the cost of developing and maintaining a disclosure form and customer relationship guide. To receive data for this estimate, SIFMA surveyed its members regarding the “prospective costs associated with developing, preparing, maintaining, and updating such an up-front disclosure and relationship guide.”

While there will be substantive differences between the Department’s new proposal and exemptions and any future SEC regulation that would establish a uniform fiduciary standard for BDs and RIAs, there are also some similarities between the cost components in the SIFMA survey and cost that will be incurred by BDs to comply with the Department’s new proposal and exemptions. For example, with respect to the first estimate regarding up-front disclosures, SIFMA asked its members “to consider any (i) outside legal counsel costs, (ii) outside compliance consultant costs, (iii) other out-of-pocket costs, and (iv) employee- and staff-related costs. For each of these components, [SIFMA] also asked [its] members to consider the initial, one-time, up-front costs to develop and prepare the guide, as well as the ongoing annual costs to maintain and update the guide.”

In responding to the survey, SIFMA asked its members “to assume that that relationship guide would contain a description of, among other things, the firm’s services and fees, and the scope and terms of advisory services offered to retail customers, including: (i) whether advice and related duties are limited in time or are ongoing, or are otherwise limited in scope (e.g., limited to certain accounts or transactions); (ii) whether the BD only offers or recommends proprietary or other limited ranges of products; and (iii) whether, and if so the circumstances in which, the BD will seek to engage in principal trades with a retail customer. The guide could include disclosure of other material conflicts of interest, such as conflicts of interest presented by compensation structures. Firms would also be required to maintain and update the guide with new, material disclosures and as developments arise in terms of regulatory guidance, legal precedent, and changes in the firm’s practices.”

The reported costs for preparing a relationship guide similar to the Form ADV Part 2A was an average start-up costs of \$2.8 million with a low of \$1.2 million and a high of \$4.6 million and an average annual on-going cost of \$631,000.

In addition to up-front disclosures, SIFMA also surveyed its members regarding an estimate of the costs required for BD firms to develop and implement a new, comprehensive compliance and supervisory system and procedures and related training programs to adapt to the new uniform fiduciary standard. SIFMA states in the response that firms also would be required to maintain and update their systems and procedures, and conduct initial and periodic training, as developments arise in terms of regulatory guidance, legal precedent, and/or the firm’s practices. SIFMA asked its members to consider cost components such as: (i) information technology suppliers and vendors; (ii) information technology systems, hardware and software, support and testing/audit; (iii) communications, marketing, business review and risk review; (iv) training materials: creating, editing, and circulating new materials; reviewing, editing, finalizing, and publishing all impacted training materials; (v) training: providing training and communication to all impacted personnel, particularly sales and operations personnel; (vi) reviewing and updating all existing client contracts and client disclosures (including documentation and delivery of disclosure); (vii) reviewing and updating of sales surveillance tools, all impacted policies and procedures, including written supervisory procedures; (viii) publishing and distributing revised policies and procedures; (ix) reviewing, editing, finalizing and publishing all impacted marketing materials; and (x) updating exam test modules and instructions, training examiners, and executing

additional testing procedures across all branch offices. The Department believes that BDs would incur similar costs to develop and implement compliance systems to ensure that the requirements of the new proposal and exemptions are met.

The reported costs to develop and implement new, comprehensive supervisory systems and procedures and training included an average start-up cost of \$5 million with a low of \$1 million and a high of \$6 million and an annual on-going cost of \$2 million. SIFMA also reported that the respondents to its survey had average compliance costs for FINRA Rule 2111 (suitability standards) of \$4.6 million (the Department believes that this included start-up and ongoing costs).

Charles Schwab<sup>296</sup> reported in their comment letter that they had compliance costs for FINRA Rule 2111 (suitability standards) of \$5.5 million. Based on the company's description, it is the Department's belief that this number is the total costs of compliance to date (start-up and ongoing costs).

Although the SIFMA data were helpful in evaluating the cost of the new proposal, there is a reason to be concerned that the SIFMA submission significantly overestimates the costs of the new proposal. The Investment Adviser Association comment to the SEC provided a report of a survey of their members on the actual cost of compliance with the Form ADV Part 2A and Part 2B. The information supplied indicates that the reported costs are on-going costs of compliance, not start-up costs. While there are arguments for why BDs could have higher startup cost than RIAs, once the documents and systems are in place yearly updates should be similar. Additionally, the size of the reporting firms in the two groups may not be the same. The SIFMA survey respondents could all be characterized as large BD firms, while the Investment Adviser Association survey respondents included firms of all sizes, although small firms were underrepresented, and large firms were over-represented. Firms with over \$10 billion in assets under management (AUM) made up about 28 percent of the respondents and those with over \$20 billion in AUM made-up 20 percent of the sample. But only 5 percent reported compliance cost over \$100,000 and only a single respondent reported costs over \$500,000. Those 20 percent of firms with over \$20 billion in AUM are among the largest three percent of RIAs. Accordingly, the Department looked at large RIA firms and constructed a weighted average cost of almost \$140,000 (see "BDs Scenario A" below for details of the calculation).

As a comparison SIFMA's respondents reported an estimated average ongoing cost of \$631,000 for a document similar to Form ADV Part 2A. It should also be noted that the SIFMA comment did not include costs for Form ADV Part 2B, but the Investment Adviser Association reported costs does. In fact SIFMA reported that to also implement Form ADV Part 2B would create substantial costs in addition to the reported cost. This suggests that SIFMA's estimates could be overstated by more than 450 percent relative to the costs that large RIAs actually incurred complying with Form ADV Parts 2A and 2B.

In addition to the reasons already discussed above there are additional reasons to believe that the use of the costs from the comments would over-estimate the costs of compliance with the proposed rule and exemptions.

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<sup>296</sup> Charles Schwab Comment Letter on FINRA Rule 2111 (July 5, 2013); available at: <http://www.sec.gov/comments/4-606/4606-3137.pdf>.

BDs recently implemented FINRA Rule 2111. The rule requires a firm and its associated persons to “have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer’s investment profile.”

Many of the pieces of information needed by BDs to institute a best interest standard may already be required by FINRA rules to be known to the BD. BDs also just evaluated their compliance systems and updated their computer systems due to FINRA Rule 2111. The flexibility of the DOL proposed rules and exemptions allows firms to decide how best to deal with conflicts. As a result firms may be able to use systems and procedures they have already developed to implement a best interest standard. This flexibility could result in minimal new costs of compliance.

RIAs would be expected to incur substantially lower costs to comply with the proposed regulations and exemptions. Investment advisers are subject to a comprehensive regulatory regime for providing advice to all of their clients, which requires them to serve as a fiduciary acting in the best interests of clients. Moreover, as fiduciaries, investment advisers must treat their clients fairly and not favor themselves or favor one client over another, especially if the adviser would somehow benefit. In addition, under the federal securities law fiduciary standard, whenever the interests of an adviser differ from those of its clients, the adviser must explain the conflict to the client, and act to mitigate or eliminate the conflict.

Investment advisers must provide extensive disclosures to their clients on Form ADV, which requires information about an adviser’s business, client base, industry affiliations, services, and compensation, and how it identifies and addresses potential conflicts of interest. Advisers are also subject to restrictions on advertising, entering into principal trades and agency cross transactions, holding client assets, contributing to political candidates, choosing broker-dealers, receiving soft dollar benefits, and personal investing.

Furthermore, federally-registered RIAs must (and state-registered RIAs may<sup>297</sup>) establish an internal compliance program that addresses the adviser’s performance of its fiduciary and substantive obligations under the Advisers Act. Each adviser must also adopt and implement written policies and procedures reasonably designed to prevent the adviser and its personnel from violating the Advisers Act, and must review the effectiveness of the policies and procedures at least annually. In addition, advisers must adopt written codes of ethics, which must set forth standards of conduct expected of advisory personnel to reflect advisers’ fiduciary obligations and to address conflicts that arise from personal trading by advisory personnel. Therefore, in order to comply with the new proposal and exemptions, RIAs may be required only to incur incremental additional costs to review and revise their business practices, contracts with clients, and policies and procedures to ensure that they are in compliance with the new proposal.

The compliance cost estimates presented in this section reflect the costs resulting from the proposed rule. The Department intends for the rule to operate in harmony with obligations

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<sup>297</sup> The Department invites the public to provide data as to whether state-registered advisers currently perform these functions.

imposed by the SEC, FINRA, IRS, and other regulators and has worked to ensure that the compliance requirements are harmonized across the many regimes in which advisers operate. The Department invites feedback, data, and analysis on how the proposed rule would interact with other regulations and whether and how such interactions should affect the estimates of compliance costs.

## 5.4 Presentation of Cost Estimates

As discussed above cost estimates were provided by industry groups in response to an SEC RFI.<sup>298</sup> This section discusses how those submissions were used to estimate the cost of the proposed regulation and exemptions. Several key assumptions had to be made; therefore several scenarios will be discussed below with each scenario using different assumptions leading to different total costs. While two scenarios are presented as possible cost estimates, for reasons discussed above Scenario A likely overstates the costs of the proposed regulations and exemptions by a substantial margin. Scenario B is a more reasonable estimate, but probably also overstates the costs because of the flexible standards-based approach of the Department's new proposal, which would enable firms to comply in the most cost-effective way in light of their current practices and systems.

### 5.4.1 BDs Scenario A: Over-Estimate

As discussed above, SIFMA provided a comment letter containing cost estimates. The estimates were provided by twelve firms that generated hundreds of millions or billions of dollars in revenues and six firms that generated hundreds of millions of dollars in revenues. While SIFMA did not disclose the identity of the participating firms, they appear to have been among the largest firms.

As discussed above, BD firms have been broken into three categories: large, medium, and small. Because SIFMA's cost estimates were derived from the responses of only the largest firms, the Department had to estimate (and likely overestimate) costs for smaller firms using the data from larger firms.

The SIFMA comment letter estimated that firms would expend \$5 million in start-up costs to develop and implement a new, comprehensive compliance and supervisory system. This reported cost was used as an estimate for the cost of compliance with the rule and exemptions for all large BD firms. The Department has also added some additional costs for items that do not appear to have been included.

The Department believes that few of the firms that it classified as medium-sized were included in the firms reporting cost estimates, but it cannot be certain. While there are no reported costs for medium or small BDs there are reported costs for small, medium, and large RIAs in the IAA comment letter that could be used to estimate the ratio of medium firms' costs and large firms' costs (0.133) and the ratio of small firms' costs and large firms' costs (0.048). For ease of

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<sup>298</sup> SIFMA July 5, 2013 comment and Investment Adviser Association July 3, 2013 comment on SEC RFI for fiduciary standard, available at: <http://www.sec.gov/comments/4-606/4-606.shtml>.

future reference, these ratios are referred to as the IAA ratio. A detailed discussion of the derivation of the ratios is discussed in the footnote below.<sup>299</sup>

Scenario A, shown in Table 5.4.3-1, begins with SIFMA's cost estimate of \$5 million for large BDs, and then derives an estimate of the costs for medium and small firms by using the IAA ratios. This leads to a per firm start-up cost for medium firms of \$663,000 (\$5 million x 0.133) and \$242,000 (\$5 million x 0.048) for small firms.

The same method is used to estimate on-going costs. Starting with SIFMA's estimate of \$2 million per year for large firms, the costs are again adjusted using the IAA ratio to obtain estimated costs of \$265,000 (\$2 million x 0.133) for medium sized firms and \$96,900 (\$2 million x 0.048) for small firms.

It should be noted that using the IAA ratio could lead to an over-estimate of small firms costs, particularly for start-up costs. The IAA ratio is the ratio of on-going costs between large and small firms. If the true ratio of start-up costs between large and small firms is smaller than the IAA ratio, the small firm costs are over-stated. The Department believes this is the case as large firms are more likely to have more complex personnel and asset-management arrangements, leading to significantly higher costs relative to small firms. Also the smallest BDs may rely on the larger BDs for compliance support, again reducing compliance costs for the small BDs.

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<sup>299</sup> The IAA ratio was developed using the following methodology. IAA gathered the survey cost data as ranges, reflecting the variations that different sized firms are likely to experience. The survey found that 47 percent of respondents had reported costs below \$10,000; 19 percent between \$10,000 and \$25,000; 10 percent between \$25,000 and \$50,000; four percent between \$50,000 and \$100,000; three percent between \$100,000 and \$250,000; 1.5 percent between \$250,000 and \$500,000 and only 0.2 percent reported costs in excess of \$500,000. The remaining 16 percent of respondents indicated they did not know their costs. For those firms that reported serving individuals as a "primary service," the results were even more skewed with 68 percent of firms reporting costs as under \$10,000. Also the comment noted that those firms reporting costs at over \$100,000 were "quite large in terms of assets under management or number of employees or both."

As the costs were reported in ranges, in order to calculate an average cost for each size category some assumptions had to be made. First, all small firms were assumed to have compliance costs of less than \$10,000. While some small firms could have had cost in excess of \$10,000, firms with less than \$1 billion in assets under management made up 32 percent of the sample, but 47 percent of the sample reported less than \$10,000 in costs suggesting that not only small firms, but many medium firms had costs less than \$10,000. Within a cost range, it conservatively was assumed that the average cost was two-thirds of the range. While there is no definitive reason to choose two-thirds, it is less likely to be an underestimate of costs than would the midpoint. Therefore, small firms have an estimated cost of \$6,667 (\$10,000 x 2/3).

In a similar assumption, large firms were all assumed to have costs in excess of \$50,000. Firms with AUM of over \$10 billion made-up 28 percent of the sample, but only nine percent of the sample reported costs over \$50,000. The comment also highlighted that those firms with higher costs were all large firms. The medium size firms are assumed to fall into three of the reported ranges: less than \$10,000 (15 percent of total sample); \$10,000 to \$25,000 (19 percent of total sample); and \$25,000 to \$50,000 (6 percent of the total sample). Using weights of 0.37, 0.475, and 0.15 and a point which is two-thirds of each range, the weighted average cost for medium firms is \$18,250.

Large firms had an estimated cost of \$137,600. Like the medium sized firms, this number is a weighted average of the percent of large firms that fall into each category, starting with the \$25,000 to \$50,000 range. The weights used were 0.306, 0.298, 0.258, 0.121, and 0.016. Finally, \$18,250 and \$6,667 were each divided by \$137,600 to yield ratios of 0.133 and 0.048.

These estimates of costs, combined with estimates for the number of BDs, leads to a total estimated cost in the first year of \$892 million and in subsequent years of \$357 million.

#### **5.4.2 BDs Scenario B**

Scenario B, shown in Table 5.4.3-1 focuses on the difference between the estimates derived from the SIFMA comment regarding the costs to update and maintain a disclosure similar to Form ADV Part 2A and the reported costs from IAA to update and maintain the Form ADV Parts 2A and 2B. As discussed above the difference is substantial. The SIFMA comment reports an ongoing cost of \$631,000 while the weighted average from the IAA comment for large RIAs is only \$138,000. The ratio between the two numbers is 0.2181. This ratio for ease of reference is referred to as the ADV ratio.

Scenario B takes the cost estimates that were used in Scenario A and adjusts them using the ADV ratio to derive estimates of start-up costs of \$1 million for large BD firms, of \$145,000 for medium BD firms, and of \$53,000 for small firms. Under this approach, the ongoing costs for BD firms are \$436,000 for large firms, \$58,000 for medium firms and \$21,000 for small firms. Thus, applying this scenario, the total first year cost for BD firms is \$195 million and the cost for subsequent years is \$78 million per year. As discussed above even these estimates are believed to be overestimates, possibly by a large margin.

#### **5.4.3 RIAs**

As discussed above, the Department does not expect most RIAs to incur significant costs to comply with the new proposal, because they already operate under a fiduciary standard that requires them to act in the best interest of their clients and most are not receiving conflicted payments. Some RIAs may provide additional training to their representatives to ensure that they are complying fully with the requirements of the new proposal. The Department anticipates that any necessary additional training could be incorporated into the already existing training, minimizing burden.

To be cautious, the Department has estimated a cost for RIA firms to receive a compliance review from outside legal counsel. Also, the Department has estimated the cost associated with providing a half-day of additional training to the firms' representatives.

A consultation to evaluate and ensure a firm's compliance with the rules was assumed to be conducted by a senior partner of an outside legal firm with an hourly fee of \$480.<sup>300</sup> Small firms are more likely to have less complex arrangements, so eight hours of consultation was assumed for them, with 16 hours for medium firms, and 40 hours for large firms. This leads to estimated costs for the consultation for small firms of \$3,840, for medium sized firms of \$7,680 and large firms of \$19,200.

Following the consultation, firms might choose to provide training to their representatives to ensure that they understand when they are giving advice, and how to comply with firm policies

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<sup>300</sup> The cost of outside legal work is taken from the Laffey Matrix. The senior partner rate is the average of the 11-19 and 20+ years of experience categories. The mid-level attorney's rate is the average of the 4-7 year and 8-10 years of experience categories.



and procedures regarding investment advice. There are many alternatives for how a firm could conduct the training. Many firms already use outside vendors to train employees on many issues, including compliance issues. The training could be on-site, through webinars, or on-line according to the firm's preferences. Costs could vary based on vendor and mode of delivery. A common price for such training was found to be \$1,500. This is a price similar to four hours of a mid-level attorney's time, \$1,310 (4 x \$328). Later years would only require training to help insure compliance. A cost of \$500 was used to estimate the cost of such training. This is similar to one and a half hours of a mid-level attorney's time, \$491 (1.5 x \$328).

While small firms could provide training in a single session for all their employees, mid-sized and large firms would probably need to hold multiple sessions to keep class-size low. Training costs for mid-sized firms was estimated to be \$4,000 for the first year and \$1,500 in each subsequent year. Training costs for large firms was estimated to be \$30,000 for the first year and \$10,000 in later years. These numbers are similar to what would be obtained if the IAA ratio was used instead to obtain an estimate for the medium and large firms based on the small firms cost of training.

In total, the estimated costs in the first year for large, medium and small RIA firms to evaluate their compliance with the rule and provide training for their representatives are \$49,200, \$11,700, and \$5,300, respectively. For subsequent years, the estimated costs per RIA firm are \$10,000 for large firms, \$1,500 for medium firms, and \$500 for small firms per year.

Subsequent year costs could be even lower as firms already conduct training of their staff. Training to ensure compliance with the proposed regulations could be included with annual training resulting in minimal increases in costs.

This leads to total costs for RIA firms in the first year of \$110.8 million and for each subsequent year of \$11.9 million. *See* Tables 5.4.3-1 and 5.4.3-2.

**TABLE 5.4.3-1.--Firm Start-Up Costs (Year 1)**

Firm Type and Size		Scenario A		Scenario B	
		Per Firm Costs (Thousands)	Total Costs (Thousands)	Per Firm Costs (Thousands)	Total Costs (Thousands)
Large BD	42	\$5,000	\$210,000	\$1,091	\$45,805
Medium BD	137	\$663	\$90,829	\$145	\$19,812
Small BD	2,440	\$242	\$590,938	\$53	\$128,896
			\$891,767		\$194,513
Large RIAs	124	\$49	\$6,122	\$49	\$6,122
Medium RIAs	2063	\$12	\$24,100	\$12	\$24,100
Small RIAs	15,095	\$5	\$80,606	\$5	\$80,606
			\$110,828		\$110,828
<b>Plan Service Providers</b>					
Large	142	\$49	\$6,986	\$49	\$6,986
Medium	437	\$12	\$4,987	\$12	\$4,987
Small	2,275	\$5	\$12,148	\$5	\$12,148
			\$24,122		\$24,122
		<b>Total</b>	<b>\$1,026,717</b>	<b>Total</b>	<b>\$329,463</b>

TABLE 5.4.3-2.--Firm On-Going Costs (Subsequent Years)						
Firm Type and Size		# of Firms	Scenario A		Scenario B	
			Per Firm Costs (Thousands)	Total Costs (Thousands)	Per Firm Costs (Thousands)	Total Costs (Thousands)
Large BD		42	\$2,000	\$84,000	\$436	\$18,322
Medium BD		137	\$265	\$36,332	\$58	\$7,925
Small BD		2,440	\$97	\$236,375	\$21	\$51,558
				\$356,706		\$77,805
Large RIAs		124	\$10	\$1,244	\$10	\$1,244
Medium RIAs		2,063	\$2	\$3,095	\$2	\$3,095
Small RIAs		15,095	\$1	\$7,547	\$1	\$7,547
				\$11,887		\$11,887
<b>Plan Service Providers</b>						
Large		142	\$10	\$1,420	\$10	\$1,420
Medium		427	\$2	\$641	\$2	\$641
Small		2,275	\$1	\$1,137	\$1	\$1,137
				\$3,198		\$3,198
<b>Total</b>				<b>\$371,792</b>	<b>Total</b>	<b>\$92,890</b>

#### 5.4.4 Plan Service Providers

It is believed that many of the other plan service providers will incur minimal costs to comply with these regulations. Many of them may largely fall outside the scope of the fiduciary investment rule, meet the terms of one of the exceptions from the rule, or not rely for profits on the sort of conflicted fee arrangements that would require relief under a PTE.

One of the largest costs that these firms face could be training their employees to recognize when they are offering advice, so that they do not cross the line between education and advice and become fiduciaries unintentionally.

Costs for these firms are estimated in the same way as the costs for RIA firms. The estimate includes costs for a consultation with an outside attorney to evaluate the firms' practices and procedures and then training for the employees of the firms that could be giving investment advice. The per-firm costs are identical to the per-firm costs discussed above for RIAs.

With 2,275 small service providers, 427 medium service providers, and 142 large service providers, this results in aggregate start-up costs of \$24.1 million and on-going costs of \$3.2 million annually.

## 5.5 Additional Costs of Assuming Fiduciary Status

In addition to estimating cost based on industry-provided data, the Department also estimated additional expenses such as the cost of increased insurance premiums some firms may incur, such as when they switch from broker-dealer to RIA status. The premiums for insurance - such errors and omissions or fiduciary liability insurance - would increase to cover additional responsibilities and expenses they may incur under the regulation to the extent they are required to or wish to purchase such insurance. These cost estimates are discussed below.

### 5.5.1 Increased Insurance Premiums

Some service providers purchase insurance, such as errors and omissions insurance, to protect themselves from financial exposure for claims made by clients alleging negligence, errors or fiduciary breaches resulting from rendered services. As further discussed below, the Department expects some insurance premiums to increase for certain service providers under the broader fiduciary investment advice definition provided in the new proposal. Much of the additional cost comprises transfers from service providers to plans, participants, beneficiaries, and IRA investors through the payment of recoveries. The Department estimates that 50 percent of the cost reflects the expenses and profits of insurance carriers and agents who sell the policies, while the remainder is not a cost but a transfer in the form of compensation paid to those harmed by the insured fiduciary investment adviser.<sup>301</sup> This transfer could even be considered as contributing to a just outcome because those harmed are now compensated. The change in profits could be a transfer as well (to insurance carriers and agents, from advisers and also from investors if advisers can pass through the premium payments to their clients). However, due to limitations of the literature and available evidence, the Department is not able to estimate the fraction of the profits that could be a transfer.

In response to the 2010 proposal, several commenters expressed concern that the Department's cost analysis did not provide an estimate of increased insurance premiums. The commenters did not provide any data or estimates regarding the number of affected service providers or the amount of the anticipated premium increase. Therefore, the Department's estimate of the premium increase is based on the best available data and assumptions discussed below.

The new proposal broadly defines fiduciary investment advice subject to certain carve-outs that exclude special circumstances that the Department believes should not be treated as fiduciary in nature.<sup>302</sup> Under the broad definition, a person renders investment advice by (1) providing

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<sup>301</sup> Based on conversations with industry consultants.

