THE CENTURY FOUNDATION

THE NEW ERA OF EXECUTIVE ACTION

PROTECTING RETIREMENT SAVINGS

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Background

Under the Employee Retirement Income Security Act of 1974 (ERISA), as well as Section 4975 of the Internal Revenue Code (IRC), any individual who "renders investment advice for a fee or other compensation, direct or indirect" with respect to tax-preferred retirement accounts (which include both 401(k)s and IRAs) must abide by fiduciary standards. Based in the law of trusts, a fiduciary duty is the strictest duty of care in the U.S. legal system, obligating the fiduciary to act in the interest of another party (the "principal"). Typically, this requires avoiding conflicts of interest and prohibits investment advisers from profiting from the relationship without the principal's consent.

In the specific context of retirement savings, ERISA, which governs employer-sponsored retirement plans, such as 401(k)s, demands the undivided loyalty of fiduciaries in their dealings with plan participants and beneficiaries, and it holds them personally liable for losses resulting from violation of these responsibilities. The IRC provides a more limited set of protections for IRAs, including an excise tax penalty for violations. Both ERISA and the IRC forbid "prohibited transactions" where conflicts may arise.

Under ERISA and the IRC, the Department of Labor has the authority to promulgate regulations determining when, and to what degree, the fiduciary standard applies to tax-preferred retirement account advisors. However, it last did so comprehensively in 1975—a time at which 401(k)s did not exist and IRAs were far less common than they are today. Although well-meaning, the narrow, rigid definitions in existing regulations allow investment advisors—who include registered investment advisors (RIAs), brokers, and other investment professionals—to elude fiduciary responsibilities through a variety of easily-exploited loopholes, and to thus be compensated in ways that directly conflict with their clients' best interests.

Broadly speaking, conflicted payments consist of compensation that depends on an advisee's actions; in these

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situations, advisors have incentives to steer their clients into decisions that generate higher fees, independent of the merits of those choices. Among the more common perverse payment schemes are brokerage commissions (different investment products carry different fees), revenue-sharing (some mutual funds pay advisors more than others), and proprietary bond mark-ups (selling bonds from a firm's own account can be more profitable than selling bonds from another firm)—all of these can encourage advisers to push investments that are more costly or worse-performing than alternatives. Conflicted advice can also lead to too-frequent trading, which can generate unnecessary transaction costs and expensive timing errors. In addition, fiduciary loopholes allow advisors to generally avoid punishment for providing imprudent or disloyal advice.

As set forth in the 1975 rule, the current fiduciary standard is defined by a five-part test. To be deemed a fiduciary—that is, as rendering investment advice for a fee—an advisor must meet all five parts of the test, by: (1) making recommendations to buy or sell securities or other property, or by advising as to the value of such investments (2) on a regular basis (3) pursuant to a mutual understanding that the advice (4) will be the primary basis for investment decisions, and (5) individualized to the particular needs of the retirement plan.

The narrowness of the test makes it a relatively routine matter for advisors to escape fiduciary responsibilities and to accept conflicted payments. For example, the "regular basis" requirement allows employers to bring in "one-time" consultants to make consequential investment decisions; regardless of the magnitude of the transaction, the non-recurring nature of the advice means that the consultants are not held to the fiduciary standard. A particularly problematic loophole concerns the rollover of 401(k) assets to IRAs; this process accounted for $300 billion worth of transactions in 2012, and it is expected to expand to $2.5 trillion within five years. Though rollovers can be the most important (and one of the most challenging) financial decision a family ever makes, their one-time nature means that the fiduciary standard usually does not apply.

The costs of conflicted advice are considerable. The Council of Economic Advisors estimates that conflicted advice costs investors approximately one percentage point in annual returns. With an estimated $1.7 trillion in IRA assets tied up in conflicted investments, the investors' yearly toll is $17 billion. And because investment returns compound, the ultimate impact on retirees is even greater. Assuming non-conflicted investments would return 6 percent annually and inflation averages 2 percent, the loss of one percentage point a year for 35 years reduces retirement savings by more than a quarter; in concrete terms, a $10,000 investment would grow to just $27,500 by retirement instead of $38,000.