<sup>302</sup> For example, the regulation would not treat recommendations made by a party on the opposite side of a large plan in an arm's length transaction as fiduciary investment advice provided that the carve-outs' specific conditions are met. Similarly, the proposal includes specific carve-outs relating to employees of the plan sponsor and platform providers. Additionally, the rule draws a distinction between covered fiduciary investment advice and non-fiduciary investment or retirement education. As the regulation makes clear, a person does not render investment advice merely by providing educational materials or information on generally recognized investment principles or by furnishing objective financial reports or information on investment alternatives. All of the rule's carve-outs are

investment or investment management recommendations or appraisals to an employee benefit plan, a plan fiduciary, participant or beneficiary, or an IRA investor or fiduciary and (2) either acknowledging the fiduciary nature of the advice or acting pursuant to an agreement, arrangement, or understanding with the advice recipient that the advice is individualized to, or specifically directed to, the recipient for consideration in making investment or management decisions regarding plan assets. When such advice is provided for a fee or other compensation, direct or indirect, the person giving the advice is a fiduciary.

The Department believes that, under the revised investment advice definition, the following categories of service providers may experience higher premiums: (1) consultants providing investment or investment management recommendations to employer-sponsored plans, plan fiduciaries, participants, and beneficiaries; (2) firms providing appraisals, valuation opinions, and similar statements whether verbal or written to plans, plan fiduciaries, participants, and beneficiaries concerning the value of securities or other property in connection with specific transactions involving the purchase, sale, or disposition of such securities; and (3) broker-dealer representatives that provide advice to plans, plan fiduciaries, participants, beneficiaries, and IRA investors that is individualized or specifically directed to them for consideration in making investment or management decisions with respect to securities or other property.

The Department understands that (1) premiums for these affected service providers could be expected to increase by approximately 10 percent due to their new fiduciary status,<sup>303</sup> (2) insurance is priced on a per-representative basis; and (3) the average insurance premium is approximately \$3,000 per representative.<sup>304</sup> Based on the foregoing, the estimated 10 percent premium increase would be approximately \$300 per insured.

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subject to conditions designed to draw an appropriate line between fiduciary and non-fiduciary communications, consistent with the text and purpose of the statutory provisions.

<sup>303</sup> The Department notes that parties providing investment advice to plans, participants, and beneficiaries for a fee must act prudently, solely in the interest of participants and beneficiaries, for the exclusive purpose of paying benefits and defraying reasonable expenses, and must diversify assets. If they breach their fiduciary duty, such service providers can be held personally liable by the Department, other fiduciaries, participants, and beneficiaries for any losses that arise from the breach and also are subject to a prohibited transaction excise tax. Service providers that provide investment advice to IRA investors and deal with IRA assets for their own interest or their own account or are paid by a third-party in connection with a transaction involving IRA assets only are subject to the prohibited transaction excise tax. For purposes of this analysis, the Department has assumed that the service providers to plans, participants, beneficiaries, and IRA investors will be the same even though their liability exposure is different. The Department welcomes comments regarding this assumption.

<sup>304</sup> This is consistent with insurance premium amounts provided by the Financial Services Institute (FSI) in its 2009 Annual Report provided to the Department. FSI is a trade group for independent providers of advice (those that are not unaffiliated with any funds). Their member statistics indicate that average errors and omissions premiums per individual were approximately \$2,300 in 2009. The Department used \$3,000 because premiums would be expected to increase since 2009. Additionally, \$3,000 was on the high end of costs for representative insurance according to a professional liability insurance distributor with whom the Department consulted. Thus, the \$3,000 premium is a reasonable and conservative estimate for estimating the increase in premiums.

### 5.5.1.1 Broker-dealers

Based on industry data, the Department estimates that approximately 354,000 broker-dealer representatives provide brokerage services to plans and IRA investors.<sup>305</sup> Also 18 percent of broker-dealer representatives are dually registered as RIA representatives. These individuals are not expected to experience an increase in premiums as they already have insurance. However, depending on how the fiduciary liability insurance is priced, premiums could increase to reflect additional exposure associated with the broker-dealer portion of their business. It is estimated that 290,000 broker-dealers (600,000 x 0.59 (1-0.18)) could experience higher premiums.<sup>306</sup>

The Department estimates that the total one-year premium increase would be approximately \$87 million (\$300 x 290,000).<sup>307</sup>

### 5.5.1.2 Plan Service Providers Excluding Broker-Dealers and RIAs

There is less data available to estimate the number of employees at other firms that service ERISA plans that will experience higher premiums. A review of 2012 Form 5500 Schedule C filings showed 2,800 unique service providers, not including BDs and RIAs, as providing services that could be impacted by the proposed rule. For purposes of this analysis, the Department conservatively assumes that all of these employee benefit plan service providers have aspects of their business that would involve providing fiduciary investment advice under the new proposal but not under the 1975 rule. What is not known is how many employees at these firms will be affected. The SEC Dodd-Frank Study presented a range of estimates of the number of BD representatives that are at BD firms. If firms provide other plan services, for example, consulting services, are staffed similarly to BD firms then the average number of representatives at a BD firm can be used as a proxy. As the data was presented in ranges, estimates of the weighted average number of representatives per firm were obtained using the high end (51.3) and mid-point of the ranges (38.4). Out of concern that using the high end of the range is an over-estimate and using the mid-point an underestimate, the average of the two numbers was used (45). Therefore 128,000 employees (2,800x 45) were estimated to possibly experience higher premiums.

In total, 418,000 BD representatives and plan service provide employees could experience a \$300 increase in premiums every year. However, as discussed above about 50 percent, or \$150, is paid to the insuring firms and the other 50 percent is paid out as compensation to those harmed,

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<sup>305</sup> SEC data indicate that BDs employ 600,000 representatives. The 2013 Investment Management Compliance Testing Survey suggests that 40 percent of firms advise ERISA plans and 19 percent of firms advise retail individuals. Combining these totals would suggest that 59 percent of firms advise plans or IRA investors. Applying this 59 percent to the 600,000 representatives yields an estimate of 354,000 BD representatives in the affected universe.

<sup>306</sup> For purposes of this analysis, the Department assumes that insurance premiums will increase by 10 percent for both plan and IRA service providers even though fiduciary breaches are treated differently in the two markets. The Department welcomes comments regarding this assumption.

<sup>307</sup> Whether (and to what degree) the costs are paid directly by the broker-dealer firm or by the representative varies by firm. *See* Financial Services Institute, *Annual Report 2009*. The Financial Services Institute finds that the median percentage of liability costs covered by broker dealers is 28 percent with the average being 48 percent. One would expect if the service provider pays a higher share, then other compensation for the representative would be lower.

which is counted as a transfer. Therefore, there could be a cost increase of \$63 million per year in premiums and a transfer of \$63 million per year from firms to plans or IRA investors.

### 5.5.2 BD Conversion to RIA Status

In response to the 2010 Proposal, representatives of the financial services industry expressed concerns that the proposal would impair access to commission-based advisory relationships for IRA investors and that such investors would be left with higher-cost, fee-based advice as their only alternative. Their comments argued that investors (especially small investors), therefore, would be harmed; they would receive less help in establishing IRAs, less investment advice, and be subject to higher minimum account balances, because providing such help to small accounts is expensive for BDs and they could not afford to do so without receiving revenue sharing payments. The financial services industry also argued that many BDs would no longer be able to service the IRA market, because they would have to become certified as RIAs, and the cost to obtain the Series 65 license required for such certification would be prohibitive.<sup>308</sup>

In response to these concerns, the Department has taken steps to ensure that BDs can continue many of their current business models by proposing additional and amended PTEs. These PTEs allow fiduciary investment advisers to receive a variety of transaction-based fees and compensation as a result of investments by plan and IRA investors subject to conditions that provide appropriate protections. Fiduciary advisers that comply with the conditions set forth in the exemptions and other guidance issued by the Department may continue many of their current business models without incurring the costs associated with converting from a commission-based business model to a RIA asset-based fee model.

Moreover, fiduciary investment advisers may take advantage of existing relief to receive additional fees without violating the prohibited transaction rules. Of particular note is the statutory exemption under section 408(b)(14) of ERISA (and section 4975(d)(17) of the IRC), which applies to the provision of investment advice under an “eligible investment advice arrangement,” as defined in paragraph (2) of ERISA section 408(g) to participants and beneficiaries of participant-directed individual account plans and IRA investors; and AO 2001-09A in which the Department concluded that the provision of fiduciary investment advice would not result in prohibited transactions where the advice provided by the fiduciary results from the application of methodologies developed, maintained and overseen by a party independent of the fiduciary. Certain relevant relief may also be available under PTEs 86-128 and 84-24.

Nevertheless, to ensure that the Department undertakes a comprehensive assessment of the costs associated with the new proposal, the Department has estimated that five percent (approximately 11,000) of BD registered representatives will convert to RIA status in each of the first five years as a result of the new proposal and that half as many will convert in each subsequent year. The primary cost associated with the conversion is the training cost required to

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<sup>308</sup> The Series 65 license is a securities license required by most U.S. states for individuals who act as investment advisers. Successful completion of the Series 65 exam permits an investment professional to function as an Investment Adviser Representative in certain states. The Series 65 exam, called the Uniform Investment Adviser Law Examination, covers laws, regulations, ethics and topics such as retirement planning, portfolio management strategies and fiduciary responsibilities.



receive a Series 65 license. For purposes of this analysis, the Department assumes that the converting BD representatives would spend 50 hours, on average, preparing for the Series 65 exam and values their time at \$106.06/hour, resulting in an opportunity cost of approximately \$5,300.309 Purchasing study materials cost an additional \$140 and registering for the test costs an additional \$155 per test taker. Finally, state registration costs \$25 per representative. Therefore, total costs are approximately \$5,600 for each BD representative converting to RIA representative status, resulting in a first year cost of \$59.4 million and a ten-year cost of \$445 million. The Department notes that some of these costs would be offset by firms and individuals that would no longer be required to register as BDs or their representatives.<sup>310</sup>

Some BD registered representatives that convert to RIA status might incur additional frictional cost, not accounted for here, to set up a new RIA firm. Others, however, might already be affiliated with or might join an existing RIA firm.

The cost of complying with PTEs might motivate some dual-hatted BDs/RIAs to convert customer accounts from brokerage, commission-based accounts to advisory, fee-based accounts. However, the Department has designed the PTEs to provide advisers with significant flexibility in choosing the business model that allows them to best serve their clients, including the choice of whether or not to receive direct and indirect variable payments, and thus expects the degree of conversion to fee-based advisory accounts to be minimal. The Department also anticipates that the compliance costs of the rule, per invested dollar, would be substantially less than the typical fee currently associated with fee-based advisory and thus most clients with brokerage accounts would choose to remain in a brokerage relationship. Finally, some comments on the 2010 proposal espoused a view that conversion to fee-based accounts would be limited as a result of limitations imposed by advisory firms on the types of accounts that they typically serve on a fee basis. For all these reasons, the Department anticipates little conversion of brokerage accounts to fee-based advisory accounts.

A client moving from a brokerage, commission-based account to a fee-based account as a result of the rule could face higher fees in that account. At the same time, the fees associated with fee-based accounts provide for additional services that have value for the client. To the extent that conversion occurs, the net cost to the client would be any potential increase in fees less the additional benefits of advisory services. The Department expects that any customers who do convert a brokerage account to a fee-based account as a result of the rule would be those customers who place greatest value on the services such an account provides. The Department thus concludes that the costs for any customers who do potentially convert to an advisory model would

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<sup>309</sup> The Department estimates 2015 hourly labor rates include wages, other benefits, and overhead based on data from the National Occupational Employment Survey (April 2014, Bureau of Labor Statistics) and the Employment Cost Index (June 2014, Bureau of Labor Statistics); the 2013 estimated labor rates are then inflated to 2015 labor rates. The Department assumes preparation time of 50 hours based on test preparation guidance from <http://www.securitiesexam.com>.

<sup>310</sup> According to the SEC Dodd-Frank Report, firms that no longer register as BDs would not incur costs associated with: mandated training and passing FINRA qualification tests for firm personnel; conducting continuing education; and training associated persons for compliance with specific SRO sales practice rules. *See* SEC Dodd-Frank Study 2011, 148.

therefore be minimal as well (as they would be offset by the benefits from receiving additional advice).

Additional discussion of impacts on current market practices is provided in Section 8.3. While the Department expects minimal conversion and the conversion that does occur to have minimal costs (and potentially benefits to the extent it results from savers unaware of the implicit costs imposed by currently conflicted advice choosing to convert), it welcomes data and analysis that would allow it to quantify these impacts. Data and analysis that address the change in relative prices for the services, the benefits advisory accounts offer to their owners over brokerage accounts, and the expected degree of conversion would be particularly useful.

### **5.5.3 Call Centers**

The Department expects that the cost impact of this rule on financial services industry call centers will be small. This rule and the associated PTEs will require call centers that provide fiduciary advice to provide additional disclosures and different or additional training to their staff, but it need not otherwise impair the existence of call centers. The Department understands that many call centers currently refrain from offering specific recommendations, limiting their support of IRA investors' decisions to provision of education. In such circumstances, some training may still be required to ensure that activities are limited to education as defined under this proposal, but call center would not be fiduciary advisers and therefore not otherwise affected by this proposal. The Department believes, however, that call centers can add value to the IRA advice market by offering fiduciary advice, and invites comments on the associated feasibility and cost.

The Department assumes that each medium and large BD or RIA firm will have its own call center, but it lacks sufficient data to confirm this assumption. Therefore, the Department requests comment on the number of call centers and the number of call center staff in the industry.

Based on the Department's experience in training highly skilled customer service staff on new laws and regulations, the Department believes that additional training for existing call center staff could add the equivalent of between one-half and 1 day of staff time in an online conference call or classroom-style setting to existing training programs. The training would likely be performed by in-house legal staff or similarly skilled outside contractors.

In addition to the conference call or classroom-style training, management and legal staff would need to revise internal scripts or talking points. These talking points are likely to already exist for call center staff, but would need to be revised to ensure they comply with the new regulation. Management and legal staff would also need to draft answers to frequently asked questions and to revise training protocols for new staff. Because most of these revisions and trainings would be performed by in-house legal staff knowledgeable in the new regulation,<sup>311</sup> the additional incremental burden would likely be measured in hours or days, rather than weeks or longer.

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<sup>311</sup> The time necessary to familiarize legal staff with the new regulation is factored in elsewhere in this RIA.

## 5.5.4 Cost of Contracts

Costs for creating or updating the contracts required by the Best Interest Contract Exemption are included in the cost estimates of Section 5.6. Those cost estimates do not include time or disruption costs for the situation where phone interactions between advisers and investors are interrupted (or switched entirely to e-mail, print or in-person) in order for the investor to first sign the contract. The Department does not include this situation for two reasons. First, during the transition period before the rule is effective, firms should be able to plan ahead and put updated contracts in place for their current clients so this type of incident will be rare. Second, these situations already arise in the current environment. New clients call up brokers and paperwork and agreements have to be filled out and signed before the broker will conduct transactions. Firms already have protocols in place for those situations.

## 5.6 Indirect Cost

The Department expects that the proposed rule, which seeks to improve retirement security by mitigating conflicts of interest that currently reduce the quality of investment advice, to have little effect on access to investment advice. The proposed Best Interest Contract PTE extends substantial flexibility to advice providers to adopt the business models that allow them to best serve their clients, including the ability to continue receiving direct and indirect variable compensation, such as commissions and revenue-sharing payments. In part as a result of this PTE, the Department anticipates that firms providing investment advice today will continue to provide advice to similar clienteles as they do today and incur compliance costs as discussed above. As the Department anticipates that firms providing advice will continue to provide advice, it likewise expects minimal transition costs that could arise from recipients of financial advice changing financial agents. A more extensive discussion of access is provided in the uncertainty analysis in Section 9.3.1.

### 5.6.1 Impact on Financial Sector Labor Markets

The gains to investors discussed, and partially quantified, elsewhere in this analysis consist of three parts: transfers of surplus to IRA investors from advisers and others in the supply chain, reduction in underperformance from suboptimal allocation of capital (or in other words, benefits to the overall economy from a shift in the allocation of investment dollars to projects that have higher returns), and resource savings associated with reduced excessive trading and reduced wasteful, unsuccessful efforts to outperform the market. Although resource savings contribute to net benefits when considered in a standard cost-benefit analysis, transitional frictions may introduce some social costs; for example, if the resource being saved is worker labor, then there would be search and training costs associated with finding new employment within or outside of the financial industry. These related costs have not been quantified due to lack of data, literature or other evidence on either the portion of investor gains that consists of resource savings (as opposed to transfers or improved capital allocation) or the amount of transitional cost that would be incurred per unit of resource savings. A more extensive discussion is therefore included in the uncertainty Section 8.3.4. Moreover, the Department invites detailed comment and data that would inform the estimation of rule-induced transitional costs.

### 5.6.2 Impact on Asset Providers

This chapter does not contain any cost estimates for asset providers, such as mutual funds. These entities may incur indirect, frictional costs related to product re-design, training, and information technology requirements. The RDR report, for example, shows asset providers

incurring substantial costs when the United Kingdom implemented its financial advice regulations.<sup>312</sup> On the other hand, the RDR policies were much more restrictive than this proposed rule, so asset providers may not experience large changes in the United States.

## **5.7 Additional Costs Related to PTEs and Carve-Outs to Fiduciary Investment Advice**

Not included in the industry's comments are costs for complying with the new and amended PTEs, and producing the disclosures to utilize the Seller's Carve-Out, Platform Provider Carve-Out, and Investment Education Carve-Out. The additional costs are summarized below. For a more detailed discussion of the costs, please see the PRA section of the rule, as well as the PRA sections of the specific exemptions, which are published elsewhere in today's issue of the Federal Register.

The new Best Interest Contract Exemption will result in 86 million disclosures being distributed during the first year and 66.4 million disclosures being distributed in subsequent years. These disclosures range from one page to ten pages long. Producing and distributing the disclosures and complying with the recordkeeping conditions of the PTE, including staff time to create the original disclosure templates and update IT systems, will cost approximately \$77.4 million during the first year and \$29.2 million in subsequent years.

The new Principal Transactions PTE will result in 6.3 million one-page disclosures being distributed annually. Producing and distributing the disclosures, obtaining price quotes, and complying with the recordkeeping conditions of the PTE, including staff time to adjust contracts, create disclosure templates, and update IT systems, will cost approximately \$57.4 million during the first year and \$47.8 million in subsequent years.

The amended PTE 86-128 adds a recordkeeping provision. Complying with the new recordkeeping provision will add \$198,000 in annual costs.

The amended PTE 75-1 includes disclosure requirements consistent with disclosures already required by the SEC. Therefore, the amended PTE 75-1 does not add any burden.

The amended PTE 84-24 eliminates relief for insurance agents, insurance brokers, and pension consultants to receive a commission in connection with the purchase by IRAs of annuities that are securities, and for mutual fund principal underwriters to receive a commission in connection with the purchase of mutual fund shares in transactions involving IRAs. Instead, such investment advice fiduciaries would instead be required to rely on the Best Interest Contract Exemption. Relative to the current regulatory environment, this amendment reduces the number of disclosures required under PTE 84-24 by approximately 10 and reduces the associated costs by \$3,000 annually.

The Seller's Carve-Out will result in 43,000 disclosures being distributed annually. Producing and distributing the disclosures, including staff time to draft the disclosures, will cost approximately \$6.2 million annually.

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<sup>312</sup> Europe Economics, "Retail Distribution Review; Post Implementation Review," Dec. 2014, 65, available at: <http://www.fca.org.uk/static/documents/research/rdr-post-implementation-review-europe-economics.pdf>.

The Platform Provider Carve-Out will result in 1,800 disclosures being distributed annually. Producing and distributing the disclosures, including staff time to draft the disclosures, will cost approximately \$39,000 annually.

The Investment Education Carve-Out will result in 2,800 disclosures being distributed annually. Producing and distributing the disclosures, including staff time to draft the disclosures, will cost approximately \$121,000 annually.

In total, the exemptions and carve-outs will result in the creation and distribution of 92.4 million additional disclosures during the first year and 72.7 million additional disclosures in subsequent years. Producing and distributing the disclosures and complying with the recordkeeping provisions of the PTEs, including staff time to create the original disclosure templates and update IT systems, will cost approximately \$141.5 million during the first year and \$83.5 million in subsequent years. The ten year cost is estimated to be approximately \$791.8 million.

## 5.8 Conclusion

The Department estimates the new proposal’s cost to be less than approximately \$2.4 billion over 10 years. Neither Scenario A nor Scenario B accounts for market improvements in cost effectiveness or the new proposal’s positive contribution to such improvements.

**Table 5.8-1  
Possible Ten Year Costs of Regulation and Exemptions (Millions)**

Year	Scenario A		Scenario B	
	Total 3% Discounted	Total 7% Discounted	Total 3% Discounted	Total 7% Discounted
<b>Firm Costs</b>	\$3,922	\$3,449	\$1,053	\$935
<b>E&amp;O Insurance</b>	\$551	\$471	\$551	\$471
<b>Switching/Training Cost</b>	\$401	\$353	\$401	\$353
<b>Additional PTE/Exception Costs</b>	\$792	\$686	\$792	\$686
	\$5,665	\$4,960	\$2,797	\$2,445

**Table 5.8-2.  
Possible Ten Year Costs of Regulation and Exemptions by Year (Millions)**

Years	Scenario A		Scenario B	
	Total 3% Discounted	Total 7% Discounted	Total 3% Discounted	Total 7% Discounted
Year 1	\$1,290	\$1,290	\$593	\$593
Year 2	\$561	\$540	\$290	\$279
Year 3	\$544	\$504	\$281	\$261
Year 4	\$528	\$471	\$273	\$244
Year 5	\$513	\$441	\$265	\$228
Year 6	\$472	\$391	\$232	\$192
Year 7	\$459	\$365	\$225	\$179
Year 8	\$445	\$341	\$219	\$167
Year 9	\$432	\$319	\$212	\$156
Year 10	\$420	\$298	\$206	\$146
	\$5,665	\$4,960	\$2,797	\$2,445





## 6. Regulatory Flexibility Act

The Regulatory Flexibility Act (5 U.S.C. § 601 et seq.) (RFA) imposes certain requirements with respect to Federal rules that are subject to the notice and comment requirements of section 553(b) of the Administrative Procedure Act (5 U.S.C. § 551 et seq.) and which are likely to have a significant economic impact on a substantial number of small entities. Unless an agency determines that a proposal is not likely to have a significant economic impact on a substantial number of small entities, section 603 of the RFA requires the agency to present an initial regulatory flexibility analysis (IRFA) of the proposed rule. The Department's IRFA of the proposed rule is provided below.

### 6.1 Need for and Objectives of the Rule

ERISA and the IRC together provide that anyone paid to provide advice on the investment of plan or IRA assets is a fiduciary. As fiduciaries, they are subject to certain duties, including the general avoidance of conflicts of interest. However, a 1975 rule narrowly construed these ERISA and IRC provisions, thereby effectively relieving many advisers of these duties.

The Department of Labor (the Department) found that conflicted advice is widespread, causing serious harm to plan participants and IRA investors, and that disclosing conflicts alone would fail to adequately mitigate the conflicts or remedy the harm. The Department has determined that regulatory action is necessary to extend fiduciary duty to more advisers in order to recognize the diverse and complex fee practices that exist in today's plan service provider market and their potential conflicts, to account for the shift from DB to DC plans, to expand the scope of fiduciary protections for plans and their participants and beneficiaries, and to permit EBSA investigators and attorneys to focus their efforts on the adviser's conduct rather than meeting the evidentiary requirements necessary to prove that all elements of the current regulation's five-part test are satisfied. By extending fiduciary status to more advisers and providing new and amended prohibited transaction exemptions that will preserve a variety of current business practices subject to protective conditions, the new proposal will mitigate conflicts, support consumer choice, remedy the market failure and thereby improve plan and IRA investing to the benefit of retirement security.

As discussed in further detail in the regulatory impact analysis above, the Department believes that amending the current regulation by broadening the scope of service providers, regardless of size, that would be considered fiduciaries would enhance the Department's ability to redress service provider abuses that currently exist in the plan service provider market, such as undisclosed fees, misrepresentation of compensation arrangements, and biased appraisals of the value of employer securities and other plan investments.

### 6.2 Affected Small Entities

The proposed rule and the accompanying exemptions will provide benefits to small plans and small plan sponsors, and IRA investors, and impose costs on small service providers rendering investment advice to plan or IRA investors. Small service providers affected by this rule include broker-dealers (BDs), registered investment advisers (RIAs), consultants, appraisers, and others providing investment advice to plan and IRA investors.

The Small Business Administration defines a small business in the Financial Investments and Related Activities Sector as a business with up to \$38.5 million in annual receipts. The Department lacks data on revenue to precisely measure which firms meet the IRFA size standards.

The Department believes that many of the small BDs, small RIAs, and other small service providers described previously in the Regulatory Impact Analysis will meet the definition of small entities bearing the costs of this proposed rule for the purposes of the IRFA. Accordingly, the Department estimates that up to 2,440 small BDs, 15,100 small RIAs, and 2,300 other small service providers to ERISA plans will experience additional costs imposed by this rule.

While the Department lacks data on total annual receipts, efforts have been made to find other ways to measure which firms will be impacted.

The Department consulted with the SEC staff who directed Department staff to the IRFA for the SEC rule 0-10. In that analysis, firms with less than \$500,000 in net capital were considered small entities. About 350 BDs fit that description. For the purposes of the impact analysis above, the Department has chosen to define small BDs as those with less than \$50 million in net capital which includes 2,440 BD firms.

In the impact analysis, the Department defined small RIAs as those with less than \$1 billion in Assets Under Management (AUM). Many RIAs generate revenue by assessing fees of about 1 percent of AUM. This would result in a rough estimate of revenues of \$10 million. RIAs also have other revenue streams, but this amount is indeterminate. If the only source of revenue was a one percent fee on AUM, then 16,100 RIA firms with up to \$3.9 billion in AUM would be considered a small firm.

The Department lacks sufficient data on the Form 5500 Schedule C to determine a firm's total revenue. Therefore, the Department assumed that the size distribution of other plan service providers would be similar to that of BDs and RIAs with 2,300 firms being small service providers or about 80 percent all plan service providers.

The Department also considers ERISA pension plans with less than 100 participants as a small entity for purposes of the RFA. These small pension plans will benefit from the rule as they will be able to receive non-conflicted advice from their fiduciary service providers. As discussed in Chapter 4 above, these small plans and their participants would gain value from receiving non-conflicted advice.

### **6.3 Impact of the Proposal**

As described previously, the Department anticipates that BDs will incur the largest impact from the proposed rule and associated proposed exemptions, while RIAs and other ERISA plan service providers will experience less of a burden. The Department assumes that firms will utilize PTEs – or choose to forgo conflicted fee structures – based on the particular approach that they conclude will be most cost effective for their business models. Regardless of which PTEs they use, small affected entities will incur costs associated with developing and implementing new compliance policies and procedures to minimize conflicts of interest; creating and distributing new disclosures; maintaining additional compliance records; familiarizing and training staff on new requirements; and obtaining additional liability insurance.

As discussed previously, the Department estimates that to implement the new compliance policies and procedures, train staff, and create disclosures, small BDs on average could spend approximately \$53,000 (Scenario B) or \$242,000 (Scenario A) in the first year and approximately \$21,000 (B) or \$97,000 (A) in subsequent years; small RIAs will spend approximately \$5,300 in the first year and \$500 in subsequent years; and small service providers will spend approximately \$5,300 in the first year and \$500 in subsequent years.

While two estimates are provided and discussed in detail in the Regulatory Impact Analysis section above, the Department believes that both are overestimates. In particular, the higher of the two estimates significantly overstates the costs of compliance, but the lower estimate could also overstate the costs, especially for the smallest firms. As mentioned above the smallest firms are believed to have on average simpler arrangements and they may have relationships with larger firms that help with compliance, thus lowering their costs.

Additionally, BDs and service providers will incur an expense of about \$300 in additional liability insurance premiums per representative or other individual that will now be considered a fiduciary. Of this expense, \$150 is estimated to be paid to the insuring firms and the other \$150 is estimated to be paid out as compensation to those harmed, which is counted as a transfer. Any disclosures produced by affected entities will cost, on average, about \$1.53 in the first year and \$1.15 in subsequent years. These per-representative and per-disclosure costs are not expected to disproportionately affect small entities.

These proposed regulations and PTEs will also serve to balance the playing field between firms that are currently providing unconflicted advice or providing advice that is in the best interest in their clients and those who previously may have had an unfair advantage as they offered conflicted advice with a lower standard of care even as they marketed themselves as trusted advisers or fiduciaries.

Further, although the PTEs allow firms to maintain their existing business models, some small affected entities may determine that it is more cost effective to shift business models. In this scenario, some BDs might incur the costs of switching to becoming RIAs, including training, testing, and licensing costs, at a cost of approximately \$5,600 per representative.

It is unlikely that some small service providers may find that the minimal increased costs associated with ERISA fiduciary status outweigh the benefit of continuing to service the ERISA plan market or the IRA market. The Department does not believe that this outcome will be widespread or that it will result in a diminution of the amount or quality of advice available to small or other retirement savers. It is also possible that the economic impact of the rule on small entities would not be as significant as it would be for large entities, because anecdotal evidence indicates that small entities do not have as many business arrangements that give rise to conflicts of interest. Therefore, they would not be confronted with the same costs to restructure transactions that would be faced by large entities.

## 6.4 Related Rules

ERISA and the IRC together assign fiduciary status to any person who “renders investment advice for a fee or other compensation, direct or indirect” with respect to plan or IRA investments. Under ERISA, fiduciary advisers to plan investors owe undivided loyalty to plan participants’ interests. In addition, ERISA and the IRC together forbid fiduciary advisers to both plan and IRA investors from engaging in broadly-defined “prohibited transactions” in which the advisers’ and investors’ interests might conflict. While fiduciary advisers generally must avoid conflicts, ERISA and the IRC provide certain parallel statutory “prohibited transaction exemptions” that allow some transactions that involve conflicts of interest. The Department also has authority to issue rules under both ERISA and the IRC that determine when persons rendering advice on the investment of plan or IRA assets must act as fiduciaries. The Department issued the current rule in 1975, and imposed a five-part regulatory test for determining fiduciary status, which was much narrower than the broad statutory language.

The ERISA and IRC rules governing advice on the investment of plan and IRA assets overlap with the separate and somewhat different provisions of federal securities laws such as the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 and rules issued by the SEC that govern the conduct of Registered Investment Advisers (RIAs) and broker-dealers (BDs) who advise retail investors. Congress, as part of the Dodd-Frank Act, directed the SEC to consider a uniform fiduciary standard for RIAs and BDs who advise retail customers. The Department consulted closely with the IRS/Treasury, SEC staff, and FINRA in developing the new proposal. For a complete and thorough description of the interaction of these federal laws, please *see* Chapter 3, above.

The Department strives to ensure consistency among the prudential and financial regulations with other relevant agencies. The Department does not believe that the proposed actions would conflict with any relevant regulations, federal or other, and it has consulted with staff of the SEC to ensure that compliance with the new proposal is consistent with compliance under the Federal securities laws.

## 7. Regulatory Alternatives

In conformance with Executive Order 12866, the Department considered several regulatory alternatives to the Department's chosen approach to more broadly define the circumstances under which a person is considered to be a "fiduciary" by reason of providing advice on the investment of plan or IRA assets. These alternatives were informed by public comments, hearing testimony, meetings with stakeholders, consultations with other financial regulators, Congressional suggestions, and this analysis. As discussed in more detail below, these alternatives include: excluding IRAs in whole or part; not issuing PTEs; adopting the statutory definition of fiduciary advice, treating certain ESOP valuations as fiduciary advice, deferring this rulemaking until the SEC takes related actions; relying heavily on disclosure as an adequate consumer protection; conditioning PTEs on disclosure alone; issuing a streamlined, "low-fee" PTE; issuing a prescriptive PTE in lieu of the proposed best interest contract exemption; prohibiting mandatory binding arbitration; and adjusting the date by which affected advisers must comply.

### 7.1 Exclude IRAs in Whole or Part

The Department received many comments arguing that retail IRAs should be excluded from coverage under the new proposal, and the Department carefully considered related regulatory alternatives. On the other hand, others have emphasized the need for ERISA-style protections in the rollovers and IRA arenas (Munnell, Webb, and Vitagliano 2013). Alternatives considered included: (1) excluding all advice respecting IRAs from the new proposal including advice to take a distribution from a plan and roll it into an IRA; (2) limiting the new proposal's application to advice respecting plans and rollovers from plans to IRAs; (3) limiting it to advice respecting plans, IRA rollovers, and IRA assets attributable to such rollovers, either indefinitely or for limited period of time following the rollover; (4) limiting it to advice respecting plans and IRAs while excluding advice on plan distributions and rollovers; and (5) not limiting the new proposal's application to IRAs in any way. Consistent with the fifth of these five alternatives, the new proposal would apply to plans, rollovers and IRAs without limitation. The Department's decision to propose such broad application is explained below.

#### 7.1.1 Cost-Benefit Considerations

Some commenters argued that existing protections outside the IRC are adequate and there is no evidence of harm from conflicts in advice to IRA investors. The foregoing analysis, however, concluded that there are gaps in such protections and estimated that conflicts in IRA advice are associated with significant underperformance.

Some argued that conforming to fiduciary requirements would make advice too expensive for small IRA investors and that without advisers' services to encourage them many would save less or nothing. The Department's consideration of this concern is summarized here, and detailed in Section 8.3.1 below.

Some commenters' concerns about the cost of advice for small IRA investors appear to have been based on a false premise: the commenters wrongly believed that the 2010 proposal would have barred advisers from receiving any and all commissions. Whatever the origin of the misunderstanding of the 2010 proposal, the new proposal cannot be understood to create the same uncertainty. The new proposal gives a clear choice to IRA advisers about what business model to pursue and does not foreclose a commission-based or many other variable compensation models. Under the new proposal, fiduciary IRA advisers generally may elect to continue many common business practices as long as they adhere to fiduciary standards similar to ERISA's as a condition

of relying on certain PTEs, or to avoid PTs altogether (essentially by forgoing conflicted fee structures when providing fiduciary advice to IRA or plan investors).

Moreover, in contrast to the 2010 proposal, the new proposal has been refined to purge bias from advice without unnecessarily disrupting brokers' compensation arrangements. It will limit fiduciary status to circumstances where IRA investors appropriately expect that advice will be impartial and in their best interest. It will exclude from fiduciary status education that does not include personal recommendations. In addition, unlike the 2010 proposal, the new proposal will include PTEs that give brokers flexibility to accept a wide range of compensation that would have been prohibited under the 2010 proposal, subject to protective conditions.

Some comments appeared to exaggerate the extent to which advisers, especially brokers, currently advise small IRA investors and thereby increase their savings. In fact, small savers are far more likely to save through job-based retirement plans than through direct IRA contributions. IRAs are funded far more via rollovers from plans than by direct contributions encouraged by brokers or other advisers. Service providers other than brokers, notably banks, appear to serve most small IRA investors today.

Moreover, many small IRAs are owned by households near the middle of the U.S. income and wealth distribution, or above, and hold other investable assets, likely making these households attractive as prospective advisory clients. (See Section 8.3.1 below.)

The industry today competes fiercely to capture rollovers. GAO has issued a report detailing its related concerns.<sup>313</sup> The CFPB has documented confusion and vulnerability associated with advisers who represent themselves as having special expertise or credentials in retirement matters.<sup>314</sup> The SEC found rampant abuse in audits of "free lunch" financial "seminars," where brokers who appear to be impartial educators are actually conflicted salespersons peddling financial products, usually to seniors, for their own gain.<sup>315</sup> Advisers sometimes solicit federal civilian employees and members of the uniformed services to roll their savings into IRAs from the low-fee federal retirement savings plan.<sup>316</sup> Major plan sponsors have shared with the Department their concern that brokers who aggressively pursue their retiring employees will undermine the sponsors' efforts to help employees achieve a secure retirement.<sup>317</sup>

Finally, the comments' cost concerns largely appear to ignore new, low-cost advice models that are emerging and growing in the marketplace. And, as further discussed in Section 3.9.1.3 above, more stringent anti-conflict reforms recently implemented in the UK do not appear to have compromised small investors' access to affordable advice.

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<sup>313</sup> GAO Publication No. GAO-13-30.

<sup>314</sup> Consumer Financial Protection Bureau, "Senior Designations for Financial Advisers: Reducing Consumer Confusion and Risks," 2013.

<sup>315</sup> SEC, "Protecting Senior Investors: Report of Examinations of Securities Firms Providing "Free Lunch" Sales Seminars," 2007.

<sup>316</sup> Hechinger, John, "Brokers Lure Soldiers Out of Low-Fee Federal Retirement Plan," *Bloomberg* (Aug. 12, 2014), available at: <http://www.bloomberg.com/news/2014-08-12/brokers-lure-soldiers-out-of-low-fee-federal-retirement-plan.html>.

<sup>317</sup> For a discussion of the advantages and disadvantages of IRA rollovers relative to leaving savings in job-based plans, see Turner and Klein (2014).



Some comments argued that subjecting advice to both the IRC PT provisions and other regimes would create inconsistencies between business practices related to IRAs and those related to other retail accounts. This result can easily be avoided by advisers' voluntary decision to harmonize any inconsistencies they identify as they do now in complying with inconsistent state and federal regulatory schemes or inconsistencies between SEC and FINRA rules. Many practices could be uniformly applied to both. However, the extent of any inconsistencies is likely to be less under the new proposal than would have been the case under the 2010 proposal or even current law, because of refinements to the proposed rule and the inclusion of proposed PTEs, as detailed earlier. Moreover, some inconsistency between business practices associated with IRAs and those associated with other retail accounts exists already under the 1975 rule, under which some IRA advice is fiduciary in nature, as well as under other authorities. Excluding IRAs in whole or part from the new proposal would create a different and less justified inconsistency: major IRC statutory provisions that apply to both IRAs and plans (specifically, the provisions that define fiduciary investment advice and that penalize fiduciary advisers who commit PTs without benefit of relief under an applicable PTE) would be interpreted much more narrowly for IRAs (in all or some instances) than they are for plans. Moreover, the new proposal would address a more serious inconsistency that bedevils retail investors today. As detailed earlier, consumers today do not understand the inconsistent way that different types of advisers are regulated under the various applicable securities, insurance, and banking rules, nor the different ways they are compensated and the associated potential conflicts. The new proposal would more broadly apply a single, consistent standard for all advice rendered to IRA investors, thus reducing, not increasing, investor confusion.

The foregoing strongly supports the conclusion that there is no material reason to exclude IRAs, in whole or part, from the new rule's ambit. On the other hand, there is good reason to include them in full.

As detailed earlier, IRAs play a major role in retirement security and enjoy a large tax subsidy. IRA investors are more vulnerable and in many respects less protected than plan participants. They stand to suffer large losses as a result of biased advice unless steps are taken to reduce or mitigate adviser conflicts.

From the Department's perspective, the gains to investors attributable to the inclusion of IRAs in the new proposal, which are detailed and partially quantified in Section 3.3.1 above, more than justify the associated compliance costs. Quantified investor gains – in the front-load mutual fund market segment alone – are estimated to be \$40 billion over 10 years. The incremental cost of including IRAs is estimated to be \$1 billion over 10 years. This cost is limited because many advisers and advisory firms advise both IRAs and plans, and therefore generally would incur the fixed and some of the variable costs of compliance with the new proposal even if IRAs were not covered.

### **7.1.2 Alternative Degrees of IRA Coverage**

Full, rather than partial, coverage of IRAs is critical to the protection of both job-based and individual retirement savings, and necessary to align regulations with the statutory language of both ERISA and the IRC. Excluding IRAs in part would undermine many of the new proposal's largest and most important benefits, entail practical difficulties, and do little to reduce compliance costs.



### 7.1.2.1 Covering Plans Only

Maintaining the current narrow criteria for fiduciary status for IRAs while broadening such criteria for plans is facially bad policy. IRA investors generally need more protection than plan investors, not less. Relative to plan investors, IRA investors are less financially sophisticated, are not protected in any way by ERISA, and operate in a confusing marketplace with myriad types of advisers and an endless selection of investments, good and bad.

Separate criteria for fiduciary status under ERISA and the IRC would be contrary to sound legal construction. The respective statutory provisions are essentially identical. The 1975 rule applies uniformly to both. Because plans and IRAs are both subject to the IRC, excluding IRAs would require that a single Code provision be interpreted differently for plans than for IRAs. Alternatively, the new proposal could apply only to ERISA and not the IRC. However, in that case, a plan adviser might, with respect to the same single instance of advice, be a fiduciary under broader ERISA criteria but not under IRC criteria.

Rollovers must be covered to protect job-based savings at the point where investors face monumental financial decisions, are highly vulnerable to abuse, and most in need of impartial advice. Rollovers are projected to approach \$2.5 trillion over the next five years.<sup>318</sup> In 2012, rollovers make up over 90 percent of IRA inflows.<sup>319</sup> Job-based accounts are targeted aggressively by advisers eager to gather assets.

### 7.1.2.2 Covering Plans and Rollovers

Covering rollovers but not IRAs afterward would leave ample room for losses of job-based savings after the rollover occurs. In such case, the rollover itself would be fiduciary advice subject to the requirements of the new proposal. In contrast, the subsequent IRA investment advice, to which the 1975 rule would continue to apply, likely would not be fiduciary advice and therefore would be subject to neither the IRC's protective PT provisions nor the protective conditions of any applicable PTE (including the duty of loyalty to the investor's interests). Consequently, compliant, impartial, fiduciary advice to rollover an account could be followed immediately by non-fiduciary, conflicted, and biased advice on how to invest the proceeds. In addition, covering only rollovers or, alternatively, rollovers and rolled over money in IRAs, would be unlikely to reduce compliance costs much relative to the cost of covering IRAs entirely. The systems and compliance apparatus necessary to comply with the IRC's PT provisions would need to be implemented for major segments of retail advisers' business irrespective of whether IRA coverage was partial or full.

### 7.1.2.3 Covering Plans and IRAs but Not Rollovers

Finally, the Department considered the alternative of applying the new proposal to plans and IRAs, but not to advice respecting distributions from plans and associated rollovers to IRAs. The 2010 Proposal did not include recommendations concerning the investment of securities to be rolled over or otherwise distributed from the plan as fiduciary investment advice. Instead, the

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<sup>318</sup> Cerulli Associates, "Retirement Markets 2014."

<sup>319</sup> ICI, "The U.S. Retirement Market, Fourth Quarter, 2014," 2015.

Department requested comments on whether it should be included in a final regulation. Some commenters representing the financial services industry argued that including this type of advice would give rise to PTs that could disrupt the routine process that occurs when a worker leaves a job, contacts a financial services firm for help rolling over a 401(k) balance, and the firm explains the investments it offers and the benefits of a rollover.

As discussed in the Need for Regulatory Action section above, plan participants may not be adequately protected from conflicted distribution recommendations that subordinate participants' interests to advisers' interest. Excluding this type of advice from the rule would not benefit participants, because it would not protect them from conflicted advice in connection with one of the most significant financial decisions they make with respect to their retirement income security. Therefore, the Department has chosen the alternative of including recommendations to take distributions (and thereby withdraw assets from existing plan investments) or to entrust plan assets to particular money managers, advisers, or investments within the scope of covered advice.

At the same time the Department believes that participants can benefit from information about distribution options and their tax and other implications that does not include fiduciary recommendations. Therefore the new proposal provides that advisers do not provide fiduciary advice if they merely provide participants with information about plan distribution options, including the tax consequences associated with the available types of benefit distributions. In this regard, the new proposal draws an important distinction between fiduciary investment advice and non-fiduciary investment information and educational materials. This will benefit participants and beneficiaries, promoting access to critical information regarding their distribution options by making clear that service providers who furnish such information and materials are not providing investment advice.

### **7.1.3 Conclusion**

For all of these reasons, the Department believes that full application of the new proposal to IRAs is warranted and that any limitation on such coverage would reduce the new proposal's investor gains more than its compliance costs.

## **7.2 Omit PTEs**

The Department did not propose new or amended PTEs as part of the 2010 proposal, although it indicated it planned to do so and invited comments on what new or amended PTEs were necessary. Comments on the 2010 proposal indicated that advisers newly assuming fiduciary status would need exemptive relief to sustain existing business practices that they maintain are beneficial to customers. Advisers would need such relief to engage in transactions with plan and IRA investors, either as agent or principal, involving investment by the plans in securities and other assets, to extend credit to plans in connection with certain securities transactions, and to receive variable compensation, both direct and indirect, in connection with certain transactions. Some comments indicated that these practices are beneficial to IRA investors in particular because they ease customers' access to useful investment products, and that variable, indirect adviser compensation in particular uniquely enables advisers to offer services and promote savings among lower-income customers. When the Department announced that it would issue a new proposal, it stated that it would consider proposing new or amended PTEs to address some of these concerns.

Absent additional relief, new investment advice fiduciaries would have to avoid PTs unless the transactions were covered by applicable existing PTEs, such as the statutory investment advice PTE enacted by Congress as part of the PPA. As noted earlier, this statutory PTE conditionally allows fiduciaries to give investment advice to plan participants and IRA investors even though

they receive indirect compensation in connection with investment products they recommend.<sup>320</sup> However, recognizing that such compensation can introduce harmful conflicts, Congress placed important constraints on the eligible advice arrangements to mitigate the potential for abuse and self-dealing by requiring (1) the adviser to be compensated on a “level-fee” basis (i.e., the adviser’s fees cannot vary based on investments selected by the participant) or (2) the investment advice provided by the adviser to be based on a computer model independently certified as unbiased and as applying generally accepted investment theories.<sup>321</sup> At that time, the Department specifically declined to issue an administrative PTE to extend certain broader relief for variable adviser compensation, citing its concern that associated conflicts of interest would taint advice.

The Department remains cautious about issuing PTEs covering compensation arrangements that could pose conflicts of interest for fiduciary investment advisers. As detailed in Sections 3.2.4 above and 7.6.1 below, such conflicts, even if disclosed, can taint advice and harm investors. Moreover, PTEs generally are available to all fiduciary advisers, including those who are already fiduciaries under the 1975 rule. Therefore, if the protective conditions attached to any additional relief prove inadequate, the new proposal could introduce bias into currently impartial fiduciary advice, rather than reduce bias in advice that is not currently fiduciary as intended.

The Department carefully considered the commenters’ requests for additional exemptive relief, and reviewed existing exemptive relief available to fiduciary advisers, weighing both against the risks that adviser conflicts pose to consumers. Pursuant to this consideration, the Department has adopted what it intends to be a balanced approach. The proposal narrows and attaches new protective conditions to some existing PTEs. At the same time it includes some new PTEs with broad but targeted combined scope and strong protective conditions. These elements of the proposal, detailed in Section 2.8.2 above, reflect the Department’s effort to ensure that advice is impartial while avoiding larger and costlier than necessary disruptions to existing business arrangements or constraints on future innovation.

### 7.3 Adopt the Statutory Definition

The Department considered replacing the 1975 rule with the statutory language of section 3(21)(A)(ii) of ERISA, which provides simply that a person is a fiduciary if he or she renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of a plan, or has any authority or responsibility to do so. Like the 2010 proposal, this would have the effect of relaxing the 1975 rule’s five-part test and broadening the range of advisory services that constitute fiduciary advice under ERISA and the IRC. However, the Department concluded that this approach would not provide sufficient clarity about the boundaries of fiduciary advice. Absent sufficient clarity, and fearful of committing PTs and/or incurring liability under ERISA, many service providers would interpret the rule broadly, treating as fiduciary some services in connection with which self-dealing poses little threat to plan participants or IRA investors. This could increase compliance costs without providing offsetting gains for plan participants and IRA investors. The new proposal attempts to distinguish fiduciaries

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<sup>320</sup> ERISA § 1108(b)(14); IRC § 4975(d)(17).