Losses this large can severely compromise retirees' standards of living. It is also likely that the CEA report understates the true economic cost of conflicted advice, as it considers only a subset of IRAs (load mutual funds and annuities), which account for only a fraction of all retirements savings. Other estimates also show that conflict advice creates huge loses. The Department of Labor, for example, estimates conflict-related underperformance will cost IRA investors $210 billion during the next ten years and $500 billion over the next twenty years. And because this projection considers only mutual funds investments, and because it relies upon conservative assumptions, it likely understates the full cost. Qualitatively, though, the impact is clear: conflicted advice extracts a steep price from savers and impairs economic efficiency.

Action

After several years of development, on April 20, 2015, the Department of Labor's Employee Benefits Security Administration (EBSA) issued a Notice of Proposed Rulemaking to revise conflict of interest rules for retirement investment advice, primarily by updating and broadening the regulatory definition of "fiduciary" under both ERISA and the IRC. The intent of the revision is to better protect retirement savers, beneficiaries, and retirement plan sponsors (i.e., employers) from conflicts of interest, while also modernizing fiduciary rules to better reflect statutory intent in light of the rapid evolution of the retirement savings landscape.

What It Does

The proposed rule embodies two key principles, the first of which is to broadly redefine fiduciary investment advice to limit conflicts of interest. The new fiduciary standard can be distilled into three prongs. The first concerns the nature of the advice. In general, the following categories of advice are covered:

- investment recommendations
- investment management recommendations
- investment appraisals
- recommendations of persons to provide provide paid investment advice or management

The second describes the persons providing such categories of advice, who are considered fiduciaries if they either:

- represent that they are acting as a fiduciary under ERISA or the IRC, or
- provide advice pursuant to an agreement, arrangement, or understanding that the advice is individualized or specifically directed to the recipient.

So long as the first two prongs are satisfied and the advisor is compensated, either directly or indirectly (prong three), the advisor is a fiduciary.

This new definition of fiduciary is considerably more comprehensive than the one in existing regulation. Notably, the new rule explicitly covers IRA rollovers, thereby guarding against some of the most egregious abuses. At the same time, however, the proposed definition includes seven "carve-outs" to avoid unintentionally limiting types of communications and transactions that are appropriately not considered fiduciary in nature:

- sales pitches to large, expert plan clients;
- recommendations about swap transactions regulated by the Securities Exchange Act or the Commodity Exchange Act;
- recommendations made to plan sponsors by their own employees, so long as the employees are not compensated for doing so;
- marketing of "platforms" of investment options used by plan fiduciaries to populate investment menus;

- providing investment data or identifying investment options meeting criteria specified by plan fiduciaries;
- appraisals provided for disclosure or reporting purposes;

investment or retirement education.

Such carefully tailored carve-outs reflect the rule's second key principle: avoiding inefficiency-provoking regulatory heavy-handedness. Beyond the transactional carve-outs, the main way the proposed rule accomplishes this objective is to create a new set of flexible, principles-based prohibited transactions exemptions (PTEs) to (largely) replace the myriad of narrow, transaction-specific exemptions that currently exist. Such exemptions would allow investment advisory firms to continue to utilize common compensation practices—even when such practices would generally run afoul of the new fiduciary standards—so long as the the firms pledge to abide by certain standards that commit them to delivering advice in the best interest of their clients. Permitting such exemptions is intended to prevent unintended inefficiencies and unnecessarily large compliance costs.

Chief among the new exemptions is the "Best Interest Contract Exemption," which allows advisors and firms to be paid in common, but potentially conflictual ways, such as through commissions or revenue-sharing—provided the firms and advisors contractually affirm their fiduciary status, comply with impartiality standards, clearly disclose conflicts of interest, and adopt business practices reasonably designed to minimize the impact of such conflicts. In particular, the advisor and the firm must promise to give advice that is in their clients' best interest, while avoiding misleading statements, unreasonable compensation, and violating other laws. By allowing firms to retain some discretion in compensation, the best interest exemption seeks to achieve the overarching aim of protecting consumers at the lowest possible social cost. In essence, the exemption frees firms to satisfy the rule's requirements in the manner they deem most efficient.