<sup>321</sup> 29 C.F.R. §2550.408g-1, 76 Fed. Reg. 66136 (Oct. 25, 2011).

by focusing on relationships based on trust, loyalty, and impartial advice, thereby restricting fiduciary status to situations where self-dealing poses risks for plan participants or IRA investors and where costs associated with fiduciary status are justified by offsetting benefits. Importantly, the new proposal excludes from classification as fiduciary advice certain activities by plan platform providers and counterparties in transactions with large plan investors, and education.

#### **7.4 Treat Certain ESOP Valuations as Fiduciary Advice**

Under current rules, flawed ESOP company valuations often inflict losses on ESOP participants. The 2010 proposal would have treated ESOP valuations as fiduciary advice, superseding earlier Department guidance to the contrary. Commenters expressed concern, however, that the proposal would make valuations excessively costly. As an alternative to including ESOP appraisals in the proposal, some commenters suggested that the Department finalize its regulation defining “adequate consideration” under ERISA section 3(18) to establish regulatory requirements for purchases and sales of hard to value assets. They asserted that this would be a better way to ensure that plans pay no more than adequate consideration for employer securities and other hard to value assets. Another commenter suggested creating a standard of accreditation for appraisers by grafting existing professional standards into a finalized adequate consideration regulation rather than making valuation experts ERISA fiduciaries.

The Department continues to believe that regulatory action is needed to combat abuse in ESOP valuations. Improved valuations would yield large gains for affected ESOP participants. However, the Department has elected to defer action on this issue, pending consideration of potential alternative approaches, such as a rulemaking to more clearly define what constitutes “adequate consideration” under ERISA in connection with relevant ESOP transactions.

#### **7.5 Wait for SEC Action**

Some commenters advised the Department to postpone its regulatory initiative until the SEC has completed its rulemaking activities under the Dodd-Frank Act with respect to establishing a uniform fiduciary standard of care for BDs and RIAs under the federal securities law. The commenters asserted that if the Department moves forward with its regulatory initiative, inconsistent rules and increased costs and complexities would result for participants, beneficiaries, and IRA investors who have different types of accounts at the same financial institution.

A number of consumer groups, in contrast, have jointly taken a strong position against delay of Departmental action. The groups argue that ERISA and the IRC do not conflict with other laws governing financial advice, and that retirement accounts merit special protection.<sup>322</sup>

The Department has elected to proceed without waiting for the SEC to act, although the Department believes it has had significant consultation with SEC staff to avoid conflicts between

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<sup>322</sup> October 18, 2013 letter from Fund Democracy, Consumer Federation of America, AARP, Americans for Financial Reform, and Public Citizen’s Congress Watch to The Honorable Sylvia Matthews Burwell, Director, Office of Management and Budget, Executive Office of the President. Available at: <http://www.consumerfed.org/pdfs/Fiduciary-Sign-On-Letter-10-18-13.pdf>.

the new proposal and the securities law.<sup>323</sup> A key goal of the consultation was to ensure that compliance with the new proposal would not cause a regulated entity to be out of compliance with the securities laws.

The fiduciary duties included in ERISA and the IRC are different from those applicable to RIAs under the Advisers Act. The duties would continue to differ even if both regimes were interpreted to attach fiduciary status to exactly the same parties and activities. When Congress enacted ERISA, it provided that all investment advisers to plan and IRA investors would be subject to the ERISA and/or IRC fiduciary regime. Importantly, compared with securities law, ERISA and the IRC are generally less tolerant of fiduciary conflicts of interest, and in that respect provide a higher level of protection to plan participants and IRA investors, reflecting the importance of plans and IRAs to retirement security, and the tax subsidies they enjoy. The ERISA and IRC standards applicable to fiduciary investment advisers will continue to overlap with, and differ from, those applicable under securities laws, irrespective of whatever regulatory action the Department or SEC takes. Indeed, BDs and RIAs who provide investment advice with respect to plan or IRA assets, and satisfy the 1975 rule's five-part test, are already subject to the fiduciary provisions of ERISA and/or the IRC.

The Department understands the roles of the SEC and other federal and state agencies in regulation of financial advice provided to retail investors. At the same time, however, the IRC PT provisions, as enacted by Congress as part of ERISA in 1974, specifically apply to IRA investment advice, and the Department is solely responsible for interpreting these provisions.<sup>324</sup> It is thus incumbent on the Department to protect IRA investors from harmful adviser conflicts. An examination of trends and evidence accumulated since 1974 suggests that such special protections, if anything, are even more critical today than when Congress first enacted ERISA more than 40 years ago. The Department's role in applying these protections is well established under law and in practice.

IRAs' important role in retirement security, which warrants special protections against conflicts in advice, underscores the need for the new proposal to ensure the broad application of these protections.

IRAs were established in 1974 as a vehicle to promote retirement savings. In supporting IRAs, lawmakers pointed to the need to provide tax preferences similar to those applicable to job-based pensions to workers who did not have access to such pensions. They also pointed to rollover IRAs' potential to make job-based pensions more portable.

The special protections for IRAs embodied in the IRC PT provisions are mirrored by the large tax subsidies IRAs enjoy under other IRC provisions. These subsidies amounted to \$16 billion in 2014 alone.<sup>325</sup> This figure dramatically understates the degree to which current IRA savings have been subsidized by taxpayers, however. Most of the savings flowing into IRAs comes not from direct contributions but from rollovers primarily from job-based retirement plans,

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<sup>323</sup> See Section 2.6 for discussion of the Department's coordination with the SEC and other agencies.

<sup>324</sup> See Reorganization Plan No. 4 1978, 5 U.S.C. App. (2010).

<sup>325</sup> Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Year 2014-2018," (Aug. 2014), 36. Available at: <https://www.jct.gov/publications.html?func=startdown&id=4663>.

mostly from DC plans including 401(k)s<sup>326</sup> – and much of the savings currently in these plans may eventually be rolled over into IRAs. The tax preference for DC plans amounted to \$45 billion in 2014. Moreover, these IRA and DC figures vastly understate the accumulated taxpayer subsidy in DC and IRA savings, reflecting only one-year’s subsidy.

Delay associated with waiting for SEC action would impose substantial costs on plan participants and IRA investors, as current harms from conflicted advice would continue. Likewise, delay would defer, but do little to reduce, compliance costs. Prompt action is warranted. The Department’s issuance of the new proposal before the SEC issues one is no less conducive to harmonization than would be the reverse order. The Department therefore has elected to proceed without undue delay.

The Department agrees with commenters, however, that overlapping rules should not conflict with or impair other applicable rules. The Department has taken care to adhere to ERISA’s and the IRC’s specific text and purposes. At the same time, however, the Department has sought to understand the impact of the proposed rule on firms subject to the securities laws and other Federal and state laws, and to take the effects into account by appropriately calibrating the impact of the rule on those firms. In the Department’s view, the current proposed regulation neither undermines nor contradicts the provisions or purposes of the securities laws. Instead, the Department has sought to draft the regulation to work in harmony with other federal laws, and the Department has consulted – and will continue to consult – with other federal agencies to ensure that, to the extent possible, the various legal regimes are appropriately harmonized.

## **7.6 Rely Heavily on Disclosure to Mitigate Conflicts**

Many comments on the 2010 proposal advocated disclosure as the preferred remedy for any bias that advisers’ conflicts of interest introduce into their advice. Certainly disclosure, if effective at achieving its aim and not excessively costly, would offer many advantages over other regulatory tools. It arguably would minimize any risk of harmful distortions in the market, allowing different advisory businesses, and business models, to compete in the sunlight, to the benefit of IRA and plan investors. The Department therefore carefully considered placing greater emphasis and reliance on disclosure as a condition of broad PTEs. The new proposal includes disclosure provisions which the Department believes have the potential to help reduce advisers’ bias (or investor harm from such bias) at acceptable cost. Alternatives considered included relying exclusively on disclosure, omitting the new proposal’s pre-transaction disclosure PTE condition, requiring as a PTE condition an additional, pre-engagement disclosure, and requiring as a PTE condition public disclosure of investment results.

### **7.6.1 Condition Broad PTE(s) on Disclosure Alone**

Some commenters argued that disclosure of potential adviser conflicts is, by itself, sufficiently protective of plan and IRA investors’ interests. If conflicts are transparent, then investors can choose optimally between more and less conflicted advisers. Therefore the Department should issue broad PTEs that exempt all or almost all existing and potential adviser

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<sup>326</sup> ICI, “U.S. Retirement Market, Fourth Quarter 2014,” 2015, available at: [www.ici.org/info/ret\\_14\\_q4\\_data.xls](http://www.ici.org/info/ret_14_q4_data.xls).



business models and compensation arrangements, on the sole condition that material conflicts be disclosed. The Department estimates that relying on disclosure alone could reduce compliance costs by between \$1.8 billion and \$2.0 billion over ten years.

This argument necessarily presumes that investors will adequately understand the implications of disclosed conflicts and factor that understanding into their choice of adviser and investments. This presumption is highly questionable. Available evidence strongly suggests that disclosure alone will be ineffective at mitigating conflicts in financial advice.

As noted earlier in Section 3.2.1.2, IRA investors are often older, and older investors are particularly vulnerable to and targeted for abuse. Available evidence suggests that IRA owners may be poorly equipped to act as a check on adviser misbehavior. Most are not financially sophisticated, and even those that are might find it difficult to accurately detect lapses in the quality of advice. Nor are IRA owners likely to understand advisers' conflicts. Many ignore disclosures. Some others may react to disclosures in ways that exacerbate the problem. Plan sponsors, especially small plan sponsors, likewise may lack financial expertise, and/or be unclear about the fiduciary status of their advisers.<sup>327</sup>

It appears that disclosures often fail to make investors aware of their advisers' conflicts, let alone understand their nature and potential implications. Representatives of all brokerage firms interviewed by (Hung et al. 2008) reported extensive efforts to clearly disclose conflicts, but several acknowledged that "investors rarely read these disclosures ... [F]or many investors, the fact that they were given disclosures was seen as meaningless." Burke et al. (2014) summarizes additional literature suggesting that retirement investors often fail to devote meaningful attention to relevant disclosures.

Haziza and Kalay (2014) study investor behavior following a ruling by the Israeli Securities Authority that portfolio managers must obtain written investor consent before receiving part of the commission investors paid their broker to execute a trade. According to the authors, "One would expect an overwhelming opposition to the kickback as consenting investors are exposed to avoidable losses due to (moral hazard) access trading." Yet 89 percent of investors affirmatively consented. The authors characterize this finding as "quite remarkable considering that not responding is taken as prohibition." They find that more sophisticated investors are less likely to consent, consenting investors underperform in the following year, and consent is not a reward for past success.

If IRA investors could somehow be prompted to pay attention to and understand adviser conflicts, would that serve to mitigate the conflicts? Available evidence suggests that investor reaction to clear disclosure of conflicts is difficult to predict and not always beneficial to their own interests (Robertson 2011; Cain, Loewenstein, and Moore 2005).

Loewenstein, Cain, and Sah (2011) describe how disclosure of adviser conflicts can "backfire." Once conflicts are disclosed, advisers might employ "strategic exaggeration" of their own bias to offset customers' discounting of their recommendations. They might feel "morally licensed" to pursue their own interests over that of customers who have been duly warned. Advice

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<sup>327</sup> U.S. Government Accountability Office, GAO-08-774, Private Pensions: Fulfilling Fiduciary Obligations Can Present Challenges for 401(k) Plan Sponsors (2008), available at: <http://gaonet.gov/assets/280/278247.pdf>.



recipients might “anchor” to the advice and then adjust insufficiently for bias. They might interpret disclosure as a sign of honesty and/or believe that payments that cause conflicts signal high professional standing. They might follow biased advice because they feel socially constrained from questioning their advisers’ integrity or threatening their livelihood. The authors go on to review some experimental evidence for these phenomena. Also according to the authors, “discounting advice appropriately for a disclosed conflict of interest requires a mental model of adviser behavior to predict the impact of the conflict – let alone the disclosure of that conflict – on the advice. Lacking such a model, advice recipients will not know what to do with the disclosed information...”<sup>328</sup>

The Australia study questions whether investors can judge how disclosed conflicts might influence advice, and offers anecdotal evidence that investors simply trust that advice is in their interest and do not appreciate the potential negative effect of conflicts on advice (*see* 2.2.3.4.1). Chater, Huck, and Inderst (2010), in contrast, find (with respect to an experimental setting in the European Union) that disclosure of conflicts can have a different negative effect. Even investors who see conflicts as a red flag may respond poorly.

“Disclosing conflicts of interest elicits a ‘knee jerk’ reaction that can be harmful as well as helpful. Subjects exhibited contrarian behavior in their investment choices when biased incentives were disclosed. This led to better decisions when the adviser’s and advisee’s interests were adversely aligned but to worse decisions when their interests were aligned. Subjects lost trust even when an adviser with misaligned incentives was not actually able to deceive them, showing that their reaction is reflexive” (Chater, Huck and Inderst 2010, 9-10).

Prentice (2011) provides a thorough discussion of “stock brokers and the limits of disclosure.” He argues that “investors who receive a document indicating that their stock broker owes them no fiduciary duty often (a) will not even read it and therefore go on assuming that they are, in fact, owed a fiduciary duty by their brokers, as most investors currently believe, or (b) if they do read it, they will not go to the trouble of figuring out what...it means...” (internal citations omitted). He surveys a number of well-documented human cognitive behavioral biases, and explains how each is likely to render disclosures of an adviser’s non-fiduciary status ineffective or

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<sup>328</sup> Similar conclusions have been reached in connection with other types of professional advisory relationships. In one example, Malmendier and Shanthikumar (2007) find that small investors fail to account for the positive bias associated with recommendations from analysts (or brokers) who are affiliated with the underwriters of the firms they are reporting on, and consequently their returns suffer. In a second example, as summarized by Burke et al. (2014), Potential conflicts of interest are also a concern in the medical field: doctors and dentists are often compensated directly or indirectly for recommending particular treatments, in ways that may conflict with the interest of patients; the position of trust that medical professionals attain may exacerbate the problems of these conflicts. Schwartz, Luce, and Ariely (2011) use health care claims data to show that dental patients in long-standing relationships with their dentists are likely to choose more expensive (but not necessarily clinically superior) procedures; in experiments, they go on to show that patients are reluctant to seek second opinions for fear of damaging their dentist-patient relationship, and that clinically-irrelevant social behavior (a dentist granting or refusing to grant a personal favor to the patient) affects propensity to seek second opinions. Using survey data, Schwartz, Gino, and Ariely (2011) show that patients recognize conflicts of interest for other people’s doctors but focus less on their own doctors; that patients are not concerned by “indirect” conflicts of interest (e.g., doctors recommending a drug on which they are doing research); and that trust developed over time reduces the willingness of patients to discount potentially conflicted advice.

harmful. These include “over optimism” (other people might be misled by their advisers but not me), “overconfidence” (I can tell whether my adviser is honest and his or her advice is impartial), “illusion of control,” (I can look out for myself), “false consensus effect” (I’m honest, like most people, so my adviser must be too), “personal-positivity bias” (perhaps many advisers are dishonest, but not mine), “insensitivity to the source of information” (whether the advice is trustworthy is unrelated to whether the person giving it is conflicted), a tendency to discount low-probability risks (I will not be defrauded), and “social proof” (lots of people trust my adviser, or advisers generally, so I should too). He further observes that an adviser’s oral communications with his or her client can color the client’s perception of any written disclosure, and that an adviser’s “likeability” can cement trust. “Cognitive dissonance” (in this case, not wanting to admit error), confirmation bias (focusing mostly on information that affirms initial belief), and a tendency to anchor to initial intuitive judgments<sup>329</sup> – can prevent an investor from adjusting his or her opinion of an adviser based on new information. Finally, even an investor who wished to adjust his or her level of trust to account for an adviser’s conflicts cannot know how or how much to do so. It seems clear that disclosure of an adviser’s conflicts alone would do little or nothing to help his or her clients eliminate or adjust for any bias in his or her advice.

According to Prentice, advisers, in turn, exhibit behavioral cognitive biases that make it more likely that their conflicts will bias their advice at their customers’ expense, sometimes without realizing that they are doing so. They may suffer from “bounded ethicality” (it seemed like the right thing to do based on my incomplete information), “self-serving bias” and a tendency to anchor on first intuition (if it benefits me/feels good, I will focus most on information that makes it also look like the right thing to do). They may be wedded to a self-image that is moral, competent and deserving (my advice is never influenced by my conflicts, and any related gains to me are merited), and/or exhibit “ethical fading” (moral considerations wane as personal interests wax). All of these tendencies can lead advisers to calibrate advice to profit themselves at their customers’ expense, even as they believe that they are acting honestly in their customers’ interest. The more an adviser stands to gain, the more she will be unconsciously pressed to convince herself that the most profitable path is also the right one.

Prentice concludes that “disclosure alone is a frail tool with which to attack the many ills that arise from blatant conflicts of interest in the financial industry.”

A broader look at transparency as a policy tool further suggests that disclosure alone would be ineffective at mitigating conflicts in financial advice. There is evidence that disclosure alone fails to ensure efficiency in the U.S. mutual funds market (Palmiter and Taha 2008). According to Ben-Shahar and Schneider (2011), advice must be “genuinely in the service of the client, free of conflicts and influences,” and “experts are needed in the first place because people cannot rely solely on disclosures.” They cite loans and credit cards as two retail financial products where the law combines disclosure requirements with outright bars against certain potentially abusive terms and practices (Ben-Shahar and Schneider, *The Failure of Mandated Disclosure* 2011). Weil et al. (2006, 158, 161) argue that disclosure is effective only where it provides “pertinent information that enables users to substantially improve their decisions with acceptable [user] costs” and is

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<sup>329</sup> See Bubb (2014), however, who suggests that disclosures that act on an investor’s initial intuitive judgment might be effective.

comprehensible. Given that investors are hard pressed to understand advisers' conflicts or their implications, this suggests that disclosure of conflicts will be ineffective. Finally, Willis casts doubt on the potential for financial education to improve consumers' financial decisions and use of financial advisers (Willis 2008).<sup>330</sup>

Overseas experience also suggests that disclosure alone does not effectively mitigate conflicts in investment advice. Regulators in the UK found that requiring disclosure and demanding that advisers act in their clients' interest together failed to adequately discourage mis-selling. They have since implemented anti-conflict rules more stringent than those included in the Department's new proposal.<sup>331</sup>

For all of these reasons the Department believes that a rule that relies on disclosure alone to mitigate adviser conflicts would be ineffective and would therefore yield little or no investor gains and fail to justify its compliance cost. The new proposal therefore attaches additional investor protections to its PTEs.

## 7.6.2 Omit Pre-Transaction Disclosure

The new proposal, as a PTE condition, requires disclosure in advance of each transaction, at the "point of sale." The disclosure must include, in dollars, the (estimated) amount the investor will pay in fees and expenses in connection with the acquisition and holding of the recommended assets, given various hypothetical holding periods. The Department intends this disclosure to make expenses clearer and more salient to investors exactly at the time they can use this information to inform an optimal decision. This in turn could help mitigate any adviser bias that might be introduced by conflicts associated with such fees and expenses.

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330 According to Willis (2008, 247-248), "Unfortunately, consumers have difficulty selecting advisers who possess sufficient expertise and incentives to act in the consumers' best interests. Once a consumer has selected an adviser, reliance on the advisor can become another form of passivity in that consumers do not always sufficiently monitor the adviser's performance.

"Before implementing an expert's advice, a consumer has little means to determine whether the benefits of the advice outweigh the costs of obtaining it. Without independent advice, consumers tend to rely on the advice dispensed by the "expert" closest at hand, the seller. Even with substantial literacy gleaned from financial education, the consumer rarely is as familiar as a salesperson with the latest financial products. This "free" advice can have a price. Among other things, yield-spread premiums for selling borrowers higher-cost mortgages than those for which they qualify, and soft-dollar payments to investment brokers for favoring particular funds, can place the financial interests of mortgage and investment brokers at odds with their clients.

"Financial-product salespeople can take advantage of the 'reciprocity effect' invoked by 'befriending' the consumer, who then reciprocates the seller's 'kindness' with trust and business. Social mores inhibit customers from challenging the credibility of this new 'friend.' Linguistic conventions contribute to role confusion: the broker, officer, or agent is 'my broker,' 'my loan officer,' or 'my agent,' even without any fiduciary duty to the consumer, and the insurer or lender 'gives' the coverage or credit, rather than 'selling' the financial product. Once trusted, sellers have broad opportunities to influence consumer financial decisions." (Internal citations omitted.)

<sup>331</sup> Letter from David Geale, FCA. UK, to Joseph Piacentini, U.S. Department of Labor, 2014.

As discussed in Section 5.4 above, this disclosure will entail some cost, which is likely to be passed on to the plan to IRA investor.<sup>332</sup>

The evidence for its benefits is mixed. Disclosure might be effective if, for example, it acts on the investor's initial intuitive judgment, rather than (or in addition to) her subsequent more reasoned consideration (Bubb 2014). A disclosure's potential effectiveness will also be higher if it is accurate, and easily understood and factored meaningfully into the relevant decision. The Department intends the new proposal's pre-transaction disclosure PTE condition to exploit this potential – to act on investors' initial intuitive judgments, be easy to understand and factored into their investment decisions.

However, the Department considered omitting this disclosure requirement, in light of evidence presented in Section 7.6.1 above. Available research shows that investors mostly do not take beneficial account of fees, even if they are disclosed clearly at the point of sale (Choi, Laibson, and Madrian 2010).

In addition, the proposed disclosure may be inaccurate and potentially misleading. Fees actually paid in the future will depend on holding periods, investment performance, and possibly future account inflows or outflows (in particular, because of fee break points).

Omitting this disclosure would reduce estimated compliance costs by between \$65 million and \$75 million over ten years. The Department invites comments on the effectiveness and cost of this proposed, pre-transaction disclosure requirement.

### **7.6.3 Require Pre-Engagement Disclosure**

The Department separately considered, but rejected, requiring certain “pre-engagement” disclosure as a PTE condition.

An accurate, salient, and simple pre-engagement all-in fee disclosure might facilitate comparison shopping among advisory firms by investors. Such a disclosure could be published on each advisory firm's website and on any marketing or promotional materials used by the firm. The adviser would be required to present the disclosure to each prospective customer. The disclosure's purpose would be to make transparent customers' full cost of services rendered to them by the firm and its advisers.

Under one possible approach, the disclosure would present the preceding year's aggregate reportable revenue, expressed as a percentage of aggregate customer assets (or as “cents for every dollar”). Reportable revenue would include all firm revenue associated with customers' holdings and transactions, including (but not limited to) normal account fees (opening, maintenance, closing), commissions, load sharing, 12(b)-1 fees, revenue sharing, and mark-ups/downs (in connection with principal transactions). It would be broken down between what is paid to advisers and what is paid to the firm (and not passed on to advisers). If the firm offers multiple types or levels of service and/or multiple pricing structures (such as for accounts of different sizes), each

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<sup>332</sup> Cost concerns contributed to the SEC's decision not to finalize its own “point-of-sale” disclosure rule, which it proposed in 2005.

should be included separately, and the adviser must direct the prospective customer’s attention to the category in which the engagement will fall.

The firm could elect additionally to report (and include in the total) the aggregate amount “paid to others.” This would include (but not be limited to) load amounts not shared with the firm, the amount attributable each mutual fund’s expense ratio that is not subsequently paid (directly or indirectly) to the firm, and mark-ups/downs on securities traded with other firms. Inclusion of this information could be encouraged as a best practice. Alternatively it could be mandatory, but the Department believes advisory firms are likely to lack systems that capture this information, so this might be costly. The firm/adviser would be free to append additional information, such as a brief description of each service category, as long as these do not materially obscure or distract the customers’ attention from the required information.

A sample disclosure might look like the following:

	WHAT OUR CUSTOMERS PAID IN [PRECEDING YEAR] AS A PERCENT OF CUSTOMER HOLDINGS			
	Overall	Service category #1	Service category #2	Service category #3
<b>Paid to firm</b>				
<b>Paid to advisers</b>				
<b>(Optional) Paid to others</b>				
<b>Total</b>				

In practice, however, such disclosure probably cannot be “accurate” for each customer due to the diversity of retirement investment profiles and associated variability in fees. Moreover, given the volatility in investment returns and the variability in individual customers’ holdings, there is no guarantee that past payments based on the aggregate value of customer holdings would be a predictive indicator of a customer’s expected or likely payments. As a result, it could drive poor decision-making by consumers when comparison shopping.

The Department invites comments on the effectiveness and feasibility, and benefits and costs, of such a pre-engagement disclosure. With respect to effectiveness and feasibility, can such a disclosure achieve its aims in light of its potential inaccuracy, and of evidence [see Section 7.6.1 above] that investors frequently ignore disclosures, and do not adequately understand the implications of disclosed fees and conflicts or how to factor such disclosures into their choice of advisers and investments? With respect to benefits and cost, the Department is particularly interested in comments as to whether advisory firms possess, or how they could acquire, accurate data on all upstream fees.

#### 7.6.4 Condition PTE(s) on Public Disclosure of Investment Results

The new proposal includes a proposed best interest contract exemptions that allows fiduciary advisers to receive a wide range of variable compensation in connection with their advice, subject to certain protective conditions.

One of those conditions requires advisers to keep, and make available to the Department upon request, certain aggregate or account-level data on the investment results achieved by the IRA owners they advise. Reviewing such data, the Department could roughly assess whether a particular adviser's advised plans and IRAs performed better or worse than the market overall, on a risk adjusted basis, net of fees and expenses.

The Department considered attaching to this Best Interest Contract Exemption, and potentially to the proposed amended PTEs and/or the proposed PTE covering certain principal transactions, which are also part of the new proposal, a condition that would require similar aggregate data to be disclosed publicly, and similar account level data to be disclosed to each affected IRA owner. To facilitate comparability, in both instances the data would be reported separately for accounts that fall into a number of risk categories, ranked according to the variability of account returns relative to the variability of overall market returns (*see* Advanced Analytical Consulting Group (2013) on approaches to investment risk tiers). Accounts whose returns varied less than market returns would be classified as lower risk, while those whose returns varied more would be categorized as higher risk. The Department believes such a condition would strongly promote market efficiency and protect IRA owners.

Some comments on the 2010 proposal argued that any apparent underperformance in accounts advised by conflicted advisers in fact merely reflected fair compensation taken by the adviser for services provided to the investor, often including the advice itself.<sup>333</sup> The disclosure of results would empower the market to decide whether any underperformance is fair to IRA owners. An IRA owner could consider her own results, her adviser's aggregate results, and the aggregate results of other advisers, against the level of service provided by her own and other advisers, and shop for the best value. Third parties, such as media outlets, rating enterprises, and academic researchers, would likely analyze and publicize the information, further promoting competition.

The information this disclosure would add to the market would not be perfect. Not all IRA owners seek or consistently follow advice. Even if advice is consistently followed, adviser performance is noisy, especially at the individual account level, so some observed differences would be attributable to chance rather than adviser skill and effort. The timing of flows in and out of accounts can distort account performance relative to market performance, again especially at the individual account level. There would be no information on accounts where advisers do not rely on a PTE that carries this disclosure condition.

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<sup>333</sup> Based on its review of available evidence, as reflected in the foregoing analysis, the Department believes much of such observed underperformance consists of transfers of surplus from IRA investors to advisers or others in the supply chain and social welfare losses from capital and other resource misallocation, reflecting the harmful effect of conflicts on advice.

Nonetheless, the information would reveal something about what if any value an adviser is taking from accounts where he relies on a relevant PTE. The market could weigh this against the value of the services he is rendering. If such disclosure can be affordable and widely communicated in a form helpful to investors, it might deliver benefits to justify its cost and secure investor gains with a lighter touch than some other regulatory approaches.

The Department has elected to omit this provision from the new proposal because important threshold questions are not yet answered. To what degree is the financial industry currently equipped to provide this disclosure, and what would such disclosure cost? How would the cost and effectiveness of such disclosure with those of the PTE conditions be included in the new proposal? Would third parties make beneficial use of this data at efficient cost? What, if any, privacy concern would be raised by such a disclosure requirement? Pending further consideration of these questions, the Department has elected to include in the new proposal a requirement that such information be kept by the adviser and made available to the Department, rather than publicly disclosed.

## **7.7 Issue a Streamlined, “Low-Cost Safe Harbor” PTE**

The Department considered issuing a PTE that would effectively provide relief from the relevant ERISA and IRC PT provisions where investment recommendations appear facially to be without bias. Such a PTE might establish thresholds for “low cost” investments that advisers could recommend. The PTE would allow the adviser to receive a wide range of variable and third-party compensation. The PTE might attach no or few additional conditions. For example, additional conditions might be limited to satisfaction of fiduciary standards of care and loyalty.

The aims of such a PTE might include:

- Providing a targeted reduction in regulatory burdens where market failures are absent or very small by enabling fiduciary advisers to accept variable, third-party compensation without having to satisfy the conditions of the Best Interest Contract Exemption;
- Rewarding and encouraging best-practices with respect to optimizing the quality, amount, and combined, all-in cost of recommended financial products, financial advice, and any other bundled services;
- Ensuring small savers’ access to quality, affordable financial products and advice.

If these aims can be achieved, the PTE might make it possible to secure some investor gains at lower cost than otherwise achievable under the new proposal. However, the Department identified a number of practical challenges in designing and implementing a PTE that would achieve these aims, and therefore did not include one in the new proposal. The Department invites comments on the feasibility and desirability of such a PTE, whether such a PTE would achieve its intended aims or other beneficial aims (or have unintended negative consequences), as well as comments that identify practical design and implementation challenges, and offer suggestions to overcome such challenges. The following discussion elaborates on the Department’s current thinking about such a potential PTE.



### 7.7.1 Reduce Burdens

As noted above, one aim of the streamlined PTE would be to enable fiduciary advisers (especially those exemplifying best practices) to accept variable, third party compensation without having to satisfy the conditions of the Best Interest Contract Exemption. This could minimize burdens where market failures, as reflected by investment costs, are absent or very small.

The Department invites comments on the potential impact of such a streamlined PTE, including the impact on the new proposal's investor gains and compliance costs. The contractual PTE offers advisers considerable flexibility, subject to protective conditions. Had the Department elected to issue a more prescriptive PTE in lieu of the contractual PTE (*see* Section 7.8 below), the need for a streamlined alternative PTE might have been greater.

The Department also invites comments as to whether a streamlined, low-fee PTE would enable advisers to be fairly compensated via variable and third-party payments, without exposing investors to losses from biased advice. Could such a PTE achieve both of these aims at once? A low fee threshold might deny advisers a fair level of compensation for their services. For example, low-cost mutual funds may pay little or nothing for distribution. As noted above, a high threshold might leave investors vulnerable to abuse.

It is also unclear whether such a PTE would do much to reduce advisers' costs. It may be in some investors' best interest to hold some higher cost investments (with fees above the applicable threshold), and advisers would have to use a more demanding exemption, such as the Best Interest Contract Exemption, to the extent they accepted conflicted fees. Other investors may pay more than a competitive price for a given product, but receive valuable advisory services bundled with the product such that the price, though above the threshold, is fair. Again the adviser would have to use the contractual or some other PTE. Stated differently, a given adviser is likely to be able to rely on such a streamlined, low-fee PTE for only some of the recommendations she makes to only some of her clients. Many of the costs of compliance with the contractual PTE's conditions – such as the cost to establish and follow policies and procedures to mitigate conflicts – are fixed or quite concave with respect to the number of recommendations requiring its relief. Relying on the streamlined PTE's relief in connection with one-half of an adviser's recommendations might do little to reduce his cost of compliance with the contractual PTE, on whose relief he must continue to rely in connection with the other half.

### 7.7.2 Encourage Best Practices

Another aim of this streamlined PTE would be to reward and encourage best-practices with respect to optimizing the quality, quantity, and combined, all-in cost of recommended financial products, financial advice, and any other bundled services.

The Department has identified certain challenges in using a low-fee threshold as a mechanism to jointly optimize quality, quantity, and cost. Fundamentally, it is unclear what the "low-fee" threshold should be. A single threshold would be too low for some investors' needs and too high for others' - insofar as some investors might require more expensive asset classes or product types, or opt to bundle the cost of valuable service into the cost of the product. A low threshold (such as 10th percentile) might excessively favor passive management (index funds and passive ETFs) over active management and insurance products, low-cost exposures (such as bond funds) over high cost ones (such as overseas emerging markets), and skinny service bundles over fat ones (discount brokers and "robo advisers" versus full service brokerage). A high threshold

(such as the median) would sanction abuse. And any threshold might encourage the lowest existing prices to rise to its level, potentially harming investors.

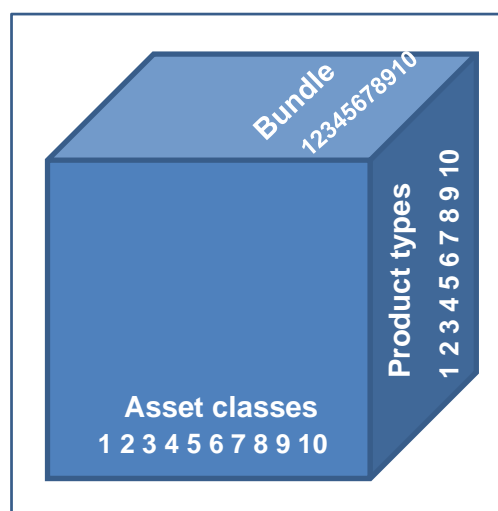
In theory, multiple thresholds could be established for various investment categories distinguished from one another by asset classes, service bundles, and/or product types. But it is not clear how the categories should be delineated, and there is risk that advisers could be biased toward investments for which the threshold most exceeds their cost. The Department invites comments on effective designs for a low-fee or other threshold that would help achieve this PTE's aims. The Department's thinking about issues identified already is summarized immediately below.

With respect to asset classes, some, such as money market funds, tend to be less expensive than others, such as emerging markets equity funds. Separate thresholds could be established for each asset class. But it is not clear how asset classes should be delineated – by tiers of volatility, or some other distinguishing characteristic? How many separate classes would be appropriate? The Department invites comments on these questions. *See* Advanced Analytical Consulting Group (2013) on approaches to investment risk tiers for a discussion of how asset classes might be distinguished by tiers of relative volatility.

With respect to bundling, holding quality and quantity constant, the optimal cost would be the minimum amount achievable in an efficient market. But the quality and quantity of fiduciary investment advice and other services often bundled into the price of a financial product are not constant. They can vary widely across advisers and across customers of a single adviser. The optimal cost for differing amounts of advice of differing quality must also differ. Therefore it is unclear how a single low-cost threshold can serve as a fair benchmark for otherwise similar investments offered with different bundled services. For example, an expense ratio of 100 basis points might be very high for an S&P 500 equity index fund. But it might be a fair price if the fund comes bundled with sufficiently valuable other services. The Department invites comments on whether separate thresholds should be set for different bundles, and if so, how such bundles could be valued or otherwise categorized.

With respect to product type, even within an asset class, costs can sometimes vary. For example, an exchange traded fund, a mutual fund, and a variable annuity might all offer the same risk and return exposure – might even have nearly identical underlying holdings – yet have very different costs.

The accompanying diagram represents how different investments might be categorized along three different dimensions: asset class, product type, and service bundle. If 10 categories were delineated across each of the three dimensions, a separate threshold might be set for up to 1000 unique investment categories. This is a large number, and its size might translate into excessive complexity. The Department believes that no official such benchmarks currently exist. The Department invites comments on how the number can be reduced without compromising the aims of the streamlined PTE.



Both across and within investment categories, a number of additional questions must be addressed in order to arrive at appropriate thresholds. The Department invites responsive comments.

- At what levels should the thresholds be set? Should they be related in any systematic way to the distribution of fees observed in the marketplace? For example, a threshold for an investment category might be set at the level that separates the least costly 10 percent of assets invested in the category from the more costly 90 percent. (Table 7.7.2-1 presents as an example the distribution of mutual fund expense ratios across funds in a single asset class.)

<b>Table 7.7.2-1 Annual Report Net Expense Ratios (Fund-Weighted)</b>									
	<b>Large Cap</b>			<b>Mid Cap</b>			<b>Small Cap</b>		
	<b>Growth</b>	<b>Value</b>	<b>Blend</b>	<b>Growth</b>	<b>Value</b>	<b>Blend</b>	<b>Growth</b>	<b>Value</b>	<b>Blend</b>
<b>Average</b>	1.21	1.15	1.09	1.31	1.25	1.18	1.38	1.35	1.25
<b>99th Percentile</b>	2.48	2.34	2.39	2.50	2.22	2.64	2.50	2.58	2.45
<b>90th Percentile</b>	1.96	1.87	1.91	2.05	1.96	1.98	2.08	2.06	2.01
<b>75th Percentile</b>	1.50	1.40	1.41	1.55	1.50	1.49	1.66	1.58	1.49
<b>Median</b>	1.10	1.06	1.05	1.22	1.20	1.15	1.29	1.26	1.20
<b>25th Percentile</b>	0.84	0.80	0.70	0.96	0.93	0.84	1.05	1.01	0.95
<b>10th Percentile</b>	0.65	0.63	0.35	0.78	0.74	0.29	0.89	0.84	0.69
<b>1st Percentile</b>	0.15	0.23	0.04	0.47	0.32	0.06	0.25	0.11	0.07

<b>Annual Report Net Expense Ratios (Asset-Weighted)</b>									
	<b>Large Cap</b>			<b>Mid Cap</b>			<b>Small Cap</b>		
	<b>Growth</b>	<b>Value</b>	<b>Blend</b>	<b>Growth</b>	<b>Value</b>	<b>Blend</b>	<b>Growth</b>	<b>Value</b>	<b>Blend</b>
<b>Average</b>	0.75	0.70	0.39	0.99	0.87	0.48	0.92	0.87	0.74
<b>99th Percentile</b>	1.85	1.79	1.80	2.01	2.01	2.16	2.04	1.93	2.01
<b>90th Percentile</b>	1.10	1.07	0.99	1.35	1.22	1.18	1.34	1.32	1.33
<b>75th Percentile</b>	0.90	0.88	0.66	1.15	1.01	0.91	1.15	1.15	1.11
<b>Median</b>	0.70	0.67	0.17	0.96	0.82	0.22	0.92	0.98	0.81
<b>25th Percentile</b>	0.60	0.52	0.05	0.78	0.72	0.08	0.79	0.52	0.24
<b>10th Percentile</b>	0.38	0.28	0.04	0.66	0.52	0.06	0.34	0.37	0.09
<b>1st Percentile</b>	0.08	0.08	0.02	0.24	0.09	0.06	0.08	0.08	0.06

Source: DOL calculations using Morningstar data

- If thresholds remain fixed while relevant market prices fall, the risk of abuse will grow. Conversely, if they are fixed and prices rise, the availability of products with expenses below the thresholds will dwindle. How if at all should thresholds periodically be reset to reflect market changes? If advisers rely heavily on a streamlined, low-cost PTE, it is likely that assets will migrate toward investments with expenses below the applicable thresholds. Should the thresholds then be lowered to maintain the same position – for example, at the 10th percentile – relative to the new, lower fee distribution? If so, might this sometimes cause 10 percent or more of all assets in the category to become concentrated in the single, lowest-cost product in the category?
- Should the thresholds be set with the goal of being neutral across categories? Or is it acceptable or even desirable to favor some categories over others? For example, in an asset class where both actively and less expensive, passively managed product types are available, should the threshold be set to generally cover the passive vehicles only?
- For any particular investment category, for purposes both of setting the threshold and assessing which product recommendations fall below it, “all in” costs arguably must include any applicable one-time front- or back-end loads. Investors’ costs therefore will vary depending on holding period and performance. If a long holding period is assumed, a load fund might satisfy the cut-off, but investors who are advised to trade frequently might, in connection with the very same load fund, incur higher costs that exceed the PTE’s applicable threshold.
- Expenses in some categories may vary with the size of the account, investment, and/or transaction. Generally, expenses are proportionately lower when the amount involved exceeds certain “breakpoints.” Therefore an investment might have expenses above a threshold when the account, investment, and/or transaction are small, but below it when they are large. How if at all should thresholds be adjusted for such variation? The Department notes that such adjustment could add a fourth dimension to the hypothetical matrix of product categories and associated thresholds.
- The Department also notes that the distribution of fee levels and the position of any given product within such distribution can also be affected by such breakpoints. Generally, a product that disproportionately attracts larger accounts, investments and/or transactions will pull the distribution down and fall more toward its low end. If such products attract disproportionately large aggregate investments (i.e., total assets under management), then their impact on the asset-weighted distribution will be larger than that on the product-weighted distribution.

### **7.7.3 Small savers**

Another aim of a streamlined, low cost PTE might be to further enhance small savers' access to quality, affordable financial products and advice. To the extent that advisers believe that it is in the best interest of their lower income clients to recommend that they invest in low-fee products, the streamlined, low cost PTE could provide those advisers with an avenue to do so without having to address at all whether their compensation from such products poses a conflict. If such an option reduces the cost for advisers to offer such low-cost products to lower income consumers, the effect of the proposal rule could be a beneficial expansion of services.

The Department recognizes, however, that a streamlined, low-cost exemption might have little or no positive impact on small savers' access to affordable fiduciary advice. As noted in Section 7.7.1, it may simply do little to reduce advisers' costs. Also, in order to ensure that thresholds are sufficiently high to fairly compensate fiduciary advisers for services they provide to small savers, it would be necessary to adjust thresholds for variation in service bundles – and possibly also for account size, adding a fifth dimension to the investment category matrix and thereby bringing the hypothetical total number of categories to 10,000. The Department requests comment on whether a streamlined, low-cost exemption would encourage greater access for small savers.

### **7.7.4 Conclusion**

In light of the foregoing discussion, the Department has elected to omit from the new proposal a streamlined, low-cost PTE. However, such a PTE might achieve at least some of its aims if optimal thresholds could be determined, set, and periodically updated for each combination of asset class, product type, service bundle type, and account size. The Department would welcome suggestions on how to implement a low-fee safe harbor in a way that would achieve its aims, while avoiding abuse.

## **7.8 Issue a Prescriptive, Rather Than Contractual, PTE**

The new proposal includes a contractual PTE that permits advisers to accept a wide range of variable and third-party compensation, subject to general principles rather than prescriptive conditions. The adviser must adopt and follow policies and procedures that effectively ensure that its advice is impartial. The advice rendered pursuant to those policies and procedures must satisfy fiduciary standards of care and loyalty. The conditions are in essence goal-oriented. The adviser has broad latitude to design its own policies and procedures, including its own mechanism for determining whether they are being followed and whether applicable fiduciary standards are met. This approach provides increased flexibility for firms to design compensation programs that are consistent with their individual business models without imposing one size fits all requirements.

As an alternative to this approach, the Department considered issuing a PTE covering a similarly broad range of compensation, but whose conditions would be prescriptive with respect to process. Such conditions might include rigorous reporting and disclosure, detailed fee-leveling provisions, and audit requirements, among others. The Department invites comments on the effectiveness and costs of these and other potential protective, prescriptive conditions, as compared with those associated with the conditions of the new proposal's contractual PTE.

Fee-leveling provisions might prohibit an adviser's compensation from varying depending on the investor's choice of investments within a specified asset class. Such a condition could directly reduce the magnitude and incidence of conflicts, rather than rely solely on protective measures to prevent advisers from acting on conflicts. The Department invites comments on the

cost and effectiveness of fee-leveling relative to that of other types of conditions, and on desirable and practical designs for fee leveling requirements. Pending comments on the foregoing discussion, the Department believes that prescriptive conditions would be more costly and not substantially more effective at delivering investor gains than the conditions of the new proposal's Best Interest Contract Exemption.

## 7.9 Prohibit Mandatory Binding Arbitration

As noted in Section 2.8.2.1 above, the new proposal's contractual PTE would permit advisers to impose a mandatory pre-dispute binding arbitration provision on individual claims, but they could not impose such a condition on class claims. This is consistent with FINRA rules, which prohibit arbitration of class action claims.<sup>334</sup> The Department considered, but rejected, prohibiting all mandatory, binding arbitration clauses in adviser-client agreements. Under this alternative, a plan or IRA investor whose fiduciary adviser breaches contract terms, such as by failing to act in the investor's best interest, would always be able to seek redress in court.

There are reasons to believe that such a prohibition might be an important and needed consumer protection. Prentice (2011) notes that behavioral biases might impair an investor's decision whether to sign such an agreement and thereby waive his or her right to sue. For example, an investor might sign away beneficial legal protections based on "social proof," or in this context, a belief that signing the agreement is safe because the adviser's other clients must have done so, and because other advisers and their clients also enter into such agreements. Nelson (2015, forthcoming) criticizes mandatory pre-dispute arbitration agreements between advisers and investors. He characterizes such agreements as "a dispute resolution system that lacks transparency, requires the investor to relinquish certain Constitutional rights and lacks any effective mechanism to correct erroneous decisions." According to Nelson, investors should be able to choose whether to pursue any particular actions through binding arbitration or in court.

The Department shares these concerns. However, the Department is uncertain as to the potential cost and burden – to advisers, investors, and courts – that might attach to a prohibition against mandatory binding arbitration agreements. Moreover, the harms from such agreements might be substantially reduced as a consequence of the new proposal's protections against adviser bias, so a prohibition might yield little gain to investors. Finally, the Department understands that FINRA already administers a broadly supported arbitration program. The Department invites comments on this issue.

## 7.10 Adjust the Compliance Date

The Department understands that affected advisers and others in the financial industry will need time to modify business practices. A longer compliance period would defer and may reduce compliance costs, but would forgo large, near-term gains to investors, which in turn could have long-term negative effects on investors' retirement savings trajectories. The Department invites comments as to whether the new proposal's compliance dates are workable, or whether dates

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<sup>334</sup> See Section 12204 of FINRA's Code of Arbitration Procedure for Customer Disputes ([http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=4110](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4110)).

should be adjusted with respect to some or all of the proposal’s provisions and entities and transactions it affects.

## 7.11 Conclusion

In conclusion, the Department has examined a variety of important regulatory alternatives, including several identified by commenters. The qualitative and, where possible, quantitative assessments of these alternatives (detailed immediately above and summarized in Table 7.11-1 below) suggest that none would protect plan and IRA investors as effectively as the Department’s new proposal. Compared with the alternatives, the new proposal is expected to deliver additional investor gains that far exceed any additional compliance costs. The Department invites interested parties to share their views on these or other regulatory alternatives and on whether, and to what extent, any alternative would provide effective protections without imposing unreasonable costs.

Table 7.11-1		
Regulatory Alternative	Effect of Alternatives Relative to New Proposal	
	Investor Gains (+/-)	Compliance costs (+/-)
1 Exclude IRAs	- \$40 to \$44 billion over 10 years in front-load mutual fund market segment alone plus additional, unquantified gains across the broader market.	- \$1 billion over 10 years.
2 Omit PTEs	+ Minimal. PTEs’ protective conditions will adequately secure investor gains. (Would also simplify the proposal.)	+ Large. Might unduly disrupt common existing business practices and advice arrangements.
3 Adopt the statutory definition	+ Minimal. Exceptions for plan counterparties and platform providers, and for education, do not open door to biased advice.	+ Substantial. An insufficiently clear definition could encumber valuable activities (e.g., education) that entail no material risk of adviser bias.
4 Include ESOP valuations	+ Substantial for ESOP participants. Will be addressed by future, targeted rulemaking.	+ Uncertain. Comments on the 2010 proposal warned of possible disruption to ESOP market.
5 Wait for SEC	- Large. Would forgo near-term investor gains. Emerging, technology-based advice services would face market pressure to accept conflicted payments.	- Modest. Costs would be accelerated rather than substantially increased.
6 Rely on disclosure	- Large. Approaching the entire quantified gain of \$40 billion over 10 years in front-load mutual fund market segment alone plus additional, unquantified gains across the broader market. Would not remedy adviser bias.	- \$1.8 billion to \$2.0 billion over 10 years.
7 Issue a “low-cost” PTE	+/- Uncertain. Unclear why best-interest recommendations would differ materially under this alternative.	- Uncertain. Unclear whether PTE would materially reduce adviser costs. Complexity might render infeasible.
8 Prescriptive (not contract) PTE	+ Minimal. Contract exemption is expected to be adequately protective.	+ Substantial. Risks inefficiency and undue rigidity, could encumber innovation, difficult to administer.