Other significant exemptions include a "principal transactions" exemption and a "credit extension" exemption. The principal transactions exemption would allow fiduciaries to make otherwise prohibited purchases and sales of debt securities (that is, bonds) out of their own accounts in transactions involving client retirement accounts, so long as conditions similar to the best interest exemption are met. The credit extension exemption would allow fiduciaries to be compensated when they extend credit to retirement plans and IRAs in order to avoid failed securities transactions; in the absence of the exemption, fiduciaries are typically prohibited from loaning funds to clients. In addition, the Department of Labor is requesting comment for whether the PTE's should include a "low-fee" exemption that would allow advisors to receive conflicted payments in cases where they recommend the lowest-fee products in a given product class.

Status

Following his 2015 State of the Union address championing "middle-class economics," President Obama, on February 23, 2015, announced the Department of Labor would be re-issuing the reconfigured fiduciary rule. On April 14, 2015, the Department of Labor made the details of the proposed rule public, while also releasing its regulatory impact analysis. The proposed rule was published in the April 20th issue of the Federal Register, with the proposed transaction exemptions published separately in the same issue.

The public had until July 6, 2015 to comment on the proposed rule. The Department of Labor is currently reviewing the comments and will then draft a final rule, in a process that can take upwards of a year (for major rules.) An OMB review will follow, which can last an additional 90 days. The final rule will be effective no sooner than 30 days after its publication in the Federal Register. In all likelihood, given these constraints, it will be some time before a new fiduciary standard becomes operative. Indeed, even the timeline outlined here may be an understatement, as the process can also be delayed by legal challenges and congressional review.

Impact

As the Council of Economic Advisors' report makes clear, there are substantial gains to be had from reducing conflicted payments in the retirement savings sector. The Department of Labor anticipates that the new fiduciary standards will generate large returns for investors. While quantifying these gains is complicated by a lack of data, the department's regulatory impact analysis estimates that, if the rules are successful at eliminating underperformance associated with variable front-end loads (a type of conflicted payment), IRA investors would gain between $88 billion and $100 billion over 20 years. Moreover, front-end loads are only one type of conflicted payment; scaling up the benefits to all types of conflicts and including the impacts on employer-sponsored plans as well could reap gains an order of magnitude larger. The advantages may be greater still if the clarity and flexibility of the new rules promotes transparency, competition, and innovation in the retirement savings marketplace.

Given trends in retirement savings, more and more Americans will be impacted in the coming years. During the last four decades, traditional pensions' share of Americans' retirement assess shrank from 70 percent to just about a third; today, half of U.S. retirement savings are in defined contribution plans and IRAs. If the new rule took effect today, 75 million Americans would benefit—and their numbers are growing rapidly.

Response

Chief among the proposal's opponents are those whose business would be most affected: investment advisors, brokers, and the financial services industry more generally. Major industry trade groups, including the Securities Industry and Financial Markets Association (SIFMA), the Financial Services Institute, the American Society of Pension Professionals and Actuaries, and the National Association of Plan Advisors have been quick to wage a media campaign calling into question the proposal's merits. The most common challenges are that the new rules would limit investor choice, increase advisement costs, and restrict investor education. Opponents are also apt to question the Department of Labor's jurisdiction—or at least to characterize the agency's regulations as duplicative—given that the activities at issue are also regulated, to a degree, by the SEC and the Financial Industry Regulatory Authority. Congressional Republicans have allied themselves with these lines of attack.

Equally predictable are the proposal's supporters, who include a number of prominent advocates for investors and retirees, such as the American Association for Retired People (AARP), Better Markets, the Financial Planning Coalition, and the Consumer Federation of America. These supporters stress the importance of investor security, emphasize the financial benefits to retirees, and urge the Administration to move expeditiously through the rulemaking process.