<b>9 Prohibit mandatory arbitration</b>	+ Probably minimal. New proposal's protections mitigate risk, and FINRA arbitration process well established.	+ Modest. Likely to be little demand for court review given new protections and available arbitration.
<b>10 Delay compliance date</b>	- Large. Would forgo near-term investor gains. Emerging, technology-based advice services would face market pressure to accept conflicted payments.	- Modest. Costs would be accelerated rather than substantially increased.



## 8. Uncertainty

Based on the best available evidence and data, the Department has assessed the potential investor gains (quantifying only the subset of such gains for which the best measures are available)<sup>335</sup> and estimated the potential compliance costs anticipated under the new proposal, and believes that its assessment is well supported and its estimates are reasonable. The Department concludes that, even when focusing only on the subset of potential gains to investors expected in the front-load mutual fund segment of the IRA market, these gains would justify the entirety of the anticipated compliance costs. However, like all estimates, the Department's assessment of the effects of the new proposal is subject to uncertainty.

The uncertainties can be grouped into three areas. First, the quantitative estimates of the IRA-mutual-fund performance gap associated with conflicts in advice and of the new proposal's front-load-mutual-fund-gains-to-investors and compliance costs are subject to imprecision, of unknown magnitude. In addition, because the new proposal's PTEs would be available to all fiduciary advisers – including those who today are fiduciaries under the 1975 rule – some heretofore impartial advice might become tainted by conflicts. Third, the new proposal's market impacts cannot be fully foreseen. The investment advice market is competitive and dynamic. There may be unanticipated positive, and/or unintended negative, consequences.

### 8.1 Imprecision in Estimates

This analysis provides three sets of quantitative estimates in three distinct areas: the performance gap associated with conflicts of interest in IRA mutual fund investment advice, and the new proposal's anticipated investor gains within the IRA front-load mutual fund market segment and complete compliance costs. All are subject to some level of uncertainty.

#### 8.1.1 IRA Performance Gap

The magnitude of IRA investor losses attributable to adviser conflicts is uncertain. Because of data limitations, none of the studies identified by the Department is able to examine all such losses. Across all of the studies, the Department identified evidence of each of the aforementioned types of losses, at least in connection with mutual fund investments common to the directly-affected IRAs. There is strong and deep evidence that conflicted advisers often recommend more expensive and poorer performing investments. A careful review of this data, which consistently points to a substantial failure of the market for retirement advice, suggests that IRA holders receiving conflicted investment advice can expect their investments to underperform by an average of 100 to 200 basis points per year over the next 20 years. The underperformance associated with conflicts of interest – in the mutual funds segment alone – could cost IRA investors \$210 to \$430 billion over the next 10 years and approximately \$500 billion to \$1 trillion over the next 20 years.

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<sup>335</sup> Limiting the quantitative analysis is a lack of comprehensive data that would allow for a precise calculation of the total gains to investors expected to result from the rule. In the absence of such data, and recognizing the inherent uncertainties of such forecasting, the Department has taken the approach of specifically quantifying potential gains to investors related only to one category of investments and fee practices (front-end-load mutual funds) within the IRA market for which there is particularly strong data and evidence of harm.

The estimates are uncertain in part because the estimates in the underlying research papers themselves are uncertain due to limitations in the data and statistical methods used. For example, some of the papers measured the performance differential between two groups: a group with higher conflicts relative to a comparison group with lesser or no conflicts of interest. Because some of the comparison group may also have conflicts, the difference between the two groups is likely to capture only part of the performance gap associated with conflicts, so the estimated performance gap may be understated. Differences in the scope and findings of different papers introduce additional uncertainty. Uncertainty about the future growth and composition of the IRA market and the market for IRA investment advice introduce still more uncertainty.

The degree of uncertainty differs across different segments of the IRA and advice markets. Those segments where available evidence is stronger and more plentiful are subject to less uncertainty than those where evidence is weaker or scarcer.

Some of the performance gap may reflect deliberate and fair payment by IRA investors for observable or intangible services. If so, that portion should not be interpreted as a performance gap associated with conflicts in advice.

The performance gap illustrates the new proposal's potential to produce gains for IRA investors with assets in front-end load mutual funds. It comprises multiple parts: excessive fees that amount to transfers of surplus from IRA investors to advisers and others in the supply chain, reduced resource usage associated with reduced excessive trading, and underperformance (gross of fees) from less than optimal allocation of capital. The relative size of the different parts is uncertain.

The Department believes it made every effort to develop the most reliable estimates possible, and that its estimates are reasonable and of the right order of magnitude.

Before settling on the methods adopted in the analysis, the Department considered two other preferred methods – randomized trials and observational studies -- but rejected them due to unavailability of requisite data.

Randomized trials are often held to be the gold standard for detecting the effects of an intervention, but they are less useful in measuring totals across a population. In this case, the intervention would be the application of conflicted advice.<sup>336</sup> To measure the total impact across the population using a randomized trial, the conflicted advice would have to be applied by a group of conflicted advisers that are representative of all conflicted advisers serving IRA investors in the U.S. This is not feasible for many reasons. For one, the Department does not have a list of conflicted advisers serving IRAs at this time. There would also be serious concerns about experimenter effects in this type of randomized trial. Finally, account performance would have to

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<sup>336</sup> The Department could randomly select a sample of IRA investors and divide them into two groups, treatment and control. The Department could then send the treatment group out to advisers that are known to harbor conflicts and the control group to advisers that are free from conflicts. The Department would then monitor account performance over the course of several decades to determine if there are any welfare differences across the two groups. In order to extrapolate these differences to the U.S. as a whole, the conflicted advisers would need to be randomly selected from the complete, known, U.S. population of conflicted advisers and the unconflicted advisers would need to be similarly selected.

be monitored over several decades to accurately measure the welfare differences across the two groups.

Observational studies are often recommended when a randomized trial is not feasible. If the Department could observe account level returns for IRA investors subjected to conflicted advice and compare those to returns for IRA investors who received non-conflicted advice, the Department could then measure the welfare differences between the two groups. The primary drawback to observational studies is that subjects – in this case, IRA investors – have already self-segregated into groups. IRA investors with particular characteristics, such as financial knowledge or willingness to follow established investment norms, may have, more often than not, chosen a conflicted adviser over a non-conflicted adviser or vice versa. Researchers often attempt to at least partially correct for such “self-selection” effects by identifying observable characteristics that appear to push subjects toward one group or the other. In this case, those observable characteristics might include IRA investor demographics and economic attributes, financial literacy measures, risk appetite measures, and strategic preferences.

The Department considered pursuing an observational study similar to that described above. In December 2011, the Department sent a letter to relevant industry groups asking for the data needed to perform this study.<sup>337</sup> Unfortunately, the industry groups responded that the vast majority of the data was unavailable or too expensive to provide. The Department held several meetings with the industry groups to clarify the data request. The Department made every effort to make clear that the list of data items was a “wish list,” and it did not expect the industry groups to be able to provide every single item. Many different subsets or combinations of items would have provided an alternative basis for an alternative reasonable estimate of any harm from conflicts in the IRA marketplace. To date, the industry groups have not provided the Department with any data at the level of the individual account. Nor did they provide such data to the SEC as part of its consideration of a uniform fiduciary standard.

Absent individual account level data on returns and conflicted advice arrangements, the Department turned to published academic studies which investigate return differences across distribution channels or fund classes. These studies each measure returns differences over unique (but sometimes overlapping) historical time periods. The Department could have chosen a particular historical period over which to estimate the total harm from conflicted advice. However, the Department decided that it would be most fruitful to utilize the measured return differences to generate a rough estimate of the harm that would occur over the next ten years, should the current regulatory environment and business practices persist.<sup>338</sup>

### **8.1.2 Investor Gains**

The magnitude of the proposal’s anticipated investor gains is uncertain. As discussed above, (*see* Section 3.3.1) even if one only considers the impact of the rule on a subset of the negative effects of just one category of harmful conflicts of interest with respect only to front-end

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<sup>337</sup> The letter was sent to the American Bankers Association, American Council of Life Insurers, Financial Services Institute, Financial Services Roundtable, Investment Company Institute, and Securities Industry and Financial Markets Association.

<sup>338</sup> This statement implicitly assumes that past return differences are the best estimate of future return differences.

load mutual funds in the IRA market, the new proposal is in the Department's view expected to produce gains for IRA mutual fund investors that will total \$40 billion over 10 years. This excludes large, additional expected gains, including gains from reductions in excessive trading and associated transaction costs and return-chasing (timing errors), and improvements in the price and performance of IRA investments other than front end load mutual funds. It also excludes gains to plan investors. A reasonable assessment of the total 10-year retirement investor gains expected from the rule may be tens of billions of dollars greater than the partial investor gain estimate of \$40 billion.

It is uncertain whether the protective conditions attached to the PTEs included in the new proposal will be adequate to eliminate bias from investment advice. If they are not, the new proposal's front-load-mutual-fund-gains-to-investors will be reduced. However, less-than-100% effectiveness would not necessarily imply that the total investor gains (including the gains not quantified here) from the rule will be less than the front-load-mutual-fund-gains-to-investors estimate. Many sources of investor gains remain unquantified, including those resulting from the reduction of bias in advice with respect to plan assets, IRA assets that are not in mutual funds, and mutual fund IRA assets that are not in front-load funds. The Department invites input that would make it possible to quantify the magnitude of the rule's effectiveness and of any additional, not-yet-quantified gains for investors.

The estimates are uncertain in part because the estimates in the underlying research papers themselves are uncertain due to limitations in the data and statistical methods used. For example, some of the papers measured the performance differential between two groups: a group with higher conflicts relative to a comparison group with lesser or no conflicts of interest. Because some of the comparison group may also have conflicts, the difference between the two groups is likely to capture only part of the performance gap associated with conflicts, so the estimated performance gap may be understated. Differences in the scope and findings of different papers introduce additional uncertainty. Uncertainty about the future growth and composition of the IRA market and the market for IRA investment advice introduce additional uncertainty.

Because of the limited scope of the research paper underlying the front-load-mutual-fund-gains-to-investors estimates, the estimates themselves are limited in their scope. The estimates capture only the potential for improved performance and reduced loads in IRA mutual fund investments. They do not capture the potential for transaction cost savings from longer holding periods, or the potential for reductions in return-chasing/timing errors. They do not capture the potential for narrower spreads in principal transactions. There may be additional sources of underperformance attributable to conflicts that the new proposal would address, yielding additional investor gains. The larger magnitude of the Department's estimates of the overall performance gap suggest that the overall investor gains from the new proposal are likely to be substantially larger than the quantified portion alone, but the magnitude is uncertain.

Additional investor gains, discussed qualitatively herein, are also of uncertain magnitude. The IRA and plan markets for fiduciary advice and other services may become more efficient as a result of more transparent pricing and greater certainty about the fiduciary status of advisers and about the impartiality of their advice. There may be gains from the increased flexibility that the new proposal's PTEs will provide with respect to fiduciary investment advice currently falling within the ambit of the 1975 rule. The new proposal's defined boundaries between fiduciary advice and education may improve access to plan participant and IRA investor educational services. Innovation in new advice business models, including technology-driven models, may be beneficially accelerated, and nudged away from conflicts and toward transparency, thereby promoting healthy competition in the fiduciary advice market.

A major expected positive effect of the new proposal in the plan advice market is improved compliance and associated improved security of plan assets and benefits. Clarity about advisers' fiduciary status will strengthen EBSA's enforcement activities resulting in fuller and faster correction, and stronger deterrence, of ERISA violations. The magnitude of this impact is uncertain.

### **8.1.3 Compliance and Government Costs**

Based on industry estimates, which the Department believes may overestimate the compliance cost, the new proposal's ten-year compliance cost is estimated to be between \$2.4 billion and \$5.7 billion, or less if, as expected, more cost effective business models gain market share. This estimate is uncertain, reflecting uncertainty about the number and mix of affected advisers, the time and effort required to review practices for compliance, the degree of change in such practices necessary to achieve compliance (including the degree to which such practices fit within the scope of existing and proposed PTEs), the cost associated with such change, and the potential magnitude and speed of improvements in cost-effectiveness. The price and loss ratios associated with errors and omissions insurance is also uncertain.

Much of the estimated compliance cost is associated with satisfaction of PTE conditions. The number of advisers who will take advantage of the relevant PTEs is uncertain, however. Some advisers may find it more advantageous to simply avoid PTs. The Department has aimed to err on the side of overestimating the compliance costs.

Regulators will also incur some cost to implement and enforce the proposed rule. The net amount of such cost is highly uncertain as it depends on compliance levels and efficacy of advisers' policies and procedures. High compliance and effective policies and procedures would limit regulators' net cost.

## **8.2 Effectiveness of Protections**

The effectiveness of the new proposal's protections is uncertain. Under the proposal, amended and new PTEs would allow both existing fiduciary advisers (under the 1975 rule) and new fiduciary advisers (added by the new proposal) to receive certain variable fees and compensation resulting from the provision of fiduciary advice, subject to protective conditions intended to ensure the advice's impartiality. However, it is impossible to predict with certainty just how successful the exemptions will be in removing all the adverse impacts of conflicts of interest. If the protections are not as strong as they should be, then the new proposal may not reduce harms to investors (both quantified and unquantified) as much as it would if relevant PTEs were narrower and/or carried stronger protective conditions.

The Department intends the relevant PTEs' scope and conditions to be effective at ensuring advisers' impartiality. For example, provisions intended to ensure this result include the Best Interest PTE's requirement that a contractual provision prohibit the use of differentiated compensation, actions, or incentives to encourage advisors to make recommendations that are not in the customer's best interest.<sup>339</sup> The Department intends to monitor compliance and market

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<sup>339</sup> See Section 2.8.2.1 for more information on the Contractual Prohibited Transactions Exemption.



developments under the new rule to assess whether it is achieving its goals and inform possible future changes to the regulation and/or the PTEs' scope or conditions.

In addition, the Department notes that as impartiality increases, products that are not in the best interest of the investor will see a net outflow of funds while assets that are in the best interest of the investors could experience an inflow of assets. As discussed earlier in the RIA, providers who sell their products by incentivizing advisers to recommend the products will find that those incentives have been mitigated. As a result, any movement by advisers toward more impartiality is expected to reduce the propensity of those who compensate them to use variable payments to induce advisers to recommend preferred products. This in turn will lead to still more impartiality on the part of advisers.

Nonetheless, the Department has considered the possibility that: (a) the industry may not fully comply with the rule and exemption conditions, and (b) the combined rule and exemption conditions may not be fully effective at ensuring advisers' impartiality in the manner anticipated by the Department. If advisers identify ways to circumvent the protections in the rule, they would continue to impose costs on their customers and — because of their ability to continue subordinating their clients' interests to their own — the anticipated gains to investors would be reduced, but the Department nonetheless believes that these gains alone would far exceed the proposal's compliance cost. For example, if only 75 percent of anticipated gains were realized the quantified subset of such gains — specific to the front-load mutual fund segment of the IRA market — would amount to between \$30 billion and \$33 billion over 10 years. If only 50% were realized, this subset of gains would total between \$20 billion and \$22 billion over 10 years, or several times the proposals' estimated compliance costs of \$2.4 billion to \$5.7 billion over the same 10 years.

Similar to other quantified gains presented herein, the estimates presented above omit large, unquantified expected investor gains. Many sources of potentially large, expected investor gains remain unquantified.

### **8.3 Market Impacts**

The new proposal's market impacts cannot be fully foreseen, because the investment advice market is competitive and dynamic. There may be unanticipated positive, and/or unintended negative, consequences.

### 8.3.1 “Small Savers” and Access to Opportunities to Save

Many comments on the 2010 proposal expressed concern that making more IRA advisers fiduciaries would adversely affect the IRA market. According to these comments, as fiduciaries, advisers’ cost to provide advice would be higher. Commenters asserted that lower-income IRA investors, or those with smaller IRA balances (or both groups), would be unable to afford or unwilling to pay enough to cover that cost, so their access to advice would diminish, and their investment results would suffer. Also, because advisers help IRA investors not only with investment decisions, but also with setting and achieving savings goals – even with opening an IRA and beginning to save – retirement savings itself might suffer. Such negative consequences could more than offset the investors’ gains from eliminating bias from advice, the comments said.

The Council of Economic Advisers points out, however, that “the costly effects of conflicted advice may be particularly relevant for Americans with modest retirement savings, as historically they have relied on types of advice often subject to conflicts. Due to these patterns, some observers have asserted that advising structures using conflicted payments are the only way that savers with lower balances can obtain advice and that without such advice the adequacy of their retirement savings would suffer. This argument, however, falls short in multiple ways and overlooks channels that could provide high-quality, conflict-free advice to moderate-income savers at the same cost as conflicted advising structures.

“First, advisers can provide the same quality of advice while receiving non-conflict-based payments as they can when receiving a payment of equal amount based in conflict. The cost of advice depends primarily on the resources necessary to provide it—the adviser’s time, IT infrastructure, and other inputs—rather than the form of the adviser’s compensation. Thus, an adviser receiving payment through non-conflicted structures should be able to provide advice at the same cost as an adviser receiving conflicted payments, as long as the inputs in time and infrastructure are equal. If advisers serving moderate-income Americans can remain profitable regardless of whether they receive conflicted or non-conflicted compensation, one would expect the number of advisers working with lower-balance savers to remain the same regardless of whether conflict-based payment systems remain in use.

“Second, the prevalence of conflicted payments today may actually interfere with low-balance savers’ ability to get advice. Ongoing developments in the financial industry are sharply reducing the cost of advice, but it may be difficult for new entrants providing quality, unconflicted, low-cost advice to compete on price when other advice erroneously appears to be free. Therefore the prevalence of hidden fees and conflicted payments may make it more difficult for low-cost, high-quality alternatives to compete on a level playing field, reducing moderate-income Americans’ available options for inexpensive advice. As just one example, new approaches to advice that exploit technological advances are allowing firms to offer personalized advice at costs well below those of traditional advice.

“Finally, savers with modest balances today tend to become savers with larger balances tomorrow. According to the Employee Benefit Research Institute, more than 60 percent of IRA contributors in 2010 contributed in at least one of the next two years and nearly 40 percent

contributed in every year from 2010 to 2012 (Copeland 2014). A significant motivator for the services provided to low-balance customers today is likely their potential to become higher balance customers in the future. Financial advisers have strong incentives to work with lower-balance savers regardless of whether using conflicted or non-conflicted payment structures.”<sup>340</sup>

### 8.3.1.1 Small Saver Market

The Department believes that “small savers” (that is, those with low balances or those with modest means) are most negatively impacted by the detrimental effects of conflicted advice. With fewer economic resources, small savers are particularly vulnerable to any practices that diminish their resources by extracting unnecessary fees or by yielding lower returns. They cannot afford to lose any of their retirement savings.

The comments appear to misconstrue the nature of the small saver market. They appear to exaggerate the extent to which advisers, especially brokers, currently advise small IRA investors and thereby increase their savings. In fact, small savers are far more likely to save through job-based plans than through direct IRA contributions. IRAs are funded far more via rollovers from plans than by direct contributions encouraged by brokers or other advisers. Service providers other than brokers, notably banks, appear to serve most small IRA investors today. In fact, small savers turn most often to friends and family for investment advice. By increasing trust in professional advisers, small savers may actually seek out more professional advice.

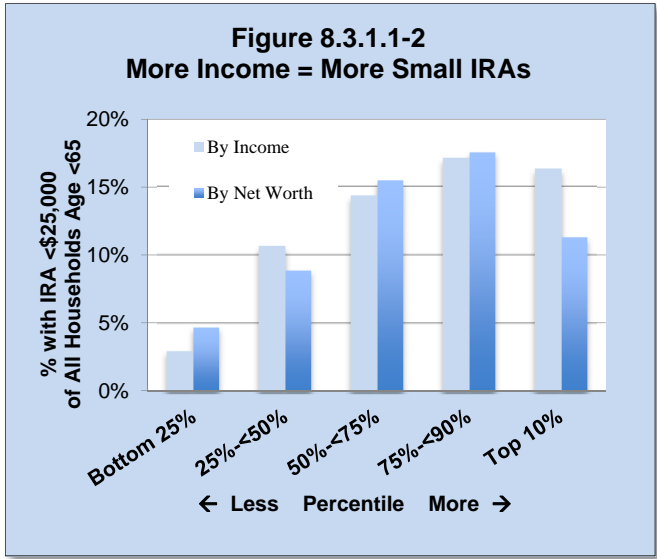
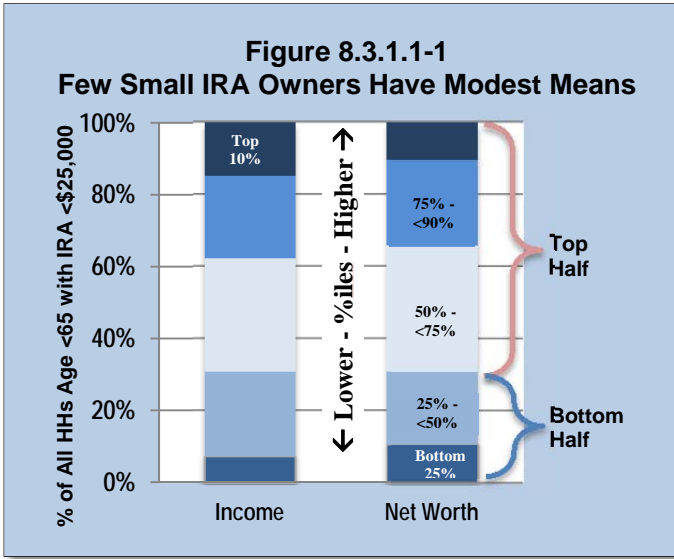
Moreover, the comments appear to conflate small IRA accounts with small savers and thereby base their predictions on faulty assumptions. Many small IRAs are owned by households near the middle of the US income and wealth distribution, or above, and hold other investable assets, likely making them attractive as prospective advisory clients. The industry today competes fiercely to capture rollovers.

“Small savers” are sometimes assumed to be those who hold small retirement savings accounts, such as total IRA balances of less than \$25,000 or some other threshold. But this can be misleading. Many small accounts are held by people with high income and/or wealth.

In fact, nearly 70 percent of all households headed by individuals under age 65 with IRA savings less than \$25,000 are in the top half of the U.S. income distribution (Figure 8.3.1.1-1). An overwhelming majority of households owning such small IRAs also own their homes (75 percent), and many own one or more financial assets outside of IRAs, including job-based defined contribution (DC) accounts (59 percent), stocks (21 percent), savings bonds (18 percent), mutual funds (12 percent), and CDs (7 percent).

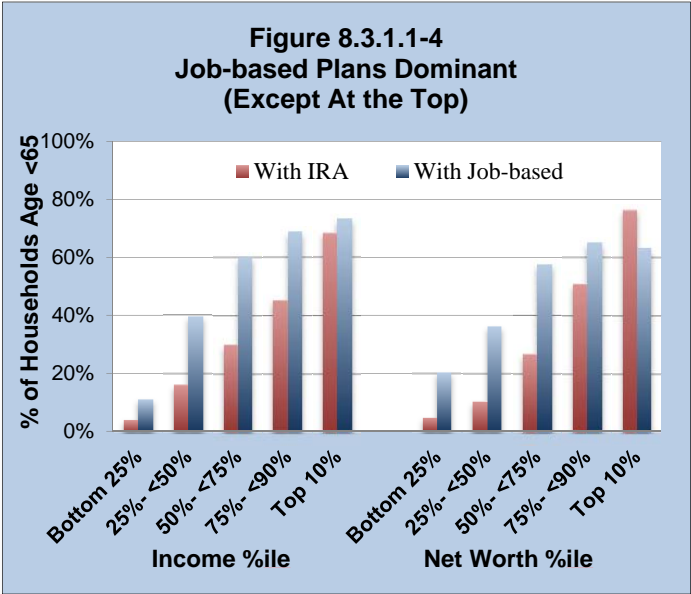
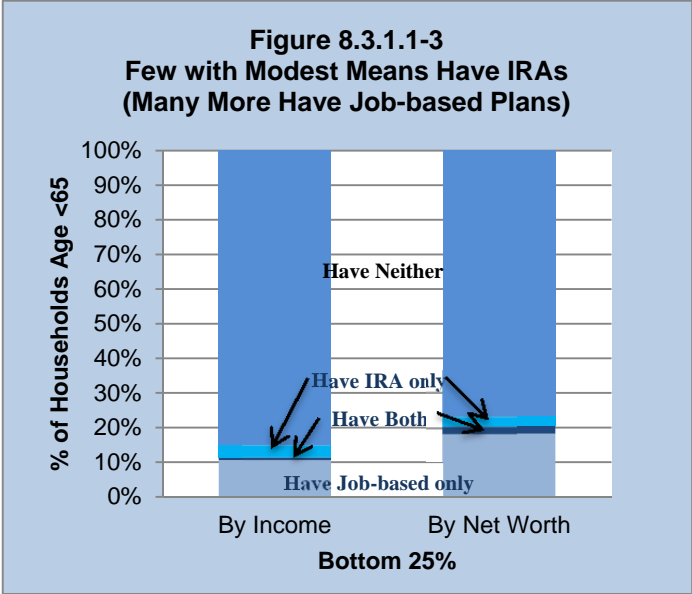
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<sup>340</sup> See “The Effects of Conflicted Investment Advice on Retirement Savings,” Feb. 2015, available at: [https://www.whitehouse.gov/sites/default/files/docs/cea\\_coi\\_report\\_final.pdf](https://www.whitehouse.gov/sites/default/files/docs/cea_coi_report_final.pdf).



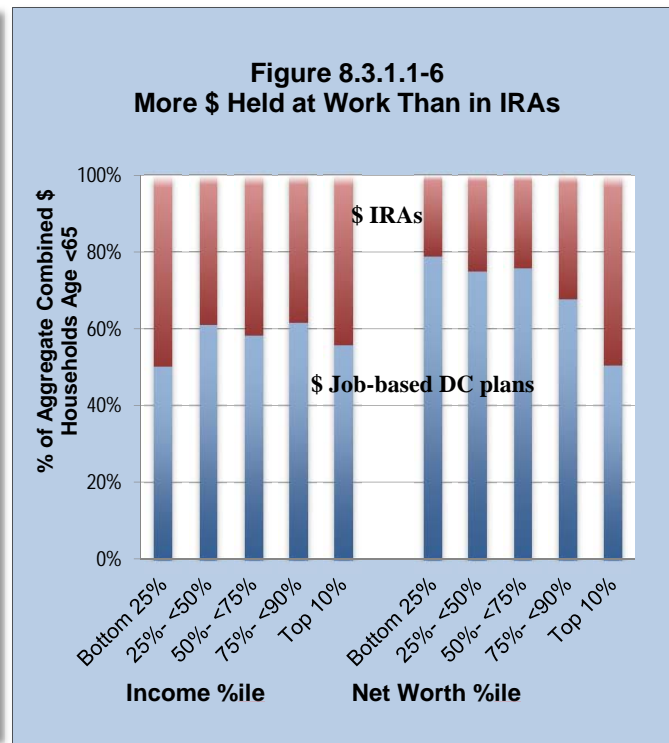
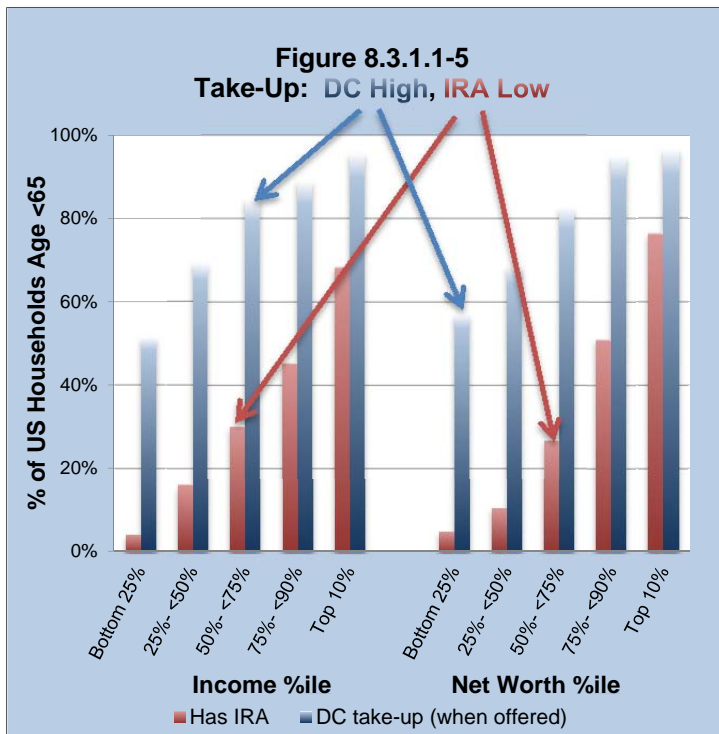
Altogether, 11 percent of all households headed by individuals under age 65 own IRAs valued at less than \$25,000. The proportion owning small IRAs increases with both income and net worth. Just 3 percent of those in the bottom income quartile and 5 percent of those in the bottom net worth quartile own such small IRAs. Wealthier households are far more likely to own small IRAs (Figure 8.3.1.1-2).

A substantial number of people with modest means do save specifically for retirement, but these savings are held mostly in job-based plans, not IRAs. And what little of their savings is in IRAs mostly originates from job-based plans. Among households headed by individuals under age 65, those with modest means are far more likely to participate in a retirement plan at work than to have an IRA. Among the bottom one-fourth of such households by both income and net worth, a substantial minority participate in retirement plans at work, while very few of those that lack such plans have IRAs (Figure 8.3.1.1-3).



In fact, job-based plans are far more common than IRAs among all but the most well-off households (Figure 8.3.1.1-4). This is the case even though low-paying jobs often do not come with any retirement benefits, and those that do often require workers to elect to participate and to shoulder most or all of the funding out of their modest paychecks. Many workers of modest means do join these plans when offered, while few have IRAs.

While families with modest means rarely open IRAs, those offered DC plans on the job enroll in large numbers (Figure 8.3.1.1-5). DC take-up rates far surpass IRA ownership at low and moderate income and wealth levels, and even wealthy households are more likely to join DC plans when offered than to own IRAs. A similar picture emerges if we consider the aggregate amount that households have saved for retirement: Job-based DC plan savings outweigh IRA savings on aggregate among those with low or moderate net worth (Figure 8.3.1.1-6).



While these statistics make clear that, for most moderate income families, DC plans play a far larger role in retirement savings than IRAs, they actually understate the case. Looking only at the incidence and size of DC accounts and IRAs obscures the fact that most IRA savings originates as rollovers from job-based plans rather than direct contributions. According to one survey,<sup>341</sup> of all new IRAs in 2012, two-thirds were funded solely by rollover, and another 22 percent were funded by transfer from an IRA that was held at a different financial firm. Just 10 percent were funded in whole (8 percent) or part (2 percent) by direct contributions. Eight percent of IRA investors made contributions in 2012, contributing \$3 billion. Meanwhile, 10 percent rolled over

<sup>341</sup> Investment Company Institute, “The IRA Investor Profile: Traditional IRA Investors’ Activity, 2007-2012,” March 2014.

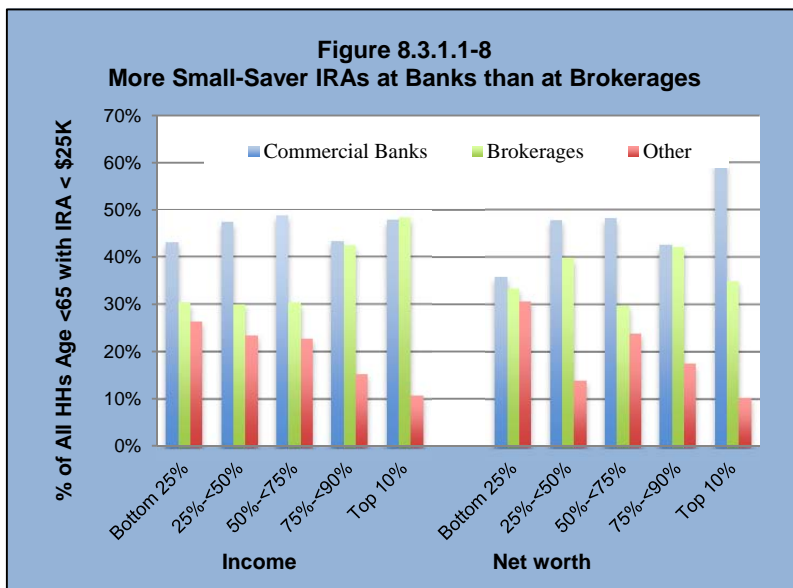
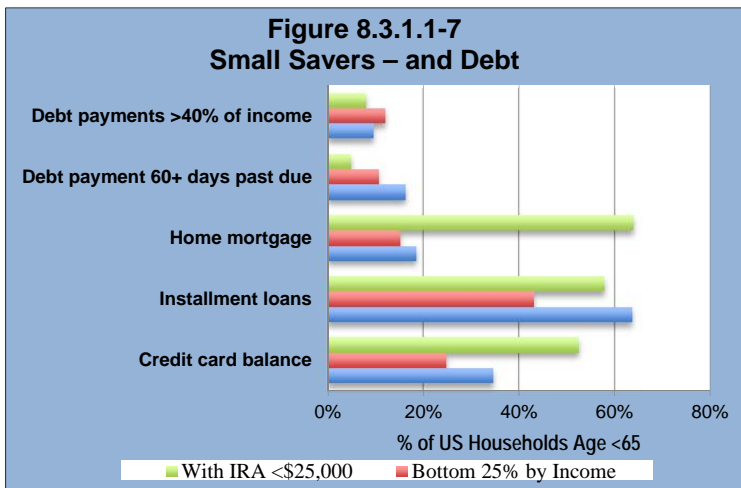
\$72 billion from job-based plans to IRAs. Forty percent of 2012 IRA investors had made a rollover sometime from 2007 through 2012. Most IRA savings originates as rollovers from job-based plans rather than direct contributions.

Commissions and revenue sharing might encourage brokers to sell savings products (such as mutual funds) to families of modest means, and this might encourage them to save more.

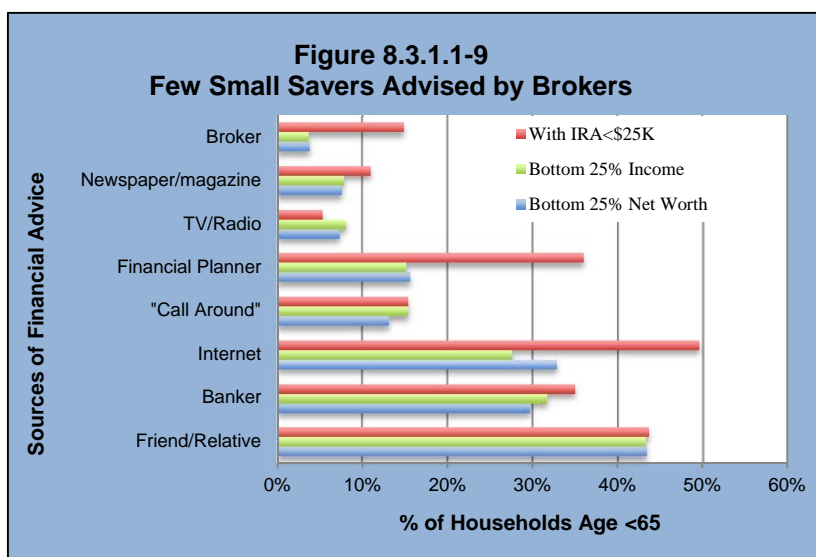
However, this might not always be in the family's best interest. Some hold expensive debt. Ten percent of households under age 65 that fall in the bottom net-worth quartile face debt payments in excess of 40 percent of their income, 16 percent are more than 60 days behind in debt payments, and 35 percent maintain a credit card balance (Figure 8.3.1.1-7). For households saddled with expensive debt, buying mutual funds instead of retiring debt is likely to reduce net worth and financial security, not increase it. Brokers'

compensation arrangements typically reward them for recommending high-fee funds over better, lower-fee funds – and for recommending that families invest as much as possible, even if paying down debt would be a far better choice. Their financial interest therefore often conflicts acutely with that of small savers they might advise.

The Department notes that small savers turn to banks more often than to brokers to hold their IRAs, and rarely turn to brokers for financial advice. Among households under age 65 that own IRAs worth less than \$25,000, just 30 percent of those in the bottom income quartile, and one third of those in the bottom net worth quartile held their IRAs in brokerage (Figure 8.3.1.1-8). Likewise, very few households with modest means or small IRAs seek advice from brokers, while much larger proportions seek advice on-line or from bankers.







Among households headed by individuals under age 65 who are in the bottom net worth quartile, just 4 percent report turning to brokers for financial advice, whereas 33 percent turn to online sources, 30 percent to bankers, 16 percent to financial planners, 8 percent to magazines, books, and/or newspapers, and 7 percent to TV and/or radio (Figure 8.3.1.1-9). More report relying on accountants or even lawyers than report consulting brokers. Just 6 percent of

households headed by Hispanics and 5 percent of those headed by African Americans report getting financial advice from brokers, as do just 10 percent of those headed by Caucasians. Even among households holding IRAs in brokerage accounts, less than one-fourth report receiving financial advice from brokers, while 52 percent get advice online, 44 percent from financial planners, and 22 percent from magazines, books and/or newspapers. As many rely on bankers as on brokers for financial advice.

### 8.3.1.2 Innovation

The Department believes that the new rule could spur positive innovations in the market that would serve small savers particularly well. As elaborated in Section 8.3.5 below, enabled by new technologies, new business models already are delivering inexpensive, quality advice to small investors. The new proposal will promote the availability of such advisory services, both because the business models' technologies can help efficiently ensure the impartiality it demands, and because the new proposals' public fee disclosure provisions will help the business models compete for clients of all sizes by highlighting the now more transparent higher price of what had sometimes appeared to the retirement investor to be "free" advice provided by full service BDs and others.<sup>342</sup>

<sup>342</sup> This requirement would require the Financial Institution to maintain a public webpage disclosing the direct and indirect material compensation available to the adviser, the financial institution and any affiliate in connection with each asset or class of assets that a plan or IRA investor may purchase, hold or sell. The purpose of this requirement is to provide a broad base of information about various pricing and compensation structures to allow retirement investors to better evaluate an adviser's or financial institutions compensation practices.



### 8.3.1.3 Flexibility

The Department believes that the new proposal is very unlikely to have such unintended negative consequences predicated in the comments on the 2010 proposal, for several reasons.

Relative to the 2010 proposal, the new proposal has been refined in light of public comments to more carefully limit fiduciary status to circumstances where plan and IRA investors appropriately expect that advice will be impartial and in their best interest. For example, the new proposal excludes from fiduciary status education that does not include personal recommendations, arm's length transactions between counterparties and large plans, the provision of platforms of DC investment alternatives if advice is not rendered, and routine valuations that are not connected with transactions, among other services. In addition, unlike the 2010 proposal, the new proposal includes proposed PTEs that give advisers flexibility to accept a wide range of compensation that would have been prohibited under the 2010 proposal, subject to protective conditions.

The new proposal's refinements and PTEs will minimize the potential for any negative effects on the availability and affordability of advice and beneficial financial products to plans, plan participants and IRA investors. Its estimated ten-year compliance cost of \$2.4 billion to \$5.7 billion, which ignores expected savings from proliferation of more cost effective business models and therefore is most likely overstated, is tiny relative to the assets of plans and IRAs. The scope of the proposed PTEs is sufficiently broad to give plan and IRA customers access to a very wide range of products and advice business models.

The Department believes that many of the comments' dire predictions were exaggerated, in part because of commenters' misunderstanding of the 2010 proposal. One comment in particular, which included the Oliver Wyman report, predicted major disruptions in the IRA market, including reduced savings by lower income households,<sup>343</sup> appeared to have misunderstood important elements of that proposal. For example, it wrongly assumed that fiduciary advisers to IRA investors could not accept commissions, when in fact much of such compensation would have been permitted under PTE 86-128. It also wrongly assumed that such fiduciary IRA advisers would be liable for breaches of ERISA's fiduciary duties of prudence and loyalty, when in fact such liability existed only for plan advisers, not IRA advisers.

Finally, the comment also neglected other statutory and administrative PTEs available to fiduciary advisers. It failed to account for the indirect fees currently paid by IRA investors to BDs. And it did not examine whether conflicts of interest influence adviser recommendations or erode

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<sup>343</sup> See Oliver Wyman report (2011). According to this comment, many brokers do not have the Series 65 license required to operate as fee-based RIAs. Therefore, the comment argues, if the proposed rule were implemented, these representatives would need to receive additional certification to serve existing clients or attract new clients at a significant cost. Some brokers will choose not to incur the costs of new certification leading to significant job loss in the financial services industry and lower levels of retirement savings and increased costs for investors. Moreover, according to the comment, many IRA investors could become "orphaned," or left without the support of a representative who under the new regime will be willing or able to provide information and education. The comment projects that approximately 10.7 million IRAs would have insufficient assets to switch to an advisory account at their current firm and 7.2 million accounts would have insufficient assets to move to an advisory account at any firm. The Department commissioned RAND to provide an independent review of this comment and one other comment (Fischel and Kendall 2011 Comment Letter to DOL) that also provided an economic assessment of the 2010 proposal that predicted negative consequences for IRAs (Burke et al. 2014).

IRA results, thereby overlooking the billions of dollar of harm that IRA investors currently suffer as a result of conflicted investment advice.

### 8.3.2 Call Centers and Rollovers

The Department gave careful consideration to the potential impact of the new proposal on plan participants' decisions whether to take distributions from their plans when leaving their jobs, and if so, whether to roll such distributions into IRAs. In most instances participants will be better off if they preserve all or most of their account balance in a tax-preferred vehicle, be it a plan or an IRA. If they do not, they generally will owe income tax on the full amount, at their marginal rate, in the year the distribution is made, and, if the distribution is premature, an additional 10 percent penalty. Participants will often, but not always, be better off leaving their balance in the plan than rolling it into an IRA, for two reasons. Plans, especially large plans, often enjoy lower expenses than retail IRA investors. And plan accounts enjoy strong ERISA fiduciary and other protections not available to retail IRAs. The Department expects the new proposal to increase the likelihood that a participant will make the optimal decision, because it will ensure that any professional advice he receives is impartial. In contrast, advisers currently may sometimes bias their advice in favor of rollovers, a decision which typically profits them at the participant's expense.

Faced with the decision whether to retain, rollover or cash out a plan account, participants often seek or are offered guidance from call centers. The first contact is usually between the participant and a call center representative of a service provider to the plan. However, such contact may be followed by referral to an affiliated representative who deals with retail IRA customers. In addition, participants are sometimes contacted by retail IRA call center representatives who are not affiliated with a plan service provider, via a so-called "cold call." In any case, the guidance offered by the call center representative generally is not fiduciary advice under current Department guidance, but generally would be ERISA fiduciary advice under the new proposal, unless it doesn't include a specific recommendation and is limited to education.

A recent report, commissioned on behalf of a coalition of financial services organizations, expresses concern that a Department rule strengthening protections against conflicted investment advice would disrupt participants' access to call centers, and that as a result, some participants would cash out an additional \$20 billion to \$32 billion from their accounts, thereby reducing their accumulated savings by 20 to 40 percent.<sup>344</sup>

The Department and several independent experts have closely reviewed this report and found it to be fundamentally flawed. For example, in a 2014 letter to the Honorable George Miller, Ranking Member of the House Committee on Education and the Workforce, Charles A. Jeszeck, Director, U.S. Government Accountability Office Education, Workforce, and Income Security Team stated that "[t]he report mischaracterizes several points from [GAO's] recent report."). Alicia Munnell stated in her *Market Watch* blog that the report's "calculations rest on a flawed assumption and a flawed econometric model;<sup>345</sup> and a Better Markets blog said the report

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<sup>344</sup> Quantria Strategies, LLC, "Access to Call Centers and Broker Dealers and Their Effects on Retirement Savings," 2014; available at: [http://quantria.com/DistributionStudy\\_Quantria\\_4-1-14\\_final\\_pm.pdf](http://quantria.com/DistributionStudy_Quantria_4-1-14_final_pm.pdf)

<sup>345</sup> Munnell, Alicia, *Market Watch*, "Fiduciary rules would help, not hurt, savers," (May 7, 2014), available at: <http://blogs.marketwatch.com/encore/2014/5/07/fiduciary-rules-would-help-not-hurt-investors.>

“provides little evidence,” “assumes a false premise,” and in effect argues that bad advice that profits the adviser at the investor’s expense is better than none.<sup>346</sup> A more detailed independent review of the report prepared for the Department concluded that “the study is based on flawed or arbitrary assumptions, flawed methods, and misrepresentations of external findings” (Panis 2014) (to be published with proposal).

A few of the report’s most troubling weaknesses merit summary here.

The document itself reports that “none of the research to date has examined the effects of employee access to call center assistance on retirement savings. As a result, very little information is available concerning the effects of call center assistance on retirement savings outcomes.” The only “empirical” evidence presented in the document is a statement that “one financial services company reported that cash-out rates for individuals with account balances between \$35,000 and \$50,000 decline significantly when an employee receives a proactive call (3.3 percent cash-out rate) relative to those who only receive a written communication (10.5 percent cash out rate). This compares to a cash out rate for this company of 34 percent for all former employees each year.” (Presumably the 34 percent rate includes accounts of all sizes. By law, all separating workers with accounts must receive written communications.) This provides no basis for estimating whether or to what degree call center access affects cash outs generally. How do this one financial company and these separating workers compare to the wider population? Why focus just on accounts of certain sizes? What was the nature of the proactive calls? Were the callers conflicted sales persons, or impartial expert advisers? Did they provide education only, or recommendations, and if the latter, what did they recommend? Was the written material that which is legally required, or more than that?

Other data presented in the document do not pertain to the question of call center effects on cash outs and therefore cannot support the document’s conclusion. The document presents as purportedly corroborating evidence one estimate of a positive relationship between contributing workers’ account balances and use of financial planners. But this fails as evidence. Consulting a financial planner is not comparable to accessing a call center, especially if the latter means receiving a call from an IRA sales person paid by commission. The document looks only at contributing workers, ignoring retiring workers who on average have larger balances and are less likely to cash out. In any event, high balances may motivate planner consultations rather than vice-versa (or some other force, such as education, might cause both).

For the foregoing reasons, the Department gives little weight to this report. Nonetheless, the Department understands that the new proposal will, as intended, have some effect on participant call center guidance respecting distribution opportunities. The primary expected effect will be to ensure that any recommendations offered are impartial and in the participants’ best interest. The Department believes the new proposal is sufficiently flexible to avoid any material negative impact on participants’ access to beneficial call center guidance. Rather, by explicitly extending guidance on the bounds of non-fiduciary education to cover education about

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<sup>346</sup> *Better Markets* Blog, “The Latest Attack on the DOL’s Rulemaking to Protect Retirees From Conflicts of Interest: “Bad Advice Is Better Than None,” (May 2014); available at: <http://www.bettermarkets.com/blogs/latest-attack-dol%E2%80%99s-rulemaking-protect-retirees-conflicts-interest-%E2%80%9Cbad-advice-better-none%E2%80%9D#.U4j0-0EpC70>.

distributions and rollovers, the new proposal is likely to make call center guidance more available and robust, not less. However the precise nature and magnitude of the new proposal's effects on participant call centers, and of call centers on participant distribution decisions, are uncertain because it is unclear whether and to what extent call center staff today are providing education, or by their actions, advice.

### 8.3.3 Plan Sponsor Responses

A May 2014 survey conducted by Greenwald & Associates for the United States Hispanic Chamber of Commerce and a coalition of financial services organizations found that sponsors have grave concerns about Department's expected rulemaking addressing conflicts of interest in plan investment advice. According to this survey, 65 percent believe that a Department rulemaking would be a bad idea, and 29 percent reportedly believe it is at least somewhat likely that they would drop their plan if the Department's rulemaking took effect.<sup>347</sup>

This finding stands in stark contrast to the results of a March 2014 survey conducted by AARP of plan sponsors.<sup>348</sup> The latter found that plan sponsors overwhelmingly support subjecting DC plan providers who advise participants to the fiduciary standard of loyalty. Specifically, among the 3,010 sponsors who responded to the survey, 68 percent strongly favor and 21 percent somewhat favor requiring DC providers to give advice that is in the best interest of plan participants. Just 7 percent oppose this requirement. Seventy-seven percent strongly or somewhat agree that it is important for DC plan participants to receive investment advice from an independent adviser who does not make money from the plan's investments.

What explains the divergence in these survey findings? Why would sponsors express grave concerns about a rulemaking to establish standards that they strongly favor? The answer appears to be that the Greenwald survey described a proposal very different from the Department's 2010 and new proposal. The surveyors told sponsors that the Department "is considering prohibiting both retirement plan providers and the advisers who sell retirement plans to employers from assisting the employers in the selection and monitoring of the funds in the retirement plan." Neither the 2010 nor the new proposal would do this. Rather, the new proposal would require that such providers and advisers adhere to fiduciary standards, including loyalty to participants' interests, when rendering investment advice to sponsors in connection with the selection and monitoring of such funds.

Many such providers and advisers already render fully compliant fiduciary investment advice to sponsors in connection with the selection and monitoring of such funds. The new proposal would not limit or impair such existing arrangements. Nor would it prevent providers or advisers who currently avoid fiduciary status (for example, by disclaiming, pursuant to the 1975

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<sup>347</sup> Greenwald & Associates, "The Impact of the Upcoming Re-proposed Department of Labor Fiduciary Regulation on Small Business Retirement Plan Coverage and Benefits," (May 2014); available at: [http://ushcc.com/wp-content/uploads/2014/05/survey\\_0029436\\_embargoed\\_002095743.pdf](http://ushcc.com/wp-content/uploads/2014/05/survey_0029436_embargoed_002095743.pdf).

<sup>348</sup> AARP Survey, "Fiduciary Duty and Investment Advice: Attitudes of Plan Sponsors," (March 2014); available at: [http://www.aarp.org/content/dam/aarp/research/surveys\\_statistics/econ/2014/Fiduciary-Duty-and-Investment-Advice-Attitudes-of-Plan-Sponsors-AARP-res-econ.pdf](http://www.aarp.org/content/dam/aarp/research/surveys_statistics/econ/2014/Fiduciary-Duty-and-Investment-Advice-Attitudes-of-Plan-Sponsors-AARP-res-econ.pdf).

rule, that their advice should not be understood to serve as the primary basis for investment decisions) from profitably entering into such arrangements.

Such arrangements are both straightforward and affordable. A provider that had previously avoided fiduciary status need only: (1) honor participants' interests over its own and (2) rely on direct fees from the plan or sponsor, or treat any variable fees received from fund providers as part of an agreed upon service fee otherwise fully payable by the plan or sponsor. Alternatively, the adviser or provider could take advantage of an existing or proposed PTE that permits variable and third-party compensation.

The Greenwald surveyors also incorrectly told sponsors they would be forced to get advice from an independent third party or make decisions entirely on their own. Not surprisingly, sponsors expressed concern with these alternatives. Yet in fact, as just noted, sponsors could continue to get advice from their plan providers or the advisers who sold them the plan, so such concerns are unfounded.

The Greenwald surveyors broadly indicated to plan sponsors that plan providers and advisers could no longer support their decisions in any way. Yet the Department's initiative would have no bearing whatsoever on informational and educational support for plan sponsor decisions. It would attach fiduciary duty only to investment advice involving specific recommendations.<sup>349</sup>

The Department notes that the Plan Sponsor survey that found sponsor support for fiduciary standards was funded by an independent consumer advocacy group (AARP) and reflects responses from more than 3,000 sponsors. In contrast, the Greenwald survey that found concern with an untrue description of a hypothetical (and objectionable) Departmental rulemaking initiative was jointly funded by industry stakeholders, and reflects responses from just 505 sponsors.

In light of the foregoing, the Department believes that plan sponsors are highly unlikely to withdraw from the market or reduce valuable plan offerings in response to the new proposal. Any suggestion that they will terminate their plans or decline useful advice is essentially implausible.

### **8.3.4 Impact on Existing Markets for Financial Products and Services**

The proposal will have a variety of indirect effects on existing markets for financial products and services. The character and magnitude of these effects are highly uncertain. The Department believes these effects are likely to tend toward greater long-term economic efficiency and thereby improve overall social welfare. However, transitional frictions may introduce some social costs, and the long-term distributional impacts are uncertain. The discussion that immediately follows explores qualitatively some potentially important indirect effects and their potential social welfare implications, with an eye toward the starting point of historical market

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<sup>349</sup> The wording was: "The Department of Labor is considering prohibiting both retirement plan providers and the advisors who sell retirement plans to employers from assisting the employers in the selection and monitoring of the funds in the retirement plan. Under possible new rules, the employer would have two options: (a) find an independent expert on investments to provide, for an additional fee, guidance on the selection and monitoring of investment options, or (b) do the selection and monitoring themselves, subject to fiduciary liability if this selection is not done in a prudent manner by someone with sufficient expertise. If "a" is chosen, the plan sponsor would be subject to fiduciary liability if the expert is not chosen in a prudent manner."



conditions. It is not intended to be exhaustive. Section 8.3.5 below elaborates, with emphasis on already emerging market trends.

The proposal may affect demand for financial advice in multiple ways, and supply will adjust in response. The Department expects the proposal to make retirement investment advice more impartial. It also aims to make the prices of advice, investing, and investments more transparent. It may improve IRA investors' heretofore poor understanding of how advisers are regulated and paid, and raise awareness that many are newly obligated to honor retirement investors' interest. All of this may increase investors' trust in advisers and increase their demand for advice. At the same time, the price of advice might rise to reflect advisers' compliance costs. As a result, the amount of advice provided might rise or fall, and the mix of kinds of advice may change. This in turn may affect the labor market for advisers. These dynamics may involve frictional costs and have distributional effects. The overall movement is likely to be toward greater long-term efficiency, with a more efficient allocation of labor and other resources to investment advice and other productive enterprises.

The proposal will affect the demand for financial products and financial services beyond advice, and supply will adjust in response. Passive and other lower cost investments may gain market share. As discussed earlier in the RIA, providers who sell their products by incentivizing advisers to recommend the products will find that those incentives have been mitigated. As a result, products that are not in the best interest of the investor will see a net outflow of funds while assets that are in the best interest of the investors could experience an inflow of assets. This flow of assets will cause shifts in the asset provider market, with associated frictional costs and distributional effects. As with the advice market, these markets are likely to move toward greater efficiency, with a more optimal allocation of resources to producing a more optimal mix of financial products and services.

The Department notes that the markets for financial advice, financial products and other financial services are highly dynamic. They are characterized by innovation in both product lines and business models, and by large ongoing shifts in labor and other resources across product and service vendors and business models. These dynamics often involve large transactions, including recruiting bonuses, client account transfers and other asset flows, all of which may entail substantial frictional costs. Therefore the Department believes it likely that any frictional cost associated with this proposal will be justified by the proposal's intended long term effects of greater market efficiency and a distributional outcome that favors retirement investors over the financial industry.

The Department also notes that mutual funds and other financial product providers generally are not expected to incur direct compliance costs. The proposal would apply to advisers who distribute financial products, not to the providers of such products. Any costs incurred by mutual funds would be indirect, and would be most associated with mutual funds that are relatively expensive and/or underperforming, and currently relying biased advice to keep their net flows competitive.

### **8.3.5 Promoting Healthy Competition and Innovation**

The Department believes the new proposal will promote healthy competition in the market for advice on the investment of IRA assets, to the advantage of IRA investors. This analysis has presented evidence that consumers currently mistake biased advice for impartial advice, and are unaware of some of the fees they pay for that advice. This indicates an inefficient market where consumers spend too much and get too little. Imperfect information is causing the market for IRA

advice to fail. Under the new proposal, IRA investors will expect and get impartial advice and the price will be more transparent, so the market will be more efficient.

The market is already beginning to serve small accounts with quality, impartial, affordable advice or other effective support for sound saving and investing decisions. The new proposal is likely to promote healthier development of emerging business models that rely heavily on technology to generate and deliver advice and/or that build advice into financial products themselves, as is the case with target date funds. Such new technologies and innovations in financial products already appear to be making advice and other potentially effective investment support more affordable and available to many consumers. For example, technologies make it possible to automatically pull data from customers' accounts with nearly all financial institutions, with customer consent. Computer algorithms can compare their financial information with data on the price and performance of a wide universe of investment alternatives, generating options for consideration, or even recommendations, very inexpensively. Some of these newer business models lean toward independence in advice, but absent policy changes such as those included in the new proposal, they may face the same competitive pressures that have led more conflicted models to prevail so far. Conflicted models currently can prevail even with inferior value because their price and quality are shrouded. Under the new proposal more efficient models may gain market share. More consumers, such as small IRA investors, may migrate to inexpensive solutions such as passively managed target date funds or similar ETFs. They may mix such strategies with other innovative products recently gaining favor, such as deferred annuities that insure them against exhausting resources at very advanced ages, sometimes referred to as "longevity insurance." Following such simple and inexpensive yet potentially effective strategies can reduce the need for complicated and expensive advice.

So-called "robo-advisers" and products (such as target date funds) that minimize the need for complex advice are already rapidly gaining market share.<sup>350</sup> Going forward, they promise to make advice far more affordable for small investors, especially young investors who generally are more accustomed to technology-based tools. More traditional advisory firms are scrambling to develop, partner with, or acquire such innovative tools, and to combine these with more traditional services to deliver tailored services to more market segments at far lower cost than that historically associated with traditional approaches alone.<sup>351</sup>

Robo-advisers can have various business models in terms of the amount of hands-on assistance and the types of services offered.<sup>352</sup> Despite this variation, they share a common characteristic - they utilize technology to meet the core portfolio management needs of mass retail investors.<sup>353</sup>

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<sup>350</sup> A robo-adviser is an online wealth management service that provides automated, algorithm-based portfolio management advice without the use human financial planners.

<sup>351</sup> Steve Sanduski, *Investment News*, "The Reasons Why Human and Robo-Advisers Will Soon Converge," (July 14, 2014); and Joyce Hanson, *Investment News*, "Traditional Advisory Firm Hammers Out Deal With Robo-Adviser," (Aug. 1, 2014).

<sup>352</sup> Liz Moyer, *Wall Street Journal*, "Taking Stock of Automated Financial Advisers," (August 8, 2014).

<sup>353</sup> Megan Graf, *Investment News*, "Debunking 3 big myths about robo-advisers," (September 17, 2014).



Because the core portfolio management is captured in a computer algorithm, robo-adviser services generally can be scaled up more easily than traditional advisory services.<sup>354</sup> The marginal cost incurred by a robo adviser to service additional customers is very small relative to that incurred by traditional advisers. Consequently robo-advisers can profitably service small investors – and even bring new investors into the market – at low prices. Robo-adviser firms often serve investors with assets under \$500,000.<sup>355</sup> Historically, small investors sometimes have been underserved by traditional investment firms because it has not been economical to serve them one at a time.<sup>356</sup> However, this advantage in scale comes at a price – a somewhat limited range of services. Services provided are typically comprised of asset allocation with passively-managed ETFs or mutual funds only.<sup>357</sup> Some may believe that this is not a huge limitation because small investors are the main client base. The financial needs of small investors can be easily met by basic services and given the low balance of such accounts it is probably not worth paying for a personalized strategy.<sup>358</sup>

Robo-advisers and other inexpensive investment firms have grown quickly over a short period of time. Although their market share is still small – about 0.1% of total household investible assets,<sup>359</sup> they can influence the market significantly by means of their low fees and cost-efficient business models. Some would predict that this new type of firm will replace traditional firms; however, robo-adviser and traditional firms are not necessarily substitutes for several reasons.

First, robo- and traditional advisers serve different populations. Robo-advisers or other low-cost investment firms often attract young technology-savvy investors with low balances,<sup>360</sup> whereas traditional advisers often target older investors with high net worth. Because robo advisers' client bases are relatively young, robo-advisers are well positioned for future growth.<sup>361</sup> If a firm provides a simple technology-only platform for young investors with low-balances and helps such investors accumulate more wealth over time, later those investors can be easily brought into a full service program within a more traditional firm. Due to this generational component, it would not be surprising to see traditional firms acquiring robo-adviser firms or robo-adviser firms partnering with traditional firms.<sup>362</sup>

Second, robo-advisers and traditional advisers have advantages in different tasks related to investment services. Beyond portfolio management, human advisers provide a wide range of

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<sup>354</sup> Megan Graf, *Investment News*, “Why I left a traditional IRA for a robo-adviser,” (May 30, 2014).

<sup>355</sup> Joyce Hanson, *Investment News*, “Wealthfront CEO sees his robo-adviser as the next Schwab,” (June 13, 2014).

<sup>356</sup> Megan Graf, *Investment News*, “Why I left a traditional IRA for a robo-adviser,” (May 30, 2014).

<sup>357</sup> Joyce Hanson, *Investment News*, “Traditional advisory firm hammers out deal with robo-adviser,” (August 1, 2014).

<sup>358</sup> Megan Graf, *Investment News*, “6 lessons traditional advisers can learn from robos,” (July 25, 2014).

<sup>359</sup> Eric Clarke, *Investment News*, “Don’t be afraid of the robo-adviser – it might actually help you grow,” (June 9, 2014).

<sup>360</sup> Yodlee, White Paper, “Can your wealth management firm stand up to the new wave of FINTECH disruptors?” Available at: <http://www.yodlee.com/resources/downloads/>.

<sup>361</sup> Eric Clarke, *Investment News*, “Don’t be afraid of the robo-adviser – it might actually help you grow,” (June 9, 2014).

<sup>362</sup> Steve Sanduski, *Investment News*, “The reasons why human and robo-advisers will soon converge,” July 14, 2014).

services such as tax and estate planning.<sup>363</sup> In contrast, robo-advisers offer a somewhat narrow range of services within portfolio management. Using computer algorithms, robo-advisers automate a few elements of investment services, such as portfolio rebalancing and tax-loss harvesting.<sup>364</sup> These are typically time-consuming and error-prone tasks if done manually.<sup>365</sup> If human advisers automate these tasks using technology, human advisers can more efficiently allocate their time to the tasks that can bring more revenues. This difference in comparative advantage makes robo-advisers and traditional adviser firms complement rather than substitute each other.

Third, robo-advisers have not been tested in a bear market. If or when the economy next slows down and the market goes through a correction, relying on a computer algorithm only may be inadequate to avoid panic selling and the need for a human adviser may increase. To prepare for a potential downturn, some robo-advisers reportedly diversify their revenue streams. Some firms may choose to reach out to financial firms and build partnership with them.<sup>366</sup> Others may offer more contacts with human advisers.<sup>367</sup> Although it is not clear how the investment market will shape up during a future market correction, the partnerships between robo-adviser firms and traditional firms may become prevalent.

Because of the complementary nature of these two types of business models, robo-advisers and traditional firms may merge and morph into one business model.<sup>368</sup> Whether they are merged or remain separate, unbundling of services may be accelerated due to the presence of robo-advisers. Investment firms may be more willing to differentiate the levels of services and charge fees accordingly. This differentiation is likely to increase profit for the firms, as it would bring more investors to the market. This is likely to positively affect investors, as well, because investors can have more choices on the level of services and fees based on their needs.

Although it is too early to precisely predict how the investment market will evolve over time, the Department expects the number of low-cost automated investment service firms to increase and their presence will accelerate changes in the market. Therefore, it is critical to create a regulatory environment where these new innovative firms can grow free from conflicts. Currently, some robo-advisers are offering services mostly free from conflicts: some claim no commission, no performance fees and/or no compensation from third parties,<sup>369</sup> and others claim to serve

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<sup>363</sup> Megan Graf, *Investment News*, “6 lessons traditional advisers can learn from robos,” (July 25, 2014).

<sup>364</sup> Megan Graf, *Investment News*, “Debunking 3 big myths about robo-advisers,” (September 17, 2014).

<sup>365</sup> Sheryl Rowling, *Investment News*, “Using technology to beat the robo-adviser at their own game,” (August 21, 2014).

<sup>366</sup> Joyce Hanson reports in the *Investment News* on July 24, 2014 that Jemstep Inc. is reaching out to a variety of financial firms and putting together business distribution partnership.

<sup>367</sup> Joyce Hanson reports in the *Investment News* on July 24, 2014 that Personal Capital is offering more personal touch.

<sup>368</sup> Steve Sanduski, *Investment News*, “The reasons why human and robo-advisers will soon converge,” (July 14, 2014).

<sup>369</sup> Internal document reports various business practices concerning fees: Financial Engines claims no fees are calculated on varying bases for various customer accounts, and Betterment, LLC, the second largest robo-adviser firms in terms of asset under management as of June of 2013, claims no interests or positions in securities

investors as fiduciary.<sup>370</sup> However, this conflict-free model may not last long as more robo-advisers expand their businesses through partnering with traditional firms. For example, one robo-adviser firm assists financial advisers in working with their clients using their automated account system and they work with other brokerages and custodians, as well.<sup>371</sup>

The Department expects that the new proposal will help ensure that these new approaches evolve toward less conflicted and more innately impartial business models, rather than succumbing to the competitive pressures that have led more conflicted models to dominate today's highly imperfect marketplace. In addition, the new proposal will in the Department's view promote the availability of such advisory services, both because the business models' technologies can help efficiently ensure the impartiality it demands, and because the new proposals' public fee disclosure provisions will help the business models compete for clients of all sizes by highlighting the now transparent higher price of what had appeared to be "free" advice provided by full service BDs and others.

Also, financial services firms already are moving toward more fee-based advice models, considering flatter compensation models, and integrating to technology.<sup>372</sup> A growing number of advisers appear also to be favoring broader application of fiduciary standards.<sup>373</sup> And there is evidence that holding BD representatives to fiduciary standards at the state level does not impair access to their advice services.<sup>374</sup>

For all of these reasons, the Department does not anticipate that its new proposal will have substantial unintended negative effects on the availability or affordability of advice. Rather, it is more likely that the new proposal will nudge the investment advice market's evolution toward greater efficiency and better results for plan and IRA investors.

Nonetheless, the possibility for some negative consequences for some plans, plan participants or IRA investors cannot be ruled out. At a minimum some might experience short-term disruptions in service as their existing advisers make changes in response to the new rule. There may be a period of increased rates of switching to new advisers, with associated transition costs, although this would most likely lead to a more efficient market equilibrium, reflecting better informed matches between customers and advisers.

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recommended. Vanguard Personal Advisor Services (VPAS), low-cost but not robo-adviser investment firm, claims no performance fees.

<sup>370</sup> Joyce Hanson reports in the *Investment News* on August 1, 2014 that Jemstep serves all of its online consumers as fiduciary.

<sup>371</sup> Joyce Hanson, *Investment News*, "Robo startup will work with advisers exclusively," (July 15, 2014).

<sup>372</sup> See Ernst and Young, "Financial Adviser Compensation;" available at: [http://www.ey.com/Publication/vwLUAssets/EY\\_-\\_The\\_changing\\_approach\\_to\\_advisor\\_incentives/\\$File/EY-The-changing-approach-to-advisor-incentives.pdf](http://www.ey.com/Publication/vwLUAssets/EY_-_The_changing_approach_to_advisor_incentives/$File/EY-The-changing-approach-to-advisor-incentives.pdf).

<sup>373</sup> ThinkAdvisor Fiduciary Survey, "Trustworthy Advice and Individual Investors: Will Regulators Act In Investors' Best Interest? Findings of the 2013 fi360-ThinkAdvisor Fiduciary Survey"; available at: [http://www.fi360.com/uploads/media/fiduciarysurvey\\_resultsreport\\_2013.pdf](http://www.fi360.com/uploads/media/fiduciarysurvey_resultsreport_2013.pdf).

<sup>374</sup> Finke, Michael, Langdon, Thomas, "The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice"; available at: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2019090](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2019090).

The Department invites comments that will help it address the foregoing issues.



## 9. Conclusion

Based on the foregoing analysis, the Department believes that the new proposal would mitigate adviser conflicts and thereby improve plan and IRA investment results, while avoiding undue disruption of existing business practices. The Department further believes that it would deliver large gains for retirement investors and other important economic benefits.

A wide body of economic evidence supports a finding that the impact of adviser conflicts of interest on retirement investment outcomes is large and negative. The supporting evidence includes, among other things, statistical analyses of investor results in conflicted investment channels, experimental studies, government reports documenting abuse, and economic theory on the dangers posed by conflicts of interest and by the asymmetries of information and expertise that characterize interactions between ordinary retirement investors and conflicted advisers.

The Department believes that the proposal would deliver large gains for retirement investors. Because of limitations of the literature and available evidence, only some of these potential gains can be quantified with confidence. Focusing only on how load shares paid to brokers affect the size of loads IRA investors holding load funds pay and the returns they achieve, the proposal has the potential to deliver to IRA investors gains of between \$40 billion and \$44 billion over 10 years and between \$88 and \$100 billion over 20 years. These quantitative estimates are calculated with an assumption that the rule will eliminate (rather than just reduce) underperformance associated with the practice of incentivizing broker recommendations through front-end-load sharing; if the rule's effectiveness in this area is substantially below 100 percent, these results may overstate rule-induced gains to investors in the front-load mutual fund segment of the IRA market. However, these estimates also exclude additional potential gains to investors resulting from reducing or eliminating the effects of conflicts in financial products other than front-end-load mutual funds. The Department invites input that would make it possible to quantify the magnitude of the rule's effectiveness and of any additional, not-yet-quantified gains for investors.

The Department believes that the proposal would yield large additional expected gains for IRA investors, including improvements in the performance of IRA investments other than mutual funds and potential reductions in excessive trading and associated transaction costs and timing errors (such as might be associated with return chasing). Because this approach to the economic analysis accounts for only a fraction of conflicts, associated losses, and retirement assets, the total gains to IRA investors attributable to the rule are, in the Department's view, likely to be much higher than the quantified gains alone.

The new proposal's positive effects are expected to extend well beyond the limited scope for which the Department was able to provide quantitative gains for retirement investors. The IRA and plan markets for fiduciary advice and other services may become more efficient as a result of more transparent pricing and greater certainty about the fiduciary status of advisers and about the impartiality of their advice. There may be benefits from the increased flexibility that the new proposal's PTEs will provide with respect to fiduciary investment advice currently falling within the ambit of the 1975 rule. The new proposal's defined boundaries between fiduciary advice, education, and sales activity directed at large plans, may bring greater clarity to the IRA and plan services markets. Innovation in new advice business models, including technology-driven models, may be accelerated, and nudged away from conflicts and toward transparency, thereby promoting healthy competition in the fiduciary advice market. Another major expected positive effect of the new proposal in the plan advice market is improved compliance and associated improved security of plan assets and benefits. Clarity about advisers' fiduciary status will strengthen EBSA's

enforcement activities resulting in fuller and faster correction, and stronger deterrence, of ERISA violations.

The Department estimates that the compliance cost associated with the proposal will total between \$2.4 billion and \$5.7 billion over 10 years, mostly reflecting the cost incurred by new fiduciary advisers to satisfy relevant PTE conditions.

In conclusion, the Department believes that the new proposal would mitigate adviser conflicts and thereby improve plan and IRA investment results, while avoiding greater than necessary disruption of existing business practices. Based on its analysis, the Department is confident that the proposed rule would deliver large retirement investor gains and important other economic benefits, which will more than justify its costs.



